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Voices Changes to changes: Financial planning after the CARES Act and the SECURE Act

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Change is something we now very much face with the coronavirus pandemic. This is exemplified by how the CARES Act has modified the SECURE Act, which itself caused sweeping changes to retirement planning

For decades, the individual retirement account has been a key element for retirement planning, and for those who did not need the money, they could take advantage of the Stretch IRA, which allowed non-spouse beneficiaries to take required minimum distributions over their lifetimes, as determined by the Uniform Lifetime Table, and to thereby leave a financial legacy for their descendants. For example, a six-year-old grandchild could take withdrawals over a 76.7-year period, with an IRA balance of almost 99 percent of principal remaining for continued tax-deferred growth following the initial withdrawal.

Among the major changes caused by the SECURE Act was the elimination of the Stretch IRA and the establishment of a 10-year rule whereby individuals must withdraw their accumulated value over a 10-year period, even if doing so causes an adverse tax impact. Therefore, traditional IRAs must now be entirely withdrawn within 10 calendar years, and taxes paid. Likewise, for Roth IRAs, all tax-deferred growth must be withdrawn within a 10-year period.

Available planning alternatives

But now, the CARES Act permits early withdrawals, allows loans, and suspends the 10-year rule and required IRA distributions for 2020. As such, the 10 percent penalty for taking withdrawals prior to age 59 ½ is waived for distributions taken between Jan. 1, 2020, and Dec. 31, 2020, the total amount of which can be up to $100,000 without penalty.

Despite elimination of the Stretch IRA, several planning alternatives remain available, which (thanks to the CARES Act) can be leveraged to replicate some otherwise lost benefits, by now permitting early withdrawals of up to $100,000 (but, as indicated, only during the balance of 2020). Loans and an eleventh withdrawal year are also made possible. In addition, as a result of the significantly reduced values of a client's IRA portfolio, clients can make a Roth conversion and take advantage of the reduced tax liability they would need to currently pay. Furthermore, the purchase of life insurance, and benefit from charitable planning, along with the use of an irrevocable life insurance trust, or ILIT, or a combination thereof for maximum impact.

An owner may convert to a Roth IRA, and thereby potentially reduce overall taxes by prepaying them, with beneficiaries later receiving distributions tax-free. This permits leverage with the recent significant stock market decline, by permitting those taxes otherwise due for gains to be reduced accordingly. In addition, required distributions from an IRA (or from an early withdrawal or loan) can be used to purchase life insurance, the proceeds of which will be received income-tax-free and can offset the lost tax deferral.

Trust planning

A charitable remainder trust naming non-charitable annuity beneficiaries and a non-spouse remainder beneficiary can also be formed and funded with IRA funds, to permit "stretched" distributions for a term of up to 20 years or the life or lives of the annuity beneficiary or beneficiaries. The annuity distributions can then be used to purchase life insurance, to replace the "lost" principal of the CRT. Moreover, with a second-to-die policy, the policy death benefit can be maximized while limiting premium costs.

Furthermore, a protective trust may be named as the life insurance policy's beneficiary or CRT annuity beneficiary, to allow the trustee to distribute or retain income (even though funds are withdrawn from the IRA), to protect the protective trust's beneficiaries from external threats — whether due to poor life choices, accident, divorce or disability.

Moreover, if the protective trust provides a limited right to vest (that is, a Section 678 power), its existence should not increase tax liabilities.

In addition, the life insurance policy may be owned by an ILIT, to permit its proceeds to be both estate-tax and income-tax-free. If drafted as a discretionary trust, the ILIT can provide creditor protection too. In addition, the purchase of life insurance, and benefit from charitable planning, along with the use of an ILIT, or a combination thereof, can provide for maximum impact.

Going forward, an IRA owner can redirect future contributions to an infinite banking policy, to create tax-free access, tax-free growth and a tax-free death benefit payout. With the purchase of a rider, their long-term care needs can be addressed.

As such, with alternatives available, existing retirement and estate plans should be reviewed, given the SECURE Act and the changes made to it by the CARES Act. Updates may be advisable, including (for the balance of this year) the ability to capitalize on those leveraging opportunities made possible by the CARES Act.

Life insurance

The Federal Reserve has responded to the coronavirus pandemic by cutting the federal funds rate by a total of 1.5 percentage points since March 3, reducing it to 0 percent. In addition, the recent stock market plunge adversely affected many non-guaranteed universal and variable life insurance strategies, further increasing the likelihood that these types of life insurance policies will have their cost of insurance increased, further exacerbating already deteriorating conditions, causing many more policies to expire prematurely.

Despite this, life insurance will become a more visible and important planning tool as people realize it’s an efficient way for children and non-spouse beneficiaries to pay the increased income taxes on their distributions, to prevent further erosion of their inheritance. There will be many useful, creative and efficient new ways to use life insurance and annuities, to supplement and ease the tax burden of beneficiaries. One way to offset higher taxes will be for the IRA owner to gift IRA assets, to purchase sufficient life insurance to pay for the additional taxes. These additional taxes may also be at higher income tax rates, due to the necessary bunching of distributions caused by the 10-year rule and the beneficiaries themselves often receiving them during their peak earning years.

Differing life insurance strategies

As discussed above, some of the more popular planning strategies can include converting all or a part of the proceeds to a Roth IRA, or simply using a CRT to make a charity a remainder beneficiary, thereby retaining the ability to defer paying taxes beyond the 10-year period. The IRA holder can then purchase a single or second-to-die life insurance policy in that amount, providing a leveraged and tax-free death benefit back to the family.

There's also an opportunity to provide life insurance payouts on an intergenerational basis, where the IRA holder can make a gift of life insurance to insure the second generation (sons and daughters) for the future benefit of the third generation (the grandchildren).

The government is also doing its share, by making it easier for retirement accounts to be converted to a lifetime annuity through safe harbor provisions that allow employers to offer annuities inside qualified plans.

Since the SECURE Act will be a major reason for many agents and brokers to recommend their clients' purchase of new life insurance and annuities, keep in mind there are many different types of life insurance products, each with its own distinct features, benefits and best uses. Since the objective of many of these policies is to remain in force beyond the insured's or IRA owner's life expectancy, it's important for these policies to have a guaranteed nature and to last until the insured is at least into their nineties. Since the intent of the policy is to provide a maximum death benefit with minimum accumulation, a guaranteed universal strategy would be more effective than a non-guaranteed universal, indexed universal, variable or even a whole life policy.

A recent case illustrates the benefits of using life insurance when planning for the next generation's needs. A couple in good health in their early to mid-seventies, as a result of having to distribute 100 percent of their accumulated IRA by the tenth year, would cause their only daughter to incur a current tax due of approximately $400,000 upon the death of the surviving spouse. To offset this burden, it was suggested that they purchase a $500,000 second-to-die guaranteed universal life insurance policy, naming their daughter as beneficiary, with the $14,000 annual premium paid directly from the current RMDs of their IRA. It should be noted, however, that as a result of the pandemic, there are currently only about five or six life insurance companies that will provide guaranteed coverage into an insured's nineties for individuals over age 70.

Agents and brokers under New York State's new "Best Interest Rule" (Rule 187), which just became effective Feb. 1, 2020, must now provide their clients with full written disclosure of a recommended life insurance product's risks and an understanding of what it can and cannot accomplish. It is also important to communicate the varying costs of these products, as some contain guarantees and others do not. Furthermore, some provide long-term care coverage, while others do not.

Lastly, it is critical to help your clients understand that life insurance is a "buy and manage" asset, not a "buy and hold" asset, as many mistakenly think. This is especially so if a decision is or was made to purchase a non-guaranteed life insurance policies. Keep in mind that ratings, crediting rates and financial information, including internal costs, can and often do change, resulting in one's coverage expiring prematurely and not being available to accomplish the task it was initially intended to provide.

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