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Roth IRAs:
The Un-Stretch Planning Vehicle

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2020 has seen huge changes in retirement distribution planning. First, the Secure Act was passed in December 2019, which eliminated the lifetime distribution option for most beneficiaries of retirement plans and IRAs. Then, in February, the COVID-19 crisis reared its ugly head. The Cares Act then eliminated Required Minimum Distributions (RMDs) for the year. In addition, stock values have been reduced significantly and are in a very volatile state. For many, starting a micro-Roth IRA conversion strategy makes a great deal of sense.

Prior to last year, the retirement distribution option of choice at the death of the owner of an IRA or retirement account was taking distributions over the life expectancy of the beneficiary. This allowed you to stretch out the income tax liability over several years. Using this strategy generally gave the beneficiary a greater amount of after-tax dollars. The Secure Act, however, eliminated this option in most situations and replaced it with a 10-year rule. Now the account must be liquidated within 10 years of the owner's death, unless the beneficiary is a spouse, a minor, or a disabled or chronically ill individual. If the beneficiary is a minor, then a lifetime distribution is allowed until the beneficiary reaches the age of majority, and then must be liquidated within 10 years. These new rules can cause substantial income tax liability to the beneficiary. However, a Roth IRA could, with other strategies, reduce this possibility.

Retirement assets left to a trust for the benefit of a beneficiary are even more problematic under the new law. Prior to the Secure Act, if certain requirements were met, distributions were taken out over the life expectancy of the oldest beneficiary of the trust. There are generally two ways this can be accomplished; a conduit trust or an accumulation trust. With a conduit trust, all required minimum distributions must be paid out immediately to the trust beneficiary, who must pay tax on the distribution at their tax rate. With an accumulation trust, the RMDs can either be paid out to the beneficiary (who would pay the tax at his/her rates) or kept in the trust and have the tax paid at accelerated trust tax rates. Under the prior law, either type of trust could be chosen and receive the lifetime distribution option. However, with the Secure Act all trusts, except trusts for the benefit of the disabled or the chronically ill, must be conduit trusts to achieve the greatest distribution allowed. If an accumulation trust is chosen, then all distributions would have to be made within 5 years. Two examples are helpful to illustrate this point.

Steve Grantor leaves his IRA to a trust for the benefit of his minor child, who is 15 years old. If a conduit trust were chosen, distributions could occur over the life expectancy of the minor child until the child reaches the age of majority; at that time the remainder would have to be paid out over the next 10 years. Susan Grantor leaves her IRA in a trust for the benefit of her adult child; if a conduit trust is chosen, the IRA must be liquidated within 10 years, but if a accumulation trust is chosen, all payments

must be made within 5 years of the death of Susan. One important difference between an accumulation and a conduit trust is that when the distribution period ends (generally 10 years) for a conduit trust, all of the retirement plan assets must be paid out to the beneficiary, whereas with an accumulation trust, it can stay in the trust. Assets that remain in a trust can be more beneficial from an asset-protection standpoint, such as when the beneficiary is a spendthrift or involved in a troubled marriage.

The downside of being forced to take a distribution from your IRA or retirement plan by year ten, instead of over the life expectancy of the beneficiary, is that the income taxes are no longer deferred. This means that the beneficiary would receive less money from a present-value approach. One potential solution is to do a Roth conversion prior to your death. Any amounts left to a trust that are in a Roth will generally be tax-free when received by the beneficiary. An example is necessary to understand the power of having a Roth left to a beneficiary, as opposed to a traditional IRA or retirement plan. Sam Decedent dies with an IRA worth $1 M, which he leaves to his daughter, Sarah. She decides to wait the full 10 years before liquidating. The IRA has grown to $2 M. Assuming Sarah is in the 40% tax bracket, she will pay $800,000 in federal incomes taxes, leaving her with $1.2 M. If on the other hand, if the IRA were a Roth, the full $2 M would not be taxable, leaving her with an additional $800,000. Clearly, it is better to be the beneficiary of a Roth than a traditional IRA.

Roth conversions are advantageous to the beneficiary, but taxable to the owner. The best strategy is to do micro-Roth conversions so that the least amount of tax is payable in any one year. For example, if the owner has a substantial IRA, he generally does not want to do a conversion that will put him/her in a significantly higher income tax bracket. Also, Roth conversions are best done at different times of the year (monthly/quarterly) to avoid being taxed when the portfolio value is at its highest level. The risk of doing micro-Roth conversions is that you could die too soon, so it is best to hedge that risk by purchasing a life insurance contract. If the owner dies prior to the completed Roth conversion, the insurance policy would be used to pay the tax on the unconverted Roth. An example is necessary to show how this would work.

Ron Diedrich, age 60, has a $1 M IRA, which he is going to leave to his wife Betty, who will in turn leave it to their son Jason. Betty has plenty of money other than the IRA to live on. Ron decides to convert $50,000 a year to a Roth, because that will keep him in the same tax bracket. He buys a survivorship policy on his and Betty's lives as a hedge against the micro-Roth strategy becoming incomplete. If Ron dies first, he will leave the IRA to Betty and she will continue the micro-Roth strategy.

No matter the order of death, Jason will receive all IRA assets without having any income tax liability. This is possible because the assets are in a Roth or because the death benefit from the insurance policy would be used to pay the income tax liability he would be responsible to pay when taking a distribution from the IRA that has not yet been converted.

The second consideration you might have when making a Roth conversion is whether you desire to make all the retirement assets payable to a trust for the benefit of several children who are in different income brackets. Distributions from a trust are taxable to beneficiaries at their income tax brackets, and the trust gets a corresponding distribution deduction. Consequently, distributions from a Roth will be tax-free to the beneficiaries if it is the trust's only asset, while distributions from a traditional IRA would be taxable at the beneficiaries' tax rates. Generally, you want any Roth assets to be payable to a trust for the child in the highest tax bracket, and purchase insurance as a hedge if that is possible. If not, you need to know which children are likely to be in the highest tax bracket so you can leave the Roth for their benefit. An example follows.

Ron Settlor, age 60, owns a $3 M IRA, which he desires to leave to his three sons, George, Henry, and Kevin. George is a doctor in the 37% tax bracket, Henry is self-employed and is in the 30% tax bracket, and Kevin works as a laborer and is in the 15% tax bracket. Ron is uninsurable, so the purchase of a life insurance policy is not an option. Ron has decided to convert $75,000 a year to a Roth. Ron creates three trusts, one for each child. He leaves all the Roth for the benefit of George until his 1/3 is used up. He then leaves any remaining amount in the Roth to Henry until his 1/3 is used up. If any of the Roth is remaining, it will go to Kevin. The goal is to leave the tax-free Roth IRA for the benefit of the beneficiaries in the highest tax brackets, to the greatest extent possible.

The third consideration is when the only significant asset is an IRA that is needed to fund a Special Needs Trust (SNT) for a disabled beneficiary. IRAs left to a disabled beneficiary can be paid out over the beneficiary's life expectancy in an accumulation trust. The reason the Secure Act created this rule was to have it in conformity with the third-party SNT rule. In a special needs trust, money can be distributed to the disabled individual (if needed) to supplement what state and federal programs pay. If the money is just used to supplement, then it does not disqualify the beneficiary from receiving government aid. Leaving a traditional IRA to a SNT can cause significant income tax problems. Many years no distributions (or very few distributions) will be paid from the SNT to the beneficiary because they are not needed.

Recent significant legislation impacting IRAs may cause some investors to rethink their distribution strategy.

It is advised that people meet with their advisors to discuss whether a micro-Roth conversion make sense.

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At the same time, because the IRA distributions must be distributed to the trust over the beneficiary's life expectancy, any undistributed amount would be taxed to the trust at very accelerated income tax rates. If this occurs, it could cause substantial diminution of trust assets, making it so the special needs child would not receive the supplemental distributions, if needed, and there may be very little money left over at the special needs child's death to pay the remainder beneficiaries. The solution to this problem is to do a series of micro-Roth conversions. If the only asset a SNT receives is a Roth, then there will be no income tax liability on the annual distributions, whether they are paid to the special needs child or retained by the trust. As always, you should consider whether a life insurance policy could be purchased to hedge against early death.

An example will illustrate this concept. Ron Jackson, age 60, has as his only asset a $2 M IRA. He has three children: one special needs child, a doctor, and the successful owner of a small business. It is determined that the SNT needs $500,000 to be properly funded. He can convert $75,000/year into a Roth. He makes these annual conversions until the Roth account balance is at least $500,000. The unconverted amount will be used for Ron's income needs and left to his non-special needs children. Ron creates an irrevocable SNT, which will be the beneficiary of the $500,000 IRA. . The unconverted amount will be used for Ron's income needs and left to his non-special needs children. Ron creates an irrevocable SNT, which will be the beneficiary of the $500,000 IRA.

The Roth will have to take distributions over the special needs child's life expectancy but no income tax will occur, whether paid out to the special needs child or retained in the trust because distributions from a Roth are not subject to income tax. At the death of the special need child, the remainder of the trust will pass equally to the other children.

The Secure Act significantly changed estate planning for retirement assets. The option of choice for the stretch IRA is no longer available. Instead, in most cases, retirement plans and IRAs must be liquidated within 10 years. This causes significant income tax liability to the beneficiary, which means their inherited amount will be much less. The solution to this problem is the micro-Roth conversion, where for a little tax cost, the beneficiary can receive a Roth IRA and not have his inheritance reduced.

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