August 14, 2020

Three Alternatives To The Stretch IRA

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At the end of 2019, the Setting Every Community Up for Retirement Enhancement (SECURE) Act was passed with dual purpose. The foremost focus of the act was to bolster retirement security throughout the country by providing broader access to retirement accounts. While that aspect of the SECURE Act is modest in magnitude, the second focus, ending the stretch IRA and cashing in on the trillions of pre-tax dollars held within American retirement accounts, will have material implications for how millions of Americans should ideally handle estate planning.

Upon death of an IRA account owner, distributions to non-spouse individual beneficiaries must now be made within 10 years. The current rules that allowed a non-spouse IRA beneficiary to "stretch" required minimum distributions (RMDs) from an inherited account over their own lifetime (and potentially allow the funds to grow tax-free for decades) has been eliminated. The rule applies to inherited funds in a 401(k) account or other defined contribution plan as well.

For those who wish to see their excess retirement assets get passed along, worry not. There are other strategies that can imitate the power of the stretch IRA in carrying wealth forward to the next generation.

The Roth IRA

The tax advantages of the Roth IRA are well documented. Roth IRAs are funded with after-tax money and remain tax free through their growth period and withdrawal after age 59½. The tax free status of Roth assets is what makes them an attractive vehicle for passing wealth to 'not designated beneficiaries'. Even though the newly minted 10-year limit applies to traditional and Roth IRAs alike, beneficiaries of a Roth IRA will not have to pay taxes as they make withdrawals over those 10 years. By passing a Roth to an heir, you are footing the tax bill they would have been responsible for had they instead received a traditional IRA. To compound this, quite literally, the beneficiary can allow these Roth assets to continue growing tax free for the entire 10-year time span and make one lump-sum withdrawal in the final year.

Now more than ever, Roth conversions should be seriously considered. Current tax rates are both historically low and are unlikely to go lower upon expiration, so it is a good time to take advantage of the opportunity. It is important to note that Roth conversions contribute to your annual taxable income, and they should be carefully planned out so as to avoid bumping up to the next tax bracket.

Life Insurance

Life insurance is another option that will provide significant funding to an heir while decreasing their tax burden. Proceeds from life insurance are not included in gross income and thus do not get taxed. For those who do not need their RMDs to sustain themselves, this money could be repurposed to pay for life insurance premiums. The problem with a life insurance-based strategy when compared to the old stretch IRA strategy is the accompanying price tag. Life insurance premiums will greatly increase as you age, so this may not be a worthwhile strategy if well priced premiums are out of the picture.

Reconsider Primary Beneficiaries

The danger of the 10-year limit on inherited IRAs lies in the increased income tax the beneficiary will produce as a result of taking required distribution. The distributions are unlike normal RMDs in that they are not required annually; rather, the distributions can be taken freely as desired as long as the account is fully depleted by the time the 10-year limit is up. This opens up an aspect of financial planning where the beneficiary is allowed to fully cash out the IRA in a lump sum at any point of the 10-year time frame, or they could strategically make smaller annual withdrawals to limit how much income tax will be applied to those assets.

Adding primary beneficiaries to your IRA strategy can possibly further limit the IRS's ability to dip into your savings. As an example, let us assume you have 3 primary beneficiaries: your wife and two kids. When your wife receives her third of the IRA she will not be subject to the 10-year limit. The two kids will be able to spread out their distributions from their respective portions of the inheritance, lowering income tax. After the wife's passing, the kids will inherit her IRA assets and they will be able to spread those assets out over 10 years as well, again limiting the income tax. This gives the heirs up to 20 years to fully divide those assets into smaller distributions and potentially lowering their income tax bracket

The stretch IRA was a valuable estate planning tool that will be sorely missed, but it is not without alternatives. Although none of these replacement strategies carry quite the same flexibility and value, they are still worth considering if you are looking to efficiently pass wealth to the next generation. As the SECURE Act's rules are more thoroughly studied and understood, new strategies for achieving your individual goals will likely be designed and implemented.