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The Elimination of the Stretch IRA: 7 Strategies to Consider

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It used to be that you could leave your IRA to your children after you die and they could stretch the taxable withdrawals out of that IRA account over their life expectancy of 20, 30, even 40 or more years. This was a great tax-deferral strategy.

Well, the government has $23 trillion in debt, so it passed the SECURE Act which went into effect on January 1, 2020, which could lead to higher income taxes being owed on your IRAs.[1,2]

The biggest change for my retired clients is the elimination of the Stretch IRA. Most non-spouse beneficiaries can no longer stretch the IRA out over their lifetime. Most non-spouse beneficiaries not only have to take distributions over a shorter period of time, they may also be in a higher tax bracket.

The 10-Year Rule Replaces the Stretch IRA concept

Under the SECURE Act, non-spouse beneficiaries who inherits an IRA or qualified plan *must distribute the entire IRA* ***within 10 years of the account owner's death.*** The only exceptions besides spouses are beneficiaries who are disabled or chronically ill, a minor child of the account owner (until age of majority is reached), or a beneficiary who is not more than 10 years younger than the deceased account owner.

This 10-year rule carries a number of important potential concerns for IRA inheritances:

1. **Lost opportunity for compounding**. The new 10-year rule means fewer years available for tax-deferred or tax-free interest compounding. Albert Einstein said that the most powerful force in the universe is compound interest, and this could limit the compound interest because it forces income taxes to be paid sooner than planned.[3]

2. **More income is compressed into fewer years.** Income from inherited IRAs will get compressed into 10 years of distributions or less, rather than spread out over decades. Your beneficiaries don't have to take out the distributions each year, however if they want to spread the taxation out over time that might make sense especially if it's a large IRA.

Because all the income must be realized within only ten years, more of your beneficiary's ordinary income could move into higher tax brackets. This is called bracket creep.[4]

This potentially could be a concern. For example, if you assume your IRA will earn 4% annual returns over that 10-year period after you leave it to your beneficiary, and your heirs want to spread out the taxable income over the 10 year period, that means that your beneficiary will have to take out approximately 14% of the IRA balance each and every year. This would allow them to take out the 4% annual yearly earnings along with 10% of the principal so that the entire IRA is drained over that 10-year period without a potential big tax hit in year 10. So, if your IRA is $1 million, and your beneficiaries want to spread the taxable income out evenly over 10 years, then a 14% withdrawal would be $140,000 in taxable revenue the government gets to collect on every year. That's on top of any income your other assets might generate, and income your children might be earning if they are still working as well. The $140,000 income should be lower year by year as there is less principal in the account.

3. **More risk of the loss of the IRA you leave your children from potential future divorce, lawsuits, bankruptcy, etc.** The biggest potential tax problem is that any taxable income that stays within a trust will get taxed at the highest 37% tax bracket on all income over $12,950 per year![5] This hasn't changed from before the SECURE Act, however bigger taxable distributions mean potentially higher income taxes owed within the trust. Your beneficiary will have to decide whether they want to: 1) Pay the higher income tax in the trust, so they can keep those assets in the asset-protected trust, or 2) Remove that taxable income from the trust and pay the taxes at the individual level. The second option would probably result in a lower income tax bill, but if they do that your beneficiaries would lose the asset protection that the trust affords them.

7 Estate Planning Strategies to Consider

While we're not happy at my firm about losing the stretch IRA technique as a way to pass on your hard-earned wealth to future generations, there are seven strategies we've identified that may help mitigate the loss of the stretch IRA, and help maximize the *after-tax* legacy you can leave to your children and/or grandchildren. Keep in mind, that we do not offer legal advice and all individuals are encouraged to seek the guidance of a qualified tax and or legal professional prior to making any decisions about their personal situation.

1. Revisit your IRA trust strategy and update your trust if necessary.

The SECURE Act means many existing IRA trusts will have to be re-evaluated. Because of the SECURE Act, if your beneficiaries take out all of the IRA assets from their trust by the end of the 10-year period following the inheritance, that means that *the entire IRA inheritance* would be exposed to the claims of creditors because it left the protection of the trust.

If that's a concern for you, consider having your trust redrafted so your children can choose whether they want to remove the IRA assets from the trust or accumulate those assets within the trust which would maintain the trust's asset protections longer. The IRA still has to be empty after 10 years – but by accumulating the IRA assets within the trust this helps protect those assets from potential car accidents, lawsuits, bankruptcy claims, divorce proceedings and other serious threats. However, it could be subject to higher income taxes as described previously.

2. Do Roth IRA conversions early and often.

Essentially the idea behind why you might want to do a Roth conversion is summed up in the image below:

Converting existing traditional IRA's into Roth IRA's, could potentially mean you can take on a tax obligation in the current year, but you can *control* it! I would much rather IRA owners withdraw money from their IRAs over their 20-year life expectancy, plus have 10 more years after that of tax-free growth, than wait until the IRA could be potentially much bigger and your beneficiary might have to withdraw 14% per year of your IRA over 10 years as discussed above.

The idea is to shift income forward so that it's exposed to lower tax brackets *now,* rather than leave it to compound until you're required to take it in a potentially much higher tax bracket later.

The U.S. national debt has now reached *$23 trillion*.[6] That money has to be paid back somehow. It's very likely that a future Congress could impose even higher income taxes. That tilts the needle strongly in favor of converting as much as you can into a Roth, since Roth assets are generally never taxed again as long as you live (as long as you keep the assets in the Roth at least five years).[7]

But even if tax rates don’t go up, gradually converting assets into a Roth IRA could still work in your favor. Inheriting assets in Roth IRAs could be much, much better than inheriting a traditional IRA and having to pay income tax on the entire distribution each year – accelerated under the 10-year rule for the following two primary reasons:

1. Your beneficiaries still have to remove the money from the Roth within 10 years of your death, however they can wait until the very last day to remove all of the money from the Roth, so your children would get 10 more years of tax-free growth after they inherit your Roth IRA![8]
2. Another benefit is that your beneficiary can leave that Roth money they removed from the Roth IRA inside that asset-protected trust you set up without worrying about the higher trust income tax brackets.

One final point about Roth IRA conversions: If you are converting to Roth it’s much better to pay the income taxes owed on that Roth IRA conversion from money not in the IRA… from a non-IRA account. That way the full amount of the Roth IRA can grow tax-free. And if you or your spouse need the money in the future, you can always withdraw that money from the Roth and use it if necessary.

Aside from taking a close look at your trust and considering Roth conversions, here are brief descriptions of the rest of the strategies we think make sense at this time. To learn more about how each of them work, talk to your financial adviser, or contact us at 1-800-807-5558.

3. Spread the income taxes around using multi-generational “spray trusts.”

If you leave your retirement assets to a multi-generational spray trust, you can direct the trust to “spray” income not just to your children, but to grandchildren, great-grandchildren and anyone else you choose. By spraying the income to many different people, you avoid concentrating it on any single individual tax return, where much of it would be exposed to higher tax brackets.

4. Consider “strategic disclaiming” of spousal IRAs.

Your family *may* be better off if the surviving spouse *declines* part of an IRA. That would result in your children inheriting IRA assets in two stages: The death of Spouse 1, and the death of Spouse 2. There are some potential downsides to this plan, but it is an option. The main downside I see is that what if your spouse one day needs that IRA money you gave to your children?

5. Make IRAs payable to charitable remainder trusts at your death.

Upon your death, you can structure the charitable remainder trust to provide an income to your beneficiaries for their life expectancy, and meanwhile, you get a charitable tax deduction on any taxable assets you transfer to the irrevocable CRT at death. This is a strategy only for the high net worth as it’s complicated and could be an expensive plan to implement.

6. Rather than leave tax-inefficient IRA assets, leave life insurance instead.

Life insurance can also effectively *buy you time to keep making Roth conversions!* See, you have to be alive to make Roth conversions. If for some reason you don't make it, the life insurance death benefit will kick in, providing some or all of the tax-free assets to your heirs that you had hoped to provide over many years of Roth IRA conversions.

The death benefit to beneficiaries is tax-free. Life insurance works best under these circumstances: The insured(s) are in reasonably good health when applying; the policy is a second-to-die policy which keeps premiums down; and the insured(s) can easily afford the annual premiums.

7. Choose low-tax states for IRA trusts, if possible.

If one or more of your beneficiaries lives in a state with a substantial income or inheritance tax, you may be able to avoid those state taxes by locating your trust in lowest-tax state possible. Again, this strategy is more important if you're leaving a substantial IRA to one beneficiary, perhaps $500,000 or more.[9]

Example: You live in Florida, which has no state income tax.[10] But your children live in Minnesota, which has a state income tax up to 9.85%.[11] If you leave IRA assets directly to your children in Minnesota, they have to start pulling money out under the Ten-Year Rule. And all that income could be subject to up to 9.85% Minnesota tax, on top of the federal income tax rate.

Depending on the circumstances, you *may be* able to enable your beneficiary to avoid the Minnesota tax by leaving your IRA assets to a Florida trust, where there is no state income tax, rather than leaving it to your kids directly.[12]

Then later in the game, when you pass those assets on to your children in Minnesota, only the *current* income your children receive in their pocket is subject to the Minnesota state tax. Since Florida doesn't have a state income tax, previous accumulation from the trust in Florida is not taxed as income. Payments retained in the trust will not be treated as income under the Minnesota state income tax.[13]

The specifics vary a great deal by state law.[14] The taxation of the trust may depend on where the trust was created, your location or domicile when you created the trust, your trustee's location and/or the location of the beneficiary(s). Every state is different. So be sure to work with an attorney with experience and a focus on estate and tax planning and the use of trusts.

Conclusion

Estate planning has always been complex, and with the SECURE Act, it just got a little more challenging. Getting the right information and learning all you can about your options is always a smart first step. Whatever you do, don't ignore the SECURE Act, because doing so could potentially cost your family needless tax exposure. If you'd like to learn more attend one of our upcoming retirement planning and estate planning dinner workshops at Ruth's Chris or Abe &

Louie's Steakhouse in Boca Raton or Fort Lauderdale by calling us at 1-800-807-5558 or go to our website at www.StuartPlanning.com.

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