Ding, Dong, the ‘Stretch IRA’ is Dead

One of the most significant changes made by the SECURE Act, signed into law effective January 1, 2020, is the impact on many people’s financial planning due to the elimination of the ‘Stretch’ provisions for most non-spouse beneficiaries of defined contribution plans and IRA accounts. This popular retirement and estate planning provision has been under threat of elimination since first proposed in legislation all the way back in 2012.

Under prior law, the designated beneficiaries (generally, living human beings and certain qualifying trusts) are eligible to stretch distributions over their life expectancy, or in the case of a qualifying trust, over the oldest applicable trust beneficiary’s life expectancy.

However, for most designated beneficiaries who inherit in 2020 (i.e., where the retirement account owner themselves dies in 2020 and beyond), the new standard under the SECURE Act will be the **“10-Year Rule”**.

Under this **10-Year Rule**, the entire inherited retirement account must be emptied by the end of the 10th year following the year of inheritance. Unique in the new rules are that during the 10-year period, there are no distribution requirements, whereas in the past there was a “required minimum distribution” to be made annually to the beneficiary.

Under the new rule, designated beneficiaries *will* have some flexibility when it comes to timing distributions from the inherited account(s) for maximum tax efficiency… as long as the entire account balance has been taken by the end of the 10th year after death.

There are examples where the new rule will not have large undesirable consequences.

Example 1: *On January 20, 2020, Josh’s father passed away, leaving Josh his $400,000 IRA. Josh, who is currently age 62, is still working and earns roughly $150,000 per year, but plans to retire in 3 years, at age 65.*

Given the fact that Josh’s income will substantially decrease when he retires, it may make sense for him to avoid taking any distributions from the inherited IRA while he is still working (i.e., during the first 3 years of the distribution window provided by the 10-Year Rule). Instead, since he can now opt to delay distributions from his own accounts until age 72, he can distribute the funds from the inherited account during years 4-10 instead and level the tax implications between all sources.

However, larger IRA accounts left to a limited number of beneficiaries that will still be working during the majority of the 10-year window, may realize substantial supplemental income pushing them to higher tax brackets beyond their control.

NEW PLANNING CHALLENGES FOR TRUSTS NAMED AS RETIREMENT ACCOUNT BENEFICIARIES

In general, trusts created to serve as the beneficiary of a retirement account are drafted in such a manner as to comply with the "See-Through Trust" rules, which allow the trust to stretch distributions over the oldest applicable trust beneficiary. Broadly speaking, there are two types of such trusts; Conduit Trusts and Discretionary Trusts. Both types of trust are unfavorably impacted by the SECURE Act.

For instance, many Conduit Trusts are drafted in a manner that only allows for the Required Minimum Distribution to be disbursed from an inherited IRA to the trust each year, with a corresponding requirement for that amount to be passed directly out to the trust beneficiaries. In light of the changes made by the SECURE Act, for those beneficiaries subject to the 10-Year Rule, there is only one year where there is an RMD… the 10th year!

As a result of this change, Conduit Trusts drafted with language similar to that above might not allow the trustee to take ***any*** distributions of the inherited account until the 10th year after death (because prior to that 10th year, any IRA distributions would be 'voluntary'). And then, in the 10th year, the ***entire*** balance would have to come out in one year to the trust ***and*** be passed along to the trust beneficiaries. The result could amount to a very high tax bill, as the entire value of the retirement account is lumped into a single tax year as a distribution to the beneficiary. Not to mention the loss of any protection of such assets after they are distributed from the trust.

Discretionary Trusts (spendthrift clauses, etc.) may not fare much better. Such trusts often require that all, or a substantial portion of retirement account distributions, remain ***in*** the trust and are specifically not distributed out to the trust beneficiaries. In such circumstances, amounts retained by the trust are subject to trust tax rates, which are *highly* compressed as compared to individual tax rates.

For example, in 2019, trusts reach the highest Federal tax bracket of 37% at just $12,750 of taxable income! Given that such trusts will have, at best, 10 years to spread out distributions from inherited retirement accounts, significant amounts of wealth could evaporate in the form of high trust taxes.

In both cases, it will be important to revisit the specific terms of your existing trusts containing conduit or discretionary clauses as the language will need to be amended to allow greater trustee discretion over the IRA accounts. For Conduit clauses, it may necessitate replacement language to address the tax implications of the 10-year rule with respect to beneficiaries. Formulating a strategy for Discretionary trusts to retain the assets for the benefit of the beneficiary will require advanced planning with the IRA account itself.

POTENTIAL SOLUTIONS FOR ADDRESSING THE NEW ISSUES WITH INHERITED IRAS

Every situation will be unique as the variables to consider may tip your planning in one direction or the other depending on your intended outcomes. Your situation may use one or more of these in combination to reach your personal goals.

TAKE LARGER IRA DISTRIBUTIONS DURING YOUR LIFETIME

In the past, it wasn't uncommon to vary IRA distribution rates from year to year to take advantage of certain tax bracket limits, using other after-tax funds one year and more IRA in another. The practice of considering tax rates will become increasingly important if you are interested in maximizing your opportunity to leave IRA assets to beneficiaries. The goal is to utilize the lowest tax bracket by which to get the proceeds out of the IRA – be that your rate or the expected future rate of the beneficiaries. As these excess proceeds are paid out sooner, they can be accumulated and/or reinvested in other accounts, either under the terms of a trust or transferred outright upon death using the cost basis step up rules.

ROTH IRA CONVERSIONS

With the lower tax rates passed for 2018, the value of ROTH IRA conversions increased as the cost to "pay taxes now" in exchange for "forever tax free" became more attractive. Since beneficiaries also receive ROTH IRAs tax-free, they are the best vehicles to inherit. Utilizing amounts left in lower tax brackets or in combination with charitable giving, ROTH IRA conversions will become a more widely used option for many people. Your beneficiaries will still be required to liquidate the ROTH IRA in 10 years, but it will be 100% tax-free when they do.

CHARITABLE REMAINDER TRUSTS

A technique that was more frequently used years ago, particularly for those looking for large current income and/or estate tax deductions while taking an income for life, was the use of CRT's. It may now become useful for these vehicles to be named the beneficiary of an IRA, allowing the assets to be placed inside a trust, generate income to a beneficiary for a set period (greater than 10 years), and get a tax deduction today for the anticipated remainder that is designated to go to a qualified charity. This may, however, have limited appeal as it locks in very specific terms (a set amount of income, no discretion for additional income or principal needs and a significant remainder to a charity), but might be a tool for part of a large IRA transfer when a couple or individual has charitable intent.

INCREASING CURRENT IRA DISTRIBUTIONS TO FUND LIFE INSURANCE

This option will not be for everyone either but may play a role in certain cases. Effectively you take an additional amount of the IRA balance each year to fund a second-to-die life insurance policy on a couple to generate an after-tax death benefit to the children. This amount may be considered "in lieu" of the lost taxes created by the abbreviated payout period under the new rules, or in the case of "stretching" the intended terms of the inheritance, the life insurance proceeds could be placed in trust to begin after, or extend beyond, the IRA's 10 year payout. It may be most appropriate for larger IRAs with a single or few younger beneficiaries with high incomes.

IN SUMMARY

Every situation will be unique as the variables to consider may tip your planning in one direction or another, or possibly in some combination. It will be important to begin the process of considering your overall estate, the value of your IRA in your later years and the goals for your beneficiaries. The initial steps to take are to amend any conflicting or non-conforming language in existing Trusts relative to inherited IRA accounts and work with your advisor to discuss new options for meeting your goals. Creating a comprehensive approach may take one approach now and potentially change over time as account values, tax rates and the needs of beneficiaries change.

Sources:

Planning Around the New Limitations of Stretch IRAs, *Financial Advisor Magazine*

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