Planning Around the Death of the Stretch IRA

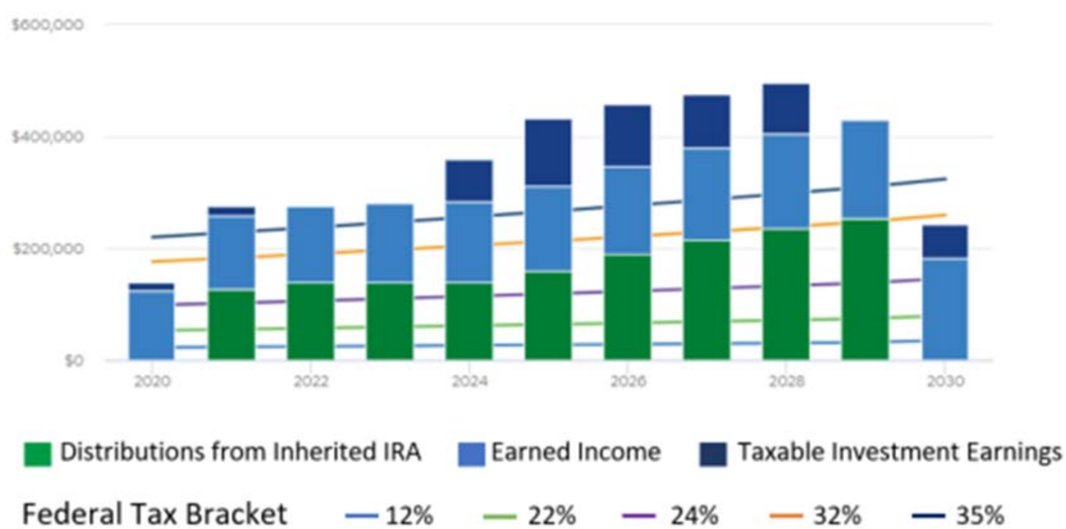
Legacy planning is a topic that always requires vigilance. Your planning may need to be adjusted not only because your personal situation changes, but also because the tax laws surrounding how your wealth transfers to loved ones after death is something we have seen change every few years for the last few decades. Most recently, retirement assets were the target of the changes. Beginning in 2020, due to the Setting Every Community Up for Retirement Enhancement (SECURE) Act, the legacy planning strategy that provided lifetime benefits for an inheriting beneficiary, what many have known as the “stretch-IRA”, has been lost for most beneficiaries.

Fortunately, if you are the surviving spouse, the choices you have for inheriting retirement assets have not changed. A surviving spouse can still elect to roll over their deceased spouse’s IRA into their own IRA. This would allow the surviving spouse to begin required distributions when they reach their own required beginning age. In addition, a surviving spouse can elect to establish an inherited IRA and begin required distributions when the account owner would have been required to start distributions.

Non-spouse beneficiaries are impacted more significantly. Although there are some limited exceptions, most non-spouse beneficiaries will be required to distribute an inherited retirement account over a 10-year period. What is unique about the 10-year rule, is there are no annual required distributions. You can choose to distribute as much or as little as you like each year, but by the end of the year containing the 10th anniversary of the account owner’s death, the account must be fully distributed with no remaining balance.

Many beneficiaries inheriting 401(k) and IRA assets under the 10-year payout rule also would be receiving the taxable income during their peak earning years, potentially pushing them into a higher income tax bracket.

Consider this example:
Your IRA is worth $1 million at the time of your death at age 80. Your only son is your sole primary beneficiary, and he is 55 years old, 10 years away from his own retirement. He earns $125,000 a year and is in the 24% income tax bracket. With the combination of his own earned income, income from his investment portfolio and from the IRA he inherits from you, even if he spreads out the inherited IRA and its earnings by withdrawing 10% a year over the next 10 years, he will quickly move from the 24% income tax bracket into the 35% bracket before his own retirement. An illustration of this point is below.



*This illustration assumes varying returns on investments averaging 7.5%

If the loss of a lifetime income benefit for your heirs has you concerned about the legacy planning you currently have in place for your retirement account, it may be time to consider a new approach.

Four Things You Can Do Right Now

1. **Review Beneficiary Designations.** One of the first action items to consider with the new SECURE Act rules is to review your beneficiary designations on all your retirement accounts. You should look at each of your plan agreements to first determine who are your current primary beneficiaries and whether those are still your intended beneficiaries. It's very common for ex-spouses to be named, or even having no one named at all as a beneficiary. Recall the beneficiary designation trumps any outside planning, including a divorce decree, a will or trust.

   You should also review your secondary (contingent) beneficiaries, e.g. those beneficiaries that may inherit if your primary beneficiary was to predecease you. Again, a "blank" designation is very common. While some plan agreements may have default provisions to have assets pass to your family, this is not always the case. Much like you don't want to pass away without a will, you don't want to pass away without a conscious decision about your primary and secondary beneficiaries on your retirement accounts.

If you named a trust as either your primary or secondary beneficiary, you should review the terms of that trust and determine if the trust remains an appropriate beneficiary considering the SECURE Act changes. For example, before SECURE there were trusts known as "conduit" trusts that directed trustees to act based on certain required minimum distribution rules. The SECURE Act has generally done away with such rules, meaning pure "conduit" trusts may no longer make sense or may even cause distribution problems. Moreover, the new distribution provisions may call into question the advisability of naming a trust. While reviewing your beneficiary designations now is important, it's even more important to review a trust designation in light of SECURE.

Once you've confirmed your current designations, consider whether these new rules require you to modify your primary or your contingent beneficiary. Did you name grandchildren hoping for a long stretch IRA? Did you implement or forgo trust planning due to the old rules? It is imperative that you look at what you have in place now and then review how your plan will be affected by the new rules. Upon completing your beneficiary review, perhaps you need to consider new planning.

2. **Consider Roth Conversions and Roth Savings Strategies.** Instead of leaving your beneficiaries a retirement account that creates taxable income, shift your retirement income and savings strategy to Roth accounts that provide tax free income to you and your beneficiaries. There are a few ways you can go about it.

- ***Convert Traditional IRAs to Roth IRAs.*** Any assets that you have accumulated in your traditional IRA can be converted to a Roth IRA. Conversion creates an income tax liability for you in the year you move the assets from your traditional IRA to your Roth IRA. It is also a one-way street. Once the conversion has been done, it cannot be undone so it is important to consider the tax impacts of a conversion with your tax professional before moving forward with this strategy.

  The assets converted to your Roth IRA begin accumulating tax-free earnings for your own retirement. Qualified tax-free Roth IRA withdrawals are available after 5 years and age 59 ½.[1] After your death, Roth IRAs are required to be distributed in the same way as traditional IRAs, but the withdrawals are not taxable.

- ***Make Contributions to Roth Accounts.*** Saving in Roth accounts can also be of value in legacy planning because of the income tax-free benefit they provide when withdrawn. Roth

[1] Roth IRA qualified withdrawals also include withdrawals after 5 years when you are disabled, you use the funds for a first-time home purchase ($10,000 limit), or when paid to your heirs after your death.

IRA contributions can only be made if your modified adjusted gross income does not exceed certain limits. In addition, contributions are capped at $6,000 (an additional $1,000 catch-up contribution is available if you are age 50 or older).

If your employer's retirement plan offers designated Roth accounts, that is another way to accumulate Roth savings. Employee Roth salary deferrals are after-tax dollars contributed out of your pay that can provide tax-free income or be rolled into a Roth IRA after your retirement or separation from service.[2]

By shifting all or a portion of your salary deferrals to a Roth account, you are also building a tax-free legacy benefit for your heirs. There are no income limits on making employee salary deferrals into Roth accounts in your employer's retirement plan. Just make sure you don't exceed the annual salary deferral limit between your pre-tax and Roth deferrals.

- ***Convert Savings Inside Your Retirement Plan.*** If your 401(k), 403(b) or 457(b) retirement plan offers designated Roth accounts, you can also convert any pre-tax employee salary deferrals to a Roth account inside your employer's retirement plan.
  As with traditional IRA to Roth IRA conversions, in-plan Roth conversions are also taxable events and will distribute to you or your beneficiaries, income tax free, after 5 years and age 59 ½.

3. Leverage Lifetime Withdrawals into More Tax Efficient Uses.

- ***Life Insurance Can Provide Leverage Against Income Taxes.*** Converting your traditional IRA to a Roth IRA can be a great way to enhance your legacy plan, by providing an income tax-free asset to beneficiaries. A downside of this strategy is that income taxes will be due in the year of the conversion. An alternative plan to the Roth conversion idea would be to purchase a life insurance policy with annual IRA distributions. These taxable distributions could then be used to pay the annual premiums on a permanent life insurance policy. Life insurance is a unique asset class that provides an immediate leveraged income tax free death benefit. In addition, some policies will allow for the purchase of a long-term care rider which can provide for an income-tax free acceleration of the death benefit should nursing home, assisted living, or home health care be needed prior to death.

- ***Reinvest Distributions in a Taxable Account for Step-Up at Death.*** Another way to help with income taxes as assets are passed to the next generation is to take the withdrawals and reinvest into a taxable account. By doing this, upon your passing, your beneficiaries could receive a step up in the cost basis if the assets have appreciated. For example, if you reinvest

[2] Qualified withdrawals from designated Roth accounts are available after 5 years and age 59 ½, disability or death. In addition, balances in designated Roth accounts are included in the plan's required minimum distributions. Designated Roth accounts can be rolled over directly to a Roth IRA after separation from service (or other triggering event), however, the 5-year period does not carry over into the Roth IRA.

your distributions into stocks for $10 a share, that would set the cost basis at $10. If the stock appreciates to $20 a share by the time of your death, instead of paying tax on the $10 of appreciation, your beneficiaries would receive the stepped-up cost basis – the new fair market value of $20 share.

- ***Qualified Charitable Distributions and Other Charitable Gifting Strategies***. If you don't need the income or are being forced to take more retirement income through required minimum distributions than you need, giving away your retirement assets during your lifetime is another strategy to consider. Qualified Charitable Distributions (QCDs) are income tax-free withdrawals from traditional IRAs that are made directly to a qualified charity in amounts up to $100,000 a year. QCDs are not available to everyone. They can only be made by individuals who have attained age 70 ½ or older. With QCDs, your IRA distribution is not included in income so you get the tax benefit whether you itemize or not.

  If you are not 70 ½ or older, you could still take IRA distributions, include them in taxable income, and then deduct your charitable gift if you itemize. Either strategy is a way to reduce your estate and receive a tax benefit today for your charitable giving.

4. Discuss Other, More Complex Beneficiary Designation Strategies with Your Team of Financial, Tax, and Legal Advisors.

- ***Leaving Retirement Assets to a Charity.*** While lifetime planning decisions are important, even more planning issues arise when it comes to post-mortem planning with your retirement plans. First, recall that any pre-tax qualified plan (IRA, 401(k), etc.) passes to your beneficiaries with an unrealized income tax liability. Consequently, leaving qualified assets to charity can be an excellent way to not only leave your charitable legacy, but also do so in a tax efficient manner. Since charities do not pay income tax, they can inherit a portion or all of your qualified accounts and liquidate them at full value as opposed to any individual beneficiaries that must pay income tax on each dollar they inherit from a qualified account.

- ***Making Use of Spray Trusts.*** Now that all non-eligible beneficiaries are under the same 10-year withdrawal rules, this could lead to more planning considerations. For example, a more complex planning idea may be leaving your qualified dollars to a trust with multiple beneficiaries, sometimes called a "spray" or "sprinkle" trust. As an example, perhaps you create such a trust with your children and grandchildren (or maybe even great-grandchildren) as beneficiaries. You can then leave your trustee the discretion to determine when and who may benefit for distributions of the qualified dollars over the next 10 years.

  Maybe your children have retired and are in a lower tax bracket? Perhaps your grandchildren are going to school and have virtually no income? Maybe your trustee holds onto the qualified assets and lets it grow tax deferred for another 10 years and then makes various distributions? Any, and all of these options are available.

Of course, a spray trust would also have costs. First, the trust becomes its own taxable entity, meaning tax returns must be filed. Also, someone must serve as trustee which comes with the fiduciary responsibility of managing, investing and distributing the dollars per the trust terms. Maybe you need a professional trustee to assist or run this plan, which would charge a fee for such services. Either way, the uniform distribution rules open up planning ideas like these that perhaps wouldn't have been considered under the old distribution rules.

- ***Using Multiple Beneficiaries in Lower Tax Brackets.*** A similar, but less complex plan, may be for you to proactively select beneficiaries that you expect to be in lower tax brackets. Similar to the spray trust, you can have "spray designations" that scatter your inherited qualified accounts to as many or as few beneficiaries that you prefer. In such a plan you would not have the discretion of a trustee determining when withdrawals from the account would occur. Your beneficiaries would have direct control over those decisions.

  This plan, though, also has pitfalls to consider. First, you have no control over the beneficiaries once they inherit, so they may withdraw the entire amount on day one. Next, those that may be in lower tax brackets today may find themselves in a different spot when they inherit, therefore requiring you to monitor and update your beneficiaries on an "as needed" basis.

Perhaps the most important thing to take away from the new SECURE Act rules is that there's really no such thing as a "default plan." Everyone's situation is different, and it's important that you work with your financial advisor, in coordination with your tax and legal advisors, to make sure that your specific plan meets your specific goals. Accordingly, use this moment to review your situation and make updates as appropriate so that you can achieve your legacy goals in the most efficient manner available. ■