The End of the Stretch IRA

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Because of IRA tax benefits and flexibility, they are an essential tool in the retirement planning toolbox. Through a lifetime of saving, many individuals accumulate substantial assets in these accounts that can then help sustain them during retirement. But some high-net-worth individuals find themselves in the lucky situation of having more in their IRA than they need. What is to happen to these accounts after a person passes?

Under prior law, taxpayers could leave remaining IRA assets to children or grandchildren. This then reset the required minimum withdrawal rate based on the children's or grandchildren's longer life expectancies, stretching out the life of the IRA assets and becoming what's known as a "stretch IRA." This stretch IRA planning technique was leverageable by those with a sufficient asset base, allowing them to spend other wealth during retirement and then leave their IRA to their family instead. Think of it as creating a powerful wealth transfer tool out of a powerful retirement planning tool.

But the end of the stretch IRA is in sight. In May, the House of Representatives passed the SECURE Act—proposed legislation that the Senate passed on December 17. The SECURE Act seeks to eliminate the stretch IRA technique by requiring beneficiaries to withdraw all inherited IRA assets within 10 years of the owner's death. Exceptions remain available for surviving spouses, minors, and disabled persons, who can make withdrawals over a longer period of time. (Congress first began this discussion in 2012 when, during the presidential campaign, it came to light that Mitt Romney's IRA balance was over $100 million—something both surprising and, as it turned out, wholly legal.)

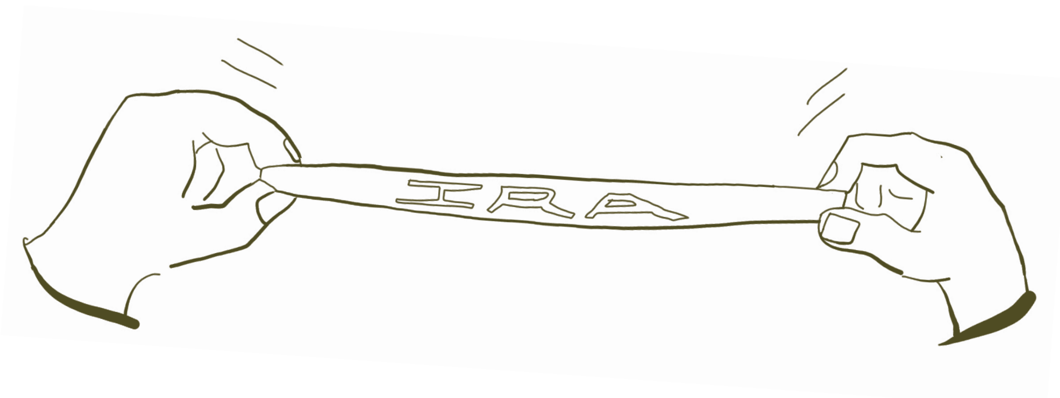
We originally wrote this article when the SECURE Act was still tentative legislation because we think this specific topic provides a great opportunity to start conversations with our clients about other ways to leverage IRAs as a planning tool. Below are a few good-housekeeping tips to get your accounts in order based on the implications of the SECURE Act, as well as a few ways your advisor can help you get more out of your IRA regardless of the Act.

Review and Evaluate Your Beneficiary Designations

Do you know who the current beneficiary of your IRA is? Is it your spouse, other family members (or trusts for their benefit), or a charity? Each is affected in slightly different ways by the SECURE Act.

In the first instance, spouses have the unique ability to roll over their partner's IRA into their own and extend payments over their lifetime. This will not change under the SECURE Act.

However, under the SECURE Act, other family members need to withdraw IRA account assets within 10 years if named as beneficiary. This would accelerate income tax rapidly for them. Naming a trust as beneficiary might only compound this problem, especially given that distributions to trusts can be subject to higher trust income tax rates. »



Naming a charity as beneficiary will not avoid accelerated distributions but will eliminate the income tax drain on IRA assets. For those without a spouse, then, the IRA is an ideal source from an overall tax perspective for funding any charitable gifts at death.

Regardless of who your current IRA beneficiary is, the passage of the SECURE Act is a good reason for you to discuss with your advisor whether that beneficiary is still in line with your wishes and your tax strategy.

Tax Bracket Management

Most financial planning software assumes that people will fund their retirement by spending from taxable accounts first and retirement accounts last. For those who retire ahead of age 70, it can sometimes make sense to poke a hole in your retirement account bucket to fund spending earlier. By doing so, you can manage your tax bracket sooner, lower your retirement account balance somewhat, and thereby lower your required minimum distributions that otherwise would be forced upon you later. This technique can potentially lead to lower effective income tax rates over a longer time period.

Talk to your advisor about running this comprehensive asset allocation, location, and income tax analysis if you think this could be right for you.

Roth Conversions

The SECURE Act is focused on IRA accounts, not Roth IRA accounts. By converting IRAs to Roth IRAs, you can avoid any concerns over accelerated distributions related to the SECURE Act.

Since Roth conversions accelerate tax immediately, however, your advisor would need to consider whether this planning technique makes sense for you. Some people would rather pay more tax now so they can shelter future growth from tax when they later distribute to their family or themselves. Others would rather defer tax over time, especially if they plan to use IRA accounts to fund their own retirement. Your advisor can help you evaluate these options.

Life Insurance and Wealth Replacement

For those who would like to have their cake and eat it too, a life insurance wealth replacement planning technique holds appeal. For this purpose, a person could take their required minimum distribution from an IRA and use the after-tax portion to fund life insurance. They could then leave the remaining IRA balance to charity upon their death, while leaving the insurance benefits to family. The IRA gift to charity would create a charitable deduction for income and estate tax purposes, whereas the insurance benefit would not be subject to income tax and, with appropriate planning, may not be subject to estate tax either.

This provides a way for you to use a highly taxed asset (i.e., the IRA) to fund a tax-efficient asset(i.e., life insurance) and shift more wealth to your family at a lower tax cost.

Charitable Trust Planning

Outside of philanthropic intent, some people look to charitable giving as a way to provide tax benefits » while also preserving family wealth. A charitable remainder trust provides exactly this type of win-win.

A charitable remainder trust is a tax-exempt gift trust that can receive and sell assets without income tax consequences. It then can use the assets to pay income to family members for life before paying the remaining account balance to charity thereafter.

For example, your advisor could help you create a charitable remainder trust and then make it the beneficiary of your IRA. Upon your death, the IRA would pay to the charitable remainder trust without income tax consequences. The trust would then pay income to your family for life before paying the remainder to charity thereafter.

Of course, some terms and conditions apply. IRS rules require that the charity receive at least 10% of the original trust value. They also require that the annual beneficiary payments be at least 5% but not exceed 50% of the original trust value. These parameters still allow you to pass more wealth to your family with greater flexibility than you'd have if you simply designated a family member as a direct beneficiary of the IRA under the SECURE Act.

Planning opportunities aren't limited to the above handful of techniques. More opportunities exist, and the techniques above can sometimes be used in tandem, too. For example, you and your advisor may decide to use required minimum distributions to then fund life insurance that's payable to a charitable remainder trust. Eliminating the stretch IRA takes away one powerful planning tool from clients and financial advisors. But thankfully, it's by no means our only one. ■