Scratch the Stretch

Since their introduction in 1974, IRAs have become one of the most popular tools for retirement savings. And with an average of one out of three Americans now owning an IRA, they are also among the most significant assets addressed in many estate plans. Although funding retirement remains the primary purpose of an IRA, not everyone intends to use the entire balance during retirement. Efficient wealth transfer of these accounts to heirs is a vital estate planning goal.

Historically, the most tax-efficient strategy for managing an inherited retirement account has been to convert the account into a “Stretch IRA,” which lets the beneficiary gradually withdraw the balance over the duration of his or her life expectancy. However, with the advent of the SECURE Act, Stretch IRAs may no longer be a viable option. The SECURE Act has eliminated this option for all but the surviving spouse and a few other beneficiaries. Most IRAs will have to be fully distributed within 10 years of death, with beneficiaries paying income taxes due for distributions over that shorter period, often at a higher rate and without the benefit of potential growth during the longer period.

The aim is to transfer IRA wealth to succeeding generations in a manner that is both tax-efficient and maximizes growth potential.

The Stretch IRA has been the go-to strategy for minimizing taxes on inherited IRA distributions. When an inherited account is converted into a Stretch, income taxes aren’t due on the inherited money until the funds are distributed — not at the time of inheritance. Under prior tax rules, a beneficiary could “stretch” account distributions over his or her entire lifetime (based on life expectancy at the time of inheritance).

Because a Stretch IRA allows for distributions over the longest possible timeframe, the required distributions are smaller. The smaller distributions equate to lower annual tax bills and, in many cases, a lower effective rate for the aggregate distributions. And, more importantly, the longer the income taxes are deferred, the longer the earnings within the account can continue compounding.

The multi-generational deferred growth facilitated by a Stretch IRA can lead to long-term wealth accrual exponentially larger than if the taxes are paid at the time of inheritance and then each year as the after-tax funds earn investment returns. Unfortunately, though, with the passage of the Secure Act, Stretch IRAs are headed for extinction.

Under the new law, someone inheriting an IRA is now required to distribute the entire balance within ten years of the original owner's death. So, beneficiaries must pay taxes on the inherited wealth within 10 years and can no longer "stretch" distributions over the remainder of their own lifetimes.

Remember, traditional IRAs and 401ks are funded with pre-tax money, which means that, when the funds are withdrawn, they are treated as taxable income to the recipient — whether that is the original owner or a beneficiary. If you opt to receive the money as a lump sum, all the taxes are due right away, usually pushing you up into a higher tax bracket and resulting in a greater overall tax bill.

By contrast, if you withdraw the money over time, you typically pay a lower effective rate. Crucially, the longer you defer distributions, the longer the money continues compounding within the account. Money that would otherwise be paid to the IRS instead remains invested and earning returns.

And the returns earn more returns — all with no income tax liability until the money is actually withdrawn

Under the Secure Act, IRA beneficiaries can't use Stretch IRAs to extend distributions for life — the money must all be withdrawn within ten years. In most cases, the required distributions will be larger; the total tax bill will be higher; and the growth accruing on the deferred amounts will be considerably reduced.

The Secure Act excludes a few classes of beneficiaries from the new accelerated distribution requirement. First, if the beneficiary is a surviving spouse, the rule is wholly inapplicable. Likewise, beneficiaries who are disabled or who are less than ten years younger than the original account owner are excluded — as are minor beneficiaries (but only during the period while they are still minors).

Alternatives to a Stretch IRA

In general, it is ideal for most people to defer taxes on funds held within a retirement account for as long as possible. That was the theory behind the Stretch IRA to begin with — by "annuitizing" (or creating monthly distributions for a selected time period) an inherited IRA over the rest of your life, you minimize total income tax payments and maximize the account's growth potential. Now that the IRS requires complete withdrawal within ten years, the goal is to find an alternative means of limiting the taxes beneficiaries have to pay without reducing the gross inheritance.

One possible approach is to convert a traditional IRA into a Roth IRA during the original account owner's life. When the beneficiary inherits the account, he or she won't owe any taxes on it because Roth IRA withdrawals are not taxable income. So, even though the money still needs to be completely withdrawn within ten years, taxes won’t eat away at the total value. The beneficiary can reinvest the funds in another tax-deferred investment and at least approximate the lifetime distributions that a Stretch IRA could have otherwise provided. This approach usually works best if the original account owner makes the conversion after retirement when he or she is likely paying a lower tax rate.

The downside of converting to a Roth IRA is that, to turn the pre-tax money in a traditional IRA into after-tax Roth money, you need to either pay the taxes out-of-pocket at the time of conversion or reduce the account’s value to cover the taxes. Whatever you pay out as income taxes now isn’t accruing future growth for your beneficiary to inherit. Thus, converting to a Roth will alleviate your heir’s potential tax liability but could also noticeably reduce the gross inheritance — depending on how long you live after the conversion and how well the investments in the new Roth IRA perform.

Another option is to use permanent life insurance to transfer wealth held within a traditional IRA with as little reduction for taxes as possible. This approach is more sophisticated but also allows for a great deal of flexibility because permanent life insurance is a highly customizable financial product.

Using Life Insurance to Replace a Stretch IRA

This strategy uses the money from IRA distributions (which you have to take anyway) to pay premiums for a permanent life insurance policy. After receiving a distribution, you pay any taxes due for the withdrawn money and invest some or all of the remainder in the policy. The balance of the IRA stays in the account, continuing to grow tax-deferred. If you need access to cash, you can make additional withdrawals from the IRA or tap the policy’s interest-accruing cash value.

Both permanent lifeinsurance premiums and RMDs are based, in part, on life expectancy. Thus, a death benefit approximating the value of the IRA is often obtainable for annual premiums completely covered by the RMD — depending on factors like your age and health status. When the death benefit is eventually triggered, it is not taxable income to the policy's beneficiary.

The net result is that you pay whatever income taxes are owed for IRA distributions as they are taken, and your heir receives an inheritance (in the form of the life insurance benefits) in an amount approximating the IRA balance and with no income taxes owed. To obtain a long-term income stream like with a Stretch IRA, the beneficiary can annuitize the death benefit so that it continues earning interest while also paying out for life.

Alternatively, you can set up the policy to pay into an irrevocable trust that holds legal ownership of the policy. If structured properly, the death benefit is excluded from your taxable estate, helping to reduce any estate taxes which might have otherwise been owed. And, if desired, the trust can be designed to pay a steady income to trust beneficiaries under terms established when the trust is created. As an added benefit, an irrevocable trust can also be used to prevent squandering and to provide protection for beneficiaries from lawsuits.

Any funds remaining in the IRA can be inherited as normal. But, with the balance reduced to fund the life insurance policy, the eventual tax for the beneficiary should be much less substantial.

The end of the Stretch IRA will disrupt the plans of many clients, potentially causing beneficiaries to increase their taxable income by six-figure amounts on large IRAs. If you would like to discuss this strategy, please don't hesitate to contact us at Northeast Financial Group.