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Wave the Stretch IRA Goodbye… What Does That Mean to You?

In late December 2019, the SECURE Act was signed into law. It's acronym, "Securing Every Community for Retirement Enhancement" seems like a tax cut, it really isn't. As you will read, the IRS provides some minor tax relief, but seems to have taken more than they gave.

For tax-minded people, this law change may be sending a new message to Americans. In my opinion, the government needs additional tax revenue from YOUR retirement plan, and they will get it sooner rather than later. Based on our current government deficits, rising tax rates seem almost inevitable.

This article will address (in an oversimplified way) some of the financial and estate planning aspects of the SECURE Act as well as planning strategies you may see as a result.

Change to Required Minimum Distributions ("RMD") Rules

Under prior law, qualified retirement plans (IRAs, 401(k)s, etc.) required participants to begin taking RMDs THE YEAR they turned 70 ½. The SECURE Act delays RMDs to the year you turn age 72. This is a modest benefit, but will probably prove insignificant over your lifetime. Please note that if you turned 70 ½ in 2019, YOU MUST CONTINUE taking RMDs and will see no benefit from the law change.

What Is a Stretch IRA?

Qualified retirement plans allow the owner to name one or more beneficiaries to inherit their IRA upon their demise. Prior to the SECURE Act, properly named beneficiaries were able to "STRETCH" their inherited IRA distributions (also called RMDs) over their lifetime. Thus, these beneficiaries could take small distributions over many years, deferring income tax for years to come.

For example, Suppose Ralph is a 40-year-old was named the beneficiary of his father's $500,000 IRA, who passed away at 11:59 PM on December 31,2019. Based on prior IRS regulations, Ralph would have to begin taking RMDs by December 31, 2020 (the year following death).

The IRS has a life expectancy table, based on Ralph's age in 2020, which determines the rules for Ralph's annual RMD. Ralph, who will be 41 years old in 2020 would be allowed to "stretch" his beneficiary IRA distributions over the next 42.7 years. He must take each annual RMD by December 31 every year – failure to do results in a 50% IRS penalty.

To calculate Ralph's 2020 RMD, he would take the December 31 balance of the IRA ($500,000) and divide it by 42.7 which totals $11,709.60 (or 2.34%). The $11,709.60 would be treated as taxable income to Ralph in 2020 and the money would have to be withdrawn from the account. Ralph could continue to defer income tax on the remaining balance. Each subsequent year, the divisor (42.7) is reduced by 1, so in 2021 it would be 41.7 (2.4%), in 2022 – 40.7 (2.46%) and so on. This continues until the IRA is exhausted.

The Stretch Is Now Gone!

Now, suppose the father's doctor got busy and didn't declare him dead until January 1, 2020. The SECURE Act changes all the rules. There are no longer RMDs for beneficiaries. Instead, 100% of the IRA must be distributed by the end of the 10^{th} year. Ralph may take it all out in the first year or all of it out in the 10^{th} year, but the account must be liquidated, and the entire account value would be taxable, by December 31 of that year.

Now, Ralph is forced to consider how much to withdraw each year based on his personal financial situation. What if his IRA grows over the next decade because he invests it? What if Ralph's income goes up substantially in the ensuing decade? What if Ralph is a major league baseball pitcher making $10 million per year?

Consider what would happen if Ralph inherited a really large IRA, say $2 million? His income tax situation would change dramatically since the $2 million would have to come out of the IRA in the next 10 years.

You should also consider that many IRA beneficiaries inherit money in their 50s and 60s, when they are in their peak earning years. Inheriting a large IRA, or other retirement plan, can have a significant impact on the beneficiaries' tax situation.

Hopefully, this illustrates how the SECURE Act looks like a tax increase.

What If I Named the Trust as My IRA Beneficiary?

In the last decade or so, many parents have decided to name trusts as beneficiaries of their IRAs. In some cases, the same is done to protect their hard-earned assets from their kids' creditors. In other cases, they want to protect their kids from squandering their inheritance. If this sounds like something in your retirement and estate plan, you need to seek legal counsel as soon as possible. Different types of trusts are affected differently, but you need to reevaluate how you and your family will be affected personally.

What Can You Do?

The SECURE Act seems like another tax increase. Many more may follow. You really need to seek appropriate advice from a number of different advisors (financial, legal, tax). Surround yourself with a solid team who will communicate together for your benefit.

For those of you with large IRAs, there will be additional planning strategies to efficiently transfer your wealth to subsequent generations. Again, you should start planning TODAY and assessing whether any of the strategies will work for you.

Roth IRA conversions are an option that has increased in popularity. Many are concerned about tax rates going up, so they are converting their IRAs to Roth IRAs and have been doing so for several years. With the Roth IRA, you pay taxes on your IRAs now, and the money grows tax-free forever (providing IRS requirements are met). The money will grow tax-free both for your lifetime and for an additional 10 years, which may be a substantial benefit.

Life insurance planning will likely be more prevalent for wealth transfer. Numerous strategies exist (beyond the scope of this article) that can be applied in the hope of transferring wealth more tax efficiently.

Whatever your preference, do yourself a favor and find the appropriate experts to help you start planning now for what might be a long-term trend of higher taxes down the road.

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