



What Happened To MY STRETCH IRA?

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In December 2019, the federal government approved significant legislation known as the Setting Every Community Up for Retirement Enhancement Act. The SECURE Act sought to make saving for retirement easier and more widely available, which is essential when many Americans are insufficiently prepared for retirement. According to the U.S. Bureau of Labor Statistics, only 55% of the civilian adult population even chooses to participate in their employer's retirement plan with their own contributions, and many participants don't save nearly enough.

Unfortunately, while much of the content of the SECURE Act does provide more flexibility and options for individuals and business owners, some of the changes can present new challenges. In particular, the legislation put some critical limitations on distributions from inherited Individual Retirement Accounts.

Before the Secure Act, anyone who inherited an individual retirement account from a parent or other account holder could choose to "stretch" their distributions from those accounts out over their lifetimes (technically, over their calculated remaining life expectancy). For a young adult beneficiary, that could be 50 years or more. The longer the assets remained in an IRA, the longer one could defer the tax obligations for withdrawals from the IRA.

However, Congress had intended for IRAs to be used more like pensions for the original account holder, not as a means to transfer

wealth across generations. IRAs also quickly grew to hold far more assets than previously anticipated. According to the Internal Revenue Service, as of 2018, the total value of existing IRAs exceeded \$8 trillion. As a result, the SECURE Act reined in the stretch and associated tax deferral. It requires most beneficiaries other than surviving spouses to accelerate their distributions. Accelerating the distributions, of course, means earlier taxable income to those beneficiaries and thereby generates tax revenue for the government.

With certain limited exceptions, non-spousal beneficiaries must now deplete their inherited IRAs within 10 years after inheriting them. In many cases, the planning around this does not need to change while both spouses are still living, although there are situations where spouses do not intend to leave IRA assets to each other. Issues typically arise when a single, divorced, or widowed individual with a substantial IRA must determine how the IRA should pass after their death. How can this be done in the most tax-advantageous way after the SECURE Act?

Here are a few strategies to consider:

- Spend down the IRA first and leave taxable assets to beneficiaries instead.
- Take the IRA distributions and purchase life insurance with some of the money.
- Make Roth IRA conversions from time to time.
- Embrace the 10-year rule.
- Designate a charity as the beneficiary of the IRA.
- Make a charitable trust the beneficiary of the IRA.

Spend Down Your IRA First

The first strategy is a rather common-sense approach to working around the new rule. Previously, it was common to accumulate assets in an IRA and spend taxable assets for retirement expenses whenever possible. Now an IRA owner can choose to take distributions from the IRA that exceed any required minimum distributions and pay the associated taxes each year. By drawing down the IRA over time, the tax burden of distributions remains on the owner's tax return instead of the beneficiary. The non-IRA assets, which now contain more for beneficiaries if the IRA is being spent down, can be passed on without income tax liabilities or required minimum distributions. However, this approach does not come without costs, as every dollar distributed from an IRA account is taxable in the calendar year of the distribution.

Consider Purchasing Life Insurance

The second strategy would also involve the IRA owner assuming more of a tax burden than the beneficiary. Anyone who is not dependent on their IRA distributions to pay for expenses might consider reinvesting this money into something more tax-friendly for their beneficiaries. For example, by using some IRA distributions to purchase life insurance, the IRA owner assumes the income tax liability of the distributions. Since life insurance proceeds are not taxable, this would provide the beneficiaries with a sum of cash they could use for whatever they choose, including reinvesting the money into an investment or savings account. Essentially, the IRA owner here prepays the taxes that the beneficiaries would have paid and exchanges the remaining funds into a form that will be tax-free for the beneficiaries.

Roth IRA Conversions

The third strategy is similar to the first two, with the basic premise of transferring the tax liability back to the IRA owner and reducing the taxes for the beneficiary. However, the IRA owner could consider a full or partial conversion to a Roth IRA instead of using life insurance. If the original IRA owner makes a Roth conversion, taxes are owed in the year of the conversion. However, the long-term benefit is the addition of money to a very tax-favorable Roth IRA account. Roth IRAs are funded with after-tax dollars (contributions



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or conversions), and there is no taxation on the appreciation. That means the IRA owner is funding an account that will not incur any taxes during the owner's lifetime or the beneficiary's lifetime! From a tax perspective, this is as good as it gets—if it is affordable to do so, why not provide beneficiaries with an account that has all the favorable features of an IRA (tax-free compounding) without the eventual income tax liability?

Embrace the 10 Years That You Have to Work With

The fourth strategy recognizes that the SECURE Act's 10-year rule may not be too onerous in some situations. Smaller IRAs, for instance, are often depleted within 10 years, and one benefit of the new regulations is that distributions can be left until the end of that period without any required distributions in the first few years. Financial advisors can help select the appropriate tax year or years for a beneficiary to realize that income based on their overall tax and non-tax situation.



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Make a Charity Your Beneficiary

For IRA owners who want to leave a charitable legacy, designating a qualified 501(c)(3) organization as the beneficiary of your IRA is an effective technique. While the strategies discussed above primarily involve prepaying taxes to avoid saddling beneficiaries with a tax burden, naming a charitable organization as an IRA beneficiary wipes out the IRA's tax liability entirely. No income taxes have to be paid on distributions to qualified charities. Doing this does mean that family members will not receive the IRA at all, but some IRA owners already have general charitable gifts set up under their wills or trusts. In those cases, it is typically more tax-efficient to make the charitable gifts from the IRAs and let the other assets go to individual beneficiaries. For example, leaving \$100,000 in cash to a charity and a \$100,000 IRA to a child results in the child receiving much less due to the eventual income tax they must pay. However, leaving the IRA to the charity and the cash to the child ensures the child receives the total \$100,000. IRA owners can also make

smaller or periodic gifts of this type by taking advantage of qualified charitable rollovers. Under certain conditions, up to \$100,000 in charitable donations can be made from an IRA each year, satisfying any required minimum distribution requirements while not counting as taxable income.

Use a Charitable Trust as Your IRA Beneficiary

The final strategy is more complex and best suited for someone seeking more control over the timing of distributions to their beneficiaries but also interested in leaving a charitable legacy. Designating a Charitable Remainder Trust, otherwise known as a CRT, as the beneficiary of an IRA ensures an efficient transfer of assets from one tax-exempt vehicle (the IRA) to another tax-exempt vehicle (the CRT). Like an IRA or a 401(k), with certain exceptions, a CRT has no taxable income, so taxes are only paid when distributions are made to a tax-paying beneficiary.

The CRT is an irrevocable trust that will distribute a percentage of the IRA account value each year to one or more individual beneficiaries. The trust can be written to make distributions for the beneficiaries' lifetime or a fixed period up to a maximum of 20 years. The annual distribution from the IRA can be as low as 5%, and there are up to five different calculation methods to consider. Two popular calculation methods are a fixed percentage of the initial value of the trust, or Charitable Remainder Annuity Trust (CRAT), or a fixed percentage of the trust value, but recalculated annually, or Charitable Remainder Unitrust (CRUT). Generally speaking, CRUTs are more popular for planning because payouts are adjusted and help keep pace with inflation. It guarantees that the trust will never run out of money. One of the key points to remember about this strategy is that there must be a remainder interest in this trust worth at least 10% of the trust's initial value. For someone who is not charitably inclined, this approach may not be a practical solution.

To see the charitable trust approach in action, suppose that Jim is his father's IRA beneficiary. At the time of his father's death, the IRA had a value of \$400,000. Based on the SECURE Act changes, Jim would be required to take the entire balance of this account within 10 years, and he would pay taxes on the annual distributions he takes. If he took one-tenth out in the first year, this would be \$40,000 of additional income tax on top of any of his personal or household earnings. If Jim is in a 22% income tax bracket, this calculates to about \$8,800 of additional income tax. If Jim decided to cash out the entire balance of the IRA in year one, this would put him at least in the 35% tax bracket and create about \$140,000 in additional income tax!

If Jim's father had used a CRUT as the beneficiary of his IRA, it would be funded with the \$400,000. Suppose the CRUT is written to pay out 7% per year for Jim's lifetime



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and that the account is invested in a balanced strategy that generates \$4,000 per year in income. For the first year, Jim would receive \$28,000 ($\$400,000 \times 7\%$). From a tax perspective, Jim would only pay taxes on the \$4,000 of income generated from the trust, so his taxes for the first year would be only about \$880 of additional income tax ($\$4000 \times 22\%$). If Jim's tax bracket were higher than 22%, the tax savings would increase.

Using a CRT does require some additional planning. There are costs associated with the initial setup and the ongoing management of the trust over a period of years. Other factors include choosing a proper trustee and a designated charity to receive the remainder of interest. It is possible to use a donor-advised fund rather than naming a specific charity, allowing the donor's descendants to choose which charity or charities benefit from the gift.

By taking away the stretch IRA for non-spousal beneficiaries, the SECURE Act has made significant changes that should be addressed by anyone whose assets include substantial IRAs. No one should make snap decisions in reaction to this legislation. There are factors other than tax rules, such as family dynamics and individual financial needs, to consider in many cases. IRA owners should take a deep

breath, consult their investment, tax, and legal advisers, and think about how best to handle these important tax-deferred assets in the future. ❖

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Disclosures:

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