Stretch IRAs Lose Potency under the SECURE Act

The Setting Every Community Up for Retirement Enhancement (SECURE) Act contains a number of favorable provisions that will help Americans save more for retirement. However, the new law also contains an unfavorable provision that will affect nonspouse IRA beneficiaries who inherit accounts with substantial balances. As a result, some carefully constructed estate plans will be damaged. Here's the story.

Old Rules

Before the SECURE Act, the required minimum distribution (RMD) rules allowed a nonspouse beneficiary to gradually drain inherited IRAs over the beneficiary's IRS-defined life expectancy.

For example, Ann is 40 years old when she inherits her elderly Aunt Lilly's $500,000 Roth IRA. The current IRS life expectancy table estimates that Ann will live for another 43.6 years.

Ann must start taking annual RMDs from the inherited account by dividing the account balance as of the end of the previous year by her remaining life expectancy as of the end of the current year. So, her first RMD would equal the account balance as of the previous year end divided by 43.6, which would amount to only $11,468, or 2.29% of the balance ($500,000 divided by 43.6 years). Her second RMD would equal the account balance as of the end of the following year divided by 42.6, which translates to only 2.35% of the balance. And so on until the account is fully depleted.

Before the SECURE Act, the RMD rules allowed nonspouse beneficiaries to keep an inherited account open for many years and reap the tax advantages for those years. With an IRA, this is sometimes called the "stretch IRA" strategy. It's particularly advantageous for inherited Roth IRAs, because the income those accounts produce can grow and be withdrawn free from federal income tax. So, under the pre-SECURE Act RMD rules, a stretch Roth IRA could provide protection from future federal income tax rate increases for many years.

New Rules

The SECURE Act requires most nonspouse IRA and retirement plan beneficiaries to empty inherited accounts within 10 years after the account owner's death. This is an unfavorable change for beneficiaries who would like to keep inherited accounts (generally traditional and Roth IRAs) open for as long as possible to continue reaping the tax advantages.

This change won't affect account beneficiaries who want to quickly drain inherited accounts or account owners who empty their accounts during their retirement years. It only affects certain nonspouse beneficiaries who want to keep inherited accounts open for as long as possible to reap the tax advantages.

This change also won't immediately affect accounts inherited by a so-called "eligible designated beneficiary." This term refers to:

- The surviving spouse of the deceased account owner,
- A minor child of the deceased account owner,
- A beneficiary who's no more than 10 years younger than the deceased account owner, or
- A chronically ill individual as defined under the tax law.

Other nonspouse beneficiaries will get hit by the new 10-year account liquidation requirement. For example, continuing with the previous hypothetical situation, Ann could only keep the Roth IRA that she inherited from Aunt Lilly open for 10 years after her death, if Aunt Lilly dies in 2020 or later.

Important: Under the exception for eligible designated beneficiaries, RMDs from the inherited account can generally be taken over the life or life expectancy of the eligible designated beneficiary, beginning with the year following the year of the account owner's death.

The unfavorable changes to the RMD rules under the SECURE Act are generally effective for RMDs taken from accounts whose owners die after 2019. The RMD rules for accounts inherited from owners who died before 2020 are unchanged.

10-Year Rule Specifics

When applicable, the new 10-year rule for RMDs generally applies regardless of whether the account owner dies before or after his or her RMD required beginning date. The SECURE Act also raised the age at which the RMD rules kick in from 70½ to 72 for account owners who attain age 70½ after 2019. So, the required beginning date for those account owners is April 1 of the year following the year age 72 is attained.

There are two other key points to be aware of:

1. Following the death of an eligible designated beneficiary, the account balance must be distributed within 10 years.
2. After a child of the account owner reaches the age of majority, the account balance must be distributed within 10 years after that date.

RMD Rules in the Real World

The following examples illustrate how the new SECURE Act RMD rules work in a few commonly encountered situations.

- **Lucky Lucy**

Andy dies in 2020. He leaves his IRA to designated beneficiary Lucy, his sister, who was born eight years after Andy. Lucy is considered an eligible designated beneficiary, because she's no more than 10 years younger than the deceased account owner. Therefore, the balance in the inherited IRA can be paid out over Lucy's life expectancy. If Lucy's luck runs out and she dies before the account is exhausted, the remaining balance must be paid out within 10 years after her death.

- **Doomed Don**

Cleo dies in 2020 and leaves her IRA to designated beneficiary Don, her brother, who was born 12 years after Cleo. Don isn't an eligible designated beneficiary, because he's more than 10 years younger than Cleo. Therefore, Don is doomed to suffer a suboptimal tax outcome: He must withdraw the balance in the inherited IRA within 10 years after Cleo's death.

- **Fortunate Francine**

Ernesto died on December 15, 2019. He left his IRA to designated beneficiary Francine, his niece, who is 30 years younger than Ernesto. Because Ernesto died before 2020, the balance in the inherited IRA can be paid out over Francine's life expectancy under the pre-SECURE Act RMD rules. If Francine dies on or after January 1, 2020, the balance in the inherited IRA must be paid out to Francine's designated beneficiary within 10 years after Francine's death.

For More Information

Nonspouse beneficiaries should be aware of the changes to the rules for draining inherited accounts. If you inherit a traditional or Roth IRA with a substantial balance, contact us to determine if the unfavorable 10-year rule applies to you and to answer any other questions you have about minimizing taxes on distributions.

In addition, individuals who were relying on the Stretch IRA strategy as part of their estate plan will have to rethink things. We can help with that, too.

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