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Inheriting IRAs Just Got Complicated, Thanks to New Retirement Overhaul

The new spending package curtails the Stretch IRA, a popular strategy for passing on tax-free growth to younger heirs

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The Stretch IRA is snapping back.

Congress's year-end spending package limits the ability of savers to extend the life of their traditional Individual Retirement Accounts and Roth IRAs by leaving the accounts to much younger heirs, such as grandchildren.

The change curtails an often simple strategy that has been popular with many IRA owners who won't spend all the account's assets.

Until the change, the heirs of traditional or Roth IRAs could take required withdrawals her grandfather's IRA could take payouts over about 60 years—hence the name Stretch IRA.

Now many IRA heirs will have to withdraw the assets within 10 years, rather than based on their own life expectancy. The law takes effect for deaths of IRA owners after Dec. 31, 2019, so IRAs inherited before then still benefit from prior law.

WHO STILL GETS A LONG STRETCH

Many future heirs of IRAs, such as grandchildren, will be required to drain the accounts within 10 years of receiving the IRA, but some will still be able to stretch payouts over decades.

Who's eligible for the longer payout period:

- Heirs of IRAs whose original owners died before 2020
- Surviving spouses
- Chronically ill or disabled heirs
- Heirs within 10 years of age of the original owner
- Minor children up to the age of majority, or age 26 if the child is still in school. At that point, the 10-year payout begins.
- *Source: SECURE Act, Ed Slott*

Supporters of the change, including Rep. Kevin Brady of Texas, the top Republican on the House Ways & Means Committee, have said that tax-favored retirement funds should be used mainly for the owner and spouse's retirement security. "They are not wealth-succession management tools," Rep. Brady said in late August.

Critics say savers will think they can't trust Congress to keep its word on retirement rules. The revision especially affects Roth IRA owners who are alive and who accelerated tax bills in order to convert traditional IRAs to tax-free Roth accounts intended for much younger heirs.

"People made long-term plans believing they could rely on the tax laws at the time. This revision changes the rules in the ninth inning of the game and causes savers to lose faith in long-term tax planning," says Ed Slott, an IRA specialist who is certified public accountant in Rockville Centre, N.Y.

The new limits on Stretch IRAs are estimated to raise $15.7 billion from 2019-2029, according to the Joint Committee on Taxation. Current data on inherited IRAs isn't available.

The new legislation has exceptions to the 10-year payout. IRA heirs who are surviving spouses are still covered by the old rules. So are heirs who are disabled or chronically ill, or who are no more than ten years younger than the IRA owner.

There's also an exception for children who are minors—but not grandchildren—up to the age of 18 to 21, depending on the state, or up to age 26 if the child is in school, says

In addition, the legislation doesn't require heirs who must drain accounts within 10 years to take annual withdrawals. This means a Roth IRA heir could postpone payouts until near the end of the 10 years to receive maximum tax-free growth. (Roth IRA payouts are typically tax-free.)

Heirs of traditional IRAs can also postpone payouts, although withdrawing a lump sum could trigger higher tax brackets.

For savers who counted on a decades-long IRA stretch for their heirs, here are moves to consider in light of the rule change.

Make your spouse the heir to the IRA.

Surviving spouses still have favorable rules. For example, a spouse who inherits a Roth IRA could put the account in his or her name, not take payouts during life and then leave the accounts to younger heirs who get a 10-year stretch.

Spouses who inherit traditional IRAs also have options. For example, a 72-year-old widow could take payouts over her life expectancy of about 26 years if she claims her deceased husband's IRA as her own, and then leave the account to younger heirs at her death. Those heirs would get a 10-year stretch on remaining assets.

Review IRA trusts.

Some IRA owners have arranged to leave accounts to a trust at their death in order to preserve assets from spendthrift or ne'er-do-well heirs.

Natalie Choate, an attorney and retirement-plan specialist in Boston, says it's imperative for IRA owners who have set up trusts to revisit them soon. "Some types of IRA trusts make no sense under the new law, so people need to check its effect," she says.

Look into life insurance.

The new law favors life insurance over IRAs as a tax-efficient way to move assets to heirs, says Mr. Slott, because life insurance payouts can be free of both income and estate taxes.

Life insurance can also be more flexible than an IRA if the owner wants to leave assets to a trust, he adds. But policies must be bought with after-tax dollars, and buyers should purchase them with assets they won't need during life. It's also important to determine fees up front and learn whether insurers can raise them.

Do nothing.

A 10-year stretch is still a stretch. For inherited Roth IRAs, 10 years of tax-free growth with no required payouts is a good benefit.

If the account is a traditional IRA intended for several young-adult heirs, then multiple payouts over 10 years could be spread over many low tax brackets if the heirs are just starting out.

SHARE YOUR THOUGHTS

Were you planning to leave a Stretch IRA to younger heirs? How will you cope with Congress's change? Join the conversation below.

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