Maintaining the Integrity of the Stretch IRA

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The purpose of this article is to bore a tunnel through the mountain that the government just created and drive you to your destination. For many years, the Stretch IRA was in the driver's seat, providing financial security for individuals to safely collect qualified (pre-tax) funds and offer a legacy of taxable wealth for future generations. Now we need to be creative and find a new way to achieve the same goal that the Stretch IRA helped us achieve—to share our hard-earned savings with future generations in a tax advantageous way. Not to be morbid, but many original IRA owners, now deceased, are rolling over in their graves with the introduction of the SECURE Act. It has changed and possibly destroyed their intended legacy.

In December of 2019, the Setting Every Community Up Retirement Enhancement Act of 2019 (SECURE Act of 2019) was overwhelmingly passed by the Senate and House of Representatives.

The Stretch IRA concept is among the topics that have been affected by the SECURE Act. This is a prime example of the control our government has over your qualified assets (retirement accounts) as emphasized in my book, *Positioning 4 Retirement*. Our government has its hands in our pockets. Now, there is very little we can do with a Stretch IRA without major tax consequences. Devastating changes made by the SECURE Act will cause greater taxation while undermining estate plans that used the Stretch IRA as a strategic tool.

Prior to the SECURE Act of 2019, a Stretch IRA enabled individuals to pass qualified funds to the next generation and generations to come without immediate tax implications, but with tax deferral until the funds were distributed. This strategy could virtually go on for generations.

With the implementation of the SECURE Act, a Stretch IRA must be entirely transferred to the beneficiary and taxed by the end of the tenth year of the owner's date of death; otherwise a 50% tax penalty plus ordinary taxation, payable to the US Treasury through the IRS, is applied on the balance that is not distributed. This excludes distributions to the spouse, disabled or chronically ill individuals, beneficiaries of transfers that are already grandfathered, a person not more than ten years younger than the IRA owner, and children until they meet the age of majority, which is in most states eighteen years old or twenty-six if in school.

This change in the rules has created major legal, tax, and investment obstacles creating a single question: How do we do what the Stretch IRA did before?

The old Stretch IRA empowered people with three major benefits—it deferred taxation for generations until the funds were drawn upon, it allowed minimum required distributions based on the beneficiary's age, and it created generational wealth.

After months of listening, reading, thinking, processing, and running the SECURE Act through the legal and tax car wash, I have found no real solution that concretely solves the question. At best, I have found tax and legal theories and strategies, but they may or may not work, depending on what changes the US government makes in future IRS interpretations from Tax Court cases. Remember, the government has control of these funds until a tax has been paid. The SECURE Act is forcing taxation sooner rather than later. This is why the Stretch IRA is being attacked and disassembled. The government wants its tax money now. By forcing you to pay tax, it gives you control, but at what cost?

Those who have Stretch IRAs always knew they would have to pay tax but understood the tax could be stretched out and controlled over several generations. Now, greater-than-anticipated sums of money need to be taxed and transferred, shocking everyone involved. It's almost as though the politicians that made this change don't have Stretch IRAs; otherwise, this wouldn't have happened.

But keep reading! Although one advisor seems to suggest throwing in the towel, even he has suggestions.

Ed Slott, a renowned and well-respected CPA in the retirement field, as quoted in attorney Natalie Choate's publication, *Estate Planning for Retirement Benefits*, said, "They've taken one of the best planning assets and turned it into the worst planning asset." His general advice to wealthy clients with large IRAs is "Look for any ways you can find to get your money out of these plans at a reasonable tax cost." I can't speak for Mr. Slott, but I believe his "They" refers to the US government!

More specific suggestions come from attorneys such as Natalie Choate and Alan Gassman with their colleagues, working with Ed Slott's comments, that provide several legal strategies based on individual situations that may be useful at this time. Using combinations of trusts, many of them designed and coordinated with a tax strategy, may help minimize the tax implication of the SECURE Act.

In coordination with a new legal and tax structure, reallocating funds to plans such as a Roth account and the utilization of life insurance and annuities can help continue the tax-deferred treatment that the Stretch IRA provided. Since what we are discussing is considered wealth transfer, strategies utilizing life insurance can begin as early as infancy. Roth accounts and annuities can begin as early as eighteen years old. As an individual planning to leave wealth to generations to come, you have the responsibility to determine how and when this is to begin.

Legal Overview

Natalie Choate, a well-respected attorney in the estate and retirement planning field, published *Estate Planning for Retirement Benefits: Selected Case Studies What to Do in Real Life . . . after SECURE, 2020 Edition*, which discusses cases related to the SECURE Act. Choate and her team used outside-the-box thinking in projecting and comparing different trust strategies. One involved the federal tax exemption, another involved a family limited partnership, and a third involved a restricted management agreement. All three produced different tax issues resulting in a compromise between asset protection and taxation.

Based on the previous three strategies using trusts, tax options such as Roth conversions are used to redirect IRA assets among family members, especially those with particular family idiosyncrasies.

Alan Gassman and his team, also outside-the-box thinkers, are well-known and respected for developing legal trust documents. They have created what is now known as the TEA POT or Twin TEA POT Trust (Tax Effective Allocation POT Trust) system to include a taxable trust and an equalization trust designed to, at best, offset and address the changes the SECURE Act of 2019 has created. These trusts are strategically coordinated with a tax plan for all the beneficiaries of the Stretch IRA.

The TEA POT Trust system works, as do trust combinations discussed by Choate's team, as part of the overall estate plan by analyzing the assets of the estate, including the Stretch IRA, with the assets of each beneficiary. The overall plan, presented by both teams of attorneys, is to balance the wealth distribution, ultimately minimizing the tax implications caused by the changes made to the Stretch IRA by the SECURE Act.

This again leads to my initial question: How do we do what the Stretch IRA did before? Here are steps to answer it:

- First, with the help of a CPA and estate planning attorney, determine how to best minimize the tax implication using calculations in coordination with trusts to pay the tax moving you out of the IRA.

- Second, moving forward, reroute a portion of the post–Stretch IRA funds into a tax-deferred situation and a portion into other financial options as discussed later in this article.

- Third, revisit the rules on a regular basis, amending legal and tax documents as needed.

Much research on the SECURE Act makes clear that the act has complicated the ability for one to protect what was originally planned and thought to go to one's heirs via the Stretch IRA. The SECURE Act imposes tax assumptions and calculations that have not been clearly defined by the IRS, creating misinterpretation and the use of contrasting strategies among professionals. Clients left trying to figure this out alone are in a dismal quandary of what to do. Regardless of whom you listen to, in order to implement any of these strategies, a CPA and estate planning attorney are needed.

Continuing Tax-Deferred Treatment

Financially, there are three vehicles available to maintain the integrity of the tax-deferred treatment the Stretch IRA offered: Roth accounts via a Roth conversion, cash value permanent life insurance (universal life and whole life), and non-qualified annuities. These programs can address the two major reasons that made the Stretch IRA popular—generational wealth transfer and tax-deferred growth.

These types of products require the funds entering these tax deferred strategies to be post-tax, and they defer tax on interest growth. This allows the funds to grow with the same tax-deferred treatment as intended in the Stretch IRA. Because taxes are paid prior to entering these products, the government gets what it wants—tax money. At the same time, you get to move forward in control, recapturing what you want—tax-deferred growth.

Roth Accounts and Roth Conversions

The book *Positioning 4 Retirement*, in chapters 8 and 9, pages 49-55, and article 3, pages 164-166, explains what a Roth account is and examines the types of Roth plans available, as well as addresses a Roth conversion and the three-step process. It's a great source of information to assist individuals that want to understand the Roth conversion option. If you would like a copy of *Positioning 4 Retirement,* please reach out to me at mark@rercna.com for a digital copy. Physical copies can be purchased on Amazon.com or barnesandnoble.com.

Permanent Life Insurance

When looking at life insurance in relation to the SECURE Act and the Stretch IRA, permanent life insurance (whole and universal) becomes a tax-deferral option. Although funds entering a permanent life insurance policy are post-tax, interest grows tax deferred within the policy, as long as its funding does not go beyond limits specified by US tax laws, which would make it a modified endowment contract (MEC, pronounced "meck").

The types of permanent life insurance policies utilized in relation to the SECURE Act are fixed and variable whole life and universal life designed to serve a specific focus or purpose, such as tax-deferred accumulation or income and generational wealth transfer. Each policy type has its advantages and disadvantages; the objective should determine the product used. The point here is that the interest in the policy grows tax deferred. In addition, upon the death of the insured, the death benefit is in some cases tax exempt.

In coordination with the legal and tax structure, given that the SECURE Act allows one to transfer funds over a ten tax-year period, it may be beneficial to transfer funds each year into a life insurance policy, spreading out the tax implication and avoiding a MEC.

Since life insurance is based on the age and health of the individual, purchasing life insurance when the individual is younger and healthier provides a lower internal cost of insurance. Lower cost means greater cash accumulation growth and at times a larger death benefit.

Waiting to open and fund a life insurance policy until the end of the tenth tax year not only imposes greater taxation and a more costly insurance policy; it also has the potential to create a MEC, which can cause a tax problem during the term of the policy and yearly taxation on the growth. With these concerns in mind, it is beneficial to initiate a life insurance vehicle sooner rather than later.

If the funds are distributed through a trust, the trust taxation may be greater as well. Not only might the trust create greater taxation, but also, if deemed a simple trust, then the income goes on a K-1 and is taxed at the beneficiary's tax rate, even though cash doesn't leave the trust. This will create issues if the funds are going to be used to purchase and fund life insurance.

Most insurance companies have built systems that alert policy owners when a policy is about to morph into a MEC by refusing premium and alerting the policy owner of the tax ramifications that the premium will create. A MEC affects loans and withdrawals while the insured is alive due to the tax distribution structure. If a life insurance policy becomes a MEC, the tax distribution structure changes from FIFO (first in, first out; the principal is distributed first and interest last) to LIFO (last in, first out; the interest is distributed first and principal last), defeating the purpose of accessing tax-free funds during the accumulation phase and for retirement income. It also imposes a 10% IRS penalty on funds removed prior to 59½ years old. The life insurance policy is now following the tax structure of a non-qualified annuity, with the addition of a death benefit. If the life insurance policy is solely built for the death benefit, a MEC will not eliminate the potential tax-free nature of a death benefit proceeds of a policy owned by an individual.

Chapter 12, pages 79-86, and article 6, pages 189-201, in *Positioning 4 Retirements* explain in depth the benefits of using a permanent life insurance policy for many of the reasons a person would use a Stretch IRA. To date, the US government hasn't changed any of the tax advantages a permanent life insurance policy offers. With that said, knowing what happened to the Stretch IRA, there's no telling what can happen to life insurance in the future.

Annuities

Another option for tax-deferred interest growth is non-qualified variable or fixed annuities. Non-qualified simply means the tax has been paid; therefore, the funds placed in the annuity are post-tax. The difference between variable and fixed is variable has market risk and fixed has no market risk. Fees, charges, and costs will also vary.

Just like a permanent life insurance policy, funds entering the annuity are post-tax while interest grows tax deferred. Although some annuities are medically underwritten, the annuities discussed in this article are not; however, age plays a role. The annuitant (the person named to receive the benefit) must be older than eighteen to open an annuity and can't receive the benefit until he or she is at least 59½ years old without incurring a 10% IRS penalty on the interest. Also, since interest is the first of the funds to be released (LIFO) from an annuity, taxability can be considerable and needs to be planned for.

Choosing between the two insurance vehicles, permanent life insurance and annuities, oftentimes comes down to what fits the insurance company's criteria, as well as the taxable situation the recipient is in. For example, if we are trying to send funds to a person younger than eighteen for college, income, or wealth accumulation for retirement, life insurance may be the better option. If a person is eighteen or older, is trying to create income or generational wealth, and can't medically qualify for life insurance, an annuity may be more appropriate. This is where the legal, tax, and insurance experts kick into action and perform their due diligence. The insurance product (life or annuity) should be designed to fit the trust and tax plan written to accommodate the tangibles.

The SECURE Act has brought change. Ideally, with change come creativity and outside-the-box thinking, as we have seen within the legal structures. Financially, beyond a Roth account, life insurance, and annuities, options include real estate, certificates of deposit (CDs), stocks, and bonds.

Real Estate

Real estate may be a viable option for many people. Depending on the objective and other assets, real estate, especially rental/commercial, not only will appreciate but also can create income for generations. Not to discourage this option, but it also comes with landlord headaches, which need to be considered. Oftentimes management companies are hired to lessen this concern. LLCs are generally established for liability purposes, and management company expense is among the tax deductions for running the LLC. Since the SECURE Act requires the funds to be distributed within ten tax years, mortgages can be scheduled to meet this demand. With the help of a CPA and attorney, trusts and LLCs can be established, along with a tax plan coordinated to fulfill the objective.

Certificates of Deposit (CDs)

Although not a great option, CDs are one I don't want to readily dismiss. Their interest grows tax deferred, but a CD is probably the worst place to put a substantial amount of post-tax funds. The bank will love you, but you might be kicking yourself in the long run. The funds are inaccessible and grow at a rate built to benefit the bank, not the owner of the CD. An alternative option to a CD is a multi-year guaranteed annuity (MYGA). This is not the best option either but is better than a CD. A MYGA has accessibility and grows at a guaranteed rate, generally larger than a CD's rate. A MYGA is good for a short term (three to seven years) fix. When a MYGA matures, similar to a CD in this sense, the owner has to move it or it will automatically renew, entering another surrender charge period. A surrender charge period is a predetermined number of years, generally all years, with a predetermined percentage charge (cost) based on the value of the MYGA incurred for early withdrawal. For example, a five-year MYGA will have a surrender charge period of five years. Each year has a predetermined percentage charge, decreasing until it reaches the end of its contract. Many MYGAs have an annual penalty-free withdrawal, generally 5% or 10% of the value. *Penalty-free* means there is no surrender charge for this portion of the withdrawal. A MYGA, unlike a non-qualified index annuity, as discussed earlier, continues its tax-deferred growth outside the surrender period and can be moved without penalty, typically referred to as a walk-away contract.

Stocks and Bonds

With the purchase of a combination of stocks and bonds, growth can be managed and oftentimes readily reinvested. Stocks go up and down in value while creating capital gains or losses. The tax structure can work in coordination with the overall plan, distributing income in part, liquidating and purchasing stocks to maximize growth, while managing taxation. Held within the proper trust designed to accept post-tax funds from a Stretch IRA and properly managed, this can yield results as the Stretch IRA was established to do without the government intervention and control.

The question is does a stock/bond-minded investor move funds out of a Stretch IRA sooner or later? Earlier in this article, I addressed how moving money out of the Stretch IRA would make sense if the funds went into a life insurance policy or an annuity, capturing the benefit of youth (age and health). When discussing stocks and bonds, it may be different, depending on whom you talk to.

Contrary to the old required minimum distribution (RMD) rules, the SECURE Act allows the funds to remain in the Stretch IRA until the end of the tenth year after the contributor's death without paying out RMDs. With that in mind, a tax and investment analysis will need to be done addressing the movement of funds out of a Stretch IRA over a ten-tax-year period, compared to allowing the funds to grow within the plan and distributing the funds at the end of the tenth year. Since the funds that would normally be removed as RMDs now can remain in the Stretch IRA, the growth of that portion of the funds may offset the tax consequences caused by leaving the funds in the Stretch IRA and allowing them to grow. If the funds were to grow greater than the projected tax implication in ten years, it might be beneficial to allow the funds to remain in the Stretch IRA. If you guess right, as a stock/bond-minded investor, you could come out ahead. With that said, it will take ten tax years to determine if you made the right decision. The question now becomes will the rules and tax code change during the next ten tax years? This question—and the difficulty in answering it—makes long-term financial planning so challenging with the SECURE Act.

In the distribution of a Stretch IRA, as in all successful portfolios, the answer may be to balance risk exposure. Depending on each situation, as Natalie Choate demonstrates, it's necessary not only within the legal structure but within the financial structure as well to be balanced and diversified. The old adage, don't put all your eggs in one basket, may have some meaning here. Balancing and managing taxation while building a diversified portfolio to include new tax-deferred financial vehicles, wrapped in the right legal structure, may be just the solution.

Alternative Strategies Creating the Next Version of the Stretch IRA

When asked, "What does the next best thing to a Stretch IRA look like?" my response is, "Nothing like the one we've known and loved."

Finding an appropriate substitute for the Stretch IRA is going to take much more strategic planning and maintenance in all areas—legal, tax, investment, and insurance. Solutions will require some or all of the following:

- Legal diversification, constant tax attention, and diversified and focused investment and insurance strategies, all coordinated that change as the rules and family dynamics change.
- Multiple types of trusts balancing and protecting one from being decimated by the changes in the rules, covering all angles of the possibilities.
- Trusts that are purposely assembled and positioned to help offset taxation and protect assets from unexpected or untimely changes in the rules.
- Permanent life insurance for infants and youths supported by older generations (parents and grandparents) using proceeds that were once a part of the Stretch IRA to advance wealth to future generations.
- Income planning tools such as permanent life insurance and annuities for adults.
- Stock and bond portfolios that are balanced and coordinated with the insurance aspect integrated into different trusts with the purpose of tax planning and wealth advancement.

Bottom Line

Regardless of what needs to be done, it's obvious that the average person isn't going to be able to tunnel through this easily without the help of a sophisticated attorney, CPA, and insurance and investment professionals that are familiar with the SECURE Act and its consequences. Separating the tasks of each professional who is focused on his or her specific field is advantageous and highly recommended within your team of advisors. *Positioning 4 Retirement*, in chapter 17, "Building a Team of Professionals," and

article 9, "Team Planning Your Retirement and Estate," addresses the need and the pros and cons of the team approach. It's a true game changer!

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Fiduciary and Due Diligence
https://rercna.com/images/Fiduciaries-and-Due-Diligence.pdf

The SECURE Act of 2019 Promotes Lifetime Income Stream Planning
https://rercna.com/images/SECURE-Act-and-Income-Planning.pdf

Credits and Sources

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About the Author and RERCNA

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Disclaimer

This article has been written for broad-base informative purposes and does not replace the need for the professionals mentioned above. This article was written to help individuals understand the effect of the SECURE Act of 2019 on the Stretch IRA and the importance of having a team (attorney, CPA, insurance professional, and investment advisor) to assist in implementing the necessary changes the SECURE Act of 2019 has imposed.

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