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Death of 'Stretch' IRAs Would Mean Loss of Flexibility for Beneficiaries

If part of your estate plan is to leave a hefty IRA to your children or anyone else other than your spouse, you may want to start thinking about backup strategies now.

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Finding a way to leave a legacy to your loved ones without increasing their tax burden has always been a complicated matter.

And, unfortunately for those planning to use a sizable IRA or qualified-plan account as part of their estate plan, it may become even more difficult if the Retirement Enhancement and Savings Act of 2016 eventually becomes law. The proposed legislation, which the Senate Finance Committee passed in September 2016, calls for the elimination of the so-called "stretch" provisions currently afforded non-spouse beneficiaries of IRAs and 401(k)s.

As it is now, designated beneficiaries who inherit one of these accounts take minimum required distributions based on their own life expectancy (not that of the original account holder), and they can stretch out those payments for as long as they like – extending the tax-deferral period dramatically.

If the legislation moves forward as written, however, most beneficiaries (there are some exceptions) will be required to empty inherited accounts of all but $450,000 within five years of the account holder's death.

Everything else must go. And depending on a beneficiary's age and/or tax bracket, this would mean a significant change in tax liability.

Which is the point. Uncle Sam needs money, and he wants to get his hands on some of the cash that conscientious Baby Boomers have been stashing away in their qualified retirement plans (those funded with pretax dollars) for decades. Part of the bill's appeal to legislators is that it would generate an estimated $3.18 billion in revenue from 2017 to 2026.

It's important to note that although the legislation sailed through the Senate Finance Committee, it still has a long way to go. We've been down this road before with similar proposals, and none has become law. For example, the Highway Investment, Job Creation and Economic Growth Act of 2012 recommended a provision that would limit the use of so-called stretch IRAs unless those accounts were converted to a Roth. That provision, of course, did not come to fruition.

Still, if a stretch IRA is or might be a part of your estate plan, it's probably a good idea to start looking at some alternative strategies just in case. Here are a few things you can do now:

1. Consider purchasing life insurance with your IRA money. If you have a large IRA balance, you could make withdrawals over time, pay any applicable taxes and use the rest to pay the premiums on a life insurance policy. Your beneficiaries will receive the death benefit payout free of federal income taxes.

2. Talk to your financial adviser about a Roth IRA conversion. You can do small conversions from your traditional IRA to a Roth, which could save the beneficiaries who inherit that money when it comes to future taxes. But (here we go again, getting complicated) there are rules that apply, so you may want to run this option by your tax professional if you have questions about whether it's a good fit for you.

3. Review your beneficiary designations. If you're married, the best approach may be to name your spouse as the primary beneficiary on any IRAs, Roth IRAs and 401(k)s you have. Or name your children, but with that $450,000 limit in mind. Otherwise, make your children or grandchildren contingent or alternate beneficiaries. At your death, your spouse can decide – based on need and the current rules – what to do with your account.

Proposals such as this are another reason why it's wise to work with a trusted advisory group on a comprehensive retirement plan. It's your financial professional's job to keep an eye on any changes that could affect your plan, and to be ready with suggestions that can help you hold onto your hard-earned savings.

Kim Franke-Folstad contributed to this article.

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