

INTRODUCTION

Among the many changes of the 2019 Secure Act was the elimination of the “Stretch IRA” strategy for most non-spouse beneficiaries of retirement plan assets. Many long-time retirement savers do not fully understand this change, which was also affected by Secure Act 2.0 in 2022 and various rule clarifications made by the IRS and Treasury Department as recently as July 2024.

This article reviews key terms, changes in the Secure Act that impact inherited retirement accounts, and simple examples to reinforce the importance of understanding how the Secure Act may affect your legacy plan. There are many nuances to inherited asset distribution and valuation – we always encourage our readers to get professional advice on such topics.

KEY TERMS AND DEFINITIONS

1. **“Traditional” IRA, 401(k), 403(b), 457(b) plans:** these are funded with investments that have not been taxed. The original investment amount and all earned interest, dividends and capital gains are taxed as they are withdrawn (“distributed”) by the investor, typically after being invested for a minimal # years or until the investor reaches a certain age.
2. **Roth IRA, 401(k), 403(b), 457(b) plans:** these are funded with investments that have already been taxed. All earned interest, dividends and capital gains are exempt from tax if the investor defers withdrawals for a minimal period and has reached a certain age.
3. **Required Minimum Distribution (RMD):** minimum amounts that retirement account owners must withdraw annually from tax-deferred accounts such as traditional IRAs and 401(k)s, starting at a specified age. RMD rules also apply to inherited traditional and Roth retirement accounts.
4. **Stretch IRA:** The stretch IRA is not a type of retirement account but is an estate planning strategy that allowed inherited IRA distributions to be extended over future generations while the IRA assets continued to grow tax-free. This strategy was extremely popular because IRA beneficiaries could take required minimum distributions based on their age, a particular benefit to young beneficiaries such as children and grandchildren of the original account owner.
5. **Beneficiaries:** the person or entity that is legally designated to receive the benefits from a person’s financial products. For the purpose of this article, we are focused on retirement accounts – the beneficiaries of retirement accounts will receive the balance of the assets in those accounts at the time of the original account owner’s death.

For the sake of analyzing inherited retirement accounts, we will define three types of beneficiaries:

- a. **Eligible Designated Beneficiary:** certain individuals that are legally named to receive assets or benefits from a retirement account upon the death of the account holder. This category includes surviving spouses, minor children of the account holder, individuals with disabilities or those who are chronically ill, and non-spouse beneficiaries who are older than, or less than 10 years younger than, the deceased account owner. This designation allows assets to transfer directly to the beneficiary, bypassing probate and often overriding the provisions of a will.
 - b. **Non-Eligible Designated Beneficiary:** individuals and certain types of trusts that are legally named to receive assets or benefits from a retirement account upon the death of the account holder who do not meet the “Eligible Designated Beneficiary” definition above. This designation also allows assets to transfer directly to the beneficiary, bypassing probate and often overriding the provisions of a will.
 - c. **Non-Designated Beneficiary:** This includes entities like trusts, charities, and the estate of the account owner.
6. **Step-Up Basis Rule:** A step-up in basis resets the cost basis of an inherited asset from its original purchase price to the asset's higher market value on the date of the owner's death.

When the market value of an inherited asset is higher at the time of the owner's death than its original purchase price, the cost basis will rise, which will reduce the capital gains taxes owed if the asset is sold later. In practice, most inherited assets after death are stepped up because financial assets passed on to heirs are often long-term holdings that grow in value over the years. The step-up in basis provision applies to financial assets including stocks, bonds, mutual funds and ETFs, real estate, and other tangible properties; however, it does NOT apply to IRAs, annuities and retirement plans such as 401(k)s.

“STRETCH IRA” RECAP

- Before the SECURE Act of 2019, beneficiaries of inherited IRAs could often "stretch" the required minimum distributions (RMDs) over their own life expectancy, allowing for potential tax-deferred growth of the IRA for decades.
- A key advantage of the Stretch IRA strategy was that it reduced the amount of taxable distributions that the beneficiaries were required to take from the inherited accounts, which was particularly impactful for younger beneficiaries with significant other sources of income (salaries, commissions, etc.).
- The strategy also allowed for the IRA to be passed on to additional future generations, further extending the tax-deferred growth.

HOW DID THE SECURE ACT IMPACT THE STRETCH IRA?

- The SECURE Act, signed into law on December 20, 2019, eliminated the "stretch IRA" strategy for most beneficiaries who inherit retirement accounts after 2019. IRAs inherited before January 1, 2020, still allow Stretch IRA rules.
- Eligible Designated Beneficiaries, with one exception, can still leverage the Stretch IRA rules over their lifetimes. The exception is minor children of the account owner – they can leverage the stretch rule until they reach the age of majority (typically 21) and then must empty the inherited account within 10 years of reaching the age of majority.
- Instead of stretching distributions over their lifetime, non-eligible designated beneficiaries must now empty the inherited account within 10 years of the original account holder's death. This 10-year rule applies to most non-spouse designated beneficiaries, including adult children and grandchildren.

This change is very impactful for beneficiaries in their 40s and 50s who are likely to be in their peak earning years. Thus, the required distributions from the inherited IRA, which are taxed as ordinary income, will likely be taxed at a higher rate than if the beneficiary could stretch the distributions over their lifetime.

- For non-designated beneficiaries such as estates, charities and certain trusts, the inherited funds typically need to be distributed within 5 years of the death of the original retirement account owner.
- Generally, the Secure Act conditions hold inherited Roth IRA accounts subject to the same RMD requirements as inherited traditional IRA accounts. However, qualified Roth IRA distributions are not taxed, so there is no impact to the beneficiary re: taxation.

IMPLICATIONS OF THE SECURE ACT ON RETIREMENT ACCOUNT OWNERS

- Certain types of trusts established before the Secure Act went into effect, which leveraged the Stretch Rule strategy, may now be held to a 5-year or 10-year distribution timeline. We recommend that clients with trusts established before 2020 review them with their estate attorney to ensure any impacts related to the Secure Act are understood and accounted for.
- Retirement account owners planning to bequeath these assets to their grown children, based on an expectation of leveraging the Stretch IRA, may be steering these assets to be taxed at a high federal income tax rate, as the retirement account assets will likely be distributed during the

children's peak earning years. Some retirement account owners may consider taking distributions and investing in assets that will apply for a step-up in cost basis, or perform Roth conversions of traditional IRA assets, to reduce the tax burden on their beneficiaries. This should be analyzed closely, as the current account owner will be increasing their tax burden vs. just taking their Required Minimum Distributions.

- The retirement account owner may want to re-allocate how various asset types are assigned to different types of Beneficiaries. Let us use an example to demonstrate:
 - Lucia, a 70 year-old widow, has three primary types of assets:
 1. A home worth approximately \$1M, which was originally purchased for \$500K.
 2. A traditional Rollover IRA in which her retirement savings, and the retirement savings she inherited from her late husband, are located, and
 3. A taxable brokerage account with approximately \$1M in various stock, mutual fund and ETF holdings.
 - Lucia has two children, both in their 40s with active, well-paying careers.
 - Lucia plans to bequeath 1/3 of her estate to each of her children (2/3 total) and the remaining 1/3 to a non-profit charity.
 - Scenario 1: Lucia passes away and leaves her home to one child, her IRA to the other child based on her outdated expectation that this child could leverage the Stretch IRA rule, and her taxable brokerage assets to the charity.
 1. The child inheriting the home will receive a step-up in cost basis on the house to \$1M. If they decide to sell the home immediately for its current value of \$1M, they will have NO income taxes owed on this asset.
 2. The charity inherits the brokerage account, which would be eligible for a step-up in cost basis. Since the charity does not pay income taxes, this is a moot point – the charity will retain the entire \$1M value of the assets.
 3. The child inheriting the IRA must take the distribution of 100% of the IRA assets within 10 years. Based on how the distributions are taken, this child will lose approximately 30-35% of the asset's value to income tax obligations.Thus, approximately 10-12% of the total estate value (~\$300K) is lost to income taxes and one child will likely yield a significantly smaller inheritance than the other child.
 - Scenario 2: Lucia passes away and leaves her home to one child, her taxable brokerage assets to the other child, and her IRA to the charity.
 1. The child inheriting the home will receive a step-up in cost basis on the house to \$1M. If they decide to sell the home immediately for its current value of \$1M, they will have NO income taxes owed on this asset.
 2. The other child inherits the brokerage account, which would be eligible for a step-up in cost basis. If they decide to sell these assets immediately at the current value of \$1M, they will have NO income taxes owed on these assets.
 3. The charity inheriting the IRA must take the distribution of 100% of the IRA assets within 5 years. Since the charity does not pay income taxes, the charity will retain 100% of the distribution amount.In this scenario, none of the estate's value at the time of Lucia's death is lost to income taxes.

IMPLICATIONS OF THE SECURE ACT ON RETIREMENT ACCOUNT BENEFICIARIES

- **Reduced Tax Deferral:** The 10-year rule limits the ability to defer taxes on inherited IRA assets, potentially leading to larger tax liabilities for beneficiaries.

- **Need for Planning:** Beneficiaries need to plan for the timing and amount of distributions to manage their tax obligations. See the example in [Reference #1](#) which demonstrates how the timing of distributions over the 10-year period can have significant impacts on the amount of taxes owed.
- **Consider Spacing Out Distributions:** Beneficiaries may consider spacing out distributions over the 10-year period to benefit from tax-deferred appreciation while also managing taxes. For example, if the beneficiary is currently working but plans to retire in 5 years, they may elect to take their inherited IRA distributions in years 6-10 if that leads to the IRA distributions being taxed at a lower rate.

BOTTOM LINE

Anyone planning to include retirement plan assets in their legacy plan should understand how the elimination of the Stretch IRA strategy will have an impact on their beneficiaries, and plan accordingly.

Consulting with financial, legal and tax professionals can help you understand the implications of the Secure Act's IRA inheritance rules and to develop a plan for optimizing your bequeathed retirement plan assets.

REFERENCES

The articles below were referenced in preparing this information and are excellent resources to better understand this topic.

1. <https://www.troweprice.com/personal-investing/resources/insights/how-laws-governing-inherited-iras-may-mean-changes-to-your-financial-plan.html>.
2. <https://www.fidelity.com/learning-center/personal-finance/what-is-step-up-in-basis>.
3. <https://www.investopedia.com/terms/s/stretch-ira.asp>.
4. <https://www.investopedia.com/ask/answers/09/stretch-ira.asp>.
5. <https://www.fidelity.com/learning-center/personal-finance/retirement/secure-act-inherited-iras>.
6. <https://www.tiaa.org/public/invest/services/wealth-management/perspectives/inheritinganira>.
7. <https://www.investmentnews.com/guides/everything-you-need-to-know-about-stretch-iras/248503>.
8. <https://www.fultonbank.com/Education-Center/Retirement/Charity-as-a-Beneficiary-of-Retirement-Plan>.

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