St Louis Fed's Bullard says 'the time is right' for a tapering move

The Secure Act killed the stretch IRA — here are alternatives for your inheritance

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Life insurance, taxable investment accounts and charitable trusts are just a few options

The Secure Act changed the way some family members may leave their loved ones with an inheritance.
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Individual retirement account holders may have been quite surprised — perhaps unpleasantly — when new retirement legislation killed their attempt at a tax-advantageous inheritance for their loved ones.

The Secure Act, an expansive retirement law that went into effect Jan. 1, eliminated the "stretch IRA," which allowed non-spousal beneficiaries to withdraw assets of inherited accounts over their lifetimes. Now, those who inherited an IRA since the beginning of 2020 and thereafter have 10 years to withdraw the assets — however or whenever they'd like — or face taxation of the money all at once. Spouses and disabled beneficiaries are among the exceptions to the rule.

The new restrictions pose a problem for people who have been planning to use IRAs as an inheritance vehicle, but the strategy was never one Congress intended to offer. “The Stretch IRA was a loophole,”

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Still, with the loss of this method, IRA holders may need a new plan. Keeping these accounts as an inheritance for a non-spouse is still an option, but doing so could put adult children and other beneficiaries in a predicament, especially if they are near or in their peak earning years when they come into the money. Withdrawals of inherited IRAs are taxed at the beneficiary’s ordinary income tax-rate, which means a high earner would be paying more on their newfound assets than if they received the inheritance in another form.

Edelman suggested account holders spend down their own IRAs and use other viable options for a wealth transfer. Here are a few alternatives to the stretch IRA:

Taxable investment accounts

Beneficiaries typically don’t pay capital gains on inherited investment accounts, which make them an attractive option for an inheritance, Edelman said. Inheritors would only have to pay taxes if they sell the investments after the account was transferred, according to Vanguard.

There are ways to minimize that tax bill. The cost basis is the amount the account holder paid for the investments — the “stepped-up” part of the name refers to the asset being adjusted to its fair market value at the time of the inheritance, Vanguard said. If the value of the assets were worth more at the time of the account holder’s death than when he or she initially paid for them, the inheritor can avoid or lessen their tax burden.

Get life insurance

A life insurance policy can be a major perk for individuals and their heirs. “Parents can spend all of their assets and the kids still get an inheritance,” Edelman said. In some cases — they may even get more than they would have had they inherited an IRA, said James Gambaccini, a financial adviser and managing partner at Acorn Financial Services in Reston, Va.

Traditional IRA holders can begin taking withdrawals from their accounts to buy life insurance to benefit inheritors, said Brandon Opre, a financial adviser and founder of TrustTree Financial in Huntersville, N.C. “This may allow for not only a tax-free death benefit to be passed down, but the policy could potentially build up cash values to benefit their heirs over time.”

People interested in this strategy should consider doing so when they're younger. Account owners can begin taking withdrawals from their IRAs without a penalty beginning at 59 1/2 years old, said Catherine Valega, a financial adviser at Green Bee Advisory in Waltham, Mass. If they plan to use a life insurance policy, they should speak with an estate planner to make sure this is a right step for them, and then meet with a life insurance agent, who can run a quote based on their health.

Also see: Secure Act includes one critical tax change 'that will send estate planners reeling'

Leave the IRA to a charity

Individuals planning to leave money to charities may want to consider giving those institutions their IRAs because the charities will not have to pay taxes, said David Haas, a financial adviser and owner of Cereus Financial Advisors in Franklin Lakes, N.J.

Account owners can also name a Charitable Remainder Trust as a beneficiary of an IRA, he said. Beneficiaries would get a lifetime stretch, with the remaining balance going to a designated charity, but the downside is they don't have access to the money freely, in the case of an emergency. "I recommend using an experienced estate attorney for anyone interested in this technique," Haas said.

Another option for those with charities as beneficiaries: Qualified Charitable Distributions from IRAs, for people who are 70 1/2 and older. These vehicles draw down IRA assets, and the distributions count toward required minimum distributions, which eliminates future taxable distributions, said Rob Greenman, a financial adviser and partner of Vista Capital Partners in Portland, Ore.

Roth conversions

Traditional IRAs, which are funded with pre-tax dollars, can be converted into Roth IRAs, which house after-tax contributions. From an income tax perspective, this could be an option for those looking to leave their money with an inheritance, but not a hefty tax bill.

This strategy is best for heirs who are in a tax bracket at least as high as the original account owner. "Chipping away at the future tax liability due on withdrawals at low income bracket levels over a number of years could be a favorable move," Greenman said.