

Update: Stretch IRA Eliminated

WHAT HAPPENS WHEN AN ADULT CHILD INHERITS AN IRA FROM A PARENT?

By Robert E. Whitney, Jr., CFP®

Sometimes, even the simplest, seemingly most straightforward financial transaction can be fumbled in a hurry without having the right financial know-how at your disposal.

One of the easiest financial transactions to mishandle is an inherited Individual Retirement Account (IRA), especially now that the rules have changed. At the end of 2019, the passage of the “The Setting Every Community Up for Retirement Enhancement Act” of 2019 or “SECURE ACT,” eliminated the most tax-efficient option for the majority of adult children inheriting an IRA, the “Stretch IRA”.

The long name of the Act suggests it is beneficial to American retirees. While some of the provisions are beneficial to retirees, the SECURE Act is also extremely beneficial to the government since its elimination of the Stretch IRA is estimated to raise over \$15 billion in income taxes over the next ten years.

Inherited IRAs involve the transfer of wealth from parents to spouses, siblings, charities, endowments, etc. For illustrative purposes, we are going to concentrate on one of the most common types of transfer, which is from a parent to an adult child. Prior to 2020, the Stretch IRA allowed a non-spouse beneficiary, in this case an adult child, to preserve the tax-deferred nature of the inherited IRA for their lifetime, only distributing their Required Minimum Distribution (RMD) based on their life expectancy factor. Under the SECURE Act, however, for most non-spouse beneficiaries, the entire balance must be distributed within the ten-year period following the date of death, with no requirement for any annual withdrawals throughout the 10 years.

If you are inheriting an IRA from a parent who has recently passed away, consider these rules in your approach to processing the required documentation:

RULE NO. 1 – DO NOT DO ANYTHING ABRUPTLY. BE DELIBERATE IN EVERY STEP AND CONSULT AN EXPERT.

Do not sign anything, do not cash anything, and do not transfer anything until you have talked to a qualified advisor or knowledgeable family member or friend. Advisors report that inherited IRA recipients too often cash in their IRA prematurely, losing tax benefits that could have been theirs if they had only waited a little longer to reflect carefully. The tax benefits disappear forever once you distribute cash from an inherited IRA, with the distribution amount being characterized as taxable income. While the Stretch provision is gone for the majority of adult children, it is important to distribute this inherited IRA in the most tax-efficient manner, based on your individual circumstances.

RULE NO. 2 – IF YOUR PARENT WAS PAST AGE 72, FIND OUT IF HE OR SHE MADE THE REQUIRED MINIMUM DISTRIBUTION THAT YEAR.

- If yes, great. You won't have to make one for them.
- If no, consult an advisor and withdraw the remaining RMD by December 31 of the year of your parent's passing. Note that RMDs are suspended for 2020 for everyone with IRAs, including inherited IRAs, as a result of the Coronavirus Aid, Relief and Economic Security (CARES) Act that became law in March 2020.

RULE NO. 3 – TIME YOUR DISTRIBUTION OF THE PROCEEDS TO YOUR PARTICULAR NEEDS SO YOU CAN CAPTURE MAXIMUM TAX BENEFITS OVER THE ALLOWABLE 10-YEAR DISTRIBUTION WINDOW AND AVOID PENALTIES.

- When you withdraw the money from the Inherited IRA in the 10-year window is largely determined by when you need the proceeds.
- Plan for any big ticket expenses such as a car purchase, a home improvement, a wedding, or college tuition within your 10-year withdrawal window.
- Be sure to match your investment approach with when you will need the funds, ensuring you have sufficient funds invested in more conservative investments to cover near-term expenses, and perhaps in more growth-oriented investment for expenses that might occur in year 8 or 9.
- If you envision future years when you will be in a lower tax bracket plan to take distributions in those years. For example, if you are 55 years old earning \$150,000 per year, and expect to retire at age 60, consider delaying any distributions until you are retired and in a lower income tax bracket.

This provision of the SECURE Act relating to inherited IRAs applies to non-spouse beneficiaries inheriting an IRA in 2020 or later, with few exceptions. If you inherited an IRA prior to 2020, you must continue taking your annual RMDs based on your current life expectancy factor. So, remember, if you are inheriting an IRA, take your time to evaluate your unique situation and discuss your distribution plan with your advisor to ensure you withdraw the funds in the most tax-efficient manner.

*Always consult with your CPA and professional advisor on matters involving taxes.

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Rob is a senior financial planner for Commerce Trust Company. He is a member of the financial advisory services team—a dedicated financial planning practice within Commerce Trust that provides objective financial advice to clients. Following a thorough assessment of a client’s unique situation and thoughts regarding wealth, Rob develops holistic and coordinated plans to help clients meet their short-term and long-term goals as well as take full advantage of various planning, tax, and investment strategies along the way. With more than 16 years of experience, he specializes in building relationships with clients and providing comprehensive financial planning services to business owners and individual investors to help them achieve their goals. Rob holds the CERTIFIED FINANCIAL PLANNER™ designation. He received his bachelor of administration degree in business finance from Loyola University in Maryland and his master of business administration degree from the University of Delaware. Rob serves on the Allocation Panel for the United Way of Greater St. Louis. Additionally, he is an Eagle Scout.



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