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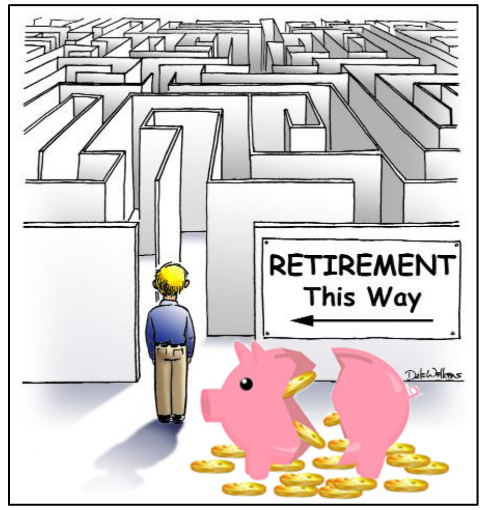
Fixing what the SECURE Act broke

Navigating the Retirement Maze



"The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing."

- *Jean-Baptiste Colbert, French statesman, minister (1619 – 1683)*

In December 2019, Congress passed the Setting Every Community Up for Retirement Enhancement (SECURE) Act to help people improve their financial preparedness for retirement. It includes provisions that make it easier for small businesses to set up retirement plans, allow part-time workers to contribute to 401(k) accounts, and permit annuities as 401(k) plan options. It also increased the age for starting Required Minimum Distributions (RMDs) to 72 and permits IRA contributions at any age.

However, to pay for these new benefits, the law tightened up on other aspects of the tax code. Most importantly, it eliminated the "stretch" Inherited IRA for most recipients of inherited retirement accounts. This threw a proverbial wrench in how people planned to bequeath assets, as the new 10-year rule can have significant tax consequences for heirs who are in their peak earning years. It also did serious damage to IRA trusts, which are trusts that hold Inherited IRAs where the assets can be allocated out to beneficiaries per the terms of the trust.

Fear not, there are ways that IRA assets can be passed on to heirs without dire tax consequences. It does take some planning, the earlier the better. I'll discuss several workarounds that can achieve similar estate results to replace the now-defunct "stretch" IRA.

Sayonara to "Stretch IRAs"

Before the signing of The SECURE Act, if IRA beneficiaries were properly specified and the asset transfer was done correctly, the result was an Inherited IRA. Although recipients needed to start taking out annual RMDs the year after the death of the donor, in most cases withdrawals were based on the new owner's life expectancy and could be "stretched" out over many years. Thus, a 33-year-old owner of an Inherited IRA only had to withdraw about 2 percent of the IRA the first year, allowing the balance to grow tax-deferred.

The SECURE Act changed that. Except for a subset of Inherited IRA recipients – surviving spouses, minor children (while they remain minors), disabled individuals under a strict IRS definition, chronically ill individuals, and persons not more than ten years younger than the IRA owner – IRA beneficiaries must now remove all assets from them within ten years.

This can have significant tax consequences for beneficiaries in their peak earning years. For example, a 53-year-old daughter who has an annual income of $170,000 and is single inherits her father's $600,000 IRA. By the end of the tenth year after her father's death, she must empty the entire IRA or face a penalty of 50 percent of funds left in it. If she waits until the tenth year to empty it and the $600,000 has grown to $900,000, she will have an enormous tax bill, most of which will be taxed at the top marginal tax rate of 39.6 percent (once the TCJA of 2017 "sunsets" at the end of 2025). Even if she spreads out the withdrawals evenly over ten years, the additional income will fall into the 32 and 35 percent marginal tax brackets, losing about a third of her inheritance to taxes.

Blowing up IRA trusts

The SECURE Act has also damaged IRA trusts. These are typically set up because the IRA owner wants to have some post-mortem control over how the assets are distributed to beneficiaries. Previously, the "stretch" Inherited IRAs held within the trust would pay out annual RMDs based on the life expectancy of the oldest trust beneficiary. These were often "conduit trusts" where the annual RMD would be paid out from the trust to the beneficiaries once withdrawn.

The problem with a trust holding an IRA with a 10-year time limit is the high tax rate on trusts. In 2021, trust income over $13,050 is taxed at 37 percent, currently the highest marginal tax rate. For example, an Inherited IRA with assets of $700,000 put into a trust, assuming no growth in the assets and one-tenth of the assets withdrawn each year for ten years, will end up taxed at an average rate of 35 percent. It doesn't matter what the marginal tax rates are for the individual beneficiaries. They're going to take a one-third tax haircut on their IRA inheritance regardless.

End runs around the SECURE Act

With planning and execution, it is possible to structure your assets and estate to overcome the restrictions imposed by the SECURE Act. Here are two strategies to accomplish this.

- **Roth Conversions –** A Roth Conversion is a relatively straightforward process: move funds from a tax-deferred IRA account to a tax-free Roth IRA account, and pay tax on the amount moved. Think of it as prepaying the taxes that you or your heirs are going to eventually owe someday, but on a schedule where you can determine when and at which marginal tax rate you pay. The "sweet spot" for Roth Conversions is between the time you retire and age 72, when your income and marginal tax rate are lower. Roth IRAs have no RMDs, so the more you convert, the lower your subsequent RMDs and thus taxes. Inherited Roth IRAs are still subject to the 10-year rule for most heirs, but as there is no tax due when funds are withdrawn, it eliminates tax problems when held in trusts and directly received.
- **Life insurance –** We're talking about permanent, cash-value life insurance policies here. The tax exemption for life insurance is possibly the single biggest benefit in the tax code. So use it to your advantage. Make IRA withdrawals to pay the premiums on a whole life insurance policy that creates a tax-free legacy for your heirs or your spouse. Get it when you are young – 60s and 70s – and healthy, and as you reduce your IRA tax liabilities, you are growing the cash value of your life insurance policy that can also be used to provide tax-free income for you. When you die, the proceeds of the life insurance go to your heirs tax-free and can be used to pay off any estate taxes due, thus preserving the rest of the estate.

There is much more to learn about using these two approaches to fix SECURE Act issues that is beyond the scope of a short article. However, just knowing that these two techniques are available can help make the difference between a retirement and legacy where you further add to the government's coffers versus enriching your lifestyle and that of your heirs.

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