The Secure Act: Proposed Federal Legislation May Affect Your Retirement Account

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For several years now, there have been rumblings that Congress may enact legislation that would affect, by the estimates of some financial news outlets, the over four trillion dollars held in Individual Retirement Accounts ("IRAs"). That appears to be one step closer to reality with the House of Representatives passing of The Setting Every Community Up for Retirement Enhancement Act ("SECURE Act") in May 2019 by a vote of 417 – 3. The SECURE Act would be the first real major retirement legislation since the Pension Protection Act in 2006. The SECURE Act is not yet finalized. The Senate has a similar bill before it called the Retirement Enhancement Securities Act ("RESA"). It is expected that some of RESA's provisions may make their way into the SECURE Act, or parts of the SECURE Act may be modified through committee or other Congressional action before being signed into law. Despite neither the SECURE Act nor RESA being finalized, the framework for retirement account reform appears to be gaining momentum and is likely to become law in the near future. This article sets forth some of the highlights of the SECURE Act and how, if it passes both the House of Representatives and the Senate, it will affect IRAs and other similar retirement accounts.

The Removal of IRA "Stretch" Distribution Rules on Inherited IRAs

The removal of IRA stretch distribution rules on inherited IRAs is probably the most significant change in the SECURE Act that will affect the most Americans with IRAs if it becomes law. Presently, beneficiaries of inherited IRAs can, if they choose to do so, can spread the required minimum distributions ("RMDs") over their own life expectancies rather than the life expectancy of the account owner. As a result, beneficiaries of inherited IRAs can take smaller RMDs than the account owner and defer (i.e. "stretch") paying income tax over their generally longer life expectancies. By doing so, beneficiaries can let the principal grow tax deferred.

However, the SECURE Act would eliminate the stretch distribution rules for all IRA amounts above $400,000. It would require beneficiaries to take distributions from inherited IRAs over a 10-year period after the death of the account owner. This change would accelerate the depletion of inherited accounts for many large IRAs and generate more federal tax dollars. Proponents of the SECURE Act argue that the elimination of the stretch distribution rules makes sense from a public policy perspective because the United States Supreme Court ruled approximately five years ago that inherited IRAs are not "retirement accounts" of the beneficiary.

Therefore, beneficiaries should not be permitted the same extended tax benefit of taking distributions over their life expectancies like an IRA account owner is entitled to do. In short, proponents of the SECURE Act argue that it is “found money” for the beneficiaries. (For an example of the negative tax consequences to beneficiaries of inherited IRA under the SECURE Act, please visit this firm’s Pittsburgh Post-Gazette article entitled Elder Law: The Secure Act – an income tax increase tapping IRAs without a vote, published on July 29, 2019).

Increase in the Required Minimum Distribution Age for IRA owners

The SECURE Act would increase the age for when IRA account owners would need to begin taking RMDs from 70.5 to 72 years of age. (The Senate, under RESA would increase the age even further to 75 for IRA account owners). While these modest increases in age would help some IRA account owners defer payment of income tax for a longer period of time, it comes at the expense of IRA beneficiaries. Many IRA owners, because of the stretch distribution rules available to their beneficiaries, do not utilize their IRAs for their living expenses. Rather, they seek to leave as large of an IRA balance as possible to their beneficiaries. If this portion of the SECURE Act passes, IRA owners will receive a short-term tax benefit at the expense of losing a long-term tax benefit for their beneficiaries. Further, what is lost at a surface level analysis of the SECURE Act is that it does not take into consideration that IRA owners can currently avoid or minimize income tax on their RMDs by making them paid to qualified charities up to $100,000 a year. In other words, the increase in raising the age requirement is considered, by some, to be a tax trap.

Elimination of the Age Limitation on IRA Contributions

Under current law, IRA owners cannot contribute to a traditional IRA, but can contribute to a Roth IRA after age 70.5. The SECURE Act would eliminate this savings prohibition by repealing the age limitation for traditional IRA contributions. While this is a welcome benefit of the SECURE Act, it will cause more income tax to be incurred by beneficiaries. Essentially, Congress is incentivizing retirement savings for IRA owners so that more money can be taxed on the back end—another tax trap.

Conclusion

While the raising of the age requirement for when an owner must begin taking RMDs and the elimination of the age limitation of contributions to traditional IRAs are improvements, the increase tax liability to beneficiaries by eliminating IRA stretch distribution rules is not a commensurate offset. Congress is now back in session. It is unknown what the final version of the SECURE Act will look like or if it will pass at all. Stayed tuned.