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Elder law: The Secure Act — an income tax increase tapping IRAs without a vote

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There are many options to leverage and protect your individual retirement account, but all of that is about to change thanks to the expected passage of the Secure Act (Setting Every Community Up for Retirement Enhancement).

The bill passed in the U.S. House of Representatives in May by a vote of 417-3, and some version of it is expected to sail through the Senate in the near future.

Why is this a big deal for millions of Americans — and their children?

Under current tax law, an IRA allows an account owner to defer income taxes on all the money invested within the account. The owner only has to take required minimum distributions at age 70 1/2.

The mandatory distribution at this age is only 3.65% of the prior year's account balance and only gradually increases, year by year, such that the mandatory distribution is still less than 10% when a person reaches 90 years of age.

While IRAs have become the replacement for defined benefit plans (aka pensions) over the past several decades, a secondary benefit has emerged. The next generation, which inherits the account, can continue to "stretch" the mandatory distributions based upon the life expectancy of the account's beneficiary — usually a child, if not the surviving spouse. That means it could continue for several more decades.

If, for example, parents did not burn through the IRA during their lifetimes, the remaining funds could be given to their children someday on the same tax-deferred basis to be distributed to their children in a tax-effective manner.

Many families have relied on this notion and "maxed out" their IRA contributions even when they know they may never need their account in retirement. The goal is that their children (many of whom are becoming known as the "pensionless generation") will be able to inherit the IRA to provide a lifetime "pension."

But under the Secure Act, it is possible that any IRA that exceeds $400,000 will have to be distributed (and taxed) within 10 years of the death of the owner. A pending Senate version of this bill is based on a five-year payout.

This proposed act does not apply to spouses, only beneficiaries other than a spouse. There are different versions of the pending bill and there may be an exception for beneficiaries who are disabled. It is possible that the limit will be $400,000 in the aggregate value; or it could be $400,000 per beneficiary.

What does this mean for the beneficiary of the individual retirement account? It means that his or her income tax liability is about to drastically increase.

Let's say a 55-year-old child inherits a $1 million IRA from a parent. Under the current rules, the child could stretch out the distribution and taxation on that money for almost 30 years according to her/his life expectancy.

The first-year required mandatory distribution for that inherited $1 million inherited IRA would be approximately $33,800. Over 30 years, that's a nice pension with relatively little income tax realization per year, compared to a potential five- or 10-year payout rule, and maybe not even drastically affecting the beneficiary's overall marginal income tax rate.

Under the proposed new law, the amount over $400,000 — or $600,000 of the $1 million — would have to be paid out to the beneficiary within 10 years.

In round numbers, that could add $60,000 of taxable income to the beneficiary's income tax return annually if that individual were to take equal amounts over 10 years — not counting any growth in the principal over that time in addition to a required mandatory distribution of approximately $13,500 on a $400,000 amount.

This can drastically change the beneficiary's marginal income tax rate, and artificially inflate her/his income while a child is applying for college financial aid. Then it's all gone, save the remaining $400,000 which can be stretched over the beneficiary's actual life expectancy.

What if the IRA beneficiary disclaims so that the money skips a generation down to the grandchildren? Uh, let's not even go there when we're talking these types of numbers.

The carrot? Congress proposes to increase the required beginning date to start taking mandatory distributions from age 70 1/2 to age 72. So, that's an 18-month increase in tax deferral on the "front end" to curtail decades of tax deferral on the "back end."

This is the way Congress can vote for increasing income taxes without directly voting for an income tax increase — pretty slick.

While the final version of the bill has yet to be finalized, it would be nice for Congress to take into consideration the millions of Americans who plowed trillions of dollars into their IRAs over the past 20 years based upon the reliance that our government would allow their children to stretch tax deferred distributions over their lifetimes.

Here's an idea: why not grandfather all IRA contributions prior to the enactment of this new law so that those contributions can be identified as exempt from the $400,000 threshold? At least in that way, people could make an informed choice about how they want to save their hard-earned dollars.

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