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Will an Unapologetic Tax Hike Affect Your 401(k) or IRA Beneficiaries?

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A New Bill in Congress May Speed Up Taxes on Retirement Benefits

Bills currently pending in Congress—and likely to pass—will severely curtail the retirement benefits that retirees want to pass on to their heirs or other IRA beneficiaries. One of the few remaining tax-saving vehicles blessed by Congress to date has been an institutionally sponsored retirement plan or IRA. The ability to retain retirement income in a tax-exempt environment until paid out from a retirement plan or IRA, is an attractive accumulation vehicle for future needs.

How the Current Law Benefits 401k and IRA Beneficiaries

Under current law, all the growth within retirement funds is free of income tax while held inside the retirement fund. Therefore, taxpayers have a substantial incentive to retain retirement funds in the tax-free environment for as long as possible. Congress accommodated that incentive by permitting a slow payout over a participant's life expectancy, followed by a slow payout over the life expectancy of the IRA beneficiary. If needed, a participant or beneficiary had the discretion to make withdrawals faster and suffer an accelerated tax payment.

Congress is now considering ways to shave the benefits of this attractive retirement vehicle for beneficiaries who inherit the retirement fund. Congress wants to force out payments more quickly from a retirement fund that is payable to a beneficiary (other than a spouse) of a deceased participant and collect the income taxes faster, even though the participant spent a lifetime trying to accumulate that fund. It would be like forcing out Social Security payments to survivors more quickly, in larger amounts, then collecting the income taxes faster at higher brackets and leaving less remaining for the future welfare of beneficiaries.

The Secure Act, the RESA Act and Retirement Benefit Retention

The U.S. House of Representatives approved a bill in this 2019-2020 116th Congress called the Setting Every Community Up for Retirement Enhancement Act of 2019 ("Secure Act"). At the same time, the U.S. Senate Finance Committee approved a similar bill, called the Retirement Enhancement and Savings Act of 2019 ("RESA Act"). Both of the bills will be effective for participants who die after December 31, 2019. Among other things, both bills seek to cap the length of time retirement funds can remain in a tax-exempt environment and grow tax-free.

The Secure Act generally limits the retention to 10 years after the participant dies, and the RESA Act generally limits the retention to five years after the participant dies, with a carve out for accounts less than $400,000 in value. There are a few exceptions to this mandatory payout deadline, applicable to spouses, minor children and disabled beneficiaries who inherit the account. Most political forecasters believe that one or the other of the bills will pass, because of the overwhelming support they are receiving in both chambers of Congress.

What Does This All Mean for Your Retirement Benefits?

So what does this mean to you? For those with a profit sharing plan, 401K and Traditional IRA account, remember that 100% of any distribution is taxable, because neither the contribution, nor the earnings had previously been taxed. After the taxes are paid, the after-tax account, once removed from the tax-exempt environment, is also subject to income taxes on its future earnings.

For those with Roth IRAs and Roth 401Ks, no part of the distribution is taxable, but once removed from the tax-exempt environment, that account too is subject to income taxes on its future earnings. Effectively, the bills' impact is to accelerate the tax cost imposed on 401k and IRA beneficiaries, much like the impact of a new inheritance tax.

For a beneficiary of a deceased participant who depends on the inherited retirement funds to last a lifetime—funds that took the participant a lifetime to accumulate—Congress will be sabotaging the beneficiary's financial security.

Five Techniques to Soften the Impact

What can the taxpayer do about this if Congress passes this legislation, which looks highly likely?

In many cases, retirement funds are a critical element in a participant's estate plan. The retirement funds are already subject to estate tax, if the estate exceeds the Federal and State Estate Tax exemption amounts.

If the proposed legislation is enacted, it will be necessary to revisit an existing estate plan in order to consider one or more of the following techniques to soften the adverse impact of accelerated taxes on 401k and IRA beneficiaries:

- Target retirement fund distributions to recipients in a lower tax bracket and even out inheritances using other assets.
- Retain the ability to "spray" taxable retirement fund distributions among heirs to achieve the lowest tax costs.
- Convert Traditional IRAs to Roth IRAs while income tax brackets are historically low.
- Pay the retirement funds to a charitable remainder trust in order to pay a lifetime annuity to the beneficiary and defer tax on current gain and future earnings over a longer period.
- Buy life insurance through an irrevocable life insurance trust in order to make up the tax dollars lost with tax-free life insurance proceeds.
- Taxpayers with retirement accounts should consult with their tax/estate plan advisors.

[Editor's Note: To learn more about this and related topics, you may want to attend the following webinars: The Legal & Tax Aspect of Investing: Asset Protection, Estate Planning, and Tax Efficiency and Estate Planning & Asset Protection – 101 2019.]

About Richard A. Sugar

Richard A. Sugar organizes the legal affairs of his clients to minimize risks, maximize returns, and preserve wealth. With the benefit of more than 35 years of legal experience, Richard approaches every client engagement providing highly personal service while searching for fresh, innovative ideas to solve his clients' most pressing problems quickly. Richard is one...

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