Financial Advisory

How the Secure Act Will Affect Your Heirs if You Have 401(k) or IRA Assets

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One of my clients called me recently and asked about how the just-signed Secure Act would affect her heirs. To answer her question, I needed to do a bit a research. This work provided the inspiration for my article this month.

The Secure Act became law on December 20, 2019 and will affect taxpayers who inherit IRA accounts starting in 2020. This law seeks to encourage more taxpayers to save for retirement with 401(k) and IRA accounts. The bad news is that the law seeks to pay for itself by raising taxes for those who inherit IRAs.

TWO QUICK POINTS

For the purposes of this article, a Standard IRA will be any qualified plan that is not a Roth IRA. (a 401(k), Simple, non-Roth IRA, etc.)

Note that IRA accounts DO NOT get a stepped-up basis upon their owners' death. The IRS does plan to collect these taxes at some point in the future, and this new law helps them get what they see as "their" money faster.

THE CHANGE IN LAW

Before this law was signed, an investor who inherits a Standard IRA account had to take minimum distributions according to a formula that spread these payments out across his or her remaining lifetime. These distributions were taxed at ordinary income rates and the investor, if he did not need the income and wanted to minimize taxes, could then accomplish this goal by taking the legal minimum every year.

Under the Secure Act; most non-spouse heirs, (exceptions are made for minor children,) who inherit a 401(k) or Standard IRA MUST take all distributions from that IRA over 10 years to reduce its balance to zero. Since distributions from Standard IRAs are taxed at ordinary income rates, these taxes could be substantial.

A CASE STUDY

Let's say that an only child inherits his father's sizable 401(k) account – it is worth $5 million. We'll also assume that this 401(k) is growing at a (very conservative) 5% per year. Using my financial calculator, I see that his distributions over 10 years will average $647,522 annually. This amount alone will put this heir in the highest tax bracket with the IRS (37%). If the heir is married, that puts him in

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the 10.3% bracket for California. If this was his only income, his tax due would be $222,000 in the graduated system. (If he had any other income at all – which he surely does – his tax due would be higher.) That 35% total tax will consume almost 2 ¼ million dollars over the next 10 years.

A WAY TO ADDRESS THIS PROBLEM – THE ROTH IRA CONVERSION

A Roth IRA Conversion now may make sense for more investors. As I mentioned; everything above refers to Standard IRAs where a portion, (that in practice is between all and none), of your IRA contributions are before-tax and where your distributions are fully taxable as ordinary income. With your 401(k), the government didn't charge you tax at first; so they are going to charge you on the (hopefully) much larger amount at distribution.

A Roth IRA, on the other hand, is built up from contributions that are not tax deductible. So – you pay the tax on your income before you contribute it to the IRA. When you take your distributions – they are tax-free because you already paid taxes on them.

To convert your standard IRA to a Roth, you basically need to pay taxes on it now to avoid paying it in the future. Nobody knows what tax brackets will look like over the next 20 years, but it is hard to make a case that they'll be significantly lower. Will tax rates in California be lower in the future?

Why pay taxes now to avoid them later for your heirs? One reason is that we can minimize those taxes today by using advanced planning techniques. Your heirs may not qualify for these programs – or they may not exist anymore 10 years from now – so today could be a great time to start talking about them.

IMPORTANT – THE 5 YEAR EXCLUSION

If I were to convert my Standard IRA to a Roth IRA – I could take distributions tax-free from it: after a 5-year period. Distributions taken prior to 5 years would be subject to taxation. If an investor who converts to a Roth dies less than 5 years after the conversion his heirs would similarly be subject to taxation. One of my investors likes to joke, "at my age, I don't even buy ripe bananas." This strategy would not be ideal for him.

If you have sizable assets in qualified plans (401(k) s or IRAs) and have an estate plan, it is probably a good time to revisit that plan in light of tax changes brought by the Secure Act. If you have any questions, call my office toll-free at (877) 313-1868.

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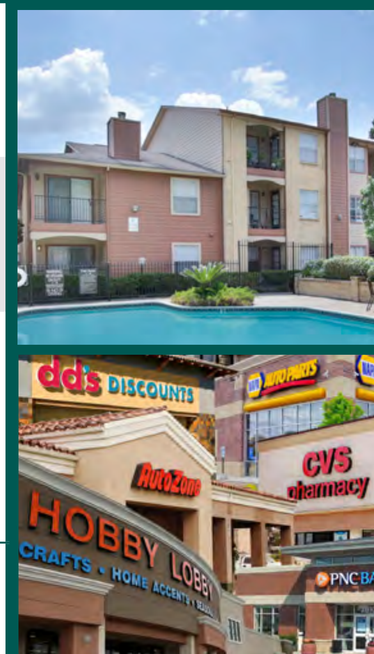

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