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Congress Is Coming for Your IRA

By Philip DeMuth

Like grave robbers opening King Tut's tomb, Congress can't wait to get its hands on America's retirement-account assets. The House passed the Setting Every Community Up for Retirement Enhancement Act, known by the acronym Secure, in May. The vote was 417-3. The Secure Act is widely expected to pass the Senate by unanimous consent. While ostensibly helping Americans save for retirement, the bill would actually reduce the value of all retirement savings plans: individual retirement accounts, 401(k)s, Roth IRAs, the works. The main problem with the Secure Act is that it eliminates the stretch IRA, the fixed star in the financial-planning firmament since 1999. The stretch IRA lets savers leave their retirement accounts to children, grandchildren or other beneficiaries. Under current rules, the recipients can parcel out the required minimum distributions from the accounts over the course of their actuarial lifetimes. Payouts tend to be relatively small for children but grow in size over the decades until the inherited IRA might comfortably provide for the child's retirement through the power of tax-deferred compounding. A parent could die with the knowledge that, whatever vicissi- tudes their children might experience in life, they won't have to worry about retirement.

Congress wants to kill this. The Secure Act gives nonspouse beneficiaries 10 years to pull out all the money in an IRA. The effect would be to make more of an IRA subject to higher taxes sooner, as distributions are made in super-size chunks. As much as one-third more of an inherited IRA would get gobbled up by taxes than under current rules. When the Tax Cuts and Jobs Act expires in 2025, taxes will rise across the board. If President Trump signs the Secure Act into law, the stage will be set for a taxpocalypse sometime in the next decade.

In exchange for its windfall under the Secure Act, Congress will push back the age at which retirees

The Secure Act would upend 20 years of retirement planning and stick it to the middle class.

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four years to avoid the financial-aid effect, they would need to double up on distributions after graduation to compensate, which would land them in a higher tax bracket. If the grandparents skip a generation and leave the IRA directly to the college-bound grandchild, the "kiddie tax" would require the distributions to be taxed at the parents' rates. Whichever way the family turns, they lose.

The Secure Act would be an estate- planning catastrophe for people with significant IRAs. It would take the sensible planning done up until now and stand it on its head. In the past, an IRA owner might have established a trust if his intended beneficiaries were young. Under the Secure Act, IRAs will no longer be subject to annual required minimum distributions, so an IRA of $1 million placed in a trust for the benefit of an 8-year-old could conceivably receive nothing for nine years. Then at year 10, by law, the IRA would have to pay out everything. Now the young beneficiary turns 18, and suddenly he gets a windfall. With a decade of additional compound growth, the original IRA could have grown to $2 million or more. All is delivered in one year, so most of it is taxed in the highest brackets. If the trust language allows the trustee to keep the money in the

must take their first required minimum IRA distributions from 70½ to 72. This isn't the deal American savers were promised when they made contributions to their IRAs the last 20 years. Before, the optimal approach was for savers to leave their IRAs to their children or grandchildren and stretch the payouts over decades.

Under the Secure Act, an IRA owner could still leave the account to a surviving spouse, who'd remain exempt from the 10year clock. But the widow would be paying taxes in the higher "filing single" bracket. The bracket can easily jump from 12% to 25% or from 24% to 35% as the mandatory payout ratios automatically increase with age. For example, the required minimum distribution for a 70-year-old is 3.7% of the retirement-account balance; for a 90-year-old it is 8.8%.

Should a $1 million IRA pass to a high-earning adult daughter, at best she would have to take payouts adding $100,000 of annual income on top of her salary for a decade. If she lives in a high-tax state, half the annual payout's value could be lost to taxes.

It gets worse. The Secure Act would be a college planning nightmare for middle-income parents. If the parents of college-age children inherit a $500,000 IRA, the resulting highly taxed mandatory distributions— say, $50,000 a year for 10 years— would make them richer on paper than they actually are, eviscerating their ability to qualify for need-based financial aid. If those parents decide to postpone taking the distributions for trust, it will be taxed at the exorbitant federal trust tax rate of 37% on income over $12,500. And don't forget state taxes.

The insurance industry loves the Secure Act's mandate that annuities be offered as a payout option in all retirement plans. Insurance companies sold more than $230 billion worth of annuities in 2018, and they would like to push that figure higher. Annuitizing retirement-plan assets is generally a bad idea unless the retiree needs all the cash for living expenses and can find a very low-cost annuity that is indexed to CPI-E—the inflation rate facing senior citizens that includes their increasingly expensive medical care. Unfortunately, such an annuity doesn't exist.

The mandatory offer of an annuity is a first step that could lead to the mandatory annuitization of all retirement accounts. This would shoehorn the distributions into higher brackets, accelerate the collection of tax revenue, and eliminate the "problem" of the inherited IRA. Best of all, politicians would get to accomplish all this without voting to raise taxes.

Ted Cruz of Texas is the Senate's main holdout against the Secure Act. His concern is that the House version dropped a niche provision that would allow tax-advantaged 529 Plans to pay for home schooling. He might be able to hold out, but it'll be a stretch.

Mr. DeMuth is author of "The Overtaxed Investor: Slash Your Tax Bill and Be a Tax Alpha Dog."