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Some retirees feeling less secure about tax rule changes in Secure Act

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Savers who spend a lifetime clipping coupons, chasing credit card points, cooking all their meals and cutting corners at every single turn typically don't stop being frugal once they quit working and they're staring at a healthy seven-figure nest egg in retirement.

"They don't change their spots," said Ed Slott, an IRA expert who has hosted a variety of retirement specials on public television.

"In fact, they tend to spend less (in retirement)."

Slott likes to joke with his audience attending retirement seminars around the country.

"I say 'Look at what you're wearing — buy new clothes,' " Slott told me by phone this week.

The retirees in the '90s sweaters, though, laugh at themselves, say they're happy and they want to avoid wasting money so that they can pass along something to the kids.

Now, some may actually need to eat out once in a while and buy some new clothes.

"Enjoy your money," Slott said. "Otherwise, the government is going to enjoy it more than you."

Two key rules regarding retirement savings are changing under the Secure Act — or the Setting Every Community Up for Retirement Enhancement. One involves an inheritance; the other how long you can delay taking money out of tax-deferred retirement savings accounts.

Neither change should cause widespread panic — after all, it's tough to completely avoid death and taxes — but baby boomers and others must carefully review the new retirement savings landscape. Some people, including super big savers, hate at least one change more than others and will need to review their estate planning strategies.

Let's look at those two big changes: The stretch IRA and the RMD, or required minimum distributions.

How has the 'stretch IRA' lost flexibility?

IRAs are less flexible as an estate planning vehicle over generations, thanks to the significant rule changes relating to a strategy known as the stretch RA. Remember, though, even after the changes, IRAs remain a reasonable way to plan for your own retirement.

When a super-thrifty saver died in the past, a beneficiary who inherited his or her IRA or 401(k) had been able to use something called a stretch IRA. With careful estate planning, the beneficiary could take the required withdrawals from those accounts over their own lifetime to limit the tax hit.

So if the beneficiary was quite young, they could be able to extend withdrawals — and taxes — over decades.

"The stretch IRA was a great planning tool to allow for inherited IRAs to be taken over life expectancy rules," said James O'Rilley, CPA and tax director for Doeren Mayhew in Troy.

Going forward, though, some beneficiaries of inherited IRAs will be forced to work with a 10-year window for making withdrawals and paying taxes, which accelerates tax revenue for the IRS, O'Rilley said.

On top of that, some beneficiaries could more likely be well established in their careers when they receive distributions so the withdrawals could be taxed at a higher income tax rate, again another way to increase tax revenue, O'Rilley said.
If you're a son or daughter in your early 50s, you could be inheriting that IRA money in your peak earning years and need to pay taxes on it within 10 years.

A family dealing with a death in 2019 or earlier would still be able to follow the old rules. As a result, many still can begin taking out small required distributions in the year after the death of a loved one to stretch out the tax hit over the beneficiary's lifetime.

But the rules change for many of those who die after Dec. 31, 2019.

It's going to be a bit tougher for many, not all, who might inherit an IRA to drag out when they're going to be forced to start paying taxes.

What's the new 10-year window?

Some exceptions exist but the new rules center around a 10-year window for designated beneficiaries to empty out that in inherited IRA or retirement plan after a death.

"The entire inherited account must be emptied by the end of the 10th year after death," Slott said. But under the new rules, there are no required minimum distributions during the 10 years for those beneficiaries.

"So you could if you're a beneficiary say 'Oh, you know what? I'm going to take it in year six because that year I just retired and I'll be in a low bracket.' You can kind of mix and match and plan your distributions. By the end of 10 years still, it has to come out and be taxed."

All the money you withdraw, of course, is taxed at your income tax rate. And the withdrawals could even push you up into a higher tax bracket.

What happens if my spouse inherits my IRA?

Some rules didn't change. "As far as the spouse is concerned," Slott said, "everything is the same."

If you're married and you're sitting on a modest 401(k), you don't want to use the new tax rules as an excuse to buy a Ferrari. You can, after all, pass your retirement savings to a surviving spouse who can manage withdrawals over his or her lifetime to limit a huge tax hit in a given year.

Beneficiaries still eligible to stretch out withdrawals over a lifetime include: Surviving spouses; minor children (but, and this is key, not your grandchildren); disabled individuals; chronically ill individuals; and someone who is not more than 10 years younger than the IRA owner (example: your brother who is two years younger than you.)

If you're leaving that money to your own minor son or daughter, Slott said, the stretch IRA rules would still apply until your child reaches the age of majority under state law or age 26 if the child remains in school.

Overall using an IRA as an estate plan soon becomes a lousy idea, Slott said.

Slott has been advocating the use of the stretch IRA for decades. His website takes consumer questions at www.irahelp.com. And he trains professionals about IRA rules.

He says people will want to think twice about how they're spending their retirement savings and how they're designating the beneficiaries. Leaving your IRA to your young grandkids is a bad idea since they no longer would be able to take minimal distributions when they're younger and let the tax-sheltered account grow tax-deferred for decades.

Remember, if you've got $200,000 or $300,000 in a 401(k) when you're 50 years old, the odds are good that you're going to spend through that money in retirement. The changes in the stretch IRA rules matter the most to people who saved a great deal and could see their retirement money outlive them.

Slott said plenty of people who have scrimped and saved are upset about the changes that Congress made.

"I think it's a broken promise by Congress," Slott said. "Remember a lot of these people did long-term planning. These rules have been in place for decades and people relied on these rules when they made their plans."

"Now in the ninth inning of the game, they get the rug pulled out from under them."

"What this SECURE Act is, if you unmask it, is a penalty on savers. They weren't Wall Street executives worth millions. The only people who have these are people who worked, these are all working people, like the 'Millionaire Next Door' type of people."

Washington wants to raise more revenue more quickly to deal with the deficit, Slott maintains, so now politicians are peddling the idea that retirement plans were designed to promote retirement savings, not serve as a way to pass along money to your grandchildren.

Industry experts say the measure was needed to make the Secure Act — which includes offering small business owners additional tax incentives for starting a retirement plan — revenue-neutral.

But Slott says such changes can drive people to distrust the future of tax laws.

"It's an old accounting expression that tax laws are written in pencil," he said.

Some other options now: Set aside more money in a Roth IRA or a Roth 401(k), which means you'd pay income taxes upfront but not pay taxes when withdrawing money in retirement. A Roth IRA would still have to be taken out within 10 years after death when left to adult children or grandchildren, but the beneficiaries would not have to pay taxes then.

"If you have more than you'll need for retirement, go with the Roth," he said.

Those who are 70 and a half and older may want to look at qualified charitable distributions from an IRA to reduce the taxable balance of the retirement account before they die. The age remains the same under the SECURE Act for these charitable distributions, but money would need to be transferred directly from an IRA to a charity.

"If they give this way, they get an exclusion from income by doing the regular charitable giving they were going to do anyway," Slott said.

What's the new 72?

Each year since 2016, another round of baby boomers has turned age 70 and a half. Not exactly a time for a big birthday celebration.

But thanks to complex rules, that birthday has triggered a time to focus on the tax bills associated with withdrawing money from 401(k) plans and IRAs.

Going forward, you're going to want to focus on when you turn age 72 — not age 70 and a half — when it comes to required minimum distributions or RMDs.

If you turned 70 and a half in 2019 or earlier, you don't get the benefit of the new delay. You're still required to take the required minimum distributions for 2019 and in future years.

Most people take more than the minimum because they need the money, Slott said, but some people will be helped because they can wait a bit longer to withdraw the money if they don't need it.

And they don't have to worry any more about trying to figure out when exactly they're turning 70 and a half. Everyone knows exactly when they turn 72; not so much for age 70 and a half.

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