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We'll probably survive the "new death tax"

Blog

Ainsley Carbone, Total Wealth Strategist Americas, UBS Financial Services Inc. (UBS FS)
Justin Waring, Investment Strategist Americas, UBS Financial Services Inc. (UBS FS)

The "stretch" feature of Inherited IRAs makes them an effective estate planning tool for many investors. However, there are currently two retirement bills being proposed by the House and Senate that call for the elimination of this popular benefit. While some commentators are calling this the "new death tax" because of its impact on estate planning, our analysis illustrates that the effect may be far less significant than it appears.

What is a "stretch IRA"?

If your spouse dies, you can roll their IRA into your own and use Required Minimum Distributions (RMDs) based on your own circumstances. But if you are a non-spousal beneficiary of an IRA—for example a grandchild of the original owner—you get to keep the tax-deferred status of the original IRA, and stretch the RMDs across your expected lifespan (see Fig. 1). This generates a larger benefit for younger beneficiaries because they are able to take smaller distributions which mean smaller tax consequences and more time to reap the benefits of tax-deferred growth.

What are the proposed changes?

While the House bill (SECURE) differs from the as-yet-unpassed Senate version (RESA), both bills call for an elimination of the stretch benefit for most stretch IRAs. The SECURE Act would mandate non-spousal beneficiaries to distribute the entire balance by the end of the 10th year following the year of the account owner's death, while RESA would mandate a 5-year distribution period for balances over USD 400,000. Each bill provides for additional exceptions for certain circumstances, such as when the beneficiary is a minor or has a disability.

What would the impact be?

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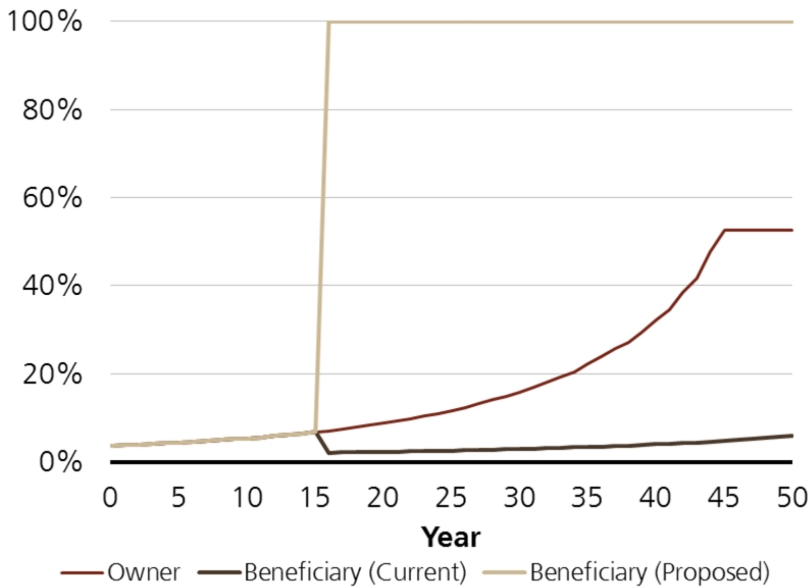
To assess the potential impact of these proposed changes, we will look at three scenarios: the owner lives and continues taking their regular RMDs; the beneficiary stretches distributions as they would under current legislation; and the beneficiary takes distributions under the proposed legislation. While both bills would allow a window where installments could be taken leading up to the distribution deadline, we'll assume a worst-case scenario where the entire IRA is distributed in the year after the owner dies. We'll also assume distributions are either spent or held in cash. Fig. 1 shows the impact of the IRA value under each scenario, assuming 6% p.a. growth of invested capital but accounting for the depletion caused by RMDs.

Figure 1 - RMDs would be much higher under the proposed law

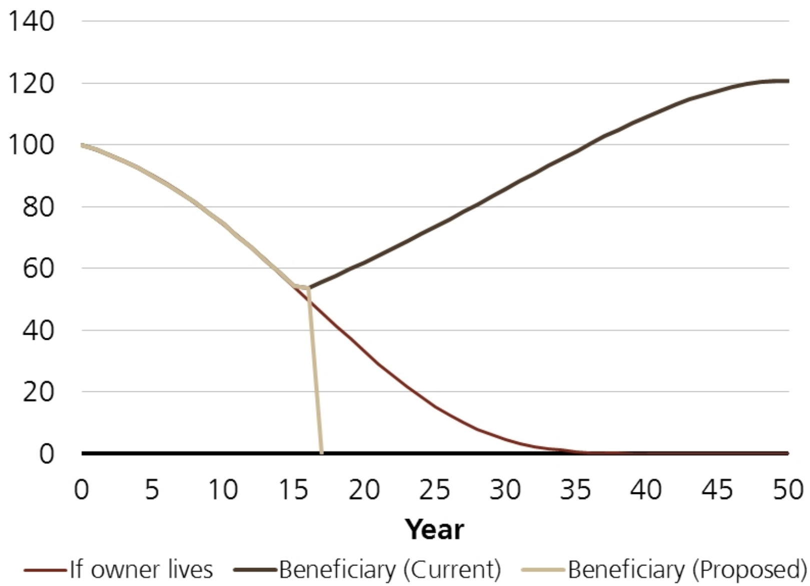
Required Minimum Distribution (RMD), % of IRA value, assuming a 70-year old owner who dies at age 85, leaving their IRA to a 35-year old beneficiary



Source: UBS

Figure 2 - Higher RMDs would deplete IRAs more quickly

IRA value, different scenarios



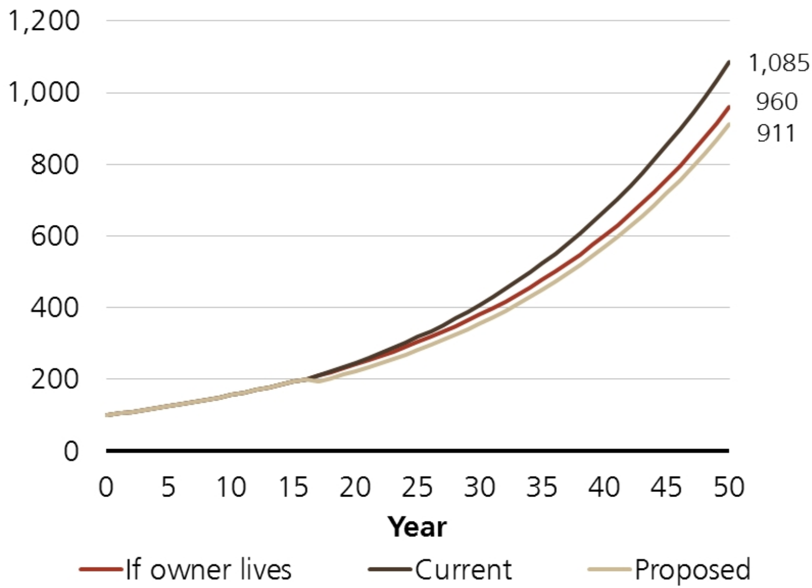
Source: UBS

As you can see, the "stretch IRA" strategy—by amplifying the assets' tax deferral and reducing their tax drag—allows the IRA capital to grow beyond what would have been possible if the account owner had lived. We're also assuming that the 35-year old beneficiary's distributions are taxed at a lower rate than the original owner, since they are likely at a lower tax bracket.

By the same token, this illustrates how the proposed changes would erode IRAs' ability to grow capital on a tax-deferred basis, thus eliminating their biggest advantage as a cross-generational savings vehicle. All things being equal, this would erode the value of some inheritances, but the actual impact might not be as disastrous as it appears. But while RMDs are forced *distributions*, they do not represent forced *spending*. In our view, it is more realistic to assume that investors would not change their investment or spending plans based on changes to their RMDs, in which case we should also consider the growth of the IRA capital after it is distributed, as illustrated in Fig. 3.

Figure 3 - The proposed law would eliminate the tax advantage of cross-generational IRAs

Total value of IRA assets, including their value post-distribution (with 4.8% p.a. growth), in USD



Source: UBS. The 4.8% return in the taxable account reflects a 6% pre-tax return with a 20% tax drag to account for capital gains, income, and dividend taxes.

In this context, the impact of the proposed changes is relatively limited. Over this 50-year period, we estimate an after-tax compound annual growth rate (CAGR) of 4.84% if the owner lived, 5.07% under the current "stretch IRA" provision, and 4.74% under the "worst-case" version of the proposed laws. It's fair to say that taking advantage of the 5- or 10-year distribution window would reduce the tax drag even further. In Part 2 of this series, once the Senate and House versions are passed and reconciled, we will address strategies that families will be able to implement to account for the new law. In the meantime, we would recommend against making any drastic changes to your legacy plans until the legislation is final.

Appendix

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