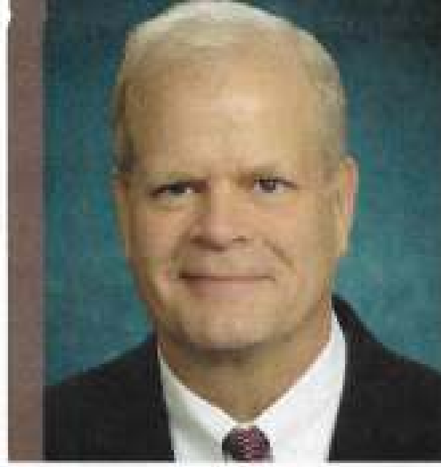
James G. Blase



Are Extended RMDs A Gold Mine Or Tax Trap?

The SECURE Act 2.0 extended required minimum distributions. For couples, it might not make sense to wait.

THE FIRST SECURE ACT EXTENDED THE BEGINNING DATE for taking required minimum distributions from the year after the account owner reaches age 70½ until they reach age 72. Just three years later, "SECURE Act 2.0" has extended this age to 73, and offers a further provision for extending it again, to age 75, beginning in 2033.

The question for financial advisors is whether these new "extensions" are a gold mine for their clients or a trap for the unwary (or at least unwary married couples).

The most important principle to consider here is the difference in the way Congress taxes couples and single individuals. The income level at which singles reach their tax bracket thresholds is half that of married people filing jointly, while the standard deduction for singles is also half as high.

Let's take, for example, a retired couple who have reached 70½ this year. They will eventually have a required minimum distribution of $89,450 from their combined $2 million-plus in IRAs. (We're using the 2023 tax brackets and standard deductions and assuming these don't change in the future). The couple also receive $27,700 in interest and dividend income during the year, which is exactly equal to the standard deduction for a married couple filing jointly. In this scenario, which is not at all unusual, the federal income tax liability of the couple, had they voluntarily withdrawn the $89,450 this year, would be $10,294 (not taking into account the taxes on their Social Security benefits).

Now let's say the couple elect not to withdraw the $89,450 during 2023. Instead, they wait until one spouse dies. The surviving spouse then withdraws that $89,450 a year after becoming widowed. Look at what happens: The survivor's federal income tax liability, on the same $89,450 amount, rises to $18,192, or almost 77% higher than what the tax liability would have been had the couple not taken advantage of the new extension rules (again, not taking into account taxes on Social Security).

Now multiply this almost $8,000 difference in federal tax liability by three years, beginning this year (or by up to five years, beginning in 2033). The point is that the surviving spouse would be subject to federal income taxes on IRA distributions at a rate that's higher than what the couple would have been subject to while both spouses were still alive. This is sometimes called the "single filer penalty."

Given the fact that some spouses survive their partner by 10 years or more, and the fact that RMD percentages increase as one gets older, the total difference in income tax liability resulting from the single filer penalty can be considerable, before state income taxes are even considered.

The question for financial advisors is whether these new "extensions" are a gold mine for their clients or a trap for the unwary (or at least unwary married couples).

What's more, as a result of "SECURE Act 1.0," the couple's children are also likely to face a higher income tax rate on what is left in their parents' IRA when both pass on. That's because the children are likely to be in their peak earning years at that point as a result of SECURE Act 1.0's requirement that survivors will generally have only 10 years max to take the entire payout after the couple passes. (This rule ended the so-called "stretch IRA" that allowed prolonged pretax growth.)

Finally, if the married couple take their IRA withdrawals earlier rather than later, they'll see a step-up in basis for all the after-tax funds they've allowed to appreciate for the rest of their lives. That completely eliminates all income tax on the appreciation. This is an important income tax benefit you don't get from IRA receipts after the death of the account owner, and it's likely something Congress had in mind when it extended

Couples can now roll early withdrawals from their IRAs into nontaxable Roths longer than they previously could have.

the beginning date for RMDs (not once but three times). Alternatively, couples can now roll early withdrawals from their IRAs into nontaxable Roths longer than they previously could have, since the required distribution date has been extended until they reach 73.

One might argue that singles, including widowed spouses, will see their IRAs grow more if they put off their distributions even longer, since the money isn't being taxed yet. But that bigger amount may push individuals or their families into a higher income tax bracket later on, and the undistributed IRA amount would then not get a step-up in income tax basis when the account holders die. Also, the undistributed IRA amount can't be rolled into a Roth IRA.

Note also that the "tax bracket strategies" outlined here can be improved if the couple takes withdrawals before they turn 70½, as long as the couple is retired at that point and not in a significant income tax bracket. It's important to remember that by taking increasing required distributions later in life, the couple will not only potentially increase their federal income tax bracket, but they will also trigger the single filer penalty on the widowed spouse.

Income taxes on Social Security benefits obviously also play a role here. For example, let's assume the couple we discussed earlier waits until age 70 to begin withdrawing Social Security benefits, and that these work out to $40,000 a year. Because the couple is also receiving $27,700 in non-IRA income each year, they have $137,150 in so-called "provisional income," which is equal to their outside income (including the IRA receipts) plus 50% of their income from Social Security ($89,450 + $27,700 + $20,000 = $137,150). With tax on Social Security benefits taken into account, we have now reduced the tax advantage of the early withdrawals we took in our previous example by approximately $5,500, or from approximately $8,000 to approximately $2,500. If the couple in our example instead had approximately $30,000 more in non-IRA income (or $57,000 total), they would have already maxed out on how much of their $40,000 annual Social Security benefits are included in taxable income, so they would not be hurt by taking IRA distributions early. Under the initially assumed $27,700 number, however, the advisor might recommend that the couple take IRA withdrawals before the age 70 deferred Social Security beginning date, and then wait until after they are age 73 to begin taking larger-than-required RMDs.

Although the circumstances will obviously vary in each instance, the point for advisors to consider in each client's case is that taking maximum advantage of the new SECURE Act 1.0 and 2.0 extensions in their clients' required minimum distribution beginning dates may not always make financial sense when the after-tax money is taken into account. FA

JAMES G. BLASE, CPA, JD, LLM, is a principal at Blase & Associates LLC. For more on the estate planning techniques described in this article, see Mr. Blase's book entitled *Estate Planning For The SECURE Act: Strategies For Minimizing Taxes on IRAs and 401Ks*, available on Amazon.