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Oppenheimer & Co. Inc. | 205 Town Center Drive, Suite 260 | Virginia Beach, VA 23462 *June Newsletter*

Eric R. Bartok, CIMA® CPFA®
Managing Director – Investments
(757) 493-5374
eric.bartok@opco.com

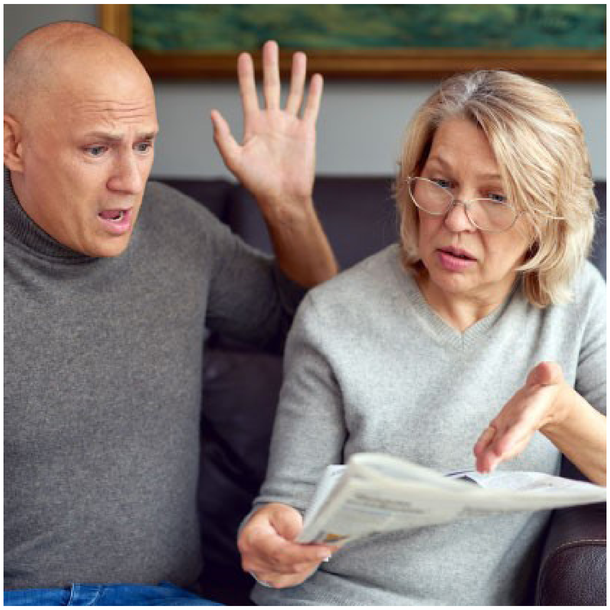
Alexandra F. Babb, CFP® CRPC™
Financial Advisor
(757) 493-5373
alexandra.babb@opco.com

Terry Hardee
Senior Director – Investments
(757) 493-5363
terry.hardee@opco.com

When wealthy people reach the distribution phase...

...their high-balance retirement accounts of $2 million and over can create some burdensome tax situations, particularly when it comes to legacy planning.

Below Are 5 Potential Pitfalls



Most people are very proud of their wealth. And why shouldn't they be? They worked their entire life to build their investment accounts and often sacrificed a great deal. However, once these same people hit the "distribution" phase, the government changes the rules on them, and these same people could essentially be punished for decades of following the rules and scrupulously saving.

The saddest part is that most people don't know what awaits them around that corner, as they have never retired before and they aren't aware of the potential pitfalls that their accumulated retirement accounts can cause.

And that's where education can save them from these "five tax gotchas."

Who is Most at Risk?

Before we hop in, let's establish the client most in danger. Those with traditional IRAs of about $2M or more today are seriously at risk. This is the starting point for the discussion below, remembering that a $2 million IRA can easily grow to a $3 million or $4 million IRA over a decade or two. And that is where the issues below really become a problem. Maybe not now, but most certainly down the road when your people are in their 80s or early 90s, and when they are trying to create a legacy for their family at the end of their life.

1. RMDs are a Burden For Life

Literally. Required minimum distributions (RMDs) start at age 72 and only increase from there. RMDs grow based on the IRA account size and they also increase as your people age. So, at age 72 the RMD may be only about 4% of the account value (let's say $2M), but that annual distribution grows to 6.25% of the account value at age 85, which could easily be $4M (assuming net growth of 5.5% per year). On a $4M account, that RMD has grown to $250,000, which now needs to be added to Social Security for two people, and your couple has racked up taxable income of over $300,000 just like that.

Even worse, there are precious few ways to avoid RMDs once they start. QCD anyone? Even if you were so inclined, they are limited to $100,000 per person. Roth conversion? Sure, but remember once the RMD and Social Security start, there is already a high taxable income which may make the Roth conversion less attractive. QLAC? Most advisors don't even know what that is, and there are many, many restrictions connected with the Qualified Longevity Annuity Contract that are unappealing to just about everyone.

The only remedy here is for people to hire an expert in distribution planning well in advance of age 70 who can position the accounts and institute the proper tax planning before it is too late. The objective is to create a lifetime wealth maximization plan along with a tax minimization plan, optimizing the client's wealth.

For example, let's say a high-income client has a $3 million traditional IRA balance and will be retiring next year (age 61). They are entering the "golden window" that starts at retirement through age 70, where income is low and larger Roth conversions can be performed to fill up the lower tax brackets (and help to start chipping away at large IRA balances). Based on the client's projected income, expenses and account values, assume Roth conversions of $100,000 each year for 10 years (age 61 through age 70).

This sounds simple enough, but the tax bill up front will be high and can be a turn-off to a client. This is where an advisor must show the long-term benefit of the Roth conversions to people, because it ends up saving about $2 million in lifetime taxes. With Roth conversions, there will be over $9 million in Roth assets and about $3.3 million in traditional IRA assets remaining at the surviving spouse's age 95 opposed to $0 in Roth assets and $6 million in traditional IRA assets at age 95 if no Roth conversions are performed. Table 1 below illustrates that overall family wealth is higher and lifetime taxes are lower with Roth conversions.

Table 1: Serial Roth Conversions Create Higher Family Wealth and Lower Lifetime Taxes

	Base case: No Roth conversions	Annual $100K Roth Conversions Ages 61–70
Beginning traditional IRA balance, Age 60	$3,000,000	$3,000,000
Roth IRA Assets (widow passes age 95)	—	$9,259,759
Traditional IRA assets (widow passes aged 95)	$6,038,710	$3,352,898
Total taxes paid (widow passes age 95)	$5,508,861	$3,662,884

2. Beware of the expiration of the Tax Cuts and Jobs Act of 2017

To make matters worse, the taxable income (generated from RMDs and everywhere else) could be taxed at an even higher tax rate once 2025 arrives, since the TCJA sunsets at the end of that year. If the TCJA is permitted to expire without any congressional action, then tax rates will be increasing across the board. In addition, the lifetime exemption for estate taxes will be cut in half, adjusted for inflation.

Neither of these changes will be good for wealthier people with large IRAs, because the highest tax bracket will increase to 39.6%. Other tax brackets will increase and will also kick in at lower amounts. For example, our hypothetical couple above with $300,000 of income is now paying taxes at the 24% marginal rate, but would be paying in the 33% tax bracket if the TCJA expires. That's a big difference.

To be clear, the expiration of the TCJA is not the only tax policy risk that wealthier people are contending with. There is serious additional tax policy risk, as income inequality is real, and so are budget deficits. Washington, D.C. is determined to politicize the income and estate tax system, with constant party wrangling and major changes along the way.

The only remedy here is to follow the tax legislation closely, and to position income and the estate for a possible repeal of the currently very favorable tax backdrop. An ounce of prevention is worth a pound of cure.

3. Beware the Widow Penalty

Many couples file as "married filing jointly," which is an advantaged status for every tax bracket except the highest one. Once one of the spouses dies, then the surviving spouse is filing as "single," which uses tax rates at roughly half of the taxable income of the married filing joint tax bracket. However, the surviving spouse will typically have about 90% of the income, as the IRAs will go to him or her. The widowed person also can step into the higher Social Security benefits, which are often the deceased spouse's (thus giving up their own lower amount, which is typically not too significant). This shift in tax rates can amount to about an extra 10% a year in a tax-rate increase for the surviving spouse.

Not only that, but the widow penalty also effects IRMAA Medicare surcharges, often causing the widowed person to pay more in IRMAA surcharges as a single than the couple did while both were alive. For reference, see the Medicare chart below. Consider income of $225,000 as a reference point, where the couple would pay $6000 in IRMAA surcharges versus $7380 for the surviving spouse. Hardly seems fair, does it?

Based on our previous example of the client with the $3 million traditional IRA balance, performing Roth conversions today would help stabilize the growth of the IRA so that when the first spouse passes, the surviving spouse will inherit a reduced IRA balance. Taking our example further, let's assume the husband passes at age 95, when the wife is age 92, and they did no tax planning. She would own a $6.7 million traditional IRA with a $625,000 RMD for her to take. These are big amounts creating big tax burdens.

Table 2 shows that if they did 10 years of Roth conversions according to the schedule outlined above, there would be a $348,000 RMD rather than a $625,000 RMD for the wife at age 92 when her husband passes. Also assuming they made serial Roth conversions, she would own a large Roth IRA of $7.5 million at the husband's passing. This strategy creates a virtuous feedback loop because a reduced traditional IRA balance means lower RMDs, lower income each year, and therefore a lower tax bill for the owners, the surviving spouse and the beneficiaries.

Table 2: Serial Roth Conversions Create Lower RMDs and a Lower Tax Bill for Widow		
	Base case: No Roth conversions	Annual $100K Roth Conversions Ages 61–70
Beginning traditional IRA balance, Age 60	$3,000,000	$3,000,000
Roth IRA Assets (husband passes first at age 95)	—	$7,553,263
Traditional IRA assets (husband passes first at age 95)	$6,753,121	$3,758,867
Estimated RMD (widow age 92)	$625,289	$348.043

4. Reconsider Leaving a Large IRA to Your Children

The government passed the SECURE Act in December 2019 to make it difficult for you to pass that large traditional IRA to your children. The SECURE Act requires the inherited IRA to be withdrawn over 10 years for most beneficiaries, often thrusting beneficiaries in their peak earning years into a higher tax bracket.

Previously, your beneficiaries could deplete that IRA over their life expectancy, allowing up to 40 years (in many instances) of tax efficient withdrawals. No more. To make matters worse, in early 2022 the IRS released proposed regulations that would require additional distributions from those beneficiary IRAs on top of the 10-year distribution rule put in place by the SECURE Act. The story continues to get worse, not better.

The remedy here is to engage in sophisticated distribution planning well before retirement. Draw down those traditional IRA accounts so the government has less to chase after as your accounts grow.

Going back to our example of the $3 million IRA client, Table 3 shows that should the surviving spouse never need to tap into the Roth IRA monies during his or her lifetime, the heirs will be left with a $9.26 million Roth IRA balance and a $3.3 million traditional IRA balance (as opposed to $0 in Roth assets and $6 million in traditional IRA assets if no Roth conversions are performed). As discussed above, heirs inheriting $6 million in tax-deferred monies would see a huge tax bill, since distributions are taxed at their ordinary income tax rate and must be fully distributed by year 10 (for most beneficiaries). With Roth IRA's, the beneficiaries are also subject to the 10-year rule, but those distributions would come out tax-free.

Table 3: Serial Roth Conversions Protect Heirs From a Huge Tax Bill		
	Base case: No Roth conversions	Annual $100K Roth Conversions Ages 61–70
Beginning traditional IRA balance, Age 60	$3,000,000	$3,000,000
Roth IRA Assets (widwo passes at age 95)	—	$9,259,759
Traditional IRA assets (widow passes at age 95)	$6,038,710	$3,352,898

5. Estate Planning is Getting Trickier and Trickier

Income taxes are not the only area of tax law that has become heavily politicized. Estate taxes are also a hot-button issue, with both parties fighting over the ability for wealthy families to pass their wealth to future generations. There have been many proposals during the years, mostly curtailing popular estate planning strategies such as GRATs, family limited partnerships and so on. In addition, the currently very generous lifetime exclusion of $12.06 million is due to expire at the end of 2025, and there have been proposals to decrease it before that time.

All of this adds up to a real threat to families who have $6 million or more in assets. There is a lot at risk. To make matters worse, while this estate planning requires years of advance planning, often this legislation is passed with very little warning—and can be retroactive if Congress so chooses.

The remedy here is for people to work with a financial professional who feels comfortable navigating this area, and who is aware of their net worth and wealth transfer goals. Tax chaos is not going away and Washington is not your friend. Again, tax planning is most effective when it is performed over a course of years. The very wealthy already know that, and now it is time for those who have accumulated wealth in the last 10 or 20 years to heed that same lesson and begin their planning.