MEMO

CONGRESSIONAL SPENDING & THE IMPACT TO SAVERS

Becky Ruby Swansburg | Stonewood Financial

In recent months, Congress has been busy debating new tax and spending packages as part of President Biden's Build Back Better agenda. The packages authorize new spending toward the expansion of health care, education, family leave, climate change initiatives, and more.

Naturally, to fund this new spending, the bills have also included a multitude of new and expanded tax proposals for individuals and corporations. Significantly, many of these tax provisions have targeted IRAs, 401(k)s, Roth accounts, and other retirement savings vehicles.

At a high level, these proposals represent a significant change in the way Washington views saving for retirement. The House Democrats stated one goal of these initiatives, is to "avoid subsidizing retirement savings" once account balances reach high levels.[1] In my opinion, Congress has shifted from incentivizing Americans to save for the future to penalizing Americans who have successfully saved.

LEGISLATIVE RISK

In my analysis, these new tax and spending provisions dramatically increase the legislative risk associated with Traditional and Roth retirement accounts. Legislative risk is the risk of Congress changing the rules, and those changes negatively impacting your retirement approach. As our elected officials pass new laws around retirement accounts, there is a risk those laws could leave savers with fewer retirement assets – and less retirement income – than planned.

Many savers want to understand the complete set of risks they may face in retirement. Unfortunately, too many Americans do not fully understand legislative risk, and how it can impact their assets.

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TAX PROVISIONS

With this in mind, let's look at some of the new retirement tax proposals from Washington.

In recent months, Congress has discussed a new Required Minimum Distribution (RMD) applicable at any age for certain savers. Essentially, any saver with combined

retirement assets of $10 million or more (Qualified and Roth) must each year withdraw from their accounts 50% of the excess above the $10 million cap. This will convert those tax-advantaged funds into annually-taxable funds. Another proposal stipulates that once a saver reaches $10 million in retirement funds, they will be prohibited from saving any additional funds in Traditional or Roth accounts – regardless of their age or career status.

Finally, Congress has discussed limiting the ability of certain savers to convert tax-deferred assets into Roth accounts. For couples filing jointly with more than $450,000 in income (or individuals with more than $400,000 in income), Roth conversions from qualified accounts would be prohibited, so that savers could not transform tax-deferred funds into tax-free funds.

ASSESSING THE IMPACT

A few important thoughts on these proposals and new bills we may see in the months ahead.

Some in the media have suggested that savers with lower retirement assets don't need to worry about the tax changes discussed in these proposals. However, this is where the talking heads don't fully understand legislative risk.

As we work to mitigate legislative risk in our retirement approaches, we must consider not just the provisions being discussed today, but how those provisions may develop, expand, and change in the future. This is especially true for Qualified and Roth accounts, where new laws can take immediate effect.

> **In these accounts, savers could find themselves accessing their retirement funds under a completely different set of rules than they were promised when saving those funds.**

Why do I feel so strongly the legislative risk of Qualified and Roth accounts has increased dramatically in today's legislative environment?

As is often the case with federal legislation, the challenge is getting a new framework passed into law. In this case, the challenge is getting the House and Senate to agree we should limit the growth and value of retirement accounts.

Less challenging, in my opinion, is the task of simply choosing the limit. In recent discussions, Congress chose a cap of $10 million in retirement assets. However, I believe that number could easily be adjusted down in the future – to $8 million, or $5 million, for example. Again, the challenge is enacting into law the framework to limit account size. After that, it's just about picking the size.

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Many experts agree Congress will need to raise additional tax revenue in the near term. Our national debt has swelled to more than $28 trillion. Democrats largely acknowledge the tax provisions in these bills fall short of raising enough revenue to cover their price tags.[2] What's more, the bills are riddled with "trick accounting" to hide their true cost. Congress has artificially lowered the price tags on these bills by phasing out some of the social welfare benefits a few years down the road. However, as we all know, once a new benefit is in place, it is politically challenging to eliminate it. President Biden has said this bill will have a zero-dollar cost,[3] indicating his commitment to raising additional tax revenue to fund this new spending.

Simply put, there's every reason to believe Washington will be searching for more tax revenue in the near term. And recent Congressional debate shows retirement accounts are a key place Congress may look.

ADDRESSING LEGISLATIVE RISK

So what does this mean for American savers?

If you want to address the complete set of risks potentially facing your retirement funds, you may want to consider strategies that mitigate tax and legislative risk.

Many savers choose to address the risk of variable taxes in retirement by incorporating tax-free strategies into their retirement approaches. As recent Congressional debate shows us, now is an important time to consider the kinds of tax-free vehicles you use for tax diversification, and assess the legislative risk these vehicles carry. Many savers have leaned heavily on Roth accounts to protect their retirement assets from rising taxes in retirement. But as we've seen with the recent tax and spending bills, Roth accounts are susceptible to legislative changes.

WHAT ABOUT OTHER TAX-FREE STRATEGIES?

One alternate strategy some savers have incorporated into their own savings approaches is the use of cash-value life insurance - specifically Indexed Universal Life (IUL) - as death benefit protection and a supplemental source of retirement income.[4] Some savers have chosen this approach to help protect a portion of their funds from legislative risk. The legislative risk of IUL and other cash-value life insurance policies was not heightened by any of the tax and spending bills. In fact, I believe this new approach to taxing retirement accounts has strengthened the value IUL may deliver.

As we've seen, Congress is looking to raise billions of dollars in new taxes from 401(k)s, IRAs, and Roth accounts. They've proposed changing multiple sections of the tax code. But which section isn't mentioned once? IRC Title 26, Sec. 7702 – the section covering life insurance.

It's worth noting that the cash value of a life insurance policy, like IUL, is not counted towards Congress's arbitrary cap on assets under this bill, whether that cap ultimately lands at $10 million, $5 million, or any other amount.

Additionally, I believe IUL is less susceptible to legislative risk than are Qualified and Roth accounts. That's because IUL policies – like all life insurance policies – are private contracts between an insurance company and a consumer.

There is a significant difference between legislative changes to accounts and legislative changes to contracts. No matter what laws were in place when you started saving in a Qualified or Roth account, Congress is able to change the rules – and those changes can take place immediately. However, the courts have repeatedly upheld a different set of rules for contracts.

Legislative changes to private contracts can only be implemented for contracts going forward – they cannot change contracts already in place.[5] This means if Congress changes the rules for IUL, it would likely only impact policies issued at later dates – and savers already owning IUL policies would experience no change. (You may remember this exact scenario unfolding in the late 1980s when TAMRA implemented the insurance industry's MEC rules.)

In this way, some savers may use IUL as a hedge against both rising taxes and legislative changes. If this is a strategy that appeals to you, please consult a qualified financial professional about your individual situation.

WHAT COMES NEXT?

The debate in Washington has uncovered areas where Congress may be looking for new tax revenue in the years ahead - and retirement assets appear to be high on that list. I see a pattern emerging in Congressional thinking, where new spending requires new taxes – and new taxes often require identifying new areas to tax.

> **One thing is clear to me: The legislative risk facing Qualified and Roth accounts is significantly higher today than at any time in recent memory. And if you aren't prepared, you may not be protected.**

Reducing legislative risk is a natural evolution of preparing for retirement. Many savers address market risk through a balanced portfolio and asset allocation, and increasingly savers have sought to address income risk through annuities. Now, as you prepare for the complete risks of retirement, you may also need to address tax and legislative risk. This would help you protect your retirement funds from the changes coming from Washington – now and in the years ahead.

BECKY RUBY SWANSBURG

Becky Ruby Swansburg is Chief Executive Officer of Stonewood Financial, a noted public speaker, and co-author of several industry-leading books including ***The New Holistic Retirement***. She has built a career in communication and policy, working in the White House under George W. Bush, and on Capitol Hill for the Speaker of the House and other Members of Congress.

1 "Responsibly Funding Our Priorities Section-by-Section," Fact Sheet, U.S. House Committee on Ways and Means, published September 15, 2021. Available online: https://waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/SubtitleISxS.pdf

2 "No, the $3.5 Trillion Spending Bill Does Not Cost $0," The Cato Institute, October 8, 2021

3 President Biden remarks to reporters, September 24, 2021. Transcript available at https://factba.se/biden/transcript/joe-biden-remarks-coronavirus-pandemic-september-24-2021

4 Life insurance policies are contracts between the client and issuing insurance carrier. Life insurance guarantees rely on the fiscal strength and claims-paying ability of the issuing insurer. Universal Life products are not bank or FDIC insured. Indexed Universal Life products are not an investment in the stock market and are subject to all policy fees and charges associated with Universal Life policies. Life insurance products contain terms, conditions and restrictions that vary by insurance company and by policy. There are suitability considerations for Indexed Universal Life products. Please refer to a specific carrier product illustration for complete information on benefits, costs, features and riders available to policy holders. The primary purpose of life insurance is to provide a death benefit. Life insurance is just one component of a person's overall financial and legacy strategy.

5 "What is a Modified Endowment Contract?", Corporate Financial Institute, accessed 10/10/21, available online https://corporatefinanceinstitute.com/resources/knowledge/other/modified-endowment-contract-mec/

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