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Inherited or "Stretch" Individual Retirement Accounts (IRAs) and Related Legislation in the 116th Congress

Background

Traditional and Roth Individual Retirement Accounts (IRAs) provide tax-advantaged ways for individuals to save for retirement. Traditional IRA contributions can be tax deductible, but withdrawals are included in taxable income. Roth IRA contributions are not tax deductible, but withdrawals are generally tax free.

Following an account owner's death, a designated spouse or beneficiary may inherit an IRA and continue to receive tax preferences by deferring taxation on IRA assets for a number of years beyond the original owner's death. This strategy is sometimes called a "stretch IRA," in which the period of asset accumulation of a retirement account is "stretched" past the lifetime of the original account owner. Some stakeholders have voiced concerns that through inheritance, stretch IRAs can be used as a tool to promote intergenerational wealth transfers rather than to encourage retirement savings as originally purposed. Provisions in several bills, including H.R. 1994, H.R. 1007, and S. 972, would modify distribution rules for inherited IRAs.

Required Minimum Distributions

Traditional IRAs are subject to required minimum distributions (RMDs), which are minimum amounts that must be withdrawn from the account annually, generally beginning when the account owner reaches a certain age. RMDs ensure that an individual uses the assets accumulated in a tax-advantaged retirement account for retirement purposes, rather than as an estate planning tool or tax shelter. To further encourage that these accounts be used primarily for retirement, IRA withdrawals before age 59½ are generally subject to a 10% penalty.

Traditional IRAs require an account holder to take RMDs at the *required beginning date*, which is April 1 following the calendar year during which an individual attains age 70½. The RMD is calculated by dividing (1) the account balance at the end of the immediately preceding calendar year by (2) the distribution period provided in the applicable Internal Revenue Service (IRS) Life Expectancy Table. The IRS publishes three RMD tables that differ based on the account owner's marital status and, in the case of inherited accounts, on the account owner's relationship with any beneficiary. For example, a 76-year-old unmarried account owner, with a distribution period of 22 years and a year-end account balance of $100,000, would have an RMD of $4,545 the following year ($100,000 divided by 22). RMDs are recalculated each year.

Traditional IRA distributions are included in taxable income except for any distribution derived from a contribution that was previously taxed. An individual who fails to take an RMD will generally incur an excise tax of 50% of the amount that was required to have been withdrawn.

Roth IRAs do not require account withdrawals during an owner's lifetime because contributions are generally made on an after-tax basis. Qualified distributions—those that occur after age 59½ from accounts that are at least five years old—are not taxable.

IRA Inheritance Rules

After an account owner's death, IRAs are passed to a person or entity designated as a beneficiary. In the absence of a designated beneficiary, the estate generally becomes the beneficiary. Rules for how to handle an inherited IRA differ for a spouse and non-spouse. A spouse beneficiary is allowed to (1) become the new account owner; (2) roll over the account to the spouse's own traditional or Roth IRA or qualified employer plan, such as a 401(k), 403(a), 403(b), or 457(b) plan; or (3) be treated as a beneficiary rather than account owner. A non-spouse beneficiary cannot take ownership of an inherited account. Instead, the account becomes an inherited IRA designated for the non-spouse beneficiary in the name of the deceased account owner.

Distributions for Inherited Traditional IRAs

A spouse beneficiary who chooses to take ownership of an inherited IRA must determine the RMD using his or her own life expectancy. A spouse who chooses to be treated as a beneficiary rather than account owner, a non-spouse beneficiary, or an estate beneficiary is subject to RMD rules that depend on whether the original account owner dies before, on, or after the required beginning date.

Traditional IRA Owner Dies Before Required Beginning Date

If an owner dies before the required beginning date, a spouse who chooses to be treated as a beneficiary and a non-spouse beneficiary have two options in taking distributions. He or she can choose either to withdraw the entire account balance by the end of the fifth year following the account owner's year of death (the *5-year rule*) or to take distributions based on the beneficiary's single life expectancy. A spouse beneficiary who is the sole beneficiary is subject to a special rule that allows him or her to postpone distributions until the original owner would have reached age 70½. The 5-year rule applies if there is no designated beneficiary or the beneficiary is an estate.

Traditional IRA Owner Dies On or After Required Beginning Date

If an owner dies on or after the required beginning date, a designated beneficiary's RMDs are calculated based on the longer life expectancy of either the original account owner or the beneficiary. For example, a 20-year-old designated beneficiary would begin taking an annual RMD in the year after the account owner's death based on the 20-year-old's life expectancy, which is 63 years in the IRS's Single Life Expectancy Table. If there is no designated beneficiary or the beneficiary is an estate, the distribution period is based on the deceased account owner's life expectancy as of the year of death. For each subsequent RMD, life expectancy is reduced by one year.

Distributions for Inherited Roth IRAs

A Roth IRA's original owner does not have to take RMDs (and therefore, has no required beginning date). Following the death of an initial account owner, a Roth IRA beneficiary must take RMDs using the same rules that apply to traditional IRAs when an account owner dies before the required beginning date.

Legislation in the 116th Congress That Would Amend Distribution Rules for Inherited Traditional and Roth IRAs

H.R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019

Section 401 of H.R. 1994, the Setting Every Community Up for Retirement Enhancement Act of 2019, or "SECURE" Act, would amend the rules governing inherited IRAs. A beneficiary would generally have to withdraw the entire account balance within 10 years of the original account owner's death, regardless of whether the account owner died before, on, or after the required beginning date. In addition, the 5-year rule would be expanded to a 10-year rule—lengthening the timeframe for situations that were previously subject to the 5-year rule.

Exceptions to the 10-year rule would apply for certain eligible beneficiaries. These include any individual who, at the date of the account owner's death, is the surviving spouse, disabled, chronically ill, 10 or fewer years younger than the account owner, or a minor child of the account owner. An eligible beneficiary would be able to take distributions based on his or her own life expectancy rather than adhere to the 10-year rule. Distributions for a beneficiary who is a minor child would be calculated based on the child's remaining life expectancy through the year that the child reaches the age of majority, after which the 10-year rule would apply.

In providing a rationale for this legislative change, H.Rept. 116-65 states that an IRA's goal is to incentivize individuals to save for expenses in retirement. Some individuals may save more than necessary to support themselves (and a surviving spouse, if applicable) during retirement, in which case the House Ways and Means Committee contends that the tax subsidy should phase down for beneficiaries of inherited IRAs.

These changes would apply to IRAs inherited from account owners who die after December 31, 2019. The Joint Committee on Taxation estimates that modifying the distribution rules would increase federal revenue by $16.4 billion from FY2020 through FY2029.

Some stakeholders support the proposed changes because they believe that current law may compound wealth inequality. Others, however, have voiced concerns that amending distribution rules would be unfair to individuals who intentionally chose to use IRAs as estate planning tools instead of other methods, as well as their would-be beneficiaries.

H.R. 1007, Retirement Enhancement and Savings Act of 2019

Section 501 of H.R. 1007, the Retirement Enhancement and Savings Act of 2019, would modify distribution rules so that following an account owner's death, any amount that exceeds $450,000 in an inherited IRA would have to be distributed within five years. This dollar amount would be excluded from the amount used to determine a beneficiary's RMD.

Exceptions would apply for certain eligible designated beneficiaries (defined similarly to those in H.R. 1994). An eligible beneficiary would take distributions over his or her own life expectancy regardless of the account's amount. A surviving spouse would not have to begin taking distributions until the date on which the original account owner would have attained age 70½. Distributions for a beneficiary who is a minor child would be calculated based on the child's remaining life expectancy through the year that the child reaches the age of majority, after which any amount that exceeds $450,000 would have to be distributed within five years.

S. 972, Retirement Enhancement and Savings Act of 2019

S. 972, the Retirement Enhancement and Savings Act of 2019, would modify distribution rules similarly to H.R. 1007, but would expedite the distribution timeframe for any amount in an inherited IRA that exceeds $400,000, rather than $450,000.

For Further Information

See the following for further information on these issues:

- Internal Revenue Service, *IRS Publication 590-B*: *Distributions from Individual Retirement Arrangements (IRAs)* (2018), at https://www.irs.gov/pub/irs-pdf/p590b.pdf.
- Joint Committee on Taxation, *Estimated Budget Effects of H.R. 1994, the "Setting Every Community Up for Retirement Enhancement "SECURE" Act of 2019, Scheduled For Consideration By the House of Representatives On May 22, 2019*, JCX-23-19.
- U.S. Congress, House Committee on Ways and Means, *Setting Every Community Up for Retirement Enhancement Act of 2019*, report to accompany H.R. 1994, 116th Cong., 1st sess., H.Rept 116-65.

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