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# Inherited or “Stretch” Individual Retirement Accounts (IRAs) and the SECURE Act

## 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.

The Setting Every Community up for Retirement Enhancement Act of 2019 (SECURE Act, enacted as Division O of the Further Consolidated Appropriations Act of 2020 [P.L. 116-94; December 20, 2019]) modified distribution rules for certain designated beneficiaries following the death of an IRA owner. Prior to the SECURE Act, some beneficiaries continued to receive tax preferences by deferring taxation on IRA assets for a number of years beyond an original owner’s death. This strategy was sometimes referred to as a *stretch IRA*, in which the period of asset accumulation of a retirement account was “stretched” past the lifetime of the original account owner. Some stakeholders voiced concerns that inherited IRAs could be used as a tool to promote intergenerational wealth transfers rather than to encourage retirement savings as originally intended. The SECURE Act modifies distribution rules for certain beneficiaries of account owners who die after December 31, 2019.

## Required Minimum Distributions

Traditional IRAs are subject to required minimum distributions (RMDs), which are minimum amounts that must be withdrawn from the account annually when the account owner reaches a certain age. RMDs are designed to 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 the age of 72 (for individuals who reach the age of 70½ after December 31, 2019; the SECURE Act increased the age at which distributions must begin from 70½ to 72). 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. Note that this example is based on IRS tables that were in place prior to the SECURE Act. The IRS has proposed updating these tables.

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who fails to take an RMD generally will incur an excise tax of 50% of the amount that was required to have been withdrawn.

Roth IRAs, in which contributions are made on an after-tax basis, do not require account withdrawals during an owner’s lifetime. Qualified distributions—those that occur after age 59½ from accounts that are at least five years old and include earnings on contributions—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 (1) a designated spouse beneficiary, (2) a designated nonspouse beneficiary, (3) an eligible designated beneficiary, and (4) a non-designated or estate beneficiary.

A Roth IRA’s original owner does not have to take an RMD (and therefore has no required beginning date). Following the death of an initial account owner, a beneficiary who inherits a Roth IRA must take an RMD using the same rules that apply to traditional IRAs as if the account owner had died before the required beginning date.

## Designated Spouse Beneficiaries

A designated 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 (in this case, see the rules for eligible designated beneficiaries below). (A nonspouse beneficiary cannot take ownership of an inherited account. Instead, the account becomes an inherited IRA designated for the nonspouse beneficiary in the name of the deceased account owner.)

A spouse who takes ownership of an inherited traditional IRA must determine the RMD using his or her own life expectancy. A spouse who takes ownership of an inherited Roth IRA does not have to take an RMD. A spouse who is

the sole beneficiary and chooses to be treated as beneficiary (rather than as owner) may postpone distributions until the original owner would have reached the age of 72. This rule applies to both traditional and Roth IRAs.

### Designated Nonspouse Beneficiaries

Under the SECURE Act, a designated nonspouse beneficiary of an account owner that dies after December 31, 2019, must distribute the entire account balance by the end of the 10<sup>th</sup> calendar year following the account owner’s year of death (the *10-year rule*), regardless of whether the original account owner dies before or after the required beginning date. Beneficiaries may choose the frequency and timing of distributions, so long as the account is depleted within the 10-year period.

### Eligible Designated Beneficiaries

The SECURE Act allowed for exceptions to the 10-year rule for an eligible designated beneficiary, including (1) a surviving spouse, (2) a child of the account owner who has not reached the age of majority, (3) an individual who is disabled, (4) a chronically ill individual, and (5) an individual who is not more than 10 years younger than the account owner. These eligible designated beneficiaries generally may take distributions over their remaining life expectancy rather than adhere to the 10-year rule. A minor child of an account owner who is a beneficiary may calculate distributions based on his or her remaining life expectancy until reaching the age of majority (18 in most states), at which point the remaining account balance must be distributed within 10 years. Beneficiaries may choose to take distributions faster than the life expectancy method (e.g., in a lump sum distribution or within five years).

### Non-designated or Estate Beneficiaries

If the account owner dies before the required beginning date and does not designate a beneficiary or designates a trust as beneficiary, the account balance must be distributed within five years (the *five-year rule*). Non-designated and estate beneficiaries of a Roth IRA must take distributions as if the account owner died before the required beginning date (i.e., within five years). If the account owner dies after the required beginning date, the account balance must be distributed at the same rate or faster than the original account owner was taking distributions (i.e., the distribution period is based on the deceased account owner’s life expectancy as of the year of death; life expectancy is reduced by one year for each subsequent RMD). The

SECURE Act did not change distribution rules for non-designated beneficiaries.

## Rationale for the Change and Revenue Estimate

In providing a rationale for modifying distribution rules for inherited IRAs, H.Rept. 116-65 (H.R. 1994) stated 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 Committee on Ways and Means contended that the tax subsidy should be phased down for certain beneficiaries of inherited IRAs.

The Joint Committee on Taxation estimated that modifying the distribution rules would increase federal revenue by \$15.7 billion from FY2020 through FY2029.

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

## 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>.
- Internal Revenue Service, “Updated Life Expectancy and Distribution Period Tables Used for Purposes of Determining Minimum Required Distributions,” 84 *Federal Register* 60812, November 8, 2019.
- Joint Committee on Taxation, *Estimated Budget Effects Of The Revenue Provisions Contained In The House Amendment To The Senate Amendment To H.R. 1865, The Further Consolidated Appropriations Act, 2020*, JCX-54R-19.

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