

Is it Time to “Retire” the Stretch IRA?

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Today’s payout rules for retirement plan death benefits don’t work. The life expectancy payout rewards a few while confounding many. Washington’s latest fix, RESA, would make things worse. But with a slight tweak Congress could create a system that would be simpler and fairer: Instead of a harsh five-year payout rule (with many exceptions) adopt a fair-to-all 21-year payout rule (and no exceptions).

INTRODUCTION

Under our current Tax Code, death benefits payable from a retirement plan or IRA¹ must be paid out over the life expectancy of the deceased participant’s “designated beneficiary.” Or rather, that is the slowest rate at which the benefits can be distributed; any more rapid distribution is also permitted. This “life expectancy of the beneficiary” payout rule creates the potential for decades of continued tax deferral after the participant’s death, depending on the age of the “designated beneficiary.”

Though it appears to create a tremendous tax shelter potential for an IRA owner’s survivors, in fact the “life expectancy of the beneficiary” payout rule (sometimes called the “stretch IRA”) is very complicated to apply. Due to these complications and other contributing causes, the holy grail of a long life-expectancy deferred payout ends up being enjoyed by relatively few beneficiaries, while the rest are slammed with lump sums or 5- or 10-year payouts.

The only worse scheme than today’s complicated and almost lottery-like system would be the hybrid life-expectancy-cum-5-year-rule Congress has cooked up in the “Retirement Enhancement and Savings Act of 2016.” “RESA” would replace the life expectancy payout rule with a 5-year payout rule for most retirement plan death benefits. The harshness of the 5-year rule would be mitigated by carving out eight exceptions—situations where the life expectancy payout system would be at least partially retained. RESA would preserve the worst features of today’s scheme (complicated rules + lottery-like application), make the system much *more* complicated, punish savings and investment success, and overburden the IRS and plan administrators—while *not* reducing the deficit, *not* helping the disabled, and *not* increasing fairness.

There’s a simpler way to cure the defects of today’s system, without these negative effects and without losing tax revenue: Repeal the life expectancy payout rule and replace it with a 21-year payout rule for all retirement plan death benefits—with no exceptions.

¹ Individual retirement account under § 408 of the Code. For brevity’s sake this article will refer to “IRAs,” but the same rules and considerations apply to all types of tax-favored retirement plans—401(k) plans, 403(b) plans, pension and profit-sharing plans, etc.

DISCUSSION

Why today's system doesn't work

Under today's law, a beneficiary who inherits an Individual Retirement Account (IRA) or other tax-favored retirement plan has the option to continue the tax-deferred status of the benefits by electing a "life expectancy payout." Code section 401(a)(9) requires the beneficiary to take annual "required minimum distributions" (RMDs) over his or her life expectancy. Except for this annual distribution, the IRA can stay in its tax-deferred state for years or even decades, depending on how old that beneficiary was when she inherited the account. A newborn beneficiary could achieve an 80-year deferred payout!²

This "life expectancy payout" system is great....for the very few people who manage to take advantage of it. That would be, the few beneficiaries who are lucky enough to inherit a retirement plan that was properly set up for them to qualify for the life expectancy payout, *and* who are young enough to have a long life expectancy to "stretch" the payments over, *and* who are knowledgeable enough and well-off enough to take advantage of it.

But what about the rest of us? As it turns out, unfortunately, most IRA beneficiaries do not benefit from the "stretch," for several reasons:

- ✓ The life expectancy payout is only available if the deceased IRA owner or plan participant named the individual as his or her "designated beneficiary." Many participants flub this step, causing their retirement benefits to pass to their estate rather than directly to their family members. Sadly, many family members who could benefit greatly from a lower tax or deferred payout don't get one, because their decedent failed to fill out his beneficiary designation form: When benefits pass to or through an estate, the life expectancy payout is not available, and beneficiaries are stuck with at best a five- or 10-year payout schedule.
- ✓ A trust named as beneficiary can qualify for the life expectancy payout under IRS rules—but only if it meets certain stringent technical requirements. Sadly, many estate planning practitioners have not mastered these requirements, so many trusts are stuck with a faster payout under today's rules.
- ✓ Happily, most retirement plan owners live a long time, meaning that by the time they die they are old—and their beneficiaries tend to be older also. It is actually quite rare for a retirement plan to be left to a *young individual* who would qualify for a multi-decade payout.
- ✓ Even when the stretch payout is an option, many beneficiaries take an immediate cashout instead, either due to financial need or because they just want to spend the money.

² See IRS Table I, IRS Publication 590-B (2016), App. A, pp. 42-43, for the distribution period applicable to a designated beneficiary based on his or her age.

Between IRA owners' living long, IRA owners' carelessness, beneficiaries' financial need or desire for immediate gratification, and other facts of human life and nature, the odds are against anyone's "winning" a long life expectancy payout.

Why replacing it with a 5-year rule is not the answer

In recent years Washington has looked at the life expectancy payout as a target for repeal. To some lawmakers it looks like a "windfall for heirs" and big revenue loser; replacing it with a 5-year rule for all (or most) death benefits would (they conclude) be more in line with the purpose of the Tax Code's retirement plan provisions, and a good way to balance the budget. This view was expressed in former President Obama's budget proposals, which would "require non-spouse beneficiaries...to take inherited distributions over no more than five years."³ Essentially, the "5-year rule" that now applies only when a participant dies before his required beginning date with no "designated beneficiary"⁴ would apply to almost all inherited benefits. This same proposal had been previously advanced by Senator Max Baucus, whose reasons for suggesting it were (similarly) to bring the law back into line with the purpose of the Tax Code's retirement provisions which is to provide for retirement, not wealth transfer, while also raising revenue and simplifying the Tax Code. RESA is the most recent incarnation of this vision.

Unfortunately, all three of those justifications are wrong. Not only do the rationales for the 5-year rule not hold up, the new proposed rules as embodied in RESA exacerbate the worst problems under today's "life expectancy" system while adding some new ones.

How the life expectancy payout got into the Code

One justification offered for switching to a universal 5-year payout rule is that our law "gives tax preferences for retirement savings accounts primarily to provide retirement security for individuals and their spouses. The preferences *were not created with the intent of providing tax preferences to the non-spouse heirs of individuals*. Because the beneficiary of an inherited account can be much younger than a plan participant or IRA owner, the current rules allowing such a beneficiary to stretch the receipt of distributions over many years permit the beneficiary to enjoy tax-favored accumulation of earnings over long periods of time." Emphasis added.

³ See the "General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals" (cited as the "Green Book") which can be found in "pdf" format at: www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf. See p. 163 of Green Book (p. 173 of "pdf" version).

⁴ See Chapter 1 of *Life and Death Planning for Retirement Benefits* for explanation of the "minimum distribution rules" applicable to retirement benefits, including explanation of the 5-year rule as it applies (to some beneficiaries) under today's rules.

It's true that the purpose of the Code's retirement plan provisions is to encourage people to save for their retirement years, but it's not true that providing a substantial benefit to the participant's heirs is inconsistent with that purpose. Building a legacy for future generations is a major motivation for people to save. Society can benefit from that urge to save for future generations, if the result is that people save adequately for their later years. Presumably in recognition of that fact of human nature, a **significant death benefit has always been a component of the Tax Code's retirement-savings provisions.**

The ancestor of today's minimum distribution rules was the "incidental death benefit rule" (IDB rule), which has decreed (since the inception of the tax-favored retirement provisions of the Code) that retirement benefits had to be distributed to the owner, upon retirement, in a form that would cause *at least half* of the benefits' value to be distributed to the owner during his/her lifetime. Not 100% of the benefit—only half! Thus a 50-percent death benefit "wealth transfer" component for heirs was considered "incidental."... and this "incidental" 50-percent-of-the-account has *always* been part of the Tax Code's retirement plan-tax savings "deal."

In fact, the life-expectancy-of-the-beneficiary payout requirement was added to the Tax Code as part of Congress's reforms in the early 1980s intended to *accelerate* the payout of death benefits. Prior to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA")⁵ there was no requirement *at all* in the Tax Code that pre-retirement death benefits ever be paid out. It was theoretically possible for beneficiaries to leave an inherited retirement plan in the plan "forever" enjoying continued tax-deferred accumulation!

TEFRA replaced "no rule at all" with a 5-year rule for everyone to be effective in 1984, but it was apparently never implemented because it was quickly replaced (as a result of Section 521(a) of the Tax Reform Act of 1984⁶) by the life expectancy payout version of § 401(a)(9) we have today, effective for 1984 and later years. Because of this sequence, the 5-year rule appears in the Code today as the "general rule" for pre-retirement death benefits, with the life-expectancy payout as the exception available to a "designated beneficiary."

If a 5-year payout is mandated for most retirement plan death benefits, many individuals will probably reduce or eliminate their retirement plan contributions. A prudent saver will not wish to place money in a format that will generate an income tax "meltdown" upon his death. Rather, the prudent saver seeks to invest in a way that will provide for himself in his future retirement years *and* leave an inheritance for his heirs. This consideration may be why Congress pulled back on a 5-year-rule-for-everybody in 1984.

⁵ P.L. 97-248. TEFRA replaced "no rule at all" with a 5-year rule, which in turn was replaced (as a result of Section 521(a) of the Tax Reform Act of 1984, P.L. 98-369) by the life expectancy payout version of § 401(a)(9) we have today.

⁶ P.L. 98-369.

Eliminating the stretch will raise little revenue

Ending the stretch payout will not raise significant revenue (except possibly by discouraging people from contributing to plans). Despite the apparent allure of the stretch IRA, very few stretchouts (in my experience) actually get implemented. Most beneficiaries want immediate cash, not a stretch payout. Even when the participant arranges his estate plan to set up a no-choice life expectancy payout for his beneficiaries, what tends to happen in most cases is that the participant lives a long time and spends the money down during his or her lifetime. A participant who dies “young,” typically leaves the benefits to a surviving spouse who rolls them over and then spends them down during his or her long widowhood. So how many stretch payouts to young beneficiaries actually get implemented? Not very many!

The world’s most complicated simplification

The third rationale for replacing the stretch payout with a 5-year rule is that the change will simplify the Tax Code. It *should* be true that a fixed-term payout system is simpler than a life-expectancy payout system. But there’s a problem: If the fixed-term chosen for the new system is *too short*, then simplification goes out the window. Why? Because you have to build in so many exceptions to a short payout period. You have to start thinking of all the cases where a rapid forced payout would be unfair or cause hardship and then try to build rules for all those cases. As Congress decided in 1984, a 5-year forced payout rule for everybody is too harsh...

And that is just what happens again in the proposed legislation currently circulating in Washington, only worse. RESA’s 5-year rule contains *eight* exceptions—eight situations where “special rules” apply, eight exceptions for which the IRS has to write new regulations, eight categories that citizens and plan administrators and advisors will have to puzzle and plan around, studying the definitions and the limitations and the rules, rules, rules. Perhaps RESA should be renamed the Estate Planner’s Full Employment Act.

There are exceptions (5-year payout does not apply) for (#1) disabled beneficiaries, (#2) chronically ill beneficiaries, (#3) the surviving spouse, and (#4) any beneficiary who is close in age to the decedent. The IRS will have to define what a “chronically ill” (though not disabled) person is...do allergies count? What happens if the disabled or chronically ill beneficiary is later cured and restored to fully abilities or health? Watch the IRS’s proposed, temporary, and final regulations rolled out over the next few years (after public hearings and comments submitted in triplicate) to find out what happens in that case.

A minor child of the IRA owner (#5) could use the life expectancy payout method—except he or she would have to switch to a 5-year payout upon reaching majority. The life expectancy payout period would also be preserved to the extent embodied in any irrevocable annuity payout initiated prior to the effective date of the new law (#6).

And (#7) the first \$450,000 of each decedent's benefits would be exempt from the 5-year rule, and would be distributed under the old (today's) rules, namely, the life expectancy payout system—assuming they qualified for that. If the decedent had more than \$450,000 of benefits, how is the \$450,000 “exemption” amount allocated among his or her various retirement accounts and multiple beneficiaries? There's another good regulatory project for the IRS! It's a good thing they don't have anything else to do.

Last but not least, here is exception #8: A beneficiary of someone who died before the effective date of the new law could continue his or her “grandfathered” life expectancy payout—but (unlike under current rules) the payout period would switch to the 5-year rule for successors to that original beneficiary once he or she dies.

By no definition does the RESA-proposed system “simplify” the payout of retirement plan death benefits. In fact the proposal complicates the payout rules substantially by *keeping* the current life-expectancy-payout system (for benefits under \$450,000, for decedents who die before it becomes law, and for disabled, chronically ill, minor, and not-too-much younger beneficiaries) and **ADDING** the new one on top of it. Maybe this is the best way to do things, but it is **NOT** simplification!

The unfair impact of the 5-year rule

For many retirement plan owners, none of the eight exceptions will be of much help. The individual who has built up a \$1-, \$2-, \$3-million or larger retirement plan nest egg, and is planning to leave it to his 45-year-old daughter who is an able adult, would be handing her a giant income tax bill along with her inheritance. There were more than 600,000 American households with IRAs worth in excess of \$1 million as of 2011.⁷

A \$1 million retirement plan paid over five years produces \$200,000 a year of taxable distributions. That will put daughter in a high tax bracket each year—regardless of how much lower Dad's income tax bracket may have been when Dad was accumulating this money.

If daughter's payout period is to be shortened from 40+ years (under the life expectancy payout method) to five years (under RESA), would it not be fairer to at least give her a lower tax bracket option? For example, give her the option to cash out the entire plan in one year at a flat 20% or 25% rate? Once upon a time our Tax Code contained an “income-averaging” provision to allow taxpayers who received a disproportionately large chunk of income in one year to average it out over several years, to offset the unfair (in those situations) effects of a highly-graduated income tax. Income averaging was removed from the Code when tax rates were lowered and flattened. But in recent years as brackets creep up, and especially if Congress is going to impose accelerated

⁷ See Report of the U.S. Government Accountability Office to the Chairman, Committee on Finance, United States Senate, on “Individual Retirement Accounts,” October 2014, www.gao.gov/products/gao-15-16.

distribution of substantial retirement plan death benefits, it would be fair to offer a one-time lower-bracket cashout option.

Why reform is needed: The life expectancy payout doesn't work

RESA may not be the answer, but there is a problem: Today's rules don't work very well for most people, and they are too complicated.

The life expectancy payout system in today's Tax Code functions like a game of musical chairs: IF at your death you happen to have young beneficiaries, and IF you correctly named them as beneficiaries of your IRA, and IF those beneficiaries want to (or are required to) take advantage of the life expectancy payout, multi-decade tax deferral is bestowed on your IRA.

But if you (as many people do) forget to fill out the beneficiary form when you open a new IRA....or if you name your estate as beneficiary because that seems simplest....or if your estate planning lawyer failed to draft your trust just right under the IRS rules....or if the beneficiaries you want to benefit are all older people....then your IRA will NOT qualify for a long life expectancy payout. The fund you built up over a lifetime of work and saving will melt down within a few years after your death—even under today's rules!

Another alternative: 21 years and no exceptions

So, I agree with RESA's sponsors that a fixed-term payout period would be preferable to the complicated and chance-y life expectancy payout system we have now. But five years is too short—as Congress decided already in 1982 when it tried a 5-year rule once before. Such a rapid payout at death *discourages savings* and *necessitates creating numerous exceptions* because of its potentially harsh impact. The exceptions, in turn, cause individuals to spend time and money consulting with professionals about how to take advantage of the exceptions. The disabled don't get the benefit of the "disability exception" *at all* unless the participant was wise enough to plan properly to take advantage of that exception.

We can get the simplification benefits of a fixed-term payout for everyone *without* the drawbacks of discouraging savings and necessitating numerous complicating exceptions—just make the fixed term longer. For example, replace the life expectancy payout rule with a mandatory 21-year fixed term payout period for all post-death benefits (keeping the spousal rollover as the sole exception). It's a long enough period (in my opinion) that it would not discourage saving money in the first place. It allows enough income-spreading so that a lifetime of gradual savings and earnings aren't forced out at an unfairly high tax bracket.

For those concerned about the "exception" categories...

Is it fair to apply a new 21-year rule to beneficiaries of people who died prior to enactment of the new rule? In my opinion, if they get a 21-year fresh start upon enactment, this should be fair

to impose “retroactively” to that extent. Remember that the alternative is to keep the life expectancy payout method, with all its rules and interpretations, alive (with IRS personnel and plan administrators having to learn it and enforce it and administer it) for as long as *80 years* after the rules are changed to the new system! (That would happen if a newborn inherits an IRA just before the effective date of the new system. She would have an 80-year life expectancy and therefore, if fully “grandfathered,” an 80-year payout.) That would be a nightmare. But if such retroactive imposition is considered unfair, how about giving the beneficiaries of any IRA owners who died before enactment a choice—either switch to the new 21-year payout now, or cash out the entire plan for a one-time tax rate of 25%?

A 21-year payout is a long enough time for minor beneficiaries to grow to majority—without the need (that would exist under RESA) for the IRS to issue regulations defining who is a “child” (do stepchildren count?), or regulate how a trust for multiple children is treated, etc. If an IRA is left to a minor child who actually wants to use a life expectancy payout—e.g., in the case of a 5-year old, withdraw only 1/77.7th of the inherited IRA the first year—then that child must not need this inherited IRA to pay for his/her living expenses, otherwise he/she would have to withdraw more. If the minors don’t need the money why are we concerned about preserving a tax-deferral benefit for them (only until they reach age 21, in RESA’s case)?

What about disabled beneficiaries? Everyone wants to help and protect the disabled. Allowing a life expectancy payout for disabled beneficiaries makes the legislator feel good, but it’s a very inefficient way to help the disabled. It does not *at all* help the disabled person whose benefactor forgot to fill out a beneficiary form—because then the 5-year rule will apply anyway. It does not help the disabled person who is so poor she needs to pull out the retirement plan money (and pay tax on it) much faster than over her life expectancy. It *does* help the wealthy disabled beneficiary who gets a bonanza deferred payout on his inherited IRA despite lack of financial need. If you want to benefit the disabled through the Tax Code, give them extra exemptions, or special lower tax rates....just don’t give them their own private set of minimum distribution rules!

CONCLUSION

It’s time to retire the life expectancy payout rule. Don’t preserve it in mangled tangled form as a bunch of exceptions to a harsh new general rule; kill it off once and for all and replace it with a simpler fairer 21-year payout rule for everyone...a rule that doesn’t punish savers or work so harshly that you have to include eight exceptions.

Under the system proposed here, the maximum payout period for death benefits would be 21 years, regardless of whether your beneficiary is newborn nephew Tommy or aged auntie Grace. Regardless of whether you forgot to fill out a beneficiary form when you opened that new IRA. Regardless of whether your beneficiary is a spendthrift trust, your estate, your mother, your grandchild, or your old Army buddy. The payout period for death benefits would become beneficiary-neutral!

About the author

Natalie B. Choate, Esq., is an estate planning lawyer with **Nutter McClennen & Fish LLP** in Boston. Her practice is limited to consulting on estate and distribution planning for retirement benefits for individuals and fiduciaries. A former ERISA lawyer, she has concentrated on the distribution rules and planning considerations for individuals' retirement benefits for over 20 years. Her book *Life and Death Planning for Retirement Benefits* is the tax professional's "bible" on estate and distribution planning for IRAs and other retirement plans. The book is available in traditional printed book form at www.ataxplan.com, or in an electronic edition via subscription at www.retirementbenefitsplanning.com. Her monthly column "Retiring with Natalie Choate" appears in www.MorningstarAdvisor.com. Her articles have been published in *Trusts & Estates*, *Leimberg's Employee Benefits Newsletter*, and *Ed Slott's IRA Advisor*. Her comments on IRAs have been quoted in the Wall Street Journal and the New York Times. Natalie has spoken at the Heckerling, Notre Dame, Southern California, and Southern Federal Tax Institutes and addressed professional audiences in all 50 states and the District of Columbia on the tax treatment of retirement savings.