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# Grandfather the Grandfather:

## Protecting the Stretch IRA and the Employees Who Have Relied on the Stretch IRA in Their Retirement Planning

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The Retirement Enhancement and Savings Act of 2018 ("RESA") includes a provision which will force the vast majority of non-spouse beneficiaries to take all IRA assets exceeding $450,000 out within five years of the owner's death. **This proposal to raise revenue by partially eliminating the "stretch IRA" is shortsighted and has the potential to harm employees who have relied on the stretch IRA for their long-term retirement planning.**

While IRAs are not the optimal vehicle for employees to save for retirement because they allow for easy withdrawals and do not provide ERISA safeguards, they play a critical role in the retirement plan system. This role is as the final receptacle for account balances of employees ("roll-over IRAs").[1]

It is logical to assume that the partial elimination of "stretch IRAs" (which allows the amount remaining in an IRA at an employee's death to be distributed over the life expectancy of the beneficiaries who inherit it),[2] will cause people to be wary of accumulating "too much" retirement money because of its ultimately negative tax treatment. Many people think retirement plans and IRAs provide significant income tax advantages, and they are correct when money is put into the plans, but **when funds are removed from the plan or IRA, the tax treatment is the worst – all of the money is subject to state and federal income and estate tax and does not receive a step-up in basis as it would outside a retirement plan or an IRA**. This was not always the case – years ago, a portion of the money received capital gains treatment and none of the funds were subject to federal estate taxes. These tax advantages were eliminated over the years. The ability to "stretch" distributions from the IRA over the beneficiary's life expectancy partially made up for this very negative tax treatment. **The SBCA is concerned that the partial elimination of the stretch IRA may cause employees to under-save for their retirement and could give rise to small and mid-sized business owners prematurely freezing contributions or closing down retirement plans.**

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[1] This is done by employees directly transferring or rolling over their account balances from retirement plans to IRAs rather than taking the funds into income.

[2] There appears to be a misconception on the part of some members of Congress and others that a stretch IRA can continue to be paid over more than one generation of beneficiaries. However, the law is clear that a stretch IRA can extend <u>only</u> over the life expectancy of the initial beneficiary designated by the IRA owner. For instance, if the first beneficiary is a child and the child were to die before receiving all the funds in the inherited IRA, the child's children (i.e., the grandchildren) would be able to continue to receive the IRA assets, but required minimum distributions would be based on their parent's (the child's) remaining life expectancy rather than on the grandchild's remaining life expectancy.

It is important to many individuals who have accumulated retirement funds that they can name their children as their beneficiaries after their spouse.[3] With the "stretch IRA," employees can save their retirement funds in an IRA not only to secure their own retirement future but knowing that, if any funds remain in the IRA after their, and often their spouses', lifetimes, they can leave the assets to their children. Even though many children will choose to withdraw the funds faster than required by law, parents know that if the children do take the funds out of the IRA over their lifetimes they will have provided the children with a safety net. If the law is changed so that it forces the children to take out a portion of the funds over just five years, this safety net is lost and the income tax treatment for the forced withdrawal is disastrous. **With every generation of employees seeming to live longer than the prior generation, the law should be structured so as to encourage employees to plan towards their futures by saving as much as possible without having to fear that over-saving in a retirement plan will result in a loss of their hard-earned money due to harsh tax treatment.**

Many small and mid-sized business owners view the retirement plans that they sponsor and the contributions made for their employees as a necessary step for their own retirement savings. **If the law disincentivizes or raises concerns for small business owners about saving too much in their own retirement plans, they will be less likely to continue to offer these plans which benefit all of their employees and will be more likely to freeze or close down the plans.** We know this is true, because this is what happened years ago when Congress enacted a 15% excise tax on "excess retirement accumulations." Accountants told their small business clients to freeze or terminate their retirement plans because they had accumulated "too much" retirement plan money and they did so. After this tax was repealed, small business plan formation and continuation of plans bounced back.

**This proposal to partially eliminate the "stretch IRA" and to force most beneficiaries to take all or a portion of the money out of the IRA within a short period of time (such as five years) after the employee's death (and his or her spouse's death, if applicable) runs counter to the essential goal of retirement security.** Further, such a change would be fundamentally unfair to the many workers who have made irrevocable financial decisions relying on the existence of the stretch IRA. For instance, older taxpayers who accumulated the funds in the belief that the law would remain as it is today, would likely not have enough time to remove the money out of the retirement plan or IRA to reinvest it in capital gains assets or in insurance products. The tax treatment of IRAs gained national attention during the presidential campaign when the media highlighted Mitt Romney's multi-million dollar IRA. Mr. Romney's IRA is extraordinary and is in no way representative of the typical roll-over IRA. Despite the existence of a few extremely large IRAs, it is probable that the majority of IRAs that have a likelihood of having enough assets to be stretched to the children are owned by small business owners. Top level management of larger companies do not rely upon qualified retirement plan contributions for their retirement security whereas as a general rule, saving in

[3] SBCA members tell us that there are many taxpayers who would have chosen not to have saved as much as they did in the retirement plan system if they had anticipated the elimination of the stretch IRA. This is especially true of individuals who converted retirement plan assets to Roth IRAs.

their own company's retirement plan is one of the primary ways, if not the only way, a small business owner can achieve retirement security.

The characterization that the elimination of the stretch IRA will be "closing a tax loophole" is inaccurate. For all traditional IRAs, the funds maintained in the IRA are inevitably taxed upon their withdrawal. Thus, the loss to the government with respect to allowing money to grow tax free inside an IRA and be distributed over the lifetime of the beneficiary is the time value of money and possibly the loss of forcing a beneficiary into a higher tax bracket.

**While proposals to eliminate the stretch IRA for retirement savings over a certain amount would be less destructive than an outright elimination of the stretch IRA, the $450,000 threshold presented in the Retirement Enhancements and Savings Act of 2018 is far too low.** In the context of retirement savings, $450,000 is a relatively small amount and well below what an average American would need to save for retirement. An individual making $50,000 per year and intending to retire at 67 would need an account balance of over $700,000 in today's dollars to retire and maintain his or her standard of living through the age of 92. An individual making $75,000 per year and intending to retire at age 67 would need an account balance of $1.2 million in today's dollars to maintain his or her standard of living through the age of 92. Such individuals would be well advised to save more than these amounts in order to prepare for the possibility of larger medical bills in old age or a longer life expectancy. Thus, such a low threshold at which the stretch IRA is eliminated would deter necessary savings just like an outright repeal.

There is another loss to the financial security of the nation which is harder to measure – retirement and investment experts have recognized for some time that money in retirement plans is not spent as readily as money outside a plan. Thus, the government, by forcing the money out of a plan or an IRA early, will reduce the financial security of the beneficiary.

There is also the matter of fairness. While a younger employee will have time to adjust to a partial or total elimination of the stretch IRA by saving less funds in a retirement plan, an older employee who has saved a great deal may not be able to use up the funds in the IRA over his or her remaining lifetime. Such an employee would be forced to choose between withdrawing the funds in the IRA as income and reinvesting them or keeping the funds in the IRA with the knowledge that they will be distributed as income to the beneficiary within a short period of time. Neither of these are desirable. **Either option would prematurely force the funds into income even though it has been well documented that employees and their beneficiaries are far more likely to exercise fiscal prudence when the monies are in a retirement vehicle as opposed to when they are in a bank account.** In other words, rather than saving this money, it will be spent, thereby resulting in the loss of another potential safety net.

Interestingly, many people who are in favor of this partial elimination of the stretch IRA say that it is good way to raise revenue because retirement plan money was never intended to help children - only the owner and spouse and thus, it is fair to force the money out shortly after the parents' passing. That may be a good argument but the question is – is it worth it for the country to take the chance that people will under save for their retirement so they can avoid

having their children face harsh tax treatment? And remember, in the small business context, not only are the small business owners likely to lose out on retirement security if the decision is made to prematurely freeze or terminate the plan but perhaps more importantly, it will be the employees of the small business who be losing valuable retirement plan contributions made by the company on their behalf. Additionally, the employees may end up losing valuable savings vehicles such as a 401(k) plan at the same time.

**This RESA proposal will cause administrative problems to IRS and to brokerage houses that sponsor the IRAs.** Establishing a blanket threshold (e.g., $450,000) for all of the IRAs owned by a decedent could be administratively difficult because it is not clear what entity (probably IRS) would be tasked with determining the total value of the IRAs at the time of the owner's passing and it is not clear how the amount that falls below the threshold will be split amongst the beneficiaries. **If a threshold is to be established, the far more workable approach would be to establish the threshold on a per beneficiary basis, so that a brokerage house would immediately be able to determine what amount of a particular beneficiary's account will be allowed to stay in the IRA and not be forced out into income.** Establishing a threshold amount per beneficiary would also eliminate the likely role of the IRS with respect to determining an owner's total amount of IRAs. If RESA were to pass with this proposal in it and IRS is the entity tasked to determine the total amount of an owner's IRAs and how the $450k (or whatever the threshold amount is) is to be spread amongst beneficiaries, then it is quite possible that one of the 5 years over which a beneficiary is likely to want to take money out of the IRA in order to spread the negative income tax consequences will be lost because of the time it would take IRS to receive the information, make the calculation and send out the necessary information to the brokerage houses and the beneficiaries.

**How should this provision be modified so as to avoid these negative consequences?**

**If the stretch IRA is to be fully or partially eliminated, the proposal should either a) grandfather current funds in plans and IRAs to receive existing tax treatment, b) not apply to those over a certain age, for instance, any individual who is age 50 or older as of the effective date of the bill, c) set the threshold at which the stretch IRA option would be eliminated at an amount that well exceeds what the majority of Americans would safely need to save for retirement (at least $1 million), indexed for inflation *and set the thresholds per beneficiary rather than for the entire amount of all IRAs,* d) allow payments to be made over the lifetimes of the children or e) allow payments to be made over a set period of time - say twenty-five years instead of a shorter period such as five years.** The first two alternatives would allow the funds in the current retirement plan system to remain in the system and provide the long-term financial security for those who saved in reliance upon the existing law. Younger employees could choose to save only the amount they were certain to spend during their lifetimes and to save the remainder in other more tax-advantaged vehicles.[4] The third option is

[4] The data is clear that most people only save in retirement plans. Thus, it is possible that people would choose to save less in a retirement plan because they would not want their beneficiaries to face such draconian taxes. Ultimately, they would simply save less because they would spend the funds outside of the retirement plan, rather

perhaps the least desirable inasmuch as it still penalizes the older individuals who chose to save during their lifetimes and are now too old to use up the funds and thus, are leaving their children with a terrible asset from a tax viewpoint. **The last two alternatives are the best since they would very likely alleviate any negative impact that the partial elimination of the stretch IRA would have on individuals saving in retirement plans**.

The Small Business Council of America (SBCA) is a national nonprofit organization that has represented the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters since 1979. The SBCA, through its members, represents well over 100,000 successful enterprises in retail, manufacturing and service industries, virtually all of which provide health insurance and retirement plans.

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than investing them in more tax-advantaged vehicles. The end result is less retirement security due to the loss of the stretch IRA.