**TAX**

# Inheriting a retirement plan? The IRS gets pushback to its stark proposal

**By Lynnley Browning June 07, 2022, 9:29 a.m. EDT5 Min Read**

*Many heirs of retirement accounts appear unaware of the IRS proposal for required annual withdrawals. Pixabay*

A proposal to require annual payouts from inherited retirement accounts is upsetting every corner of the retirement industry.

It all began last February, when the Internal Revenue Service jolted financial planners by introducing a potential rule for a recent law under which heirs must drain those accounts within 10 years. Under its proposal, the tax agency said that heirs would be required to take minimum distributions in years one through nine.

It was an about-face from the IRS's previous guidance in May 2021 that suggested the tax-deferred accounts simply had to be emptied out by year 10. That earlier advice had led many wealth advisors to assume that more money could be left in them to grow during an heir's lifetime. It also prompted some planners to tell clients they could skip taking a payout last year.

Now some heirs are facing potentially hefty tax bills and penalties. Required minimum distributions, or RMDs, are taxed at ordinary rates, now a top 37% for the highest earners. Under current law, investors who fail to take a full payout in a given year face a costly penalty equal to 50% of the unwithdrawn amount.

In recent months, ordinary Americans, accountants, lawyers, trade groups and plan sponsors and administrators filed 176 letters slamming the IRS's sudden change of position as unfair and full of gray areas. The nation's tax collector, which invited the comments as part of its rule-making process, is scheduled to hold a public hearing on the issue on June 15.

## The 10-year rule

The agency's contested proposal stems from a major law passed in 2019 that changed how tax-deferred retirement accounts are passed on to beneficiaries.

Under prior law, heirs used to be able to “stretch out” required distributions from IRAs and 401(k)s over their lifetime. That meant they could leave more money in the accounts to compound over time and pay the tax bills later.

New technology, cryptocurrency, sustainability and other trends within the financial world are on the docket at this year’s conference.

The SECURE Act of 2019 ended those “stretch” IRAs and 401(k)s by requiring heirs to empty them out by the end of the 10th year after the death of the original owner. The law applies to beneficiaries of accounts whose owner died on or after Jan. 1, 2020. Heirs who came into possession of an account earlier were grandfathered. The only exceptions to the 10-year rule: if an heir is a spouse, a minor child, disabled, ill or not more than 10 years younger than the account’s original owner. Once a minor child reaches the age of majority — which is usually 18 but can range to 21, depending on the state they live in — they fall under the 10-year rule.

Things can get tricky in other ways. If a beneficiary inherits an IRA seven years after the original owner died, perhaps because that heir was very young or the account was held in a complicated trust, then she has only three years to drain it, wrote Steven Merrell, a principal and co-founder of Monterey Private Wealth in Monterey, California.

The new law also raised the age at which savers must take RMDs from retirement plans, to 72 from 70 ½ (it stayed the latter for people born before July 1, 1949). While owners of Roth IRAs aren’t required to take minimum annual payouts, people with Roth 401(k)s are. Heirs of Roth plans are also caught by the 10-year rule.

## Say what?

Many retirement savers appear unaware of the IRS proposal’s annual payout requirement for inherited plans and assumed they could wait until year 10 to empty the accounts. The issue was made more confusing when lawmakers temporarily suspended all RMDs in 2020 under a pandemic relief bill known as the CARES Act. It resumed the requirement in 2021.

LeeAnn Buckner wrote to the nation’s tax collector on May 4 to describe how she inherited her 83-year old father’s IRA after he died of COVID in 2020. “I do not have a financial planner or tax attorney and had researched these rules on the IRS website,” she wrote in one of 155 comments the IRS published. The proposal for annual distributions “would be a major hardship for me and everyone else who isn't wealthy as I did not take a RMD in 2021 and now it is too late without a 50% penalty.” Buckner, a Colorado resident (the IRS didn’t disclose further identifying details), added that “I'm sure many beneficiaries who don't have professional tax help” are also unaware of the 10-year rule.

Many younger investors are going it alone to “buy the dip” and banking on a quick rebound, rejecting professional advice amid major market volatility.

Eleanor Speelman, who submitted three letters, wrote on April 20 that the requirement to take distributions in years one through nine, and not just drain the account in year 10, could “impose otherwise unnecessary tax advisor expense” for heirs. A Ohio resident, she cited a lack of help from Vanguard, a big manager of employer-sponsored retired plans. Vanguard says that its RMD service “doesn't accommodate accounts that are being distributed according to the 10-year rule. If you've elected, or are required, to use the 10-year rule for your inherited account, you should consult your tax advisor if you have any questions about taking distributions in accordance with this rule."

The American Bankers Association wrote that the IRS had misled IRA custodians and trustees into assuming that the 10-year rule didn't require distributions in years one through nine. "Based on that reasonable interpretation and implied support in IRS guidance, many service providers, IRA custodians and trustees sent out notifications and other materials to clients and allowed beneficiaries to forego distributions in 2021," it said in a May 25 letter.

## 'Friction'

Policy experts and lawmakers are worried about Americans' readiness for retirement, especially as people live longer. Fidelity Investments says that 55% of Americans are in danger "of not fully covering even estimated essential expenses like housing, health care, and food" after they leave the workforce.

The IRS proposal doesn't help things, according to critics. Putnam Investments wrote on May 25 that it "needlessly complicates the distribution process for heirs and their financial advisors" and "introduces 'friction' into the retirement savings process." That in turn would raise costs for record-keepers, custodians, advisors, accountants and attorneys servicing retirement assets, it said.

Ed Slott, a certified public accountant in Rockville Centre, New York, said that "the whole 10-year rule is a gray area — where'd they pick that out?" An IRS spokesman declined to comment and said he was uncertain if the June 15 hearing would be in person or virtual. It can take months to finalize a proposed regulation.

Slott added it was possible the flood of criticism would carry weight at the tax agency. "It may be," he said, "they're seeing a lot of comment letters that will change their minds."

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