BETH SHAPIRO KAUFMAN

Inherited IRAs in the Crosshairs

When Mitt Romney ran for President, his financial disclosure form reported an individual retirement account (IRA) worth between $20 million and $102 million.[1] While Gov. Romney never disclosed how his IRA grew to be that large, speculation was that he had invested his IRA in "carried interests" in the business deals of Bain & Co.

It turns out that Gov. Romney is not the only one with a supersized IRA. A newly released General Accounting Office study ("GAO Study") reveals that more than 600,000 people have IRAs with balances in excess of $1 million, and between 315 and 650 people have IRA balances in excess of $25 million.[2] The GAO Study estimates that if a person made the maximum allowable contribution to an IRA every year since 1975, and the contribution earned a return roughly equal to inflation, the account balance would be just over $300,000.

In total, some 43 million people have IRAs with assets totaling in excess of $5 trillion. The Treasury Department estimates that about $17.5 billion in net tax revenue will be lost in 2014 due to deductions for contributions to IRAs and the tax-free accumulation of income accrued in IRAs, offset by the tax collected on IRA distributions.[3]

Aside from exceptional investment returns (like Romney's), some IRA holders end up with large IRAs through inheritance, and others achieve high account balances by rolling over balances from a 401(k) account, which has higher contribution limits.

Of course, traditional IRA balances are fully subject to income tax at ordinary income tax rates when withdrawn. In addition, the balance in an IRA at the time of death is included in the account owner's taxable estate for estate tax purposes. Nevertheless, sizable retirement accounts have clearly caught the attention of Congress and the Treasury Department.

Proposal to limit deferral

Under current law, the distribution rules that apply if an account owner dies vary depending on whether the IRA owner was over age 70½ at death, whether there is a "designated beneficiary" for the account, and whether the designated beneficiary is the account owner's spouse. Permitted distribution periods range from the designated beneficiary's life expectancy to five years after the death. Roth IRAs are not subject to the minimum distribution rules while the account owner is alive, but the rules do apply after the account owner's death.

The Administration has proposed legislation to change these rules. Specifically, nearly all nonspouse beneficiaries of retirement plans and IRAs would have to take distributions over no more than five years under the proposal.[4] Narrow exceptions are provided for a beneficiary who is disabled or chronically ill, as well as a beneficiary who is not more than ten years younger than the account owner. Those beneficiaries would be able to take distributions over their own life or life expectancy. Another exception is provided for a beneficiary who is a minor child; that account would have to be fully distributed no later than five years after the child reaches the age of majority. In all of these cases, distributions would have to begin in the year following the year of the account owner's death. The distribution requirements would apply to Roth IRAs as well as traditional IRAs and other retirement accounts.

The Treasury explanation notes that the tax preferences in the Code

BETH SHAPIRO KAUFMAN, of the District of Columbia and Maryland Bars, is a partner in the Washington, D.C., office of the law firm of Caplin & Drysdale, Chartered. She is also a Fellow of the American College of Trust and Estate Counsel, and has written and lectured extensively on estate planning.

for retirement savings account were designed "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."[5]

In other words, for policy reasons, the deferral allowed to retirement accounts should be limited in most circumstances to the lifetime of the account holder and the account holder's spouse. Passing a retirement account to children, for example, does not further retirement savings and would not be entitled to tax deferral for as long a period as under current law.

Proposals similar to this have already made their way into several bills, but none have been passed. Last year a proposal to limit deferral to five years was discussed as a potential revenue raiser to offset the cost of a highway trust fund bill. Although the provision was ultimately dropped from the bill, it could well be selected by Congress as a funding source for some other measure.

Proposal to cap retirement accumulations

A separate Administration proposal would limit the total amount that could be accumulated in tax-favored retirement accounts such as IRAs, 401(k) plans, 403(b) plans, and 475(b) arrangements.[6] Present law sets a maximum amount that can be distributed from defined benefit plans and a maximum amount that can be contributed to defined contribution plans, but no aggregate maximum accumulation amount for all of an individual's plans and accounts. The proposed limitation is defined as an indexed annual annuity amount of $210,000 (in 2014) calculated over the account owner's life expectancy. As an example, the proposal notes that the maximum permitted accumulation for a person age 62 would be $3.2 million.

The limitation would be calculated at the end of each year. For an individual under the age of 62, the calculation would assume that the person would take all of his or her distributions as a joint and survivor annuity for the account owner and his or her spouse starting at age 62. For an individual over age 62, the calculation would be made as if the individual was actually age 62 (regardless of her actual age). Each year the maximum accumulation amount would be adjusted for the cost of living.

If the calculation demonstrates that the person has accumulated more than the maximum allowed amount of retirement funds, that person would not be permitted to make any further contributions or receive any additional accumulations to his or her retirement accounts. The account balances could continue to grow due to market gains and earnings. If at any point the calculated value fell below the then-maximum allowed amount, contributions would be allowed to resume. If the person made a contribution or received an accrual in excess of that allowed, the amount would be treated as current taxable income and the person would be allowed a grace period in which to withdraw it. If not withdrawn, the amount would be treated as taxable (again) when withdrawn, without regard to whether it was in a Roth account.

The Administration argues that these changes are needed because the current limitations "do not adequately limit the extent to which a taxpayer can accumulate amounts in a tax-favored arrangement through the use of multiple plans."[7] Accumulations can exceed "amounts needed to fund reasonable levels of consumption in retirement and are well beyond the level of accumulation that justifies tax-advantaged treatment of retirement savings accounts."[8] The change would "reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels, while still providing substantial tax incentives for reasonable levels of retirement saving."[9]

For those who were in practice in the 1980s and 1990s, this proposal may sound reminiscent of the excise tax on excess accumulations that was in effect from 1987 to 1996.[10] The excess accumulations tax imposed a 15% percent tax on excess distributions during life and on accumulations in retirement accounts remaining at death in excess of a threshold amount (the present value of a hypothetical life

1 Governor Romney's financial disclosure forms are available online at www.scribd.com/doc/95602925/Mitt-Romney-2012. The reason the range of values is so large is that each asset in the account has a range of values. Aggregating these ranges, $20 million represents the sum of the low values of each asset, and $102 million represents the sum of the high values of each asset.

2 GAO, Individual Retirement Accounts: Preliminary Information on IRA Balances Accumulated as of 2011, GAO-14-878T (Washington, D.C., 9/16/2014).

3 Office of Management and Budget, Fiscal Year 2015 Analytical Perspectives: Budget of the U.S. Government (Washington, D.C., 2014).

4 Department of the Treasury, General Explanations of the Administrations Fiscal Year 2015 Revenue Proposals (Washington, D.C., March 2014), at pages 179-80.

5 *Id.* at 180.

6 *Id.* at 181-83.

7 *Id.* at 182.

8 *Id.*

9 *Id.*

10 Tax Reform Act of 1986, P.L. 99-514, sections 1133 and 1134; Taxpayer Relief Act of 1997, P.L. 105-34, section 1073.

annuity for a person the age of the decedent at her date of death). The 15% excise tax applied at death, when aggregated with the already applicable top estate tax rate and highest income tax rate, could exceed 100% of the "excess" value of in the account.

In repealing the tax, Congress noted that the annual limitations on contributions and benefits were sufficient limits on tax-deferred saving.[11] The confiscatory nature of the excise tax also contributed to its repeal in 1997.

The current proposal to cap retirement fund accumulations is driven by the same concerns as the excess accumulations tax. However, the current proposal aims to eliminate the excess accumulations from forming rather than taxing them after they accumulate. It does appear however, that there is no longer any agreement that the annual contribution limitations are sufficient to prevent excessive accumulations in retirement accounts.

Roth IRAs

Clients frequently ask me whether I believe that distributions from Roth IRAs will be taxed in the future. My answer is that I do think the taxation of Roth IRAs could change, because I think the tax treatment of the Roth was never a good idea to begin with.

A bit of history is required. Roth IRAs were added to the 1997 tax act as a *revenue raiser* that was used to pay for other tax reductions, but they were available only to taxpayers who had an annual income below a stated level. In 2005 Congress enacted a change, effective in 2010, to allow taxpayers to take amounts in a traditional IRA, pay the tax on the balance, and convert the account into a Roth IRA without regard to the taxpayer's income level. This change was projected to generate an increase in income tax revenues of $9.2 billion in fiscal years 2011-2013 and an overall increase in revenue of $6.4 billion over a ten-year period.[12]

The only way a Roth IRA conversion can be viewed as a revenue raiser is through the warped view of congressional budget estimates. Those estimates take into account revenue changes over only a five-year (Senate) or ten-year (House) period. Thus, if a proposal will accelerate future tax revenue into the next five or ten years, it counts as a revenue raiser. In this case, the Joint Committee on Taxation estimated that the revenue losses would begin in fiscal year 2014, but they were greatly outweighed by the increased revenue in fiscal years 2011 to 2013.

The 2010 changes converted Roth IRAs from a modest tool not available to high-income taxpayers, to a way for the wealthy to move large sums outside the income tax system for decades. On paper this looks like it raises revenues because it takes assets in traditional IRAs that would not have been taxed until required minimum distributions triggered distributions during retirement years (or later) and it accelerates that income into the current year. This moves revenue from outside the revenue window (i.e., more than ten years from the current year) to inside the revenue window and shows up on the balance sheet as an increase in tax revenue. Never mind that the conversion to a Roth excuses from income tax all future earnings in the account!

Roth IRAs generate revenue by bankrupting one's grandchildren.[13] For that reason alone, I do not think the current tax treatment of Roths is sustainable. However, that does not mean that tax will likely be imposed on the amounts that have already been taxed. More likely the change would take the form of limitations on deferral, such as the five-year rule the Administration has proposed, so at least the tax benefits of the Roth would inure to the benefit of only the original account owner. Another possibility is that contributions to Roth accounts could be limited prospectively. A more harsh legislative change would be to tax the growth in a Roth account or to tax the growth above some inflation-adjustment amount. But in my view, the Roth IRA model is not sustainable long term and it will have to change.

More bad news for inherited IRAs

The recent Supreme Court decision in *Clark v. Rameker*[14] dealt a blow to beneficiaries of inherited IRAs. Heidi Heffron-Clark inherited a traditional IRA from her mother. The IRA was worth about $450,000 when her mother died in 2001. Heidi elected to take monthly distributions from the account. In 2010, Heidi and her husband declared bankruptcy. The inherited IRA was then worth about $300,000, and they identified the IRA as exempt from the bankruptcy estate as retirement funds.[15]

The Bankruptcy Court held that the funds in the inherited IRA were not "retirement funds" and disallowed the exemption. The district court reversed on the grounds that

11 Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997, JCS 23-97 (12/17/1997), pages 262-63, available at www.jct.gov/publications.html?func=startdown&id=1215.

12 See JCX-1806 (5/9/2006), available at www.jct.gov/x-18-06.pdf.

13 The Tax Policy Center estimated that the overall loss in revenue from Roth rollovers would be $14 billion, after adjustment for the time value of money. See Burman, "Roth Conversions as Revenue Raisers: Smoke and Mirrors," originally published in Tax Notes (5/22/2006), available at www.urban.org//UploadedPDF/1000990_Tax_Break_05-22-06.pdf.

14 573 U.S. ____, 113 AFTR2d 2014-2308 (2014).

15 11 U.S.C. sections 522(b)(3)(C) and (d)(12) (debtors allowed to protect "retirement funds to the extent those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code").

the exemption covers any account containing funds that were originally accumulated for retirement purposes. The Seventh Circuit then reversed the district court finding that "inherited IRAs represent an opportunity for current consumption, not a fund of retirement savings."

The Supreme Court noted that the Bankruptcy Code does not define the term "retirement funds," so the Court gave that term its "ordinary meaning." The Court found three characteristics of inherited IRAs that differed from regular IRAs and lead to the conclusion that inherited IRAs are not accounts "objectively set aside for the purpose of retirement." First, the person who inherits the account is prohibited from contributing to it. Second, the inheritor is required to take distributions from the account, no matter how many years away from retirement such person is. Third, the inheritor is able to take all of the money out of the account at any time, without penalty. Thus, the funds in an inherited IRA can be "freely used for current consumption" and they are not funds set aside for retirement.

Clark v. Rameker leaves a few questions unanswered. The case does not address bankruptcy protection for an IRA inherited by a spouse. The opinion, however, hints that a spouse who rolls over the decedent's IRA into an IRA of his or her own should have bankruptcy protection for that rollover IRA. On the other hand, a spouse who keeps the funds in an inherited IRA probably does not have protection for all of the reasons set forth in the opinion. Note also that the case construes only federal bankruptcy law, and a particular state bankruptcy law could possibly offer more protection for inherited IRAs.

Finally, since we now know that an inherited IRA will not be protected under federal bankruptcy law, planners should consider other means of protecting those assets. If the designated beneficiary of Mrs. Heffron's IRA had been a trust for Heidi, the terms of the trust could have been drafted to put the trust assets beyond the reach of creditors. When naming a trust as a designated beneficiary of a retirement account, however, care must be used to be sure that it will be a conduit trust or an accumulation trust that qualifies to use the beneficiary's life expectancy for calculating the minimum required distributions.

Conclusion

Treasury and the Supreme Court both view inherited IRAs as non-retirement vehicles that should not be entitled to all of the favorable treatment afforded to a retirement account. It would not be surprising if Congress were to enact legislation cutting back on the deferral of tax on inherited IRAs or limiting the overall amounts that individuals can stash away for retirement. Even without any legislative changes, if creditor protection for beneficiaries is a concern in estate planning, the inherited retirement funds should be placed in trust. ■