Simplification Proposal

Default RMDs

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"The rules around when and how much you must withdraw from your IRA and/or workplace retirement plans can get tricky."
TIAA (2023)

"Plan sponsors often discover that required minimum payments have either not been paid timely or at all."
Internal Revenue Service (2022)

Summary of the Proposal

Policymakers and pension providers have used defaults to simplify pension-related issues for pension participants, such as autoenrollment for participation and target date default funds for portfolio selection in 401(k) plans. A recent House of Representatives bill, the Lifetime Income for Employees Act (LIFE) Act (H.R. 4392), extends defaults to the withdrawal stage. It would allow retirement plan sponsors to use annuities with delayed payments as qualified default investment alternatives (QDIA) for a portion of contributions made by participants who have not made investment selections (Insured Retirement Institute 2023).

This paper argues that defaults should be extended to Required Minimum Distributions (RMDs). Even though RMDs are mandatory payments, people generally are required to request them. RMDs have some complicated aspects, such as determining their amount and what to do to request one. This paper proposes that plan sponsors notify participants by early November that if they have not taken their RMD in full by December 1, they will receive the RMD automatically sometime in December unless the participant requests otherwise. This change would greatly simplify RMDs for millions of people who would no longer be required to do anything to receive their RMDs. This simplification would also mean that the IRS and plan sponsors would no longer need to deal with older taxpayers who had not taken their RMDs. Failure to take RMDs is particularly a problem at advanced older ages.

The Thrift Savings Plan (TSP) for federal government workers, members of Congress, and the military uses this approach (NARFE 2022). If the participant does not take an RMD or the amount withdrawn is insufficient, the TSP automatically sends the participant the required amount in December. Mengle (2022) reports that some companies provide default or automatic RMDs if participants fail to make a request. This proposal would make that default mandatory for all pension providers. It would simplify the situation for many people who could receive the RMD as a default rather than needing to request the RMD.

The default would help people with memory or cognitive issues as they age or have multiple accounts. For many older persons, it would simplify dealing with RMDs, assure compliance with pension law, and end the risk of paying penalty taxes due to noncompliance. For the IRS, it would simplify the problem of dealing with RMD noncompliance, saving the IRS staff resources and money. For pension providers, it would simplify the problem of dealing with their participants' confusion and accidental noncompliance concerning RMDs. For participants, it would preserve their ability to take RMDs as they currently are doing if that were their preference.

Detailed Description of Proposal

Description of Current Law. The RMD rules apply to all non-Roth employer-sponsored retirement plans, including profit-sharing plans, 401(k) plans, 403(b) plans, and 457(b) plans. The RMD rules also apply to traditional IRAs and IRA-based plans such as SEPs, SARSEPs, and SIMPLE IRAs. Roth IRAs do not require withdrawals until after the death of the owner. Designated Roth accounts in a 401(k) 403(b) or 457b plan are subject to the RMD rules for 2022 and 2023. However, for 2024 and later years, RMDs are no longer required from designated Roth accounts. RMDs from designated Roth accounts for 2023 are still required, including those with a required beginning date of April 1, 2024 (IRS 2023c).

In 2023, the minimum age for Required Minimum Distributions was raised from 72 to 73 and is scheduled to rise to 75 in 2033. Current IRS rules require plans to notify participants that they are required to take Required Minimum Distributions and to report that to the IRS. T. Rowe Price (2023) writes, “In accordance with IRS rules, we are obligated to notify you and report to the IRS that you are required to take an RMD for 2023.” Concerning filing requirements with the IRS, “if an IRA owner has an RMD due for 2023, the financial institution that is the trustee, custodian, or issuer maintaining the IRA must file a 2022 Form 5498 (IRA Contribution Information) by May 31, 2023, and indicate by a check in Box 11 that an RMD is required for 2023” (IRS 2023b). Concerning reporting requirements to IRA owners, “Additionally, under Notice 2002-27, 2002-1 CB 814, if an IRA owner has an RMD due for 2023, the financial institution must furnish a statement to the IRA owner by January 31, 2023, that informs the IRA owner of the date by which the RMD must be distributed, and either provides the amount of the

RMD or offers to calculate that amount upon request (RMD statement)" (IRS 2023b). Similar requirements hold for providers of 401(k) plans. Thus, providers of IRAs and 401(k) plans already have substantial requirements concerning the calculation and provision of RMDs. Current law permits plans to provide a default RMD distribution in case a participant fails to take an RMD or their withdrawals are insufficient, but it does not require that a default be provided.

If an IRA owner has an RMD due for 2023, the financial institution that is the trustee, custodian, or issuer maintaining the IRA must file a 2022 Form 5498 (IRA Contribution Information) by May 31, 2023, and indicate by a check in Box 11 that an RMD is required for 2023. Additionally, under Notice 2002-27, 2002-1 CB 814, if an IRA owner has an RMD due for 2023, the financial institution must furnish a statement to the IRA owner by January 31, 2023, that informs the IRA owner of the date by which the RMD must be distributed, and either provides the amount of the RMD or offers to calculate that amount upon request (RMD statement).

The Secure Act 2.0, passed in 2022, requires that new 401(k) and 403(b) plans have automatic enrollment as the default. However, current law does not have a similar default for people who fail to take RMDs.

Reasons for Change. According to the Internal Revenue Service (2023a), in tax year 2020, an estimated 3.7 million individuals received RMDs totaling $48.4 billion. The importance of rules governing RMDs will increase over time due to the shift of retirement savings among retirees away from defined benefit plans and toward defined contribution plans. This shift among retirees is a delayed result of an earlier shift among workers.

People may make mistakes concerning the RMD, for example, failing to take an RMD or withdrawing an insufficient amount. At advanced ages, people may make mistakes concerning RMDs due to declining mental or physical health, normal forgetfulness, or lack of organization.

Other possible explanations are lack of awareness, procrastination, the complexity of the rules, or that they rely on other people.

Mortenson, Schramm, and Whitten (2019), using IRS data for 2008 and 2010, show that the percentage of traditional IRA holders taking any distributions falls gradually with age, starting at age 85 and falls sharply with age at 90. They find that the percentage of individuals who satisfy their RMD is above 90 percent until age 85, after which it declines substantially, falling to just over 80 percent at age 90 and continuing to fall after that. This key finding shows that the problem of failing to take an RMD is particularly an issue at advanced older ages. People requesting and receiving their RMDs in their seventies fail to do so in their late eighties and nineties. Assuming that a little less than 10 percent of pension participants fail to receive RMDs, that would put the number at about 300,000 persons a year.

A study using earlier data also indicates that this is a substantial problem. A study by the Inspector General of the Treasury Department found that more than 250,000 people failed to take RMDs in 2006 and 2007 (Block 2019).

Older people may have some other person—a family member, a guardian, or an advisor—managing their money, and that person may be confused or unknowledgeable about RMDs. Spouse and non-spouse beneficiaries may not understand the RMD requirements they have as beneficiaries. One of the complexities for some people is that IRAs, unlike employer-sponsored plans, are subject to RMDs even if the person is still working.

In 2018, Allianz Life (2018) did an online survey of higher-income people aged 65 to 75, having at least $500,000 in retirement savings if single and $750,000 in retirement savings if married. Among this group of people, who presumably have a higher level of financial literacy than most people related to their higher level of retirement savings, 57 percent reported that they wanted to receive their RMD "without getting involved," and 66 percent "want another way to deal with RMDS." Thus, two-thirds of the higher-income people in this survey want a more convenient way of dealing with RMDs. A default RMD would make that possible.

The consequences of RMD mistakes are serious. Before 2023, the IRS charged a 50 percent penalty, which could be thousands, or even tens of thousands, of dollars. Recognizing the severity of the penalty, in 2022, Congress reformed it. The SECURE 2.0 Act of 2022 reduces the penalty to 25 percent. The penalty drops to 10 percent if the person takes the necessary RMD by the end of the second year following the year it was due. For example, if a person fails to take an RMD due in 2023, the penalty is reduced to 10 percent if they withdraw the necessary funds by December 31, 2025. Presumably, Congress legislated these changes, recognizing the problem of people not taking RMDs or taking insufficient amounts.

Every year in November and December, numerous articles in the personal finance press remind people to take their RMDs, for example, Fidelity (2022), but with low levels of financial literacy, most people do not read articles in the personal finance press. On December 3, 2022, *Motley Fool* wrote, "There's only 28 days left for seniors to avoid this major retirement mistake in 2022" (Hagen 2022).

To deal with this problem, pension plan providers often send reminders near the end of the year to people who have not taken RMDs. Many financial institutions and retirement plan administrators provide the option that people can request periodic automatic distributions, for example, on a monthly basis.

With the growing use of artificial intelligence (AI), some financial advisors are using AI to help them ensure that their clients take their RMDs (Caruaga 2013). People without financial advisors face the issue of RMDs without that assistance.

Our proposal would be the failsafe solution when all else fails. It would also reduce the need for AI and other interventions. While this proposal would be a big help to those who might forget to take an RMD because it would provide their RMDs automatically, it also would help many other older taxpayers who may find the RMD tables confusing. The tables are described as life expectancy tables. However, the figures in the tables indicate a life expectancy substantially longer than the official life expectancy tables provided by National Center for Health Statistics (Arias and Xu 2022). Some people aren't sure how many accounts they have that require RMDs, and because of their poor recordkeeping have lost records and are not sure who to contact or what the contact information is, and how to request RMDs. It would be much simpler for them, as well as more equitable if the default were that they were paid the RMD at the end of the year if they had not requested it. A J.P. Morgan study (Hahn 2021) found that 84 percent of people taking RMDs took only the minimum required amount. Thus, a default RMD would provide those people the exact amount they desired.

Description of Proposal

The required statutory change would be that the default option of the plan automatically making the required minimum distribution at the end of the year, which is now permitted, would be required.

The default would also involve default withholding rates for federal and state income taxes. The default federal income tax withholding rate would be set at 10 percent, which is the default currently. The default for state income tax withholding could be zero unless required by the state to be a higher amount, which is also the default currently used by some providers. The default could be that the check be mailed to the participant unless the participant had provided bank routing information for an account, in which case it would be sent to their bank account.

Currently, retirees are required to calculate their RMDs separately for each IRA account they own but can take the entire sum of those RMDs from a single IRA. That rule also applies for 403(b) accounts. That rule does not apply to people who have multiple 401(k) plans, where an RMD must be taken from each plan. That complication of IRAs and 403(b) accounts having different rules than 401(k) plans is confusing for some people (Retirement Learning Center 2022). Thus, the default RMD would come separately from each non-Roth IRA, 403(b) plan and 401(k) plan the participant owned. However, the participant could notify their plan sponsors or custodians by a fixed date, say November 15, if they did not wish to receive an RMD from a particular plan.

For participants who wanted to use part of their RMD for a charitable contribution and also wanted to have the convenience of the default, a possible option would be that they could specify that a fixed dollar amount of the default payment would be sent to a specified charity. Thus, the default RMD could be split four ways—the participant, the charity, the federal government (tax), and the state government (tax).

The RMD amount is reduced if the person's spouse is more than 10 years younger than they are. In this case, the default RMD would be the RMD for people with spouses' not in that category. Alternative approaches could be that the plan provider be required to obtain from the participant the birth date of their spouse or that the participant could provide that information as an option.

If an error occurs and the participant receives an RMD that they did not need to receive and did not want to receive, they could have the option to resubmit that amount by April 15 of the following year.

Another concern is that the notification of the default RMD should be sufficiently prominent that it would not be missed by participants. This could be done by noting prominently on the plan website that the default RMD would be made in December if the participant had not fully received their RMD and had not indicated that they did not want to receive the default RMD. In addition, the notification could be included with other information the plan provides the participant, such as quarterly statements.

Detailed Analysis of Proposal

Simplification Resulting from Proposal. With this proposal, workers who did not take any action would automatically receive their Required Minimum Distribution at the end of the year. They would not have to do anything. Delaying an RMD to the end of the year gives the money more time to grow tax-deferred.

For IRAs, the proposal has a tax-planning benefit. Taxes withheld directly from an IRA distribution are treated by the IRS as if paid evenly throughout the year. This treatment allows the person to defer tax-free until the end of the year their tax withholding on their IRA RMD.

A complication arises for the first year that a person is required to take an RMD. In that year, they can delay taking the RMD until April 1 of the following year. If they do that, however, they will take two RMDs in one year, which would possibly mean that they would owe a considerable amount in taxes on those RMDs for that year, and they would be placed in a higher marginal income tax rate bracket. It could also negatively affect their net Social Security benefits. To deal with this situation, we propose that people wishing to postpone their first RMD until the following year could still do that. Plan sponsors would notify participants of that option and the need for the participant to designate that if that was what they wanted to do. If the participant did not make that designation, the default would be that the first RMD would be distributed during December of the first year that it was required. This proposal retains the right of the participant to make the delay but also protects people taking the default from a high tax bill and a higher marginal tax rate.

This proposal could also simplify the problem for beneficiaries when the account holder dies. Designated beneficiaries would automatically receive the RMD payment they were required to take. Beneficiaries dealing with the emotional and financial issues related to the death of a spouse or other family member would not be burdened with having to figure out the RMD requirements that applied to them. They would receive a notice from the pension provider concerning the RMD, indicating that they would not need to take any action and could receive the payment through the default option. The proposal preserves their right to take their RMD earlier if they wish. With multiple beneficiaries, the default would divide the RMD evenly among them.

Implications for Employee/Participant Rights. This proposal does not change the dollar value of Required Minimum Distributions; it just makes it easier for older persons to receive them. They can still take RMDs as single sums, monthly or quarterly payments, and split distributions with charitable organizations. The proposal would effectively end punitive penalties for people who failed to take RMDs and ease the burden of figuring out how to comply with the requirements of those distributions because those distributions would be made by default. Thus, it can be viewed as expanding participant rights by ending negative options and expanding positive options. Some providers, such as T. Rowe Price, permit people to set up an automatic RMD, which is conceptually similar to this proposal, except it requires action by the account holder to set it up. For those deciding to take advantage of the default, procedures could be established so that if they wished to make a charitable contribution to their church, synagogue, or other charitable organization through their RMD, they could do so by requesting a specific dollar amount from the default distribution being sent to their designated charity.

Likelihood of Enactment or Implementation. We believe that because of the simplification it would achieve, the proposal has a high likelihood of enactment. It has little or no effect on government revenues, but could raise government revenues to some extent due to more people taking RMDs. It would simplify the issue of RMDs for the IRS because the IRS would no longer need to deal with older taxpayers who had failed to take an RMD.

In addition, it would impose minimal burden on service providers because they already have the information they need to determine the value of RMDs and are already providing that information to participants. For example, they could add the notice about default RMDs with already occurring mailings, such as quarterly account statements. The default might simplify administration of RMDs if many people chose the default, and plan providers didn't need to respond to the request of each RMD recipient on an individual basis. They also wouldn't need to issue multiple reminders to participants who had failed to request their RMDs.

Congress has endorsed the concept of defaults for other aspects of pensions. This default would be mandatory, but the RMD is itself a mandate. Further, pension providers are already mandated to notify participants and the IRS concerning RMDs. In part because it would impose little new burden on pension providers, we believe that Congress would find the proposal appealing. Arguably, the mandate of having the RMD as a default payment if none is requested by the participant is a logical extension of these mandates that Congress has already enacted.

Originality. While some pension providers, such as the Thrift Savings Plan, have this default in place, we are unaware of any other proposal that addresses this issue for all providers and participants.

Required Statutory or Regulatory Changes

The primary required statutory change would be that the default option of the plan automatically making the required minimum distribution at the end of the year, which is now permitted, would be required. Related changes would be required concerning the default federal and state tax rates, the notifications to participants concerning the default, and the option to correct an unwanted distribution by April 15 of the following year.

Conclusion

Behavioral economics has demonstrated that defaults can make a substantial difference in achieving good pension outcomes for people. This default proposal would greatly simplify RMDs for many older taxpayers. Even though RMDs are mandatory payments, people generally are required to request them. Making it mandatory for 401(k) and IRA providers to provide RMD payments as a default would simplify the distribution process for participants who might otherwise forget or neglect to take RMDs. Failure to take RMDs is particularly a problem at advanced older ages. In addition, the default would be more convenient for many people than the current arrangement, where they must request the RMD.

This proposal would help ensure that millions of participants in their seventies and older would not face penalties for failing to take RMDs. The default would be particularly helpful for people with memory or cognitive issues and people who have multiple accounts. It would also remove their responsibility for calculating the RMD. This default is already being used by the Thrift Savings Plan for federal government workers, members of Congress, and members of the military. The default would not take away the flexibility and control that individuals have over their accounts if that is their preference.

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