Chambliss

New Guidance for Inherited IRAs

Historically, if one inherited an IRA, he or she was able to stretch the distributions over the beneficiary's lifetime. However, under the SECURE Act, passed in 2019, those stretch out rules were changed for most individuals inheriting IRAs.

Under the SECURE Act, the general rule is that the beneficiary of inherited IRAs of decedents dying after December 31, 2019, "must withdraw the entire account by the 10th calendar year following the year" of the decedent's date of death. However, there are two things to consider when determining how to apply the new rule:

1. What are the exceptions to the general rule?
    a) exceptions that expand payout rules
    b) two "five-year" rules

2. What does the 10-year payout actually mean?

Expanding exceptions to the rule

The 10-year rule does not apply to designated individuals who are the surviving spouse of the deceased account owner, disabled or chronically ill individuals, minor children, or individuals who are not more than 10 years younger than the deceased account owner. There are also certain types of trusts established for individuals with disabilities or chronic illnesses that qualify as exceptions to the general rule.

The surviving spouse of a deceased account owner can delay receiving distributions until the later of the surviving spouse's required beginning date (likely age 72) to receive required minimum distributions (RMDs) or the year that the deceased spouse would have turned age 72. At that time, the surviving spouse must take distributions based on his or her life expectancy. So, not only can a surviving spouse stretch out distributions, but he or she can also potentially delay receiving distributions.

Individuals with disabilities or chronic illnesses (or certain trusts established for individuals with disabilities or chronic illnesses), and individuals who are not more than 10 years younger than the deceased account owner can choose to spread out distributions over their lifetime. Unlike surviving spouses, they do not have the ability to delay receiving distributions.

A minor child of the deceased account owner who is a designated beneficiary of an inherited IRA can choose to use his or her life expectancy to calculate the RMD each year until they reach the age of majority (in most states this is age 18). Upon reaching the age of majority, the child will need to withdraw the entire account balance within 10 years.

Two "five-year" rules

There are two "five year rules" to consider in conjunction with the new "ten year rule." The first applies to beneficiaries that are a "non-individual". Non-individuals include the estate, charitable organizations, and nonqualified trusts as the designated beneficiary. This five-year rule also applies if there is no named beneficiary of the IRA. If the five-year rule applies, the deceased's estate or the ultimate beneficiary must receive full distribution of the account balance within five years instead of 10 years.

The second "five-year" rule applies to Roth IRAs that are less than five years old. Typically, distributions from a Roth IRA are not subject to income taxes. However, if the Roth IRA account is less than five years old, any withdrawals of earnings are subject to income tax. The take away here is that the designated beneficiary of a Roth IRA account that is less than five years old should ensure that any distribution of the Roth IRA is made of the principal instead of any income. Once the Roth IRA Account has been established for five years, then the distinction between principal and income is irrelevant, and all distributions will likely be income tax free.

What does the 10-year payout mean?

The guidance is changing. The first guidance that the IRS issued seemed to indicate that a designated beneficiary could wait until the 10th year and make one lump sum distribution at that time. However, in February of this year, the IRS issued proposed guidance that indicated the contrary. This guidance provides that for designated beneficiaries subject to the 10-year rule, if the deceased account owner was subject to the required minimum distribution rules, then the designated beneficiary would also be required to take annual distributions.

It should be noted that this is just proposed guidance. The IRS is still accepting comments and has not issued its final guidance, which will likely not be forthcoming until 2023. However, given the dramatic change in position in October, the IRS released Notice 2022-53, suspending the missed required minimum distribution penalty for some inherited IRAs until 2023. This suspension only applies to individuals who inherited an IRA after December 31, 2019, and it only applies to the penalties. It does not waive the requirement to take the RMD.

Tax considerations

For traditional IRAs and 401ks, any distributions are taxed to the recipient as ordinary income. As such, if a designated beneficiary receives a substantial distribution, the required distributions could potentially put them in a significantly higher tax bracket. Before the IRS issued its proposed guidance in February, much consideration was placed on tax planning around these distributions. For beneficiaries that were still working but reaching retirement age within 10 years, those individuals may have decided to hold off on receiving any distributions until retirement, when they would have little to no earned income. As such, the income generated from the retirement distribution would have likely been taxed at a lower tax bracket, as the beneficiary would have experienced a dramatic decrease in his or her overall taxable income.

On the other hand, for people that were not expecting to have much change in their overall taxable income within the next 10 years, a better tax strategy could have been to take distributions each year over the 10 year payout period. Lower payouts over several years could potentially have less of an impact on tax brackets than receiving much larger sums over a shorter period of time.

Another consideration some designated beneficiaries may have taken into account is the potential increase in taxes in future years. Many believe that the income tax rates will increase and brackets will compress in future years with future tax reform. As such, they may decide to take more distributions in these earlier years, when they know what the tax rates are, instead of waiting until the tax burden on the same distribution could potentially be higher.

One last tax consideration is the estate tax burden of IRAs. If the deceased account owner had a taxable estate and the potential designated beneficiaries have historically had high taxable income, this could create approximately 80% tax on the inherited IRA – 40% tax due to estate tax and (under today's tax brackets) 37% due to income tax.

One way around some of the tax burdens associated with inherited IRAs is by using charitable deductions. Some high net worth clients have decided to make the designated beneficiary of their IRA a charity instead of an individual, saving other non-taxable assets for their family. Other high income clients have timed making additional substantial charitable contributions to coincide with their required distributions. Still others may qualify to make qualified charitable distributions (QCD) directly from the IRA to a charity (the designated beneficiary must be at least 70 ½ to qualify and QCDs are limited to $100,000 each year).

It should be noted that the income tax consequences described above primarily deal with traditional IRAs and not Roth IRAs. As described above, unless the Roth IRA account is less than five years old, distributions from the account are typically income tax free. Additionally, Roth IRAs do not have a required minimum distribution, so the uncertainty around whether distributions need to be made in each of the ten years does not seem to be present, as, at least under today's guidance, the IRS has not indicated a requirement for annual distributions, though the requirement for the account to be completely distributed by the tenth year still applies.

The SECURE Act definitely changed the requirements around what is often the biggest asset someone has at their death. For non-spousal beneficiaries, these changes will likely create a higher overall tax burden. Some of this additional tax burden is inevitable, however some, with careful tax planning, can be mitigated.