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Beneficiary IRAs: A guide to the RMD maze

Advisers can aid inheritors of individual retirement accounts to make optimal choices for their required minimum distributions.

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A newly acquired individual retirement account (IRA) is good financial news for the recipient, but clients may need help unraveling the host of rules and requirements regulating how and when beneficiaries must take required minimum distributions (RMDs). Tax laws surrounding inherited IRAs are complicated. They became more so with the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, P.L. 116-94, and then the SECURE 2.0 Act, which passed on Dec. 29, 2022 (Division T of the Consolidated Appropriations Act, 2023, P.L. 117-328). Failure by the beneficiary to understand the requirements could result in lost income tax planning opportunities at best and excise tax penalties at worst.

The passage of the SECURE Act means that most nonspouse beneficiaries who inherit IRA assets on or after Jan. 1, 2020, are required to withdraw the full balance of the account within 10 years. This includes adult children and grandchildren and most other designated beneficiaries. This change limits the popular “stretch” IRA tax planning tool, which allowed many inherited IRAs to be distributed over the beneficiary’s lifetime. Only select groups, including spousal beneficiaries, and those in special categories created by the SECURE Act are eligible for more extended deferral periods.

The original rules under the law prior to the SECURE Act still drive many of the requirements for distributions, so they are worth briefly reviewing.

The RMD rules for defined contribution plans are set out in Sec. 401(a)(9). These basic rules apply to all defined contribution plans, including regular and Roth IRA accounts; annuity contracts; custodial accounts; profit-sharing, Sec. 401(k), and Sec. 403(b) accounts; and Sec. 457(d) deferred compensation accounts.

Sec. 401(a)(9)(A) provides rules for RMDs during the life of an IRA owner, and Sec. 401(a)(9) (B) addresses RMDs after the IRA owner's death.

Sec. 401(a)(9)(B)(i) defines rules for distributions if the IRA owner dies after RMDs have begun. If the IRA owner has already begun taking RMDs, the decedent's remaining interest must be distributed at least as rapidly as when the owner was alive.

Sec. 401(a)(9)(B)(ii) requires that if the IRA owner dies before RMDs have begun, the account must be distributed within five years after the owner's death. This requirement was significantly modified by the SECURE Act, as described below. Under the original law, the account could be distributed at any time within five years. A beneficiary could wait until the last month of the fifth year to take a distribution. This is not the case under the SECURE Act.

Sec. 401(a)(9)(B)(iii) provided an exception that allows designated beneficiaries to take distributions over their own life expectancy. Beneficiaries must make this election by beginning distributions within one year after the date of the IRA owner's death. This rule was also changed by the SECURE Act.

Sec. 401(a)(9)(B)(iv) provides a special rule for the spouse of the decedent, who can "step into the shoes" of the deceased IRA owner and follow RMD rules as if the IRA account had been his or hers all along.

THE SECURE ACT'S CHANGES

The original SECURE Act introduced Sec. 401(a) (9) (H), which applies only to beneficiaries of owners who die after Dec. 31, 2019. Sec. 401(a)(9) (H) (i) lengthens the required distribution period from five years to 10 years and applies the rule to all designated beneficiaries regardless of whether the decedent had begun RMDs. Sec. 401(a)(9) (H) (ii) also introduces the concept of the "eligible designated beneficiary." These are now the only individuals allowed to use the life expectancy payout method.

The following considers each of the five types of eligible designated beneficiaries:

1. The account owner's surviving spouse

Surviving spouses still receive the special treatment available in the original rules under the changes made by the SECURE Act. They can opt to be treated as a beneficiary of the IRA or elect to be treated as its owner. A spouse who chooses to be treated as a beneficiary of the IRA can step into the shoes of the deceased spouse. If the owner dies before his or her required beginning date (or at any age, for Roth IRA owners), RMDs to the surviving spouse can be postponed until the later of (1) the year following the owner's death, or (2) the year of the owner's required beginning date for RMDs (Sec. 401(a)(9)(B)(iv)). Generally, the owner's required beginning date for RMDs is April 1 of the calendar year following the calendar year in which the owner attains the applicable age for

beginning RMDs. At that time, RMDs will be based on the surviving spouse's life expectancy. (Note: The SECURE Act and SECURE 2.0 increased the RMD beginning age to 73 in 2023 and following (for individuals attaining age 72 after Dec. 31, 2022) and 75 in 2033 and following. For this reason, this article refers to the "required beginning age" rather than a specific age.)

In addition, beginning in 2024, the SECURE 2. 0 Act allows the spouse to be treated as the IRA's original owner. This is more favorable if the surviving spouse is younger. In that case, RMDs would be based on the younger spouse's life expectancy, and distributions would not need to begin until the spouse reached the required beginning date.

Special rules apply if the spouse is more than 10 years younger than the owner. For these younger spousal beneficiaries, the owner's lifetime RMDs can be calculated over the joint life expectancy of the owner and spouse.

A younger surviving spouse who needs financial support may choose to treat an IRA inherited before age 59½ as a beneficiary IRA. This allows the spouse to take distributions as desired without incurring the 10% penalty for early withdrawals, regardless of age. Note, however, that withdrawals are not tax-free from a Roth IRA account if it has been open for less than five years. The "five-year rule" related to Roth contributions would still apply and could potentially generate taxable income on the earnings (but no penalties).

A spouse may also choose to treat the inherited IRA as a beneficiary IRA if he or she is older than the deceased spouse. This could result in a smaller RMD than the one based on the surviving spouse's age.

To be treated as a beneficiary, the spouse must take RMDs. If no RMD is taken before the end of the year following the account owner's death, the account will be deemed to be rolled over to the spouse's own IRA (Prop. Regs. Sec. 1.408-8(c)).

If the spouse is treated as the owner of the IRA, normal IRA rules apply, whether regular or Roth. In other words, the spouse is not required to take an RMD until his or her required beginning date. If the IRA is a Roth, the spouse is not required to take RMDs at all. This gives the spouse the only remaining opportunity after SECURE Act changes to pursue the "stretch" IRA concept, naming his or her own beneficiaries and deferring tax longer after his or her death.

2. A child who is younger than the age of majority

Beneficiaries who have not yet reached the age of majority can make withdrawals from the account over their own life expectancy. They lose the "eligible designated beneficiary" designation when they reach the age of majority and the 10-year rule goes into effect. They then have until Dec. 31 of the 10th year from the child's attainment of majority to withdraw all the funds from the account.

The age of majority for this second type of eligible designated beneficiary is defined in Prop. Regs. Sec. 1.401(a)(9)-4(e)(3) as being reached on the child's 21st birthday. Note, however, that the proposed regulations would permit defined benefit plans that have used a prior definition of the "age of majority" (under plan terms that were adopted on or before Feb. 24, 2022) that met the requirements of pre–SECURE Act regulations (Regs. Sec. 1.401(a)(9)-6, Q&A-15) to retain that plan provision. In general, under these plans, the age of majority would be 26 if the child has not completed a specified course of education. In addition, a child who is disabled within the

meaning of Sec. 72(m) (7) when he or she reaches the age of majority may be treated as having not reached the age of majority so long as the child continues to be disabled.

3. Disabled individual

"Disabled" is defined under current regulations consistent with Sec. 72(m)(7) as someone who is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or to be of long or indefinite duration. For individuals younger than 18, the proposed regulations would substitute having a medically determinable physical or mental impairment that results in marked and severe functional limitations, in place of the "gainful activity" provision applicable to older disabled individuals (Prop. Regs. Sec. 1.401(a)(9)-4(e)(4)(ii)).

4. Chronically ill individual

"Chronically ill individual" means any individual who has been certified by a licensed health care practitioner as (1) being unable to perform (without substantial assistance from another individual) at least two activities of daily living for an indefinite but lengthy period due to a loss of functional capacity; (2) having a similar level of disability as determined under IRS regulations in consultation with the Department of Health and Human Services; or (3) requiring substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment (Sec. 401(a)(9)(E)(ii)(IV)).

5. A person not more than 10 years younger than the deceased IRA owner

For nonspousal eligible designated beneficiaries meeting this description, RMDs must begin by Dec. 31 of the year after the deceased owner dies. If the deceased owner had not reached the RMD required beginning date, the RMD is calculated based on the beneficiary's life expectancy. If the owner was required to take RMDs, the distributions are based on the longer of the beneficiary's or the owner's life expectancy.

If the eligible designated beneficiary dies before the account is entirely distributed, the 10-year rule reasserts itself for the next beneficiary or beneficiaries, even if they are also eligible designated beneficiaries.

WHO IS THE BENEFICIARY?

Ask these questions when a client tells you they inherited an IRA:

- "Who died?"
- "When did the IRA owner die?"
- "How old was the deceased?"

The spouse of the account owner has more distribution options than nonspouse beneficiaries. Nonspouse beneficiaries may be subject to different rules depending on their own circumstances and whether other beneficiaries are named. Beneficiary designations can be changed if planning is done in a timely manner.

A designated beneficiary (as distinct from an *eligible* designated beneficiary) is an individual who is designated as the beneficiary of an IRA. In order to be a designated beneficiary, an individual must be a beneficiary at the date of

the IRA owner's death *who remains* a beneficiary as of Sept. 30 of the year following the IRA owner's death. Any beneficiary who is "eliminated" by distribution of that beneficiary's benefit or by disclaimer is disregarded in determining the designated beneficiary for the purposes of calculating an RMD (Regs. Sec. 1.401(a)(9)-4, Q&A-4(a)).

Additionally, a decedent's individual account can be divided into separate accounts with different beneficiaries to allow the RMD to be calculated by disregarding the beneficiaries of the other separate accounts. The deadline to establish separate accounts is no later than the end of the year following the year of the IRA owner's death (Regs. Sec. 1.401(a)(9)-8, Q&A-2(a)).

WHEN SHOULD RMDs BEGIN?

When to start beneficiary distributions is a critical aspect of your advice to the client. The SECURE Act hastened distribution requirements in many cases. Failure to start RMDs at the correct time could result in excise taxes levied on the missed distributions. Prior to Dec. 31, 2022, this excise tax was 50% of a missed distribution. SECURE 2.0 reduced the excise tax to 25% beginning Jan. 1, 2023, and further reduced the penalty to 10% if the missed RMD is corrected in a timely manner.

If RMDs have begun for the owner:

- The owner's RMD must still be taken in the year in which the IRA owner died.
- If the owner was required to take an RMD but did not, the beneficiary needs to take the current-year RMD before doing anything else with the rest of the funds. An owner's RMD made after death will be reported on the beneficiary's income tax return.
- There is one exception: If the IRA owner died before April 1 of the year after the year the owner reached the required beginning date for RMDs, the heir or heirs do not need to take the RMD.
- Beneficiaries must take RMDs each year if the owner had begun RMDs, and they must empty the account based on their beneficiary designation. If RMDs have not begun:
- A spouse may treat the account as his or her own; RMDs begin when the spouse reaches the required beginning date.
- Nonspouses must take RMDs immediately, based on their beneficiary designation, and must empty the account within 10 years (unless they meet an exception).
- Nondesignated beneficiaries (trusts, estates, and charitable organizations) must empty the account with five years.

EFFECTIVE DATES AND TRANSITION RULES

When the SECURE Act was introduced, it generated confusion among advisers concerning the application of the new rules. Some thought the act's language suggested that the 10-year rule would operate like the five-year rule, i.e., that there was no RMD due for a calendar year until the last year of the 10-year period following the death of the IRA owner.

In Notice 2022-53, released Oct. 17, 2022, the IRS announced forthcoming final regulations, clarifying that the SECURE Act requires payouts for inherited IRAs and providing interim guidance AICPA RESOURCES and transition relief. These regulations are expected to finalize proposed regulations issued in February 2022 (REG-105954-20).

Notice 2022-53 clarifies that if an IRA owner had already reached his or her required beginning date, the beneficiary must begin annual RMDs in the first calendar year after the owner's death. The remaining account balance must still be distributed by the 10th calendar year after the account owner's death. The RMD requirement continues even after the death of the eligible beneficiary, applying the same time frame to the beneficiary of the eligible beneficiary. Notice 2022-53 also states that new final regulations will apply no earlier than the 2023 distribution calendar year.

RELIEF FOR THOSE WHO DID NOT TAKE AN RMD

Under normal circumstances in 2021 and 2022, failure to make RMDs was subject to an excise tax (reported on Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts)* equal to 50% of the minimum amount that should have been distributed over the amount actually distributed (Sec. 4974(a)). For beneficiaries who did not take distributions in 2021 and 2022 due to confusion about SECURE Act requirements, however, no excise tax will be applied. There will also be no requirement in the final regulations that these beneficiaries take "catch-up" distributions to satisfy Sec. 401(a)(9)(B)(i). The regulations will simply state that the new RMD rules apply to the account's existing balance as of Dec. 31, 2022.

This relief is only available to designated beneficiaries and successor beneficiaries who are subject to the 10-year rule and the employee or IRA owner died in 2020 or 2021 after that individual's RMD beginning date. A designated beneficiary who is taking distributions based on a lifetime expectancy pursuant to Sec. 401(a)(9)(B)(iii) is not eligible for automatic penalty relief. If a taxpayer has already paid excise tax for a missed RMD in 2021, the taxpayer can request a refund of the excise tax.

PROTECTING A LEGACY

The IRA owner worked hard to accumulate those retirement funds, and their wish was to pass as much of it as possible on to their heirs. CPA advisers can help beneficiaries protect that value by advising them about these RMD provisions and helping them strategize to reduce RMDs' impact and so preserve remaining assets.

About the author

Dayna E. Roane, CPA, CGMA, is a shareholder with Perry, Roane & Henley PC in Niwot, Colo. In 2021, she received the Lawler Award for best *JofA* article of 2020 ("Deducting Home Office Expenses (https://www.journalofaccountancy.com/issues/2020/may/deduct-home-office-expenses-coronavirus-remote-work.html)," *JofA*, May 15, 2020). To comment on this article or to suggest an idea for another article, contact Paul Bonner at Paul.Bonner@aicpa-cima.com (mailto:Paul.Bonner@aicpa-cima.com).

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AICPA RESOURCES

Articles

"Key Tax and Retirement Provisions in the SECURE 2.0 Act," (https://www.journalofaccountancy.com/news/2023/jan/key-tax-retirement-provisions-secure-2-act.html) *JofA*, Jan. 4, 2023

"Inherited IRA Strategies After the SECURE Act," (https://www.thetaxadviser.com/newsletters/2020/apr/inherited-ira-strategies-secure-act.html) *Tax Insider,* April 16, 2020

Podcast episode

"Planning Ideas With the SECURE Act's 10-Year Rule," (https://www.podomatic.com/podcasts/aicpa-msc/episodes/2020-07-09T21_00_00-07_00) AICPA PFP Section, July 10, 2020

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