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SECURE Act Changed IRA and Retirement Plan Inheritance Rules

A word of caution

The SECURE Act ushered in changes that could have a dramatic impact on IRA estate strategies. Account owners may want to review their beneficiary designations with their financial professionals and consider how the new rules may affect inheritances and taxes.

At the end of 2019, President Trump signed a federal spending package that included the Setting Every Community Up for Retirement Enhancement (SECURE) Act. A provision in this legislation effectively eliminated the "stretch IRA," an estate-planning strategy that allowed an IRA to continue benefiting from tax-deferred growth, potentially for decades. Most nonspouse beneficiaries, including children and grandchildren, can no longer "stretch" distributions over their lifetimes.

Individuals who plan to leave IRA and retirement plan assets to heirs — and individuals who stand to inherit retirement assets — should understand the new rules and distribution options.

The old "stretch" rules

For retirement assets inherited before 2020, a nonspouse beneficiary had to begin required minimum distributions (RMDs) within a certain time frame after inheriting the account. However, annual distributions could be calculated based on the beneficiary's life expectancy. This ability to stretch taxable distributions over a lifetime helped reduce the beneficiary's annual tax burden and allowed large IRAs to continue benefiting from potential tax-deferred growth.[1]

Example: *Consider the hypothetical case of Margaret, a single, 52-year-old banking executive who inherited a million-dollar IRA from her 85-year-old father. Margaret had to begin taking RMDs from her father's IRA by December 31 of the year following his death. She was able to base the annual distribution amount on her life expectancy of 32.3 years. Since she didn't really need the money, she took only the minimum amount required each year, allowing the account to continue growing. Upon Margaret's death at age 70, the remaining assets passed to her 40-year-old son, who then continued taking distributions over the remaining 13.3 years of Margaret's life expectancy. The account was able to continue growing for many years.*[2]

The new rules

Beginning in January 2020, most nonspouse beneficiaries are required to liquidate inherited accounts within 10 years of the owner's death. This shorter distribution period could result in unanticipated and potentially large tax bills for nonspouse beneficiaries who inherit high-value IRAs. There are no RMDs during the 10-year period, so beneficiaries can take distributions in any amount and any time frame they choose, provided the assets are completely exhausted at the end of the period. Any funds not liquidated by the 10-year deadline will be subject to a 50% penalty tax.

Example: *Under the new rules, Margaret would have to empty the account, in whatever amounts she chooses, within 10 years of her father's death. Since she stands to earn her highest-ever salaries during that time frame, the distributions could push her into the highest tax bracket at both the federal and state levels. Because the account would be depleted after 10 years, it would not eventually pass to her son, and her tax obligations in the decade leading up to her retirement would be much higher than she anticipated.*

The beneficiary of a traditional IRA might want to spread the distributions equally over the 10 years in order to manage the annual tax liability. By contrast, the beneficiary of a Roth IRA — which generally provides tax-free distributions — might want to leave the account intact for up to 10 years, allowing it to potentially benefit from tax-free growth for as long as possible.

Notable exceptions

The new rules specifically affect most nonspouse designated beneficiaries who are more than 10 years younger than the original account owner. However, key exceptions apply to those who are known as "eligible designated beneficiaries" — a spouse or minor child of the account owner; those who are not more than 10 years younger than the account owner (such

Spouses can elect to treat an inherited IRA as their own. By becoming the account owner, the surviving spouse can make additional contributions, name new beneficiaries, and wait until age 72 to start taking RMDs. (Roth IRAs do not require RMDs during the lifetime of the owner.)

as a close-in-age sibling or other relative); and disabled or chronically ill individuals, as defined by the IRS. (Note that the 10-year distribution rule will apply once a child beneficiary reaches the age of majority and when a successor beneficiary inherits account funds from an initial eligible designated beneficiary.)

Eligible designated beneficiaries may use the old stretch IRA rules and take RMDs based on their own life expectancies.[3] In these cases, RMDs must begin no later than December 31 of the year after the original account owner's death. However, if the original owner was of RMD age and failed to take the required amount in the year of death, the beneficiary must take the RMD by December 31 of that year.[4] Failure to take the appropriate amount can result in a penalty equal to 50% of the amount that should have been withdrawn.

Spouse as beneficiary

Spousal beneficiaries can roll over the IRA assets to their own IRAs, or elect to treat a deceased account owner's IRA as their own (presuming the spouse is the sole beneficiary and the IRA trustee allows it). By becoming the account owner, the surviving spouse can make additional contributions, name new beneficiaries, and wait until age 72 to start taking RMDs.[5] (A surviving spouse who becomes the account owner of a Roth IRA is not required to take distributions.)

Note that RMDs for 2020 have been waived by the Coronavirus Aid, Relief, and Economic Security (CARES) Act.

Beneficiaries may take a pass

A beneficiary may also disclaim an inherited retirement account. This may be appropriate if the initial beneficiary does not need the funds and/or want the tax liability. In this case, the assets may pass to a contingent beneficiary who has greater financial need or may be in a lower tax bracket. A qualified disclaimer statement must be completed within nine months of the date of death.

Impacts on trust planning

Prior to 2020, individuals with high-value IRAs often used conduit — or "pass-through" — trusts to manage the distribution of inherited IRA assets. The trusts helped protect the assets from creditors and helped ensure that beneficiaries didn't spend down their inheritances too quickly. However, conduit trusts are now subject to the same 10-year liquidation requirements, so the new rules may render null and void some of the original reasons the trusts were established.

Planning tips

Retirement account owners should review their beneficiary designations with their financial or tax professional and consider how the new rules may affect inheritances and taxes. Any strategies that include trusts as beneficiaries should be considered especially carefully. Other strategies that account owners may want to consider include converting traditional IRAs to Roths; bringing life insurance, charitable remainder trusts, or accumulation trusts into the mix; and planning for qualified charitable distributions.[6]

[1] For account owners who died before January 1, 2020, the old rules apply to the initial beneficiary only. Under these rules, a beneficiary also generally had the option to take distributions sooner than required.

[2] This hypothetical example is used for illustrative purposes only and does not represent the performance of any specific investment. Fees, expenses, and taxes are not considered and would reduce the performance shown if they were included. Actual results will vary. All investing involves risk including the possible loss of principal and there is no guarantee that any investment strategy will be successful.

[3] If the original account owner dies on or after the required beginning date, an older eligible designated beneficiary can take RMDs over the remaining life expectancy of the original account owner if it is longer than the beneficiary's life expectancy.

[4] The surviving spouse of an original account owner who was under RMD age at the time of death can wait until December 31 of the year in which the deceased would have had to take RMDs, or the spouse can take actions as discussed under the "Spouse as beneficiary" section.

[5] For an account owner born prior to July 1, 1949, RMDs would start at age 70½.

[6] Other trusts are generally subject to RMDs based on the owner's life expectancy if the owner had reached the required beginning date; if the owner died before the required beginning date, the account must be emptied by the end of the fifth year after the owner's death. There are costs and ongoing expenses associated with the creation and maintenance of trusts.

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