Choosing IRA Beneficiaries

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Brain Teaser of the Month: *What gets wet while drying?*

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In the last five years, there have been two broad pieces of retirement legislation that have changed the landscape of financial planning: the SECURE Act of 2019 (SECURE Act) and the SECURE 2.0 Act of 2022 (SECURE 2.0). There are many provisions in both acts, but our focus here is on a major change related to IRA beneficiaries.

When someone inherits an IRA, they are generally required to take out a portion of the IRA each year as their Required Minimum Distribution (RMD). Before the SECURE Act, IRA beneficiaries were typically able to stretch their IRA balance over their lifetime.

The SECURE Act changed this so now many beneficiaries of an IRA (or 401(k) or 403(b)) will have to withdraw the entire balance within 10 years following the death of the owner[1].

If the IRA owner (or plan participant) dies before the required beginning date (which is April 1st of the year following the year in which the IRA owner/plan participant reaches RMD age[2]), most individual beneficiaries designated by the IRA owner/plan participant can withdraw an equal amount of money each year, decide to withdraw all funds in year 10 or take withdrawals on an ad-hoc basis over the 10 years. In any case, you must empty the entire account by the end of the 10th year following the year of the account owner's death[3].

Based on the final RMD regulations issued by the IRS in July of 2024, if the IRA owner (or plan participant) dies on or after the required beginning date, a beneficiary subject to the 10 year rule would be required to both (a) take annual RMDs each year using the longer of the remaining life expectancy of (i) the deceased IRA owner/plan participant or (ii) the applicable designated beneficiary, and (b) withdraw the entire balance of the IRA by the end of the 10th calendar year following the year of the IRA owner's death[4].

There are several exceptions to the 10-Year Rule for eligible designated beneficiaries. To qualify as an eligible designated beneficiary, the beneficiary must be:

(1) the surviving spouse of the IRA owner/plan participant,
(2) the minor child of the IRA owner/plan participant,
(3) a disabled or chronically ill individual (as those terms are defined for purposes of the RMD rules), or
(4) an individual who is not more than 10 years younger than the IRA owner/plan participant.[3]

Note that the 10-Year Rule only applies if the IRA owner dies after December 31, 2019 or a designated beneficiary who is receiving annual RMDs over the applicable life expectancy and dies after December 31, 2019.

Please note, however, when there is more than one beneficiary designated for an IRA or qualified retirement plan, there are special rules to determine whether the IRA or qualified retirement plan is treated as having an eligible designated beneficiary, a designated beneficiary or no designated beneficiary for purposes of the RMD rules. In general, all the beneficiaries of the IRA or qualified retirement plan must be considered when making this determination (e.g., if at least one of the beneficiaries is an entity, the IRA/plan will generally be treated as having no designated beneficiary; if all the beneficiaries are individuals, but at least one is not an eligible designated beneficiary, the IRA/plan will generally be treating as having a designated beneficiary, but not an eligible designated beneficiary), unless the beneficiaries satisfy the “separate accounting rules” under the RMD regulations.

In the context of these new rules, below are some strategies for account owners to consider with their tax advisors as they name IRA beneficiaries:

1. <u>Increase the number of beneficiaries</u> – If you were going to leave a $2mm IRA to two adult children, you can instead consider leaving it to your two adult children and three grandchildren. Instead of your two children inheriting $1mm each ($100k per year distributions), now five people inherit $400k ($40k per year distributions), which may help reduce the amount that is paid out in taxes from the IRA. Note that these distributions would have to take the annual RMD into account.

   This strategy may work well if the grandchildren are not minors. If the grandchildren are young, they may be subject to the kiddie tax (which generally calculates their tax liability using their parent’s tax rates), so this strategy is less effective.

2. <u>Consider naming someone other than your spouse as a beneficiary and potentially create two separate 10-Year windows</u> – We know that many people will name their spouse as the their beneficiary. Now imagine a situation where Pam and Jim each have a $1mm IRA. Jim dies and Pam now has a $2mm IRA. Now Pam dies and their daughter (Cecilia) inherits $2mm and has a 10-year window to take distributions ($200k/year).

   An alternative option would have been for Jim to name Cecilia as the beneficiary (assuming Pam had enough of her own assets to live on). This may potentially give Cecilia smaller distributions over a longer time. If Jim and Pam die more than 10 years apart, Cecilia would effectively have 20 years to space out distributions. Note that if the child is in a higher tax rate bracket than the parents, this approach makes less sense.

   Of course, there are other factors to consider – for example, what is the spouse’s life expectancy? If she is much younger, than she would have a potentially long period of time for distributions. Does the spouse need this money? Their own needs will have to be considered as well.

3. <u>Consider each person’s tax situation when choosing beneficiaries</u> – This is where you would consider giving your one child with a modest income more of the traditional IRA, and your other child with a high income more of a taxable account or Roth IRA. The challenge here is that you may have to constantly tinker with your estate plan and beneficiary designations as asset values and your children’s tax situations change.

4. Remember one exception to the 10-Year Rule is for a designated beneficiary "who is not more than 10 years younger than the" IRA owner/plan participant – this works well for those who wish to leave their IRA to siblings who are not more than 10 years younger. For example, someone age 75 can name siblings who are all age 65+ and know they will generally be eligible to stretch RMDs over their lifetimes.

5. Utilize a Charitable Remainder Trust – A Charitable Remainder Trust is an irrevocable trust that allows you to donate assets to charity while also drawing income for life (or a specific time period)[4]. At death, IRA assets would be distributed into the trust and remain tax-free. Heirs would pay tax on any income that's distributed, but can generally stretch out for longer than 10 years.

   Note that this strategy reduces optionality and forces beneficiaries to take an income stream, with no access to the principal. It can work well for those who are charitably-inclined. The heirs would receive income distributions but the proceeds of the trust will be left to charity.

The above strategies are all worth considering, but we note that in many cases the best decision may be to change nothing. While the 10-Year Rule is limiting, in many cases alternative strategies are less effective. Each IRA owner will have their own objectives and goals to consider. Before implementing any of these strategies, you should consult with and rely on your own tax advisor.

If you have any questions or would like to discuss, please feel free reach to out to us. Always consult with your tax advisor on decisions that may impact your taxes.

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Brain Teaser of the Month Answer – *A Towel*

Morgan Stanley

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Sources:

1. IRS: Retirement plan and IRA Required Minimum Distributions FAQs – IRS.gov
2. RMD Age is (a) age 70 ½ for individuals born before July 1, 1949, (b) age 72 for individuals born after June 30, 1949 but before 1951, (c) age 73 for individuals born after 1950, but before 1960, or (d) age 75 for all others.
3. IRS: Retirement topics – Beneficiary – IRS.gov
4. The 10 year rule also applies on the death of (a) an eligible designated beneficiary who was receiving annual RMDs based on the applicable life expectancy, and (b) a designated beneficiary who (i) inherited the IRA or qualified retirement plan account from an IRA owner/plan participant who died prior to 2020, (ii) was receiving annual RMDs based on the applicable life expectancy, and (iii) died after 2019. The remainder (or successor) beneficiary of such an eligible designated beneficiary or designated beneficiary is required to continue receiving annual RMDs, but is also required to withdraw the entire account balance by the end of the 10th calendar year following the year of the death of the eligible designated beneficiary or designated beneficiary, as applicable.
5. IRS: Retirement topics – Beneficiary – IRS.gov
6. IRS: Charitable Remainder Trusts – IRS.gov