Ebb and Flow and the Inherited Traditional IRA

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Keeping current with the IRS is like being in a boxing match. You must be light on your feet, dodging and ducking the dynamic tax rules while avoiding a tax-penalty knockdown.

So, it would be wise to enter the ring knowing the rules about beneficiaries taking distributions from inherited traditional individual retirement accounts (IRAs). These rules had been relatively dormant until Congress passed the Setting Every Community Up for Retirement Enhancement (SECURE) Act in December 2019. The SECURE Act included several enhancements to retirement account rules.

This article focuses on the changes related to non-eligible designated beneficiaries of traditional IRAs. They are the designated beneficiaries who are neither surviving spouses nor fall into a limited number of other categories.

The elimination of the stretch IRA

The stretch IRA was a way to maximize the tax deferral nature of traditional IRAs as long as possible, thus increasing wealth for future generations. Under past law, if you named a child or grandchild as beneficiary, there was a way to structure it so the IRA assets could be distributed based on the life expectancy of the child or grandchild.

Under the SECURE Act, non-eligible designated beneficiaries would need to withdraw all IRAs and qualified plans by the end of the 10th year after a decedent's death rather than over a lifetime. There was confusion about whether a non-eligible designated beneficiary would be allowed to distribute the entire account as a lump sum at the end of the 10th calendar year after the account owner's death instead of taking annual distributions to empty the account. The provisions of the SECURE Act apply to individuals who die after Dec. 31, 2019.

ALAR: The "at least as rapidly" rule

The "at least as rapidly" (ALAR) rule requires beneficiaries to make required minimum distributions (RMDs) annually if the IRA owner/decedent has reached their required beginning date and has started taking distributions before their death. The impact of the ALAR rule is to distribute the decedent's remaining interest at least as rapidly as under the distribution method used by the IRA owner as of the date of the their death.

Proposed regulations

The IRS issued proposed regulations in February 2022 for non-eligible designated beneficiaries inheriting from retirement account owners who died on or after their required beginning date. These beneficiaries would have to comply with the 10-year distribution requirement in addition to taking annual RMDs during that period, which would satisfy the ALAR rule. These regulations, when finalized, would apply beginning with the 2022 distribution calendar year.

Since the proposed regs weren't issued until February 2022, many beneficiaries of decedents who died after the SECURE Act was passed in 2019 didn't take RMDs for 2020 in 2021. And since the IRS never finalized the proposed rules, those beneficiaries were unsure whether they needed to take an RMD in 2022. They assert that there should be transition relief for failure to take RMDs due in 2021 and 2022.

Notice 2022-53: Relief from penalties

There is a penalty for not taking an RMD. For 2021 and 2022, the penalty amount is 50% of the amount by which the RMD exceeds the amount distributed.

But there is good news. Notice 2022-53, issued in October 2022, stated the IRS would not impose a penalty if a beneficiary failed to take a distribution in tax years 2021 and 2022, effectively eliminating the RMD requirement for those years. The penalty for not taking a distribution from an inherited IRA would first apply in the 2023 tax year. This notice provided some clarity through the end of 2022, but it was still unclear about what to do in 2023.

SECURE 2.0

Well, more changes soon followed. The SECURE Act 2.0 was passed in December 2022 and included some changes and modifications to the original SECURE Act. Those included a new 2024 start date for inherited IRA beneficiaries to begin taking distributions. SECURE 2.0 also reduced the penalty for not taking an RMD to 25% of the amount by which the RMD exceeds the amount distributed. Correcting a failure to take an RMD by the end of the correction window reduces the penalty from 25% to 10%. Generally, that window is the end of the second year that begins after the year of the missed RMD.

Therefore, if a designated beneficiary took a minimum distribution in 2020, 2021, or 2022, that distribution was not actually an RMD. But, what if a beneficiary who wasn't required to take a distribution had taken one and wanted to return it? Typically, you can roll over a distribution to an eligible IRA no later than the 60th day following the day of receipt. So those who took their distribution might be outside the 60-day window and could not roll it back over.

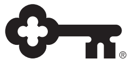
IRS notice 2023-54: More penalties eliminated

More good news. Notice 2023-54 issued this past July eliminated any penalty for failing to take a (potential) RMD for 2023, effectively wiping out the RMD for 2023. Unfortunately, there was no clarity on if and when the final regulations will be issued.

For more information, please contact your advisor.

About the Author

Stephen Augstell is a Regional Director of Planning with Key Private Client in Albany, New York. Additionally, Augstell has served as a lecturer in finance at Siena College since 2010, as well as Vice President and Regional Consultant with McDonald Investments in Albany. Augstell holds a B.S. in Finance from LeMoyne College in Syracuse, New York, and received a Master of Science with Honors in Financial Planning from the College for Financial Planning. Stephen Augstell is a Certified Financial Planner™ professional.



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