

IRS CLARIFIES INHERITED IRA DISTRIBUTION RULES

It used to be simple

Historically, inheriting an IRA was a relatively straight forward process. Most beneficiaries were afforded the ability to “stretch” distributions over their own remaining lifetimes while paying taxes on the resulting income when distributions were taken.

The SECURE act complicated matters

In 2019, the SECURE Act changed the rules for inherited IRA required distributions by replacing the lifetime stretch with a new 10-year rule for all ‘non-eligible’ beneficiaries, while ‘eligible’ beneficiaries would continue to benefit from lifetime stretch distributions. Eligible beneficiaries include surviving spouses, disabled and chronically ill beneficiaries, minor children of the deceased account owner, and beneficiaries who are less than 10 years younger than the original account owner.

The 10-year rule stated that all non-eligible beneficiaries would have 10 years to fully distribute the account and pay the resulting taxes. The new rules went into effect for anyone who inherited IRA assets on or after January 1, 2020.

The 10-year rule was intended to limit the amount of time beyond an original account owner’s lifetime that retirement assets could grow tax-deferred (or

tax-free in the case of Roth accounts). The argument for this shortened withdrawal time horizon was that retirement accounts were never intended to perpetuate tax-advantaged growth for multiple generations. In other words, the IRS wanted its cut.

Some additional planning flexibility

Initially, it was universally understood distributions in years 1-9 were allowed, but not required under the new 10-year rule. This opened up planning opportunities for clients. For example, if a client inherited a pre-tax IRA and was still 5 years away from retirement and in a high tax bracket, distributions could be back-end loaded in years 6-10, after retirement when that individual would likely be in a lower tax bracket. Or, for clients who have income-sensitive healthcare subsidies and are only a few years away from Medicare, it would be advantageous to avoid distributions until after Medicare enrollment at age 65.

Not so fast

In March of 2022, the IRS caused a lot of confusion when they indicated that for non-eligible beneficiaries inheriting from an original account owner who was past their own required beginning date for required distributions (generally over age 72), the 10-year rule would in-fact require annual distributions in years 1-9 (based upon the beneficiary’s life expectancy)

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and a full distribution of account balances by the end of year 10. If the original account owner was not yet required to take distributions at the time of their death, there would be no required distributions in years 1-9, only a requirement to fully distribute the account by the end of year 10.

This really complicated matters for beneficiaries who now had annual required distributions, were already in year 2, had not taken distributions in years 1 or 2, and were facing penalties of 50% of the undistributed amounts.

Penalties waived

Last month the IRS clarified that penalties for failing to take a required distribution in 2021 or 2022 would be waived. This waiver only applies to accounts that were inherited after January 1, 2020. The penalty waiver essentially means that distributions do not have to be taken for 2021 or 2022. Crisis averted.

Planning for 2023 and beyond

Starting in 2023, for non-eligible beneficiaries who inherited IRA accounts on January 1, 2020 or later and the original account owner was beyond their required beginning date (already taking their own required distributions), annual distributions will be required in addition to the 10-year rule.

For non-eligible beneficiaries who inherited IRA accounts on January 1, 2020 or later where the

original account owner was not yet required to take distributions, the inherited account simply has to be empty by the end of year 10 (no required distributions in years 1-9). These beneficiaries continue to have meaningful flexibility.

Owners of inherited IRA accounts must be aware of the new rules, but it's also important for all owners of retirement accounts to consider the potential future ramifications for their heirs. Whether that involves gifting to charity out of IRA's during one's lifetime, leaving a portion of pre-tax IRA assets to charity outright, or spending down IRA assets intentionally, we are having a lot of planning conversations that have been driven by the rules of the SECURE Act.

Given the overall complexity of this topic, we would like to encourage you to reach out to us directly to discuss how the SECURE Act is likely to impact your individual situation.

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