IRA distribution options for beneficiaries

Wealth Management

As a beneficiary of an individual retirement account (IRA), you are faced with important decisions regarding the distribution of these assets. How you decide to take these distributions will have a considerable impact on your overall tax burden. It is important you understand the rules in order to make the best choice to fit your circumstances.

Your distribution options from an IRA depend on a number of factors: the type and status of beneficiary, when the IRA owner passed away, and whether the IRA owner passed away before or after the date they are required to take required minimum distributions (RMDs), or required beginning date.

Date of death

The distribution options available to beneficiaries depend on the death of the IRA owner. If the owner passed away prior to January 1, 2020, the beneficiary may have the option to stretch the IRA. This allows the beneficiary to transfer the remaining assets to their own inherited or decedent beneficiary IRA and to take minimum distributions based on their own remaining single-declining life expectancy. The beneficiary may also be allowed to name successor beneficiaries.

Successor beneficiaries of the original beneficiary are generally subject to the "10-year" rule. If the original IRA owner died before 2020, or prior to the enactment of the Setting Every Community Up for Retirement Enhancement (SECURE) Act, and the original beneficiary dies in 2020 or thereafter, then the successor beneficiary will be subject to the new "10-year" rule. However, if the original beneficiary also died before 2020, then the successor beneficiary may continue taking RMDs according to the schedule of the remaining single life expectancy of the original beneficiary.

Required beginning date (RBD)

The RBD is the date that an IRA owner must begin taking required minimum distributions (RMDs)—specifically, April 1 of the calendar year following the calendar year in which an account owner reaches age 72.

Designated beneficiary

A designated beneficiary is the individual whose life expectancy is used to calculate RMDs after the death of an IRA owner. Beneficiary designations, for distribution purposes, do not become fixed until September 30 of the year following the year of an IRA owner's death. No new beneficiaries can be named after the death of an IRA owner. But beneficiaries who disclaim or have had their benefits paid out to them in full prior to this date will not be considered when determining death distribution options.

An account can only have one designated beneficiary, but if an IRA is divided into separate decedent IRAs after an IRA owner's death and prior to December 31, each decedent IRA could have a designated beneficiary. A beneficiary can disclaim all or a portion of their inherited IRA benefit. By disclaiming, the beneficiary is giving up rights to the assets, which then pass to the other beneficiaries. A valid disclaimer must meet specific requirements and generally must be executed within nine months of the IRA owner's death.

Successor beneficiaries

Upon inheriting an IRA, you can name subsequent beneficiaries. If you die before the assets are fully distributed, your subsequent beneficiaries may take a lump sum distribution of the remaining assets if they so desire. Otherwise, the successor beneficiaries of the original beneficiary are generally subject to the "10-year" rule. If the original IRA owner died before 2020, and the original beneficiary dies in 2020 or thereafter, then the successor beneficiary will be subject to the "10-year" rule. In addition, if the original beneficiary also died before 2020, then the successor beneficiary may continue taking RMDs according to the schedule of the remaining single life expectancy of the original beneficiary.

Required minimum distribution

If you are an eligible designated beneficiary, you can still stretch the RMDs over your remaining life expectancy, rather than being subject to the SECURE Act's new "10-year" rule, which will allow the remaining balance of your decedent beneficiary IRA to continue growing tax-deferred. Keep in mind, you can always take more than the required minimum distribution. However, not taking the RMD will result in a penalty of 50% on the shortfall. Distributions you take as a beneficiary are generally taxable as ordinary income but are exempt from the 10% premature distribution penalty regardless of your age.

If you are not an eligible designated beneficiary, then the balance of the inherited or decedent beneficiary IRA account must be fully withdrawn within 10 years from the date of the original account owner's death, specifically, by no later than December 31 of the 10th year following the year in which the original IRA owner died.

Roth IRA beneficiaries

There is no required beginning date for Roth IRAs, because a Roth IRA owner isn't required to take RMDs during their lifetime. A Roth IRA is not subject to RMDs until a non-spouse beneficiary inherits the assets. When a non-spouse beneficiary inherits Roth IRA assets, the distribution requirements are the same as those available to non-spouse beneficiaries of traditional IRAs.

Trust

Generally speaking, only living individuals can be designated beneficiaries. However, even though a trust is a non-living entity, a special rule may be applied to certain trusts, notably special needs trusts, or trusts established for the benefit of either a disabled individual, as defined under Tax Code Section 72(m)(7) or a chronically ill individual, as defined under tax Code Section 7702B(c)(2). Under this rule, the special needs individual who is the trust beneficiary will be treated as the eligible designated beneficiary and be permitted to stretch RMDs over their own single-declining life expectancy if the following regulatory requirements are met in order to also create a valid look-through trust:

- The trust is valid under state law and is irrevocable or will, by its terms, become irrevocable upon the death of the IRA owner
- The trust beneficiaries must be individuals clearly identifiable (from the trust document) as designated beneficiaries as of September 30 of the year following the year of the IRA owner's death
- The IRA custodian is provided with a list of beneficiaries (including contingent remainder beneficiaries) along with a written certification that the list is accurate and the trust is a valid look-through trust by meeting the above requirements by October 31 of the year following the year of the IRA owner's death
- A copy of the trust instrument is provided to the IRA custodian upon demand

Additional guidance from the IRS/Department of Treasury is still needed to determine whether or to what extent trusts named as beneficiaries of IRAs may also be permitted to allow an eligible designated beneficiary of a trust to stretch RMDs over their own remaining single life expectancy. Eligible designated beneficiaries include a surviving spouse, a minor-aged child until the age of majority, and an individual not greater than 10 years younger than the original IRA owner.

Beneficiaries of qualified plan assets

A spouse beneficiary can generally roll over death benefits inherited from a qualified retirement plan, such as a 401(k), pension or profit-sharing plan, into their own IRA. Keep in mind that if the plan participant was past their RBD when they passed away, their current year RMD must be distributed to their beneficiary(ies) and is not eligible to be rolled over.

If you have a non-spouse beneficiary and they are a living person, or a qualifying look-through trust, they can roll over their inheritance into a decedent beneficiary IRA. The rollover must be done via a direct rollover—no 60-day rollovers are permitted. The decedent beneficiary IRA must be a traditional IRA (unless you inherit designated Roth 401(k) account or designated Roth 403(b) account assets), and will be subject to the required distribution rules applicable to a non-spouse beneficiary.

The ability to do the direct rollover is significant, because qualified plans often require faster payouts to non-spouse beneficiaries than the law requires, thus accelerating taxation. In order for a non-spouse beneficiary to take advantage of the longer payout, it is important that the direct rollover occur in a timely manner, generally by December 31 of the year following the year of the plan participant's death. If you inherit qualified plan assets, your first step should be to consult the administrator of the qualified plan regarding your post-death options as a beneficiary.

Conclusion

Making a decision regarding a retirement plan inheritance can seem very overwhelming in the midst of losing a loved one. Your financial advisor, along with your tax or legal advisor, can walk you through each of the above options and help you make the decision that best fits your needs.

Beneficiary distribution options[1]

	Beneficiary	Distribution options
Death before required beginning date	Spouse	1. Lump sum distribution. 2. RMDs over their life expectancy. 3. Distribute assets over their life expectancy. • Distributions are required to begin by December 31 of either the year following the year the account owner died, or the year the account owner would reach age 72. • Distributions are based on the single life expectancy of the surviving spouse, redetermined annually. • No 10% penalty. 4. Transfer or rollover to own IRA. • RMDs must begin at age 72.
	Non-spouse—designated beneficiary	All assets must be distributed by December 31 of the tenth year following the year of the original account owner's death, unless the non-spouse beneficiary is an eligible designated beneficiary. If so, then the eligible designated beneficiary distributes the RMDs over their individual remaining single-declining life expectancy.
	Non-spouse—no designated beneficiary	The full balance of the account must be distributed by December 31 of the fifth year following the year of the original account owner's death.
Death after required beginning date[1]	Spouse	1. Distribute assets over spouse's life expectancy **or** the remaining life expectancy of the original account owner, whichever is longer. • If funds are distributed over their life expectancy, their life expectancy must be recalculated annually. • If funds are distributed over the remaining life expectancy of the original account owner, the life expectancy is fixed at the year of death and reduced by one year every following year. 2. Transfer or rollover to own IRA. • RMDs must begin at age 72.
	Non-spouse—designated beneficiary	All assets must be distributed by December 31 of the tenth year following the year of the original account owner's death, unless the non-spouse beneficiary is an eligible designated beneficiary. If so, then the eligible designated beneficiary distributed the RMDs over their individual remaining single-declining life expectancy.
	Non-spouse—no designated beneficiary (Charity, estate, or non-look-through trust)	All assets must be distributed based on the remaining single-declining life expectancy of the deceased IRA owner commencing in their year of death.

Wealth Management

1. If an account owner dies after their RBD but prior to satisfying their current year RMD, their beneficiaries must satisfy the current year RMD.

20-21-04114_2115 (12/20)