The new IRS 10-year RMD rule isn't what we thought it was

The big surprise was the IRS' announcement that if an account holder dies after their required beginning date, required minimum distributions would be required for years one through nine.

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By Ed Slott

On Feb. 23, the IRS released its long-awaited SECURE Act proposed regulations for required minimum distributions, which include some big changes to the way most of us thought these payout rules would work.

Unfortunately, even though these are "proposed" regulations, the changes are likely effective now. This isn't like tax law, where proposed legislation doesn't become a law until it's signed into law by the president. The SECURE Act was effective law as of Jan. 1, 2020; now, two years later, the IRS has issued these "proposed regulations" on how the RMD rules will work.

The big surprise was the IRS' interpretation of how the 10-year rule applies for certain individual retirement account (and workplace plan) beneficiaries.

The IRS says that when death occurs on or after the account holder's required beginning date, or RBD, under the 10-year rule, RMDs would be required for years one through nine. Then in year 10, the entire remaining balance in the inherited IRA would have to be withdrawn by the beneficiary.

This means that some beneficiaries who inherited in 2020 may have already missed an RMD (for 2021) that no one thought had to be taken. The best advice for advisers is to have affected clients hold off right now on making up any missed RMDs for 2021. Hopefully, the IRS will provide a waiver of the 50% penalty or some other guidance on this later this year.

THE 10-YEAR RULE

As a review, the SECURE Act eliminated the so-called "stretch IRA" for most non-spouse designated beneficiaries and replaced that with a 10-year rule under which all the inherited retirement funds must be withdrawn by the end of the 10th year after death.

The law created exceptions for certain beneficiaries Congress called "eligible designated beneficiaries,"who could continue to use the stretch IRA the same as

before the SECURE Act. EDBs are surviving spouses, minor children of the deceased IRA owner (up to age 21, regardless of state law), disabled and chronically ill beneficiaries, and beneficiaries who aren't more than 10 years younger than the deceased IRA owner.

Most other non-spouse beneficiaries would be subject to the 10-year rule.

But under these new rules, both the RBD and the rule known as the "at least as rapidly," or ALAR, rule become more important.

The RBD is generally April 1 of the year following the year the IRA owner (or plan participant) turns age 72. Some plan participants can delay their company plan RBD if they're still working. Under these IRS rules, the RBD takes on new significance since RMDs would be required for years one through nine if the IRA owner dies on or after the RBD, but not if death occurred before the RBD.

'AT LEAST AS RAPIDLY'

The ALAR rule was always in the tax code for RMDs but lost its significance (or so we thought) once the 10-year rule was created. That's because most commentators, including me, believed that under the 10-year rule, no RMDs would be required in years one through nine, and that the only RMD would be the balance in the inherited IRA at the end of the 10-year term.

Surprise! The IRS says no. The ALAR rule still applies, and RMDs will be required for years one through nine after death.

While the ALAR rule doesn't require the beneficiary to take the same amount as the IRA owner, it does require that the beneficiary continue RMDs. Under this rule, once lifetime RMDs begin, they must continue for beneficiaries based on their life expectancy, if they are a designated beneficiary.

Translation: Both rules apply when death occurs on or after the RBD:
1. The ALAR rule, which requires RMDs each year after death (when death occurs on or after the RBD); and
2. The 10-year rule, under which all funds in the inherited IRA must be withdrawn by the end of the 10th year after death.

EXAMPLE

In 2021, Tom, age 32, inherits an IRA from his father, who died at age 74. Tom is a designated beneficiary, but he's not an eligible designated beneficiary. This means he's subject to both the ALAR rule (for years one through nine) and the 10-year rule, for year 10. Tom's father died after his required beginning date, so Tom is required to take annual RMDs over his life expectancy (the stretch IRA) for the first nine years of the 10-year period (i.e., starting in 2022 and continuing through 2030). In 2031, by

Dec. 31, he's required to take the remaining portion of the inherited IRA. If he doesn't follow this schedule, he'll be subject to the 50% penalty on the amount not taken.

IF DEATH OCCURS BEFORE RBD

If Tom's father had died before his RBD, Tom could take as much or as little out of the inherited IRA each year during the 10-year period, but he still would have to withdraw the entire IRA by Dec. 31, 2031. No annual RMDs need to be taken in years one through nine.

ROTH IRAs

Since Roth IRAs aren't subject to lifetime RMDs, every Roth IRA owner is deemed to have died before his or her RBD, regardless of their age at death. That's because Roth IRAs have no RBD. For example, a Roth IRA owner who dies at age 100 is still deemed to have died before his or her RBD.

In the example, above, if Tom's father's IRA was a Roth IRA, Tom would not have to take annual RMDs for years one through nine of the 10-year period, regardless of how old his father was when he died (that is, whether he died before or after his required beginning date).

While some beneficiaries subject to the 10-year rule will have to take RMDs in years one through nine, this will never be the case for a designated Roth IRA beneficiary, since all Roth beneficiaries are deemed to have died before their RBD.

This can allow the inherited Roth funds to continue to accumulate income tax-free for the full 10-year term. That can benefit both individual and trust beneficiaries and is another good reason to contribute to, or convert to, Roth IRAs. Keep in mind, however, that the full balance of the inherited Roth must still be withdrawn by the end of the 10th year after death.

WATCH OUT FOR FIVE-YEAR RULE

Since all Roth IRA owners are deemed to have died before their RBD, this can trigger the five-year rule if there's no designated beneficiary. A designated beneficiary is an individual named on the beneficiary form or a qualifying trust. Examples of a non-designated beneficiary (NDB) are an estate, a charity or a non-qualifying trust.

Under the RMD rules for inherited IRAs, when an NDB inherits from someone who died before the RBD, the five-year rule applies, and the inherited IRA funds must be withdrawn by the end of the fifth year after death (but no withdrawals are required for years one through four).

CHECK BENEFICIARY FORMS!

This is yet another reason to check beneficiary forms to make sure that they have designated beneficiaries.

Alert your clients to these new RMD rules. New inheritors may already be subject to taking RMDs they thought could be delayed much longer.

Most of the latest confusion revolves around the revelation that annual RMDs are required for years one through nine after death, based on the so-called “at least as rapidly” rule, which these questions and answers address.

Q: Where does IRS come up with RMDs for years one to nine under the SECURE Act? I thought the 10-year rule replaced those RMDs?

A: So did I! But IRS says “No.” The IRS is relying on the “at least as rapidly,” or ALAR, rule. Under long-existing RMD tax rules, the ALAR rule essentially states that once RMDs begin, they can’t be stopped or turned off by a beneficiary.

This is the rule on which IRS bases its position that RMDs are required for years one through nine of the 10-year period when death occurred on or after the required beginning date, or RBD. When an IRA owner dies after the RBD, the beneficiary must continue taking RMDs. However, the ALAR rule doesn’t mean that the beneficiary must take the same RMD amounts the IRA owner was taking. It means that the beneficiary must continue using the same process by calculating RMDs based on that beneficiary’s own life expectancy (the stretch IRA), as explained in the answer to the next question.

Q: For beneficiaries who are subject to the 10-year rule, how are the RMDs calculated for years one through nine after death?

A: Designated beneficiaries (individual beneficiaries who are named on the beneficiary form and aren’t eligible designated beneficiaries or EDBs) will be subject to the 10-year rule. But if they inherited from someone who died after the RBD, then they’re subject to RMDs for years one through nine, and then a full distribution of the balance in the inherited traditional IRA by the end of the 10th year after death.

The RMDs for years one through nine of the 10-year period are based on the beneficiary’s age in the year after death, the same process as with the lifetime stretch IRA. The beneficiary finds the life expectancy factor from the Single Life Table (the new 2022 table) for the year after death and divides the prior year-end balance by that factor. For subsequent years two through nine, the beneficiary reduces that factor by one. It’s as if the beneficiary is getting the stretch IRA for the first nine years after death and it’s calculated the same way. For the RMD in year 10, no table is needed since that RMD is simply 100% of the remaining balance in the inherited account.

If the IRA owner died before the RBD, then no annual RMDs are required for years one through nine, but the balance must still be withdrawn by the end of the 10-year term.

Q: Can a spouse use the 10-year rule to delay RMDs?

A: The IRS says no in these proposed regulations. It goes further than that, though. The IRS created yet another new term to know, “hypothetical RMDs,” as a type of deterrent to ensure no RMD years are missed once a spouse would otherwise have been required to take those RMDs by reaching age 72.

Here’s an example. Ken and his wife Linda are both 70 years old. Ken dies with Linda as his primary IRA beneficiary. As an EDB spouse, Linda can do a spousal rollover or elect to remain a beneficiary. If Linda elects to remain a beneficiary, she can also elect the 10-year payout. Since Ken died prior to reaching his RBD, Linda will have no RMDs during the 10-year window. She simply has to empty the account by Dec. 31 of the 10th year after the year of Ken’s death. There’s no deadline for a spousal rollover, so Linda may believe that she can have her cake and eat it too. She may think she can use the 10-year rule (without annual RMDs) and then do a spousal rollover years later to avoid several years of annual RMDs that she otherwise would have had to take from her own IRA. That is the “loophole” the IRS is closing with this “hypothetical” retroactive spousal RMD provision.

Once again, the IRS is relying on a version of the ALAR rule. In this case though, it involves a spouse who otherwise would have been able to skip RMDs by using the 10-year rule.

In a later year (but before the end of year 9), when Linda decides to do the spousal rollover, she can’t roll over the full amount. Before completing the spousal rollover, Linda must calculate hypothetical RMDs for each year she was 72 or older. These hypothetical RMDs aren’t eligible for rollover. (The years when Linda was 70 and 71 aren’t considered because they were before her first RMD year.)

Q: How do RMDs work when a minor child of the IRA owner inherits?

A: A minor child of the deceased IRA owner (or plan participant) is an EDB, but only up to age 21. The proposed regulations state that this is the universal age of majority for this rule, regardless of state law. This is a good rule that not only simplifies the age of majority issue but is also generous given that the age of majority in most states is 18.

Once a qualifying minor (under age 21) inherits an IRA, the minor gets the stretch IRA until the year she turns age 21, but then she switches to the 10-year rule. At that point, the entire remaining balance must be withdrawn by the end of the 10-year term.

However, under one interpretation of these rules, the child must continue taking RMDs for years one through nine, even if the minor inherited from someone who died before the RBD. This would be the same rule if the minor inherited a Roth IRA.

Again, the rationale behind this interpretation (and there are some who take a different view of these messy RMD rules) is that since RMDs were begun by the minor as an EDB, the ALAR rule doesn't allow them to stop when the 10-year rule turns on once she turns age 21. Under this view, annual RMDs must continue even if she inherited from someone who died before beginning RMDs.

Hopefully, at some point, the IRS will provide more clarity on these scenarios and the ALAR rule.