Washington **Pulse**

March 9, 2022

IRS Releases Proposed Required Minimum Distribution Regulations

After a two year wait, we have guidance regarding certain changes brought about by the SECURE Act. On February 23, 2022, the IRS released proposed regulations that revise the existing required minimum distribution (RMD) regulations and other related regulations. The last major rewrite of the RMD regulations—which included substantial simplification—happened in 2002. This rewrite will undoubtedly lead to requests for clarification and revisions. Comments on the proposed regulations are due by May 25, 2022.

Proposed Regulations—Background

The SECURE Act—officially known as the Setting Every Community Up for Retirement Enhancement Act of 2019—made significant changes to IRA and retirement plan rules. Among other things, the SECURE Act raised the starting age for RMDs from 70½ to 72, changed the five-year beneficiary payout rule to 10 years (for most beneficiaries), and allowed fewer beneficiaries to take retirement distributions over their lifetimes.

Many of the new IRA and retirement plan rules contained in the SECURE Act seemed fairly straightforward. But like any new statute, these rules also created questions, such as those relating to the new post-SECURE beneficiary options. Fortunately, many of these questions have been addressed in the proposed regulations. But the new regulations also pose some challenges. For example, certain provisions seem more complex than the existing regulations. Others depart from well-established rules that we've practiced for the last 20 years. Along with these changes, however, the IRS has granted relief while we wait for final regulations.

Good Faith Compliance With the Proposed Regulations Provides Relief

The proposed regulations include provisions relating to RMDs, rollovers, and to penalty taxes that apply when RMDs are not taken properly. Although most of the SECURE Act provisions became effective on January 1, 2020, these regulations are proposed to become effective on January 1, 2022. For 2021, the preamble to the proposed regulations states that taxpayers must apply the existing regulations *and* exercise a "reasonable, good faith interpretation" of the increased RMD age and 10-year rule created by the SECURE Act. Compliance with the proposed regulations will satisfy that requirement.

Defined Contribution Plan and IRA Provisions

The SECURE Act made some fundamental changes to the distribution rules. Because the rules differ depending on whether the account owner died before 2020, or on or after January 1, 2020, we now have to understand two separate sets of rules. For example, if an IRA owner died in 2019, a nonspouse beneficiary could take annual required distributions over that beneficiary's lifetime. But if that same IRA owner died in 2020, the beneficiary may not have that option. As a result of these and other changes, the IRS has rewritten the regulations.

The 10-Year Rule

One of the most important changes contained in the SECURE Act was the elimination of the so-called "stretch" provision for many beneficiaries. As a result, beneficiaries will no longer be able to take life expectancy payments unless they fall into one of these categories.

- Account owner's spouse
- Individual who is not more than 10 years younger than the account owner
- Disabled or chronically ill individual
- Account owner's minor child
- Beneficiary of account owner who died before January 1, 2020

These individuals are called "eligible designated beneficiaries." The proposed regulations expand the eligible designated beneficiary definition from the statute to include beneficiaries of account owners who died before January 1, 2020. If an eligible designated beneficiary dies on or after January 1, 2020, the successor beneficiary must distribute all assets by the end of the tenth calendar year following the year of the eligible designated beneficiary's death. If the account owner has multiple eligible designated beneficiaries, then the assets will generally be distributed by the end of the tenth calendar year of the oldest eligible designated beneficiary's death, if that eligible designated beneficiary is still alive on or after January 1, 2020. This same deadline applies to successor beneficiaries when both the account owner and the eligible designated beneficiary die on or after January 1, 2020.

The 10-year rule changes IRA and retirement plan administration substantially. For example, adult children and grandchildren who are beneficiaries will now be subject to the 10-year rule, which requires distribution of all inherited assets by the end of the tenth year following the original account owner's death. But spouse beneficiaries retain the options of taking annual payments over their life expectancy, or (more commonly) taking the assets as their own. Nonspouse beneficiaries who are not more than 10 years younger than the decedent may continue to exercise the lifetime payout option; nonspouse beneficiaries more than 10 years younger (unless they meet another exception) are subject to the 10-year rule.

The proposed regulations provide a safe harbor for determining whether a beneficiary is disabled. The safe harbor will apply if, by the account owner's death, the Commissioner of Social Security has determined that the beneficiary is disabled. Disabled or chronically ill beneficiaries must provide proper documentation of their condition by October 31 of the year following the account owner's death.

In addition to taking a lump sum distribution at any time, minor children may take annual payments based on their life expectancy, but only until they reach the age of majority. Then they revert to the 10-year rule. The proposed regulations clearly state that the "age of majority" for required distribution purposes is age 21.

"At Least As Rapidly" Rule

Internal Revenue Code (IRC) Section 401(a)(9)(B)(i) requires beneficiaries to take distributions "at least as rapidly" as the account owner if the account owner dies on or after the required beginning date (RBD). But the existing regulations have allowed younger beneficiaries to take annual distributions based on their own single life expectancy, thus slowing down the payments. Now, the proposed regulations contain an unanticipated provision. For those beneficiaries that are subject to the 10-year rule, not only must they deplete their account balance by the end of the year that contains the tenth anniversary of the original account owner's death, but *they must also take annual distributions based on the normal single life expectancy calculation*. This added provision—if it is included in in the final regulations—may trip up some of those who are used to a much simpler 5-year rule.

NOTE: *This new rule—to take life expectancy payments for the first nine years before a total distribution—applies only when the account owner dies on or after the RBD. It does not apply to deaths before the RBD.*

Different Categories of Beneficiaries

Individuals who do not meet the definition of "eligible designated beneficiary" are simply referred to as "designated beneficiaries" and are normally subject to the 10-year rule (again, for deaths in 2020 or later years). Beneficiaries that are not individuals—such as trusts or estates—are not considered designated beneficiaries. These beneficiaries are subject to the same options as before: they generally default to the five-year rule if the account owner dies before the

RBD and to life expectancy payments based on the account owner's age if the account owner dies on or after the RBD.

Separate Accounting Principles Still Apply

The concept of separate accounting for beneficiaries remains intact in the proposed regulations. A beneficiary's status is still determined as of September 30 of the year following the account owner's death. To the extent that separate accounts are created and maintained for multiple beneficiaries by December 31 of the year following the account owner's death, each beneficiary will be treated as the sole beneficiary of that account. Practically, this means that, even if there are different beneficiary categories with different payout options, separate accounting will preserve the available options for each category.

> **Example:** Assume that an IRA owner dies before his RBD, which is now April 1 of the year following the year that he turns age 72. The IRA owner has named his spouse, his twin brother, and his estate as equal beneficiaries, each to receive one-third of his IRA. Normally, the beneficiary with the shortest life expectancy—in this case, the estate, with no life expectancy—would dictate the distribution time frame for all three beneficiaries. Under the current and proposed regulations, because the estate would be required to distribute its share under the 5-year rule, so would the other beneficiaries. But if separate accounting is in place, each beneficiary may use the distribution options that would be available to them if they were the sole IRA beneficiary. That is, the spouse could take the assets as her own, and the brother could take life expectancy payments.

Trusts as Beneficiaries

The proposed regulations contain considerable text addressing trusts as beneficiaries in the hope that "comprehensive and definitive guidance will minimize the need for taxpayers to request private letter rulings." While the IRS devotes many pages and multiple examples to addressing the twists and turns of naming trust beneficiaries, one fundamental takeaway is clear: "see-through trusts" are still alive and well. The see-through trust concept will likely remain popular because it allows the underlying beneficiaries of such trusts to be treated as designated beneficiaries—or *eligible* designated beneficiaries—if the trust meets certain requirements. To qualify as a see-through trust,

- the trust must be valid under state law;
- the trust must be irrevocable, or become irrevocable upon the account owner's death;
- the trust must contain identifiable beneficiaries (even if they are not specifically named); and
- trust documentation must be provided to the account administrator.

Naming a trust as the beneficiary of an IRA or retirement plan account may make sense in various contexts. But the rules associated with these types of beneficiaries can be complex. The proposed regulations provide detailed information and specific scenarios on certain types of trust beneficiary issues, such as those related to contingent and residual beneficiary interests. This additional guidance may help clarify many previously unanswered questions within the retirement and estate planning industries.

Life Expectancy Limit for Older Eligible Designated Beneficiaries

As discussed, eligible designated beneficiaries are permitted to take RMDs based on their single life expectancies. If an account owner dies on or after the RBD, the beneficiary may use the longer of the decedent's remaining life expectancy (based on the age *in* the year of death) or the beneficiary's life expectancy (based on the age *after* the year of death). Normally, once the life expectancy factor equals one year or less, the account balance must be fully distributed. But there's a new rule, best illustrated with an example.

> **Example:** Oliver owned an IRA and died in 2022 at age 80. His brother, Bill, is the sole beneficiary and turned 90 in the year following Oliver's death. The RMD rules allow Bill to use Oliver's life expectancy (11.2 years in the year of death, reduced by one each year) instead of his own (5.7 years in the year following Oliver's death, reduced by one each year). This means that Bill could take RMDs each year based on Oliver's longer life expectancy. But the proposed regulations require the entire amount in the inherited IRA to be distributed in the year that *Bill's* life expectancy is one year or less. So despite Bill being able to take somewhat less each year, using Oliver's life expectancy, Bill must still deplete the entire account in the sixth year following death (based on *his* 5.7 year life expectancy).

This new rule is a significant departure from the way life expectancy payments have been calculated for decades.

Other Notable Provisions

- **Deadline for spousal election to treat IRA as own.** A spouse beneficiary may treat an inherited IRA as her own by making an election (e.g., transferring the assets to her own IRA) or by making a "deemed election" (i.e., failing to take an RMD from the account or making a contribution to the account). The proposed regulations state that the deadline for such elections is the later of the year following the IRA owner's death or the year in which the spouse beneficiary reaches age 72. After these dates, a spouse beneficiary cannot treat the IRA as her own, but can distribute and roll over the inherited assets to her own IRA.
- **"Hypothetical RMDs" not eligible for rollover treatment.** Assume that an IRA owner dies before the RBD and has a spouse beneficiary who elects the 10-year rule. The spouse beneficiary rolls over the inherited assets to her own IRA before the last year of the 10-year window but in the year that she turns age 72 (or older). The proposed regulations require the beneficiary to calculate a hypothetical RMD—an amount that would have been required to be distributed had the life expectancy rule applied to the spouse beneficiary—and exclude that amount from any rollover contribution.
- **RMDs from all IRAs are aggregated for rollover purposes.** If an individual owns multiple IRAs and wants to roll over an IRA distribution in any year in which RMDs are required, RMDs from *all* of the individual's IRAs must be aggregated when determining what portion of a distribution is ineligible for rollover treatment. This means that the RMDs from *all* of the individual's IRAs must be distributed before a distribution from any IRA can be rolled over. The existing regulations apply this rule per IRA; but the proposed regulations combine RMDs from all IRAs, thus decreasing the eligible rollover amount.
- **Automatic waiver of 50% penalty tax for switching to the 10-year rule.** If the account owner's death is before the required beginning date and an eligible designated beneficiary fails to take a life expectancy payment, the IRS will automatically waive the penalty tax if 1) the beneficiary did not make an affirmative election to take life expectancy payments (e.g., a plan provision defaulted to that method), and 2) the beneficiary elects the 10-year rule by the end of the ninth calendar year following the account owner's death.
- **Automatic waiver of 50% penalty tax for missing year-of-death RMD.** The IRS will also waive the penalty tax if a beneficiary fails to take an RMD by the end of the year in which the account owner dies. To get this automatic relief, the beneficiary must remove the year-of-death RMD by the beneficiary's tax filing deadline, including extensions.

Defined Benefit Plan (and Annuity) Provisions

Under the proposed regulations, the changes regarding defined benefit (DB) plans are relatively modest; most DB provisions remain the same. The most significant changes include the following.

- Annuity contracts must be issued by an insurance company licensed in the state where the contract is sold. This rule does not apply to an annuity paid under an IRC Sec. 403(b)(9) retirement income account.
- The SECURE Act did not update the age in situations when actuarial increases of benefits must occur for employees who postpone retirement beyond the year they attain age 70½. The proposed regulations mirror the SECURE Act and confirm that this rule does not apply to five percent owners, governmental plans, or church plans.
- The proposed regulations retain the general rule that DB and annuity contract payments must be nonincreasing. But the IRS added events that would allow payment increases following certain benefit suspensions, including those for 1) re-employment after commencing benefits, 2) plan insolvency, or 3) a plan in critical or declining status. This section also allows benefit increases for 1) a final death payment that is not greater than the excess of the contract's value over the payments made before death, 2) a short-term acceleration of payments made in advance for up to one year, and 3) any acceleration of payments to meet the SECURE Act RMD rules.
- The proposed regulations address conflicts between RMDs paid out under the 5-year rule and prohibited payments under IRC Sec. 436(d) (dealing with underfunded plans). This new provision offers an exception, allowing benefits required to be paid under the 5-year rule to extend past the normal deadline. Such payments must start by the end of the fifth year and must be in a form that is accelerated as much as possible under IRC Sec. 436(d).

- The age of majority for annuity payments to children is defined as age 21 in the proposed regulations, but plan sponsors may rely on their age of majority definition if it was adopted before the proposed regulations were published (February 24, 2022).

Final Regulations May Take Some Time

At this point, a public hearing is slated for June 15, 2022, to address the comments that the IRS has received. After that, it may take several months for the IRS to release final regulations. If the regulations are finalized later this year or even early next year, then perhaps the good faith requirement will also apply to 2022 distributions. Ascensus will closely monitor the progress of RMD (and related) guidance. Visit FuturePlan.com for the latest updates.