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Important Proposed Changes in IRA Distribution Rules for "10-Year Payout" Beneficiaries

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In this article, the author discusses proposed regulations that could affect beneficiaries of retirement accounts subject to the "10-year payout" rule under the 2020 SECURE Act.

If tax regulations proposed by the Internal Revenue Service (IRS) in February 2022[1] are finalized in their current form, many beneficiaries of Individual Retirement Accounts (IRAs) and other retirement accounts who are subject to the "10-year payout" rule under the 2020 SECURE Act will have to comply with an additional requirement and take a taxable withdrawal distribution from the retirement account in each year during the 10-year payout period if the account owner died after his or her required beginning date. This change will apply as early as 2023 to all individuals and qualifying trusts who are not permitted to use age and the IRS tables to stretch required minimum distributions over their entire life expectancies.

BACKGROUND: SECURE ACT CHANGES EFFECTIVE IN 2020

The original SECURE Act was enacted at the end of 2019 and has changed the distribution rules for IRAs and other retirement accounts when the account owner or participating employee died in 2020 or later. Most of the SECURE Act changes were made to a single subsection, Internal Revenue Code (IRC) § 401(a)(9). These changes were an

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"overlay" imposed on top of detailed required minimum distribution (RMD) regulations that the IRS first finalized in April 2002. The SECURE Act obviously superseded some of the 2002 RMD regulations, but IRA owners and beneficiaries and their advisors would have to wait for new guidance from the IRS to confirm exactly which of the 2002 RMD regulations would be changed.

The SECURE Act defined a new class of retirement account beneficiary: the "Eligible Designated Beneficiary" (EDB), which comprises only the following persons: (1) a surviving spouse of the participating employee or account owner; (2) a child of the participating employee or account owner who has not "reached majority" at the time of the death; (3) & (4) an individual who satisfies the detailed definitions of "disabled" or "chronically ill"; and (5) an individual who is not more than 10 years younger than the participating employee or account owner at the time of death.[2]

Under the SECURE Act and the February 2022 proposed Regulations, only an EDB in one of the five categories (or in some cases, a qualifying trust that has such a person as a trust beneficiary) can use the age and life expectancy of the person to calculate the RMDs and to spread taxable withdrawals over the person's life expectancy.

The SECURE Act did not change the existing definition of a "Designated Beneficiary" – anyone in a broader class of individuals (or trusts for individuals that qualify for see-through treatment) who is named as a beneficiary under the terms of the retirement account or plan. But the SECURE Act drastically changed how a "Designated Beneficiary" must take withdrawal distributions from the retirement account after the death of the participating employee or account owner: If a Designated Beneficiary is not also an Eligible Designated Beneficiary (EDB), that Designated Beneficiary must take taxable withdrawal distributions from the account so that the account balance is reduced to zero by the end of the 10th year following the death of the employee or the account owner. This is the "10-year rule" or "10-year payout rule,"[3] and it applies to all non-spouse adult beneficiaries who are neither disabled nor chronically ill.

In amended IRC § 401(a)(9)(H)(i), the 10-year period was defined by simply substituting "10 years" for "5 years" in the existing definition of the 5-year payout rule in IRC § 401(a)(9)(B)(ii). The 5-year rule applied and still applies to retirement accounts that have no "Designated Beneficiary," such as an IRA that is payable to the account owner's estate or which has a charitable organization (a non-individual) as a named beneficiary. If the five-year rule applies to an account after the employee or owner's death, the "entire interest" of the deceased employee or account owner must be "distributed within five years after the death of the employee."

In 2020 and 2021, and because of the terse way in which the SECURE Act defined the "10-year rule," a majority of expert commentators inferred that the 10-year rule would allow the Designated Beneficiary to make the required withdrawal of all assets from the retirement account by taking one or more distributions in any amounts and at any times during the 10-year period – including a single distribution late in year 10 – so long as the account balance was reduced to zero by the end of the 10th year following the year of death. Based on the text of the SECURE Act, this inference seemed conclusive with respect to a retirement account where the participating owner or employee died before his or her retired beginning date (RBD), and it was a defensible inference for accounts where the owner or employee died after the RBD.

By analogy, if the five-year rule allowed a single taxable withdrawal to be made at any time in the fifth year, the 10-year rule should allow a Designated Beneficiary to postpone withdrawing the entire retirement account assets until any time in the tenth year. The idea that no annual or other regular periodic withdrawals were required during the 10-year period was also consistent with the findings and explanation of the House Ways and Means Committee when it approved the SECURE Act provisions in the spring of 2019.[4]

However, and partly in response to tax professionals' requests for clarification, the IRS published proposed Regulations under the SECURE Act on February 24, 2022. These proposed Regulations are not yet final but are likely to be finalized in 2023. The proposed Regulations preserve many of the RMD rules under the April 2002 regulations but make numerous improvements, including the official adoption of definitions for terms of art ("see-through trust," "conduit trust," and "accumulation trust") that estate planners and tax professionals had been using for more than a decade.

With respect to the "10-year payout rule," the 2022 proposed Regulations make some clarifications and one significant addition that apply to Designated Beneficiaries who are not EDBs. The addition arguably goes beyond the text of the SECURE Act's changes to IRC § 401(a)(9):

- The 10-year payout period ends on December 31 of the tenth calendar year following the year of the employee or account owner's death.[5]

- If the account owner or employee died on or after the required beginning date under IRC § 401(a)(9)(C), the Designated Beneficiary must take an annual withdrawal distribution (RMD) during each year of the 10-year period, calculated by using the IRS table and by dividing the account value at the end of the previous year by a life expectancy denominator from the IRS Single Life Table under Reg. § 1.401(a)(9)-9(c)(1). For the first post-death distribution year, the life expectancy of the Designated Beneficiary or the life expectancy of the deceased account owner or employee should be used, whichever is the larger number, and in each subsequent post-death distribution year, one (1.0) should be subtracted from the previous year's denominator.[6]

- If the account owner or employee died before the required beginning date and if there is a Designated Beneficiary who is not an EDB, the Preamble to the 2022 proposed Regulations states that the Designated Beneficiary must withdraw the account owner or employee's entire interest in the retirement account by the end of the 10-year period, but that the Designated Beneficiary is free to determine the timing of the withdrawals, may delay the withdrawals until the 10th year, and is not required to withdraw RMDs during the 10-year period.

- The proposed Regulations themselves[7] do not contain a clear statement that corresponds to the Preamble's description and which eliminates the requirement for annual RMDs during the 10-year period for a Designated Beneficiary when the account owner or employee died before the required beginning date.

On October 7, 2022, the IRS issued Notice 2022-53, which confirmed that the final regulations (including the added requirement for Designated Beneficiaries to take RMDs every year during the 10-year payout period) "will apply no earlier than the 2023 distribution calendar year."[8] Depending on when the IRS finalizes the proposed regulations, the IRS may further postpone the effective date, but no one can count on such additional relief.

The proposed Regulations' addition of an annual RMD requirement during the 10-year period will have serious practical consequences for retirement account owners, Designated Beneficiaries, and their advisors, beginning in 2023.

For example, if an IRA owner and the owner's lawyer designs and drafts a trust that (a) is intended to qualify as a "see-through trust" for RMD purposes, and (b) has two or more beneficiaries who could qualify as Designated Beneficiaries if they were directly named a beneficiaries on the IRA, and if the IRA owner dies on or after his or her required beginning date, it will be crucial to structure that trust so that the trustee can later identify which trust beneficiaries can or cannot be disregarded and which trust beneficiary's life expectancy must be used to calculate the RMDs that the trustee must withdraw from the IRA and deposit into the trust's account during each year of the 10-year payout period.

NOTES

1. REG-105954-20, 87 F.R. 10504-01, published February 24, 2022, to amend regulations under 26 U.S.C. §§ 401(a)(9), 402, and 408.

2. IRC § 401(a)(9)(E)(ii); Prop. Reg. § 1.401(a)(9)-4(e).

3. IRC § 401(a)(9)(H)(i).

4. H. Rpt. 116-65 (Report of the Ways and Means Committee), May 16, 2019, pp. 108-09. https://www.congress.gov/116/crpt/hrpt65/CRPT-116hrpt65.pdf.

5. Prop. Reg. § 1.401(a)(9)-5(e)(2).

6. Prop. Reg. §§ 1.401(a)(9)-5(d)(1)(ii) and 1.401(a)(9)-5(d)(3)(iii).

7. Prop. Reg. § 1.401(a)(9)-5(d)(2).

8. IRS Notice 2022-53, 2022-45 IRB 437, 2022 WL 6732591, published November 7, 2022.