Required Distributions: Changes You Need to Know

The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 changed the rules for taking distributions from retirement accounts inherited after 2019. The so-called 10-year rule generally requires inherited accounts to be emptied within 10 years of the original owner's death, with some exceptions. Where an exception applies, the entire account must generally be emptied within 10 years of the beneficiary's death, or within 10 years after a minor child beneficiary reaches age 21. This reduces the ability of most beneficiaries to spread out, or "stretch," distributions from an inherited defined contribution plan or an IRA.

In February 2022, the IRS issued proposed regulations (generally applicable starting in 2022) that interpret the revised required minimum distribution (RMD) rules. Unless these proposals are amended, some beneficiaries could be subject to annual required distributions as well as a full distribution at the end of a 10-year period. Account owners and their beneficiaries may want to familiarize themselves with these new interpretations and how they might be affected by them.

RMD Basics

If you own a traditional IRA or participate in a retirement plan like a 401(k), you generally must start taking RMDs for the year you reach age 72 (age 70½ if you were born before July 1, 1949). If you're age 72 or older and still working for the employer that maintains the retirement plan, you may be able to wait until the year after retiring to start RMDs from that account. No RMDs are required from a Roth IRA during your lifetime (beneficiaries are subject to inherited retirement account rules). Failing to take an RMD can be costly: a 50% penalty generally applies to the extent an RMD is not made.

The required beginning date for the first year you are required to take a lifetime distribution is no later than April 1 of the next year. After your first distribution, annual distributions must be taken by the end of each year. (Note that if you wait until April 1 to take your first-year distribution, you would have to take two distributions for that year: one by April 1 and the other by December 31).

When you die, the RMD rules also govern how quickly your retirement plan or IRA will need to be distributed to your beneficiaries. The rules are largely based on two factors: (1) the individuals you select as beneficiaries of your retirement plan, and (2) whether you pass away before or on or after your required beginning date. Because no lifetime RMDs are required from a Roth IRA, Roth IRA owners are always treated as dying before their required beginning date.

Who Is Subject to the 10-Year Rule?

The SECURE Act does still allow certain beneficiaries to continue to "stretch" distributions, at least to some extent. These eligible designated beneficiaries (EDBs) include your surviving spouse, your minor children, any individual not more than 10 years younger than you, and certain disabled or chronically ill individuals. Generally, EDBs are able to take annual required distributions based on remaining life expectancy. However, once an EDB dies, or once a minor child EDB reaches age 21, any remaining funds must be distributed within 10 years.

Significantly, though, the SECURE Act requires that if your designated beneficiary is not an EDB, the entire account must be fully distributed within 10 years after your death.

What If Your Designated Beneficiary Is Not an EDB?

If you die before your required beginning date, no distributions are required during the first nine years after your death, but the entire account must be distributed in the tenth year.

If you die on or after your required beginning date, annual distributions based on the designated beneficiary's remaining life expectancy are required in the first nine years after the year of your death, then the remainder of the account must be distributed in the tenth year.

What If Your Beneficiary Is a Nonspouse EDB?

After your death, annual distributions will be required based on remaining life expectancy. If you die before your required beginning date, required annual distributions will be based on the EDB's remaining life expectancy. If you die on or after your required beginning date, annual distributions after your death will be based on the greater of (a) what would have been your remaining life expectancy or (b) the beneficiary's remaining life expectancy. Also, if distributions are calculated each year based on what would have been your remaining life expectancy, the entire account must be distributed by the end of the calendar year in which the beneficiary's remaining life expectancy would have been reduced to one or less (if the beneficiary's remaining life expectancy had been used).

After your beneficiary dies or your beneficiary who is your minor child turns age 21, annual distributions based on remaining life expectancy must continue during the first nine years after the year of such an event. The entire account must be fully distributed in the tenth year.

What If Your Designated Beneficiary Is Your Spouse?

There are many special rules if your spouse is your designated beneficiary. The 10-year rule generally has no effect until after the death of your spouse, or possibly until after the death of your spouse's designated beneficiary.

What Life Expectancy Is Used to Determine RMDs After You Die?

Annual required distributions based on life expectancy are generally calculated each year by dividing the account balance as of December 31 of the previous year by the applicable denominator for the current year (but the RMD will never exceed the entire account balance on the date of the distribution).

When your life expectancy is used, the applicable denominator is your life expectancy in the calendar year of your death, reduced by one for each subsequent year. When the nonspouse beneficiary's life expectancy is used, the applicable denominator is that beneficiary's life expectancy in the year following the calendar year of your death, reduced by one for each subsequent year. (Note that if the applicable denominator is reduced to zero in any year using this "subtract one" method, the entire account would need to be distributed.) And at the end of the appropriate 10-year period, any remaining balance must be distributed.

The rules relating to required minimum distributions are complicated, and the consequences of making a mistake can be severe. Talk to a tax professional to understand how the rules, and the new proposed regulations, apply to your individual situation.

Questions? Contact First Financial's Investment & Retirement Center by calling 732.312.1534. You can also email mary.laferriere@lpl.com or maureen.mcgreevy@lpl.com

---