SECURE Acts - A Couple of Questions and Answers

Wednesday, October 25, 2023

Take-Away: There are still many common questions about the SECURE Acts' provisions that create confusion. Fortunately there are some clear answers to some of those questions. But, then again, there are many questions where we must wait further guidance in the form of proposed Regulations. Some fairly common questions and answers follow.

What Happens when an IRA Beneficiary is Made to the Owner's Last Will and Testament? When an estate is named as the designated beneficiary of the decedent's IRA, then either the 5-year distribution rule or the '*phantom life expectancy'* rule applies (if the owner was beyond his/her required beginning date (RBD.) An estate is a non-designated beneficiary. The 10-year rule or the *stretch* distribution rule will not be available to the estate. The Personal Representative will request distributions from the inherited IRA, which will then be paid to the estate, and the estate will then pay those funds to the estate beneficiaries. This is usually also the result if the IRA owner fails to name a beneficiary and on their death the 'default' beneficiary under the IRA custodial account agreement is the decedent's estate.

Can a Trust Be Named as a Designated Beneficiary? Yes, a Trust can inherit an IRA. Yet a Trust is not a designated beneficiary; as a rule, only individuals are designated beneficiaries, except when certain steps are taken so that the Trust is *seen-through* to its individual beneficiaries. The inheritance of an IRA by the Trust by itself is not a taxable event. However, when distributions are made from the IRA to the Trust, those distributions are subject to income tax if the IRA is not a Roth IRA. If the entire IRA is paid to the Trust then the entire IRA account becomes immediately taxable, subject to the Trust's compressed federal income tax brackets. The inherited IRA needs to be retitled in the name of the Trust as its owner. More importantly, the Trust will either have a 5-year required distribution period to withdraw the funds from the inherited IRA, or it can use the '*phantom life expectancy'* period to take annual required distributions from

the inherited IRA if the IRA owner died after his/her required beginning date (RBD) (*phantom life expectancy* being the deceased owner's over-life had he/she survived and lived their normal life expectancy.) In sum, yes a Trust can be named, but there are plenty of drawbacks if it is to inherit a traditional IRA.

Does an Eligible Designated Beneficiary (EDB) Have a Choice When Taking Distributions from an Inherited Roth IRA? Yes, but there cannot be a *flip-flop* between these two choices. With Roth IRAs the Roth IRA owner is deemed to always have died prior to his/her required beginning date (RBD.) Thus, the EDB has a choice to either *stretch* the distributions from the inherited IRA over his/her lifetime with annual required minimum distributions (RMDs) or apply the SECURE Act's 10-year payout rule with no required minimum distributions (RMDs) for 10 years. However, the EDB cannot use the *stretch* for awhile and then stop taking annual RMDs. Once the EDB's choice is made, it is permanent. There is, though, one exception to this 'permanent choice' rule. If the EDB elects the *stretch* distributions with annual RMDs but then he/she misses one or more annual RMD, the IRS will allow an automatic waiver of the missed RMD penalty if the EDB elects the 10-year distribution rule by the end of the 9th year of the 10-year SECURE Act distribution period.

Do the new SECURE ACT 2.0 Statute of Limitations Rules Apply Retroactively? The SECURE Act 2.0 created a new statute of limitations for missed RMDs, where it is either 3 or 6 years, without the need to file Form 5329. Under the prior rules, for the statute of limitations to start to run on missed RMDs the IRA owner had to file Form 5329. In the absence of a filed Form 5329 the statute of limitations on the failure to take an RMD never started to run, exposing the IRA owner to an unlimited period of liability. The SECURE Act 2.0 also reduced the penalty for the failure to take an RMD from 50% to 25% and further to 10% if that failure to take the RMD is timely corrected. But there is still confusion whether this new statue of limitations rule is retroactive or not.

Example: Ben inherited his father's IRA in 2015. Ben had to take *stretch* annual RMDs from that inherited IRA, using his own life expectancy to calculate the RMD. However, by 2023 Ben has never taken a single annual RMD from the

inherited IRA nor did he ever file Form 5329. Accordingly, Ben has missed taking 6 annual RMDs from 2016 to 2022 (2020 being disregarded due to the CARE's Act one-year waiver.) It is unclear if Ben can disregard the missed RMDs from 2016 to 2019 if the SECURE Act 2.0's new statute of limitations rule applies retroactively. Or, does this new rule apply only after the enactment of the SECURE Act 2.0 which was in late December 2022. The promised Regulations will hopefully answer whether the 3-year statute of limitations is retroactive or not, along with its lower excise taxes.

Do Contributions Have to Remain for Fixed Period in an IRA Before a *Back Door* Roth Conversion Occurs? The process of making a non-deductible contribution to a traditional IRA, and then converting those contributed dollars, through the *back door, to a* Roth IRA via a conversion, does not require that the contributed funds 'sit' for any appreciable period of time in the traditional IRA before they are converted to a Roth IRA. High earners, e.g. married couple with income between $218,000 and $228,000, or a single individual who earns between $138,000 and $153,000, cannot make direct contributions to a Roth IRA. But they can make after-tax contributions to a traditional IRA that are then promptly converted to a Roth IRA. Hence the *back door* Roth IRA conversion using those non-deductible contributions to the traditional IRA for that conversion.

If an Individual Opened a Roth IRA Many Years Ago, Is He/She Still Subject to the 5-Year Holding Rule? Remember that there are two different 5-year holding rules when it comes to distributions from a Roth IRA. One 5-year rule is for qualified tax-free distributions of Roth IRA earnings. That 'clock' never restarts once the 5 years have passed. The other 5-year rule is for penalty-free distributions of converted traditional IRA funds to a Roth IRA, if the Roth IRA owner is under age 59 1/2. That second 5-year holding rule applies separately with *each* conversion to the Roth IRA. Consequently, it may be possible to satisfy one 5-year rule but not the other 5-year rule.

Example: Betty started her making contributions to her Roth IRA when she was 21. Betty is now age 31. Betty then converted her traditional IRA to her Roth IRA at age 31. That Roth conversion has its own 5-year rule. At age 34 Betty takes a full

distribution of her entire Roth IRA. Betty will have access to all of her contributions, to the Roth IRA tax and penalty-free. However, the converted dollars in Betty's Roth IRA will still carry a 10% penalty because Betty is under age 59 1/2 and she has not yet satisfied the 5-year Roth holding period after that conversion when she was age 31. Any distributed 'conversion' earnings in the Roth IRA will be taxable to Betty and subject to the early distribution 10% penalty.

Should an Individual Keep Rollover 401(k) Funds in a Separate IRA? There is no good *income tax* reason for keeping rollover funds from a qualified plan in an IRA that is separate from the participant's own IRA held outside the qualified plan. However, there may be creditor protection reason for doing so. Only a limited amount of assets held in an IRA are exempt from creditor claims in bankruptcy [$1,512,350.] Funds held in a qualified plan account are protected in bankruptcy, no matter the size of the balance. Fortunately, the funds that are rolled over from a qualified plan to an IRA maintain 100% of their bankruptcy protection, including the future growth in those rolled over funds, even after they commingled with 'other' traditional IRA assets. So the rolled over funds from the qualified plan do not have to be segregated from the participant's IRA funds, but that might still be a wise decision in order to be able to show that their source was from the qualified plan if bankruptcy is later an option that must be considered.

Can Spouses Make a Qualified Charitable Distribution (QCD) from One Spouse's Inherited IRA? No, each spouse must use their own IRA, or inherited IRA, in order to fund a qualified charitable distribution.

Example: Harry is age 68. Sally, his wife, is age 73. Harry and Sally file joint tax returns. Harry inherited an IRA from his mother back in 2016, from which he is taking annual *stretch* RMDs. Harry wants to make a QCD to offset the income tax on his RMD from his inherited IRA. Unfortunately, Harry is under the age of 70 1/2, so Harry cannot make a QCD. While he and Sally file a joint income tax return, and Sally is over the age 70 1/2, Harry cannot 'coattail' off of Sally and

her age to make a QCD. Only Sally can make a QCD, and that is only if Sally owns a traditional IRA from which the funds can be distributed to charity.

If an Individual Owns Both a 401(k) and an IRA, Can the Individual Take his RMD for Both Out of One of These Two Retirement Accounts? No. RMDs from a qualified plan cannot be aggregated with RMDs from an IRA. Rather, two separate RMDs must be taken. While the balances of traditional IRAs can be aggregated and thus the IRA based RMD can be taken from only one IRA, that is not the case for the IRA and 401(k) balances which cannot be aggregated.

Example: Archie, age 78, owns both a traditional IRA and also he retains his 401(k) account with his past employer. Archie's RMD from his 401(k) account for the year is $40,000. His RMD from his traditional IRA is $20,000. Archie cannot combine these amounts and take them ($60,000) from just his IRA, or just from his 401(k) account. Archie must take the $40,000 from his 401(k) account to meet its RMD requirement and take $20,000 from his traditional IRA to meet its RMD requirement. Next year, if Archie rolls the balance of his 401(k) account into his traditional IRA, he will then only have to take one RMD from his traditional IRA.

What Happens if the IRA Owner I'd Divorced and then Dies? Like most states, Michigan has a statute that automatically removes a former spouse as the beneficiary of an IRA. So, if there is a divorce and the IRA owner dies without changing the beneficiary designation on his/her IRA, the statute will treat the former spouse as having predeceased the IRA owner, and the successor IRA beneficiaries will take the decedent's IRA. However, that is not the result if the decedent maintained a 401(k) account. State revocation-on-divorce statutes do not apply to qualified plans which are governed by ERISA. If the decedent did not change the beneficiary designation of his/her. 401(k) account after his/her divorce, their ex-spouse is still entitled under ERISA to receive the balance of the 401(k) account.

Conclusion: That is enough for now. Different plans, different rules for bankruptcy, divorce, the age of the decedent, and whether the designated

beneficiary is an eligible designated beneficiary (EDB) all add to the confusion and uncertainty of options available to beneficiaries. It's enough to make one's head spin, and spin, and spin, and still no final Regulations from the IRS with respect to the 2019 SECURE Act.