Three IRAs - Three Different Payout Rules

Thursday, December 7, 2023

Take-Away: Traditional, Roth, and inherited IRAs each have their own set of payout rules. It is best to follow a 'distribution roadmap' for each IRA and not make assumptions about which set of payout rules to different IRAs.

Background: Simply stated, the IRA distribution rules are confusing at best. Add to that existing confusion are the 'new' rules contained in the SECURE Act and the SECURE 2.0 Act and you have a 'hot mess' when advising IRA beneficiaries For example, the SECURE Act gave us the 10-year payout rule (unless an *eligible designated beneficiary* is named.) Then the IRS's SECURE Act Regulations surprised us that if the decedent was older than his/her required beginning date (RBD) at death, then the inheritor of the decedent's IRA had to take *annual* required minimum distributions (RMDs) from the inherited IRA, but not if the decedent had not reached his/her retirement beginning date at the time of his/her death. Then the SECURE 2.0 Act gave us Section 327 which now requires a surviving spouse to make an irrevocable affirmative election with a deadline if he/she wants to delay taking any RMD from an inherited IRA until his/her spouse's required beginning date (RBD), but no formal election is required by the surviving spouse if he/she wants to do a rollover of the deceased spouse's IRA. Congress and the IRS continue to tinker with these distribution rules which reflect the reality that most individual's wealth is now found in retirement accounts other than the equity in their home, or this continuous influx of payout changes are made to accelerate Congress's insatiable need for tax revenues, e.g., the SECURE Act's 10-year maximum payout period. These changes just add to the confusion that already exists when it comes to retirement planning and taking distributions from retirement accounts.

Example: Consider the following example of how a decedent who owns three separate IRAs can result in three different payout rules when each IRA has the same beneficiary.

Basic Facts: Bert dies at age 75 in 2023. Bert owns three IRAs. Since Bert, by nature, is easily distracted, each of Bert's IRAs fails to name a beneficiary. Bert is survived by his brother Ernie, his sole heir. Ernie seeks advice as to the payouts from Bert's traditional IRA, Bert's Roth IRA, and the IRA that Bert inherited from Bert's twin brother Elmo. The *default* rule under each of Bert's IRA custodial agreements is that Bert's estate will be deemed as the beneficiary of his three IRAs.

Inherited IRA-*Successor Beneficiary Payout Rule*: Since this was an IRA that Bert had inherited from his twin brother Elmo, and Bert's estate is the next-in-line beneficiary of that inherited IRA, that makes Bert's estate a *successor beneficiary.* Under the SECURE Act, a *successor beneficiary* follows the required 10-year distribution rule. It really does not matter who the *successor* is, or if that beneficiary could otherwise qualify as an *eligible designated beneficiary.* If the *successor beneficiary* is a spouse, or disabled, or a minor child, or as was the case here, Bert's estate, the *successor beneficiary* must follow the SECURE Act's 10-year payout rule. Under the SECURE Act's proposed Regulations, since RMDs were being taken from the inherited IRA by Bert, Bert's estate, as the *successor beneficiary,* must continue with those exact same payments, using the same single life expectancy factor (minus one for each year to calculate the next year's factor) that the original IRA beneficiary, i.e., Bert, was using. Consequently, Bert's estate, as the *successor beneficiary,* steps into-Bert's-shoes for RMD purpose in years 1-9; Bert's estate has the added obligation of having to empty this inherited IRA by the end of year 10. Accordingly, an estate-owned inherited IRA will be established, and the SECURE Act 10-year payout rule will be applied for what is left of the initial 10-year payout period which was started when Bert first inherited the IRA.

Traditional IRA-*Ghost Payout Rule*: Bert was age 75 when he died. Consequently, Bert died after his required beginning date (RBD.) Therefore, Bert was taking lifetime required minimum distributions (RMDs) from his traditional IRA. Since Bert died after his RBD with a non-designated beneficiary, meaning a non-person was the *default* beneficiary of the traditional IRA, the *ghost payout rule* applies. The *ghost payout rule* requires that Bert's traditional IRA be paid out over the single life expectancy of the deceased IRA owner, meaning Bert. To implement the *ghost payout rule,* Bert's age in the *year of his death* is used. (This is different than the normal IRA beneficiary age calculations, where the beneficiary's age in the year *after* the account owner's death is used.) As a 75-yearold, the corresponding single life expectancy factor used for distributions from Bert's traditional IRA is 14.8. Since RMDs from this second estate-owned inherited IRA would start in the year after the year of Bert's death, one is subtracted, and thus a 13.8 life expectancy factor is used in 2024 to calculate the RMD. This factor is then reduced by one (1) in each of the subsequent years. As an observation, because Bert was older than his RBD and he failed to name an individual as the beneficiary of his traditional IRA, the *ghost payout rule* produces an anomaly in that it creates a payout rule for Bert's estate that is longer than the SECURE Act's 10-year payout rule.

Roth IRA- *5-Year Payout Rule:* A Roth IRA does not have any lifetime required minimum distributions (RMDs.) Consequently, the owner of a Roth IRA is always deemed to have died before his/her required beginning date (RBD.) This is the case even if the Roth IRA owner is age 110 when he/she dies; death is always deemed to be before the owner's RBD. For an IRA owner who dies before his RBD with a non-person designated beneficiary, in this case Bert's estate, i.e., the custodial agreement's *default* beneficiary, the 5-year distribution rule applies. However, there are no *annual* RMDs during this 5-year payout period. Again, a third estate-owned inherited IRA will need to be established and the Roth IRA account must be emptied by the end of the fifth year after Bert's death.

Summary: To the advice given to Ernie will be the following:

For Bert's inherited IRA (from Elmo) Ernie as the *successor beneficiary* will need to finish the 10-year payout that Bert started, which could be from 1 to 10 years remaining;

For Bert's traditional IRA, Ernie will need to take annual RMDs from this IRA, but those distributions can be spread over the next 13.8 years which is Bert's *ghost life expectancy*; and

- For Bert's Roth IRA, Ernie will not need to take any distributions from the Roth IRA until the 5th anniversary of Bert's death, since a *non-person* is the *default* beneficiary.

Conclusion: Obviously, it is strongly advisable to avoid ever having an estate named as the beneficiary, or *default* beneficiary ,of a decedent's IRA. Unfortunately, this is more common than we would like to see. Add to this the different IRA payout rules dependent upon type of IRA and the age of the IRA owner, and there is plenty of confusion to determine which set of payout rules to apply and the maximum duration of that payout period.