TAX

Why some heirs may face a tighter deadline to drain inherited IRAs

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New rules on inherited retirement accounts aren't entirely clear for some beneficiaries. Pixabay

New curbs on inherited retirement plans are potentially doubly onerous for some heirs.

People coming into family fortunes used to be able to spend down an inherited individual retirement account or 401(k) over their lifetime. For younger heirs especially, that benefit was particularly valuable because it gave the assets many years to grow.

In 2019, lawmakers shook up the way tax-deferred retirement accounts can be passed on. Now, heirs who aren't spouses, disabled, chronically ill, minor children or more than 10 years younger than the IRA owner must drain the accounts within 10 years of the original owner's death. If a controversial proposal by the Internal Revenue Service passes muster, they'll also have to take minimum distributions in years one through nine, instead of waiting until the 10th year to zero things out — a further crimp to appreciation and long-term wealth building.

It sounds restrictive, and it's the biggest change to retirement plans in more than a decade. But for some heirs, the 10-year window may actually be five.

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It's all due to a gray area in the new law, the Setting Every Community Up for Retirement Enhancement (SECURE) Act. The 2019 law doesn't explain what happens when a taxpayer doesn't indicate to the IRS's satisfaction who their beneficiary is. This year's event features more than 40 sessions and 80 speakers, with demos, interactive panels and keynotes with industry impact makers.

“The SECURE Act changed a lot of what we believe about inherited IRAs,” said Rochelle Schultz, an estate planning lawyer at Weinstock Manion in Los Angeles. “Everyone,” she added, “needs to bring it up to their estate attorneys or financial advisors to make sure beneficiaries understand what’s going to happen.”

The 10-year rule hits retirement accounts inherited from people who pass away on or after January 1, 2020. Wealth advisors call the curb the death of the “stretch IRA,” because an heir can no longer “stretch out” withdrawals from the account over her lifetime. The change reflected the Biden administration’s desire to expand retirement options for Americans while curbing the tax benefits of passing tax-deferred wealth to heirs.

Five years

IRS rules that pre-date the SECURE Act say that if a taxpayer dies before beginning required minimum distributions, typically at age 72, and hasn’t specified who will inherit their IRA or 401(k), then the account goes into the deceased’s estate. The estate’s heir or heirs then have five years to drain the account. The five-year rule also applies to inherited Roth IRAs in existence for less than five years. And it applies to some beneficiaries who inherit a retirement plan through a so-called beneficiary account, like a trust.

Under prior IRS rules, the beneficiary of a broad type of estate planning vehicle known as a “see-through” trust is treated as if she directly inherits the trust’s assets, even as the vehicle is technically the beneficiary. The IRS “looks through” the trust to see that an actual human being — the trust’s beneficiary — is there. Before the 2019 law, those people could stretch out withdrawals over their lifetime. Now, depending on whether the trust is properly set up, the 10-year deadline could be five years.

That's in part because IRS rules for see-through trusts are strict. Along with record-keeping requirements, the tax agency requires that the vehicles be irrevocable, valid and legal in the state where they’re set up and clear about the identity of its beneficiaries. If a trust doesn't meet those requirements, beneficiaries can be required to drain them in five years.

The issue is that the SECURE Act doesn’t spell out whether its 10-year rule applies to see-through trusts. Nor has the IRS offered guidance on the issue. If the rule doesn’t apply, then some beneficiaries of those trusts might have to empty out an IRA within five years as before — an outflow that can spike an heir’s income and tax rate.

“There is still ambiguity as to how the rules surrounding ‘see-through’ trusts will apply post-SECURE Act,” wrote Fidelity Investments earlier this year.

When the tax agency said annual withdrawals would be required before an account is drained by year 10, it created a firestorm. Here’s what’s happening now.

Because trusts have their own special tax rules, the five-year window can quickly become expensive. While distributions from trusts are taxed at ordinary rates, the tax hit kicks in early. People making at least $539,900 ($647,850 for married couples) pay 37% on their income. Meanwhile, that top rate hits trusts once their income is only $13,450.

Wealthy taxpayers like see-through trusts because they allow them to control how their retirement plans will be used by heirs once they die. By bequeathing an IRA to a trust, instead of to an individual heir, the owner can ensure through the trust's language and terms that the funds won't be spent on fancy cars and expensive vacations.

Getting caught by the five-year rule "probably happens more times than it should," said Howard Hook, a principal and senior wealth advisor at EKS Associates, a fee-only financial advisory firm in Princeton, New Jersey. Hook, a certified financial planner and accountant, added that "it happens at the retail level" with people who opt for DIY estate planning.

Hook said that because lawmakers created fresh definitions of beneficiaries, investors need to make sure their estate plans reflect the tax nuances of the new law. If a person names a trust as the beneficiary of an IRA, he said, "it's up to the taxpayer to be sure" that they've spelled out how heirs will receive its assets.

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