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Another Notice Providing Relief From Certain RMD Rules in 2023

Background. The "first" SECURE Act (which we will refer to as "SECURE 1.0," although that is not its official name) became effective January 1, 2020. SECURE 1.0 made significant changes to the "RMD Rules." The RMD Rules (which are basically specialized income tax rules) dictate the amount and timing of distributions from IRAs (of all types) and "qualified plans" (such as 401(k) plans, 403(b) plans, profit-sharing plans and stock bonus plans). The RMD Rules apply to the participant in a qualified plan and to the listed owner of an IRA (we will call both of them "participants"). The RMD rules require participants to take "required minimum distributions" (RMDs) from their qualified plan and/or their IRA (except for a Roth IRA) each year upon reaching their "required beginning date" (RBD). The RMD Rules also require the participant's beneficiaries to take RMDs after the participant's death.

Most distributions from qualified plans and pre-tax IRAs are taxable as ordinary income in the year of receipt. (There is an exception for "qualified distributions" from Roth IRAs and Roth 401(k) plans--those distributions are not taxable as ordinary income.) Because distributions from pre-tax IRAs and qualified plans are taxable as ordinary income upon receipt, it is usually desirable for the RMD to be as low as possible. If RMDs are smaller, the taxable income is reduced and the amount that can remain inside the inherited plan or IRA is larger, resulting in a greater amount of tax-deferred growth. One can always withdraw more than the RMD, if desired, but one cannot normally withdraw less than the RMD without a penalty.

Before SECURE 1.0, two broad categories of beneficiaries could inherit all or a portion of the participant's plan or IRA on the participant's death: (i) "designated beneficiaries" (DBs) and (ii) beneficiaries who did not qualify as DBs (Non DBs). DBs included both individuals named as beneficiaries and trusts for individuals named as beneficiaries that were specifically drafted to qualify for DB treatment per the RMD Rules. If the participant named his "Estate" as the beneficiary of his plan or IRA, that would be an example of a Non DB.

Before SECURE 1.0, different distribution rules applied after the participant's death, depending on (i) when the participant died (i.e., before or after his RBD) and (ii) whether the beneficiary was a DB or a Non DB. In general, before SECURE 1.0, DBs (including qualified trusts for DBs) were able to take RMDs from the plan or IRA they inherited from the participant using the applicable life expectancy distribution method. For example, before SECURE 1.0, an adult child in his mid-40s named as the participant's beneficiary had more than 40 years over which to withdraw the inherited plan or IRA benefits. If the participant's DB was the participant's spouse, the spouse had a longer distribution period compared to other DBs (due to the spouse's ability to recalculate life expectancy). Further, the participant's spouse, as beneficiary, had additional options that other types of DBs did not have. For example, the participant's spouse had the option to "take over" the plan or IRA that the spouse inherited from the participant and become the participant of that plan or IRA herself. (SECURE 1.0 did not change that option for the participant's surviving spouse, but SECURE 2.0, which we discussed in our most recent prior newsletter, did make some

significant changes to the options available to the participant's "sole" beneficiary spouse.) In most cases involving non spouse DBs (and even in certain cases involving a spouse DB), the DB will establish an "inherited IRA" to receive the plan or IRA benefits inherited from the participant because few qualified plans are written to allow most types of DBs to stay in the plan as a beneficiary after the participant's death. Therefore, in discussing the beneficiaries of the participant's qualified plan or IRA after the participant's death, we will refer to what each DB owns as an "inherited IRA."

One of the most significant changes made by SECURE 1.0 was to divide DBs into two types: (i) "regular" DBs (not an official term) and (ii) "eligible designated beneficiaries" (EDBs). (Note: hereafter, if we just refer to the "DB," we mean a "regular" DB.) The five categories of EDBs are (i) the participant's spouse, (ii) the participant's minor child, (iii) a disabled individual, (iv) a chronically ill individual, and (v) an individual not more than 10 years younger than the participant. All other DBs are "regular" DBs. As a result of SECURE 1.0, a "regular" DB could no longer take RMDs from his inherited IRA using a life expectancy distribution method (that distribution method was often referred to as a "stretch IRA"). Instead, "regular" DBs, which is a category that includes adult (non disabled and not chronically ill) children of the participant, are subject to the new 10 year rule. (The new 10 year rule also applies to DBs who inherit plan or IRA benefits on the death of an EDB.) Therefore, as a result of SECURE 1.0, only EDBs are entitled to withdraw amounts from their inherited IRA using some sort of life expectancy distribution method (the particular distribution method differs based on the type of EDB).

When SECURE 1.0 first became effective, lawyers, accountants, financial advisors and others believed the new 10 year rule would be applied just like the already existing 5 year rule. The 5 year rule applies when the participant dies *before* reaching his RBD without having a DB (i.e., the participant's beneficiary is a Non DB). When the 5 year rule applies, the participant's beneficiary (i.e., the Non DB), does not have to take any RMDs in years 1 through 4 following the year of the participant's death. The Non DB is only required to withdraw the full remaining amount held in the Non DB's inherited IRA by December 31 of the year that contains the 5th anniversary of the participant's death. For approximately 26 months after SECURE 1.0 became effective, everyone assumed that DBs subject to the new 10 year rule were not required to withdraw any amounts from the plan or IRA they inherited from the participant during years 1 through 9 following the year of the participant's death, as long as they withdrew the full remaining amount held in their inherited IRA by December 31 of the year containing the 10th anniversary of the participant's death. But that assumption turned out not to be how the Treasury Department interpreted SECURE 1.0.

Proposed treasury regulations updating the RMD Rules as a result of SECURE 1.0 were published on February 24, 2022 (more than 25 months after SECURE 1.0 became effective). The proposed regulations basically said there are *two different* 10 year rules, one rule that applies to DBs when the participant dies *before* RBD and another rule that applies to DBs when the participant dies *on or after* RBD (we will just say *after* RBD). If the participant dies *before* his RBD, that particular 10 year rule is applied just like the 5 year rule. So, in that case, no RMDs have to be taken by the DB in years 1 through 9 following the year of the participant's death. In that case, the only required distribution per that particular 10 year rule is that the full amount remaining in the DB's inherited IRA must be withdrawn by December 31 of the year that contains the 10th anniversary of the participant's death. On the other hand, if the participant dies *after* his RBD, the participant's DB has to take RMDs during years 1 through 9 following the year of the participant's death and also has to withdraw the full remaining amount held in the DB's inherited IRA by December 31 of the year containing the 10th anniversary of the participant's death. While Treasury's position is not without support (although there is also support for the position that Congress intended the 10 year rule to be applied like the 5 year rule, regardless of when the participant dies), the problem is that, by the time the proposed regulations were published in February 2022, DBs of participants who died *after* their RBD in the year 2020 had already failed to take their RMD from their inherited IRA during the year 2021. Failure to take an RMD results in a penalty. In addition, DBs of participants who died *after* their RBD in the year 2021 were just now discovering that they would be required to take an RMD in 2022 pursuant to this rule

in the proposed regulations. However, by the fourth quarter of 2022, it became apparent that final regulations regarding the RMD rules would not be published by the end of that year. Therefore, to provide relief to DBs in this situation, on October 7, 2022, the Treasury Department and the IRS issued Notice 2022-53. Notice 2022-53 provided that final regulations regarding RMDs would not apply earlier than the 2023 calendar year. Therefore, if a DB in the described situation failed to take his 2021 RMD (if applicable) and/or his 2022 RMD, no penalty would be imposed (even if the final regulations eventually adopted this particular RMD rule contained in the proposed regulations). Similar relief was provided to plan administrators who failed to distribute RMDs per the rules set out in the proposed regulations.

Status of RMD Rules in 2023. During the last quarter of 2022, "SECURE 2.0" was passed. Some of the provisions in SECURE 2.0 became effective January 1, 2023, although many provisions in SECURE 2.0 will only become effective in years after 2023. In our most recent prior newsletter, we discussed one of the most problematic provisions in SECURE 2.0 applicable when the participant's spouse is the "sole" beneficiary of the participant's plan or IRA. We will not repeat that discussion in this newsletter (all of the firm's prior newsletters are on the firm's website, **www.gerstnerlaw.com**).

Now it's the summer of 2023 and we still don't have final regulations on the RMD Rules. We have heard that the final RMD regulations *may* be issued by the end of this year, but we don't have them yet. So, what are DBs with inherited IRAs holding plan or IRA benefits inherited from a participant who died *after* his RBD in the year 2020, 2021 or 2022 supposed to do in regard to taking an RMD for 2023 pursuant to the 10 year rule described in the proposed regulations? Fortunately, the Treasury Department and the IRS recently published Notice 2023-54. Notice 2023-54 provides that final regulations relating to the RMD Rules, when published by the Treasury Department, will not apply earlier than calendar year 2024. Thus, even though the proposed regulations indicate that DBs who inherited the participant's plan or IRA from a participant who died *after* his RBD in the year 2020, 2021 or 2022 would be required to take an RMD in 2023, if that RMD is not taken, no penalty will be imposed on that DB. The relief granted also applies to beneficiaries of deceased EDBs, who are subject to the 10 year rule in the same manner discussed above. Further, if a qualified plan administrator does not distribute to a plan participant the 2023 RMD that would be required based on the provisions in the proposed regulations, that failure will not disqualify the plan.

Notice 2023-54 provides relief for certain other situations, too. One of the changes made by SECURE 2.0 was to change the "Applicable Age" (used to determine the participant's RBD) from 72 to 73 for participants who attain age 73 after December 31, 2022 and before January 1, 2033. (Recall that the Applicable Age was previously changed by SECURE 1.0 from 70½ to 72, effective January 1, 2020--not that long ago.) Administrators of qualified plans and other payors of RMDs advised the IRS and Treasury that they needed more time to update their automated payment systems to reflect this recent change made by SECURE 2.0. Thus, some distributions may have been made to participants in 2023 based on the previous Applicable Age (i.e., 72) that were "coded" as RMDs but, in fact, would not be RMDs due to the change made to the Applicable Age by SECURE 2.0. RMDs made to the participant from his qualified plan may *not* be rolled over to the participant's IRA, but a distribution from the participant's qualified plan that is not an RMD may be rolled over to the participant's IRA. However, if a rollover is not a "direct" (or "trustee to trustee") transfer from the participant's plan to the participant's IRA (or from one IRA to another IRA), federal income taxes must be withheld by the payor (at the rate of 20%) and a time limit of 60 days applies for making the rollover. Notice 2023-54 provides that, if a distribution was made to a participant from his qualified plan or IRA between January 1, 2023 and July 31, 2023, that was mischaracterized as an RMD but, in fact, was not an RMD due to the change to the Applicable Age made by SECURE 2.0, that participant will have until September 30, 2023, to roll over that mischaracterized distribution.

NOTE: REMINDER TO REVIEW ALL RETIREMENT PLAN BENEFICIARY DESIGNATIONS

In prior newsletters discussing SECURE 1.0, SECURE 2.0 and the proposed RMD regulations, we have advised clients to review all of their beneficiary designations on file for all of their qualified plans and

IRAs. If you discover during your review of the beneficiary designations on file for your qualified plans and IRAs that a "trust" or a "trustee" is named as either the primary beneficiary or the contingent beneficiary of those retirement plans, you should come in for an "estate planning check up" to discuss whether that type of beneficiary designation still makes sense in view of the recent, significant changes made to the RMD Rules. Prior to SECURE 1.0, many trusts that were drafted to qualify for DB treatment were drafted as "accumulation trusts" and not as "conduit trusts." (The term "accumulation trust" refers to the type of trust per the RMD Rules and is *not* the name of the trust.) Prior to SECURE 1.0, a properly drafted *accumulation trust* was entitled to take distributions from the inherited IRA that belonged to the trust using the applicable life expectancy distribution method. As noted above, however, qualified trusts for "regular" DBs are now subject to the new 10 year rule. That means that, if the participant's plan or IRA is payable to an *accumulation trust*, much larger amounts (compared to before SECURE 1.0) will have to be withdrawn over a much shorter period of time from the inherited IRA that belongs to the trust. If most or all of those withdrawn amounts cannot be distributed out of the trust to one or more current beneficiaries of the trust, that taxable income will be "trapped" in the trust, resulting in income taxes being paid by the trust at the trust's tax rate. Irrevocable trusts that contain a "discretionary" income distribution standard (which is true of *accumulation trusts*) are "complex trusts" per the federal income tax rules. A *complex trust* reaches the top income tax bracket (currently 37%) as soon as it receives (and retains) $14,450 in ordinary income. That is an extremely low threshold. A married individual who files a joint tax return with his spouse does not reach the top bracket until the spouses' annual income exceeds $693,750 (2023 threshold). A single individual does not reach the 37% bracket until her annual income exceeds $578,125 (2023 threshold). Thus, the discrepancy regarding when the top income tax rate is reached between a complex trust and an individual is significant. As a result, everyone needs to re-evaluate whether a trust or trusts for the benefit of "regular" DBs should still be named as beneficiaries of his or her qualified plan and/or IRA.

Certain provisions in SECURE 2.0 (discussed in our most recent prior newsletter sent on May 15, 2023) will likely require some clients who have named either a Bypass Trust or a Marital Trust for their spouse as the beneficiary of their qualified plan or IRA to update the design of that trust (and to reconsider whether their retirement plan should be distributed directly to their spouse, instead of being distributed to a trust for their spouse). Before SECURE 1.0, some trusts for the benefit of spouses were drafted in the form of an *accumulation trust*, rather than as a *conduit trust*. In addition, as noted in the prior paragraph, although the vast majority of our clients create "Descendant's Trusts" for their children and grandchildren as "receptacles" to hold inherited assets, it may no longer be wise to name those Descendant's Trusts as beneficiaries of pre-tax IRAs and qualified plans. In our newsletter dated July 15, 2022, we discussed a "split the baby" approach that many clients are now adopting in order to reduce the income taxes payable on their pre-tax IRAs and qualified plans after they die. Per the "split the baby" approach, on the client's death (or on the death of the surviving spouse in the case of married couples), the client's after-tax assets can still be distributed to Descendant's Trusts for children and grandchildren, but the client's pre-tax retirement plans will now be distributed directly (outright) to the client's (responsible) adult children.

<u>Bottom Line</u>: Certain *trust* or *trustee* beneficiary designations may result in nearly 37% of your qualified plan or pre-tax IRA being paid to the IRS in income taxes after you die!

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone (713-520-5205), fax (713-520-5235) or email sent to:

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