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Franklin Templeton Wealth Planning

Unwinding the 10-year rule for inherited retirement accounts

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Bill Cass, CFP®, CPWA®
Director of Wealth Planning,
Franklin Templeton

Unwinding the 10-year rule for inherited retirement accounts

Indivduals with inherited retirement accounts received some long-awaited clarity on the “10-year rule” for account distributions when the Treasury Department issued final regulations in July.[1] The 10-year rule refers to the passing of an individual retirement account to a beneficiary wherein the beneficiary must withdraw the funds within 10 years.

Despite some new clarity on this rule, many heirs still have questions on how to proceed.

One of the primary questions is whether someone subject to the 10-year distribution rule has to take annual distributions in addition to withdrawing all the funds within 10 years.

Understanding the age of the account owner is key

The key variable to understand the rule depends on when the original account owner passed away. That is, did the account owner reach their required beginning date (RBD) before death?

Generally, the RBD is April 1 after the calendar year when the account owner reaches age 73. If the owner passed away after reaching their RBD then, absent any exception, the

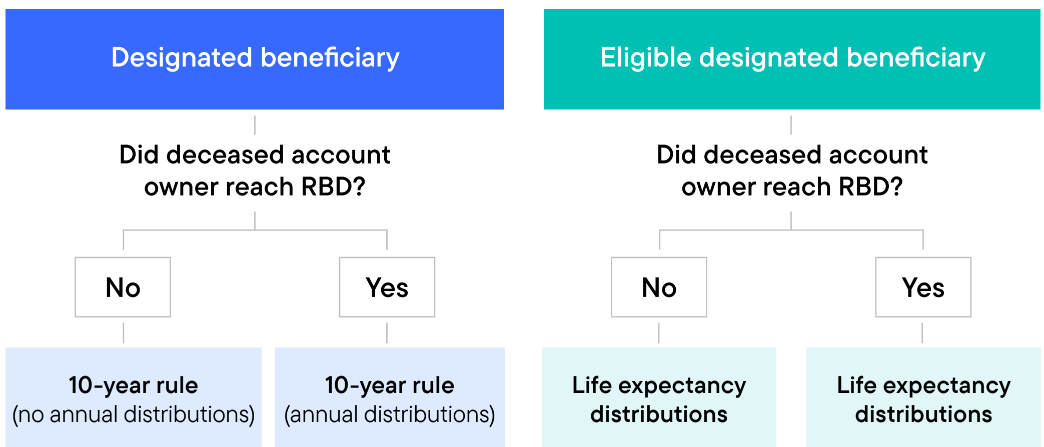
1. See the article, “Final regulations deliver clarity on 10-year rule,” at https://www.franklintempleton.com/articles-us/retirement/final-regulations-deliver-clarity-on-10-year-rule.

beneficiary is subject to an annual distribution requirement based on their life expectancy in addition to the 10-year requirement.

- There is an exception for eligible designated beneficiaries (EDBs). These types of beneficiaries include spouses, individuals with disabilities or those who are chronically ill, beneficiaries not more than 10 years younger than the account owner, or minor children of the account owner (up to age 21 upon which the 10-year rule applies).
- Instead, EDBs have the option to take distributions gradually each year based on their remaining life expectancy.
- Other beneficiaries, such as non-spouse beneficiaries where an exception does not apply, are referred to as *designated beneficiaries* and are subject to the 10-year distribution rule.

Distribution Planning Under the SECURE Act

How Distributions Apply under the SECURE Act Rules



Sources: Setting Every Community Up for Retirement Enhancement Act of 2019; Treasury Department, Required Minimum Distributions, Final Regulations. Required beginning date (RBD) is generally April 1 of the year following the calendar year in which the account owner reaches age 73. In the case of an account owner dying after RBD, eligible designated beneficiaries may opt to base annual distributions on the remaining life expectancy of the deceased account owner. Spousal beneficiaries have the option of rolling over an inherited IRA into their own IRA. While minor children of account owners are eligible for life expectancy distributions, once age of majority (21) is reached the 10-year rule applies. Eligible Designated Beneficiaries can opt to base distributions on the 10-year rule if desired, provided the original account owner died prior to reaching the Required Beginning Date (RBD).

Note: Currently, for those born from 1951 through 1959, the age of required distributions is 73. For those born in 1960 and later, the age is 75.

Beneficiary designation has an impact

The implementation of the 10-year distribution rule can vary. Here are some examples of how the rules apply in different situations when the beneficiary is a designated beneficiary subject to the 10-year distribution rule:

1. Account owner dies this year, prior to reaching their RBD

- In this example, IRA owner Roger passes away in 2024 at age 70.
- Even though he has been taking periodic distributions from his IRA he has not reached his RBD.
- For the heirs, the first step is determining whether a year of death RMD must be taken.
- Since Roger died prior to reaching his RBD no RMD for 2024 applies.
- Sarah inherits the account, which must be fully distributed by the end of the 10th year following the year Roger died (by the end of 2034). She has the flexibility to distribute the account as she chooses, provided she complies with the 10-year rule.

2. Account owner dies this year and has already reached their RBD

- In this scenario, IRA owner Jessica passes away in 2024 at the age of 80 and has been taking required distributions for several years.
- Her daughter Jill is subject to the 10-year rule AND must (at least) take annual distributions for the first nine years (she can always withdraw more if she wants to but is subject to a minimum requirement).
- The year of death RMD for Jessica must be taken in 2024, and the 10-year "clock" begins in 2025. In that year, at a minimum, Jill must take an annual distribution based on her remaining life expectancy.
- To determine the amount of the annual distribution Jill consults the IRS single life expectancy table.
- For example, if Jill is 50 years old her life expectancy factor from the IRS table is 36.2. To calculate the minimum distribution, she determines the account value as of December 31 of the previous year and divides that balance by 36.2.
- For each subsequent year's minimum distribution, she subtracts one from her life expectancy factor and repeats the process (the divisor for the second year's distribution would be 35.2 and so on).
- The inherited account must be fully distributed by the end of 2034.

3. Account owner died in 2021 after reaching their RBD

- In this example, David passed away in 2021 at the age of 87 leaving his IRA to his son Will.
- Since David had already reached his RBD and was taking required distributions, a year of death RMD was taken in 2021.
- Will has not taken any distributions from the inherited IRA yet since the IRS provided relief for heirs subject to the 10-year rule while regulations on the 10-year rule were proposed but not finalized yet (regulations were first proposed in 2022 and not finalized until recently, see IRS guidance in Notice 2024-35 for more details).
- In its announcement of relief, the IRS stated while these regulations were pending, a penalty for heirs not taking an annual distribution would not apply for years 2021, 2022, 2023 and 2024.
- Beginning in 2025, Will must, at a minimum, begin required distributions based on his life expectancy by consulting the IRS single life expectancy table (similar to the example with Jill).
- However, he must calculate his annual distributions on the assumption that he actually took his first distribution in 2022, the year after his father died.
- This means that he would consult the IRS table based on his age in 2022, subtract one from that figure for both 2023 and 2024, and then subtract one again to determine the divisor to calculate the minimum distribution for 2025.
- Essentially, the calculation for his 2025 distribution and future minimum distributions assumes that Will has already been complying with the annual distribution requirements.

- While the IRS provided relief for heirs of inherited retirement accounts for the past few years, the original 10-year period based on when the account owner died still applies.
- This means that, at a minimum, Will has to take annual distributions from the inherited IRA for the years 2025 through 2030 with a full distribution by the end of 2031.

Seek expert advice

Given the complexity of these distribution rules, beneficiaries may consider consulting with their tax professional and financial advisor for expert advice before proceeding. For more detail on these new distribution rules and ideas on how to mitigate the impact of the 10-year rule consult our piece, “Distribution Planning under the SECURE Act” (https://franklintempletonprod.widen.net/s/vqbdsvjmpg/distribution-planning-under-the-secure-act-flyer-sact-wp).

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