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Updating Your Retirement Plan Beneficiaries Matters More Than Ever

It's time to update and rethink your retirement plan beneficiaries.

Given the last year and a half, you want to make certain your designated beneficiaries are still alive and that there have not been changes in marital status or new babies that you need to take into consideration. Equally important, you need to realize the rules for withdrawing funds from an inherited IRA have changed for non-spouse beneficiaries.

The *Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019* eliminated the ability to “stretch” an inherited IRA over the lifetime of the beneficiary. Non-spouse beneficiaries of inherited IRAs are now required to withdraw and pay taxes on distributions from inherited retirement accounts within 10 years. Failure to empty the account in 10 years will result in an IRS 50% penalty on the amount remaining in the account.

There are exceptions to the 10-year rule. In addition to a spouse, an Eligible Designated Beneficiary (EDB) can withdraw funds from an inherited IRA over an extended period. An EDB includes a minor child (but not grandchild), a person with special needs or a chronic illness, and beneficiaries who are not more than 10 years younger than the IRA owner. Once a minor child reaches the age of majority - 18 or 26, the clock starts running and the individual has 10 years to withdraw the remaining balance.

Heirs of IRA owners who died in 2019 or before are grandfathered into the stretch rule and are not required to meet the 10-year withdrawal deadline.

Up until passage of the SECURE Act, many IRA holders viewed passing retirement assets onto children, grandchildren and unrelated heirs as a way to provide them with retirement security. Beneficiaries were able to stretch payments over their lifetimes, allowing assets to continue to grow tax deferred. At withdrawal, heirs were responsible for paying taxes on withdrawn funds at their personal tax rates. That is no longer possible for all beneficiaries given the 10-year requirement.

Perhaps the biggest question that arises with the 10-year rule is whether or not it makes more sense to spend retirement account assets first and leave non-retirement assets to one's heirs. In the case of smaller estates, non-retirement assets are likely to pass on to heirs tax-free. While the Biden Administration has expressed the desire to eliminate “mark to market” on estate assets potentially resulting in capital gains taxes on inherited assets, capital gains tax rates have traditionally been lower than personal tax rates.

With an inherited IRA, the need to withdraw a substantial IRA balance in 10 years could occur during the heir's highest earning years. If withdrawals push the beneficiary into a higher tax bracket, the rate would apply to personal income across the board. It's also possible that the increase in taxable income could make it more difficult for student beneficiaries to qualify for financial aid for college.

You might want to designate as a beneficiary for your traditional retirement account someone who qualifies as an EDB or is in a lower income-tax bracket. Converting a traditional IRA to a Roth IRA, could allow the retirement account holder to take advantage of the current low income-tax rates

(compared to proposed future rates). While Roth IRAs are still subject to the 10-year distribution requirement for non-EDBs, distributions aren't counted as taxable income when the beneficiary withdraws the funds. You are required to pay personal income tax on amounts converted to a Roth IRA the year in which you convert.

If your priority is to leave the maximum after-tax benefit to your heirs, discuss the new requirement for 10-year distribution of inherited IRA account assets with your estate planner or financial advisor. They can help you understand the pros and cons of different approaches to the beneficiary puzzle.

The preceding information is provided for educational purposes only and is not intended as financial or estate planning advice. Always consult a qualified financial advisor before making any changes in your estate plans or retirement accounts.

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