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New Rules for Inherited IRAs By Surviving Spouses

Changes made by the SECURE 2.0 Act

Section 327 of the SECURE 2.0 Act of 2022 (SECURE 2.0 Act), effective in 2024, which modified Internal Revenue Code Section 401(a)(9)(B)(iv), will provide over $1.1 billion in estimated new tax benefits for surviving spouses and trusts for them, but it also complicates planning and may have traps for the unwary.[1]

Under this new provision, the special delayed required beginning date (RBD) for the surviving spouse (and conduit trusts with surviving spouses as the sole beneficiary) and "fresh start" (that is, treating the individual retirement account as their own) if the surviving spouse dies before their RBD are only available after 2023 if the surviving spouse makes an election to have those rules apply. However, it sweetens the pot for those spouses making the new election, by permitting the required minimum distributions (RMDs), once they start, to be recalculated each year as if the surviving spouse were the owner, and enabling the use of the more favorable Uniform Life Table (ULT) rather than the Single Life Table (SLT).

Thus, as of Jan. 1, 2024, the surviving spouse who's the decedent's sole beneficiary has to make the election to use the special rules for the surviving spouse. These special rules include: (1) recalculating the surviving spouse's life expectancy each year, (2) using the ULT, (3) deferring the RMDs until the decedent would have reached their RBD, and (4) treating the surviving spouse as if the surviving spouse were the employee/owner if the surviving spouse dies before their RBD, which may be quite advantageous to the subsequent beneficiaries (especially if they're eligible designated beneficiaries (EDBs)).

Because the new law treats the surviving spouse as "the employee," some attorneys have interpreted this to mean that the decedent employee's date of birth should be used for calculating RMDs. However, we believe the Treasury will ultimately settle on the more logical interpretation, which is to continue to use the date of birth of the surviving spouse as if the surviving spouse were the employee (owner).

Without the election, these advantages are lost, although it's unclear and possible that the Treasury will continue to allow the surviving spouse to recalculate the life expectancy under the SLT as currently provided by existing regulation whenever the spouse is the sole beneficiary. Until clarified, it's probably safest to assume that this benefit for surviving spouses will also disappear if the election isn't made.

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Inherited IRAs

The special rules found in IRC Section 401(a)(9)(B)(iv) only apply to an inherited retirement account. If the surviving spouse rolls over the account into the surviving spouse's own IRA (or elects or is deemed to elect to treat the account as their own), the rules applicable to all IRA owners apply. A later, rather than immediate, rollover, is often advantageous when the surviving spouse is initially (that is, at the time the spouse inherited the IRA) under age 59½ or if the surviving spouse is older than a decedent spouse who died well before their RBD.

Timely Election

The surviving spouse's election must be "timely" provided to the plan administrator (or, for example, an IRA custodian/trustee). Once made, the election

can't be revoked without the Treasury's consent. The Treasury will ultimately have to provide more details, such as how the election is made, whether it's filed with the Internal Revenue Service, what's the deadline, whether the election can be made late for reasonable cause and whether the election follows the account when beneficiaries change custodians.

Conduit Trust

By far the largest impact of these new changes on estate planning is on the use of a conduit trust for the sole benefit of the surviving spouse, which is generally looked through for RMD purposes as if the surviving spouse were named as sole beneficiary directly.[2] This permits the trustee to use the above-described special rules applicable to the surviving spouse, but only if the surviving spouse (*not* the trustee of the conduit trust) makes the election.[3]

Prior to the enactment of this provision, one of the downsides of implementing a conduit trust for a surviving spouse was that the trustee had to use the SLT in calculating RMDs, even if permitted to recalculate the surviving spouse's life expectancy each year. The SECURE 2.0 Act provision makes a conduit trust much more attractive by permitting all the advantages described above, most notably the use of the ULT. This is even more enticing after the Setting Every Community Up for Retirement Enhancement (SECURE) Act eliminated the ability of accumulation trusts for spouses to get any stretch beyond the 10-year rule (unless, perhaps, all the other designated beneficiaries are also EDBs, such as a brother or sister less than 10 years younger or a disabled or chronically ill child).[4]

Examples: A few examples of how these new rules will work may be helpful, before we tackle the additional complexity of exploiting the new advantages accorded to conduit trusts:

Example 1: Husband (H) is age 70, wife (W), age 62. W dies in 2022, leaving her IRA to H. Under the law in 2022, H didn't have to begin RMDs until W would have reached age 72 (later extended by SECURE 2.0 Act for 2023 to age 73 and in 2033, age 75). No election is necessary. H can later roll over the IRA if he wishes.

If H dies before his RBD, it's as if he died as the owner, so that a new 10-year rule unsullied by RMDs in Year 1 to Year 9 applies if he names designated beneficiaries, and a completely new stretch based on life expectancy can start if he names EDBs. Or, if he names no beneficiary at all, or non-qualifying beneficiaries such as an estate or a non-qualifying trust, then the 5-year rule would apply—the same rules applying to his own IRAs.

> While the new Section 327 provision is a boon to using conduit trusts for spouses, it creates more issues for drafting and administering them.

Example 2: Same facts as in Example 1, but W dies in 2024. H fails to make the election. Instead of being able to delay RMDs until W would have reached her applicable age, H must take RMDs in the year after death, even if it's a Roth IRA. Furthermore, H must use the SLT to take RMDs (and, potentially not be able to recalculate life expectancy every year).

If H dies, it's *not* as if he died as the owner; rather, it's treated the same as when any other EDB dies, so under the proposed regulations, RMDs must be taken in Year 1 to Year 9 and the account drained by the end of the 10th year, regardless of whether he names EDBs. While this result is usually worse than in Example 1, if he names no beneficiary at all, or non-qualifying beneficiaries such as an estate or a non-qualifying trust, this may be better than the result in Example 1, in which the 5-year rule would apply.

Luckily, in our example here, H can mitigate the damage of accelerated RBD/RMDs by rolling over to his own IRA.

However, if we changed the ages of the couple in our example, and H were under age 59½ and needed funds, distributions would generate an additional 10% early withdrawal penalty, which is unlikely to be waived. This is an additional problem for younger

couples if the election is missed, because the failure of a surviving spouse to take an RMD is deemed to be an election to treat the IRA as one's own, and it would be easy for a widow to miss the election, take some funds and then be hit with nasty penalties.[5]

Example 3: Same facts as in Example 2, but H makes the election. Not only can H delay taking RMDs until the year W would have reached her applicable age, but also once the RMDs start, they can be based on the ULT. Furthermore, the fresh start advantages in Example 1 apply if H dies before his RBD.

If we modify the examples using a conduit trust as beneficiary, the results are largely unchanged.

Example 4: Same facts as in Example 1, but W leaves the IRA to a conduit trust for H in which H is the sole beneficiary for life. The conduit trust gains all of the same advantages, except that under most conduit trust designs, H wouldn't be able to roll over the IRA.

Example 5: Same facts as in Example 2, but W leaves the IRA to a conduit trust for H. This fact pattern would have the same result as in Example 2, but H is precluded from a rollover to mitigate the damage from the missed election.

Example 6: Same facts as in Example 3, but W leaves the IRA to a conduit trust for H. Remember that H must make the election, not the trustee, generating some conflicts and challenges we shall note shortly.

If we change the order of death in our examples such that H, the older spouse dies first, there are still significant advantages for the conduit trust even if there's no special delayed RBD if the election is made. Notably, the trust can use the ULT in calculating RMDs. However, the IRS will ultimately have to expand the ULT to cover situations in which the surviving spouse is under age 72, where the tables now start.

Drafting and administration. While the new Section 327 provision is a boon to using conduit trusts for spouses, it creates more issues for drafting and administering them. The drawback of using the SLT under current law is one of the reasons often cited by clients for not using the new Section 327 provision, even though they would otherwise like to use trusts to protect their assets left for their spouse. This new provision largely mitigates this drawback to using conduit trusts by allowing the same ULTs that the surviving spouse would use if they inherited outright, but the trust provides infinitely more protection for the remainder beneficiaries and numerous estate, gift, GST tax and asset protection advantages. Despite the huge upside, however, the new provision adds complexity. If the trustee is different from the surviving spouse (which is usually the case for blended family situations in which the settlor wants to protect some of the funds), the trustee must work with the surviving spouse, who's the party under the statute who must make the election. What if the surviving spouse (or their guardian) isn't cooperative?

While it may lower RMDs, the spouse in a conduit trust may want to increase the RMDs (which must in turn be paid to or for the benefit of the surviving spouse in a conduit trust) in some circumstances! Conduit trusts for the surviving spouse are used in many cases with a blended family in which the client isn't in a first marriage and has children by another marriage. This needs to be discussed with the client at the planning stage. It might be addressed in a pre-nuptial agreement (prenup) or post-nuptial agreement (postnup) as well as in the trust. While beyond the scope of this article, the potential for the surviving spouse to elect the 10-year rule, which was added not by statute but by the proposed regulations under the SECURE Act if the plan permits, should also be addressed at the same time.

First, this discussion presents ethical issues for the planning attorney when they represent both spouses. If those issues are resolved satisfactorily, then a plan could be devised that somehow compensates the would-be surviving spouse for agreeing to consent to this special treatment or penalizes them if they don't (a carrot or a stick).

As a "carrot," an IRA owner-spouse might agree to more enhanced trust provisions for the consenting spouse, such as providing the surviving spouse with the right to withdraw up to 5% of the trust principal (including the value of the IRA) or up to what would have been the RMD otherwise (but coming from other assets) each year if the surviving spouse makes the election. Alternatively, the IRA

owner-spouse might provide in the beneficiary designation for a contingent gift of a percentage of the IRA to the surviving spouse or a contingent gift of some other asset.

As a "stick," the IRA owner-spouse could provide in their trust that provisions for a conduit trust would automatically switch to a purely discretionary (or even more restrictive) accumulation trust format, if the spousal election isn't made before the Sept. 30 beneficiary determination date in the year following the year of the IRA owner's death. In most circumstances, this would cause the trust to be subject to the 10-year rule, but asset protection concerns for remainder beneficiaries may outweigh this potential result.

The consent to an election might also be addressed in a prenup before the marriage, or in most states, a postnup would also be permitted (with the customary best practice of having each spouse represented by independent counsel).

Sometimes, the complexity of becoming a see-through trust or obtaining the maximum stretch isn't worth it. It may be a huge benefit to have a delayed RBD for younger couples but not for older ones. It might be a huge benefit to get a stretch using the ULT rather than the 5- or 10-year or ghost life expectancy rule in some cases, but not as much when the owner is past their RBD but not too old (that is, no more than a few years beyond the RBD). The size of the retirement plan and its portion of the total estate size is also important. This makes a one-fits-all plan quite impossible (or foolhardy). While we welcome the additional benefit, this provision does add complexity to planning, and its import is difficult to explain to professionals, much less clients unsophisticated in tax law. There are still unanswered questions about the new Section 327 that the Treasury regulations will need to resolve.

Practitioners must reevaluate and reconsider (yet again) the effect of this new law on the choices that married couples must make in their retirement plan beneficiary designation, the design of any trusts that may receive such benefits and the post-mortem administration of the accounts. These changes are especially important for larger accounts and/or blended family situations in which outright bequests are often disfavored. We'll probably see conduit trusts for surviving spouses used more frequently in the future because of these new advantages, with the planning caveats described herein.

Endnotes

1. "Consolidated Appropriations Act, 2023," Division T, contains the SECURE 2.0 Act of 2022. *See* Joint Committee on Taxation, "Estimated Revenue Effects of H.R. 2617, The 'Consolidated Appropriations Act,' as Passed by the Senate Fiscal Years 2023-2032" (Dec. 22, 2022) for the estimated cost to the government of this provision of $1.101 million, *www.jct.gov/publications/2022/jcx-21-22/*. The new provision, effective for calendar years after Dec. 31, 2023, reads:

   > I.R.C. § 401(a)(9)(B)(iv) Special Rule for Surviving Spouse of Employee —
   > If the designated beneficiary referred to in clause (iii)(I) is the surviving spouse of the employee and the surviving spouse elects the treatment in this clause—
   > (I) the regulations referred to in clause (iii)(II) shall treat the surviving spouse as if the surviving spouse were the employee,
   > (II) the date on which the distributions are required to begin under clause (iii)(III) shall not be earlier than the date on which the employee would have attained the applicable age, and
   > (III) if the surviving spouse dies before the distributions to such spouse begin, this subparagraph shall be applied as if the surviving spouse is the employee.
   > An election described in this clause shall be made at such time and in such manner as prescribed by the Secretary, shall include a timely notice to the plan administrator, and once made may not be revoked except with the consent of the Secretary.

2. *See* Natalie B. Choate, *Life and Death Planning for Retirement Benefits*, Sections 1.6.07, 6.3.05 and 6.3.14.
3. While it's possible that the Treasury will promulgate a regulation that permits the trustee to make this election, we believe this is unlikely, as the law specifically grants this right to the surviving spouse.
4. Even if this were the case, an accumulation trust with all eligible designated beneficiaries wouldn't be eligible for the special benefits of Internal Revenue Code Section 401(a)(9)(B)(iv), because the spouse wouldn't be the "sole beneficiary," as required under prior regulations and Section 327(b) of the Setting Every Community Up for Retirement Enhancement Act.
5. Treasury Regulations Section 1.408-8, A5(b).