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A Deeper Dive Into New Rules for Retirement Plans

Understanding the changes governing inheriting and taking required distributions will help you plan better

Your Money
By
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Ever since Congress passed a spending bill in December that includes significant changes to the U.S. retirement system, Wall Street Journal readers have been asking questions about the impact on their retirement accounts.

In December, we explained how a range of provisions will work, including those designed to enhance older workers' individual-retirement-account balances and allow parents to take penalty-free withdrawals from their retirement accounts on the birth or adoption of a child.

Now, with the law in effect, we are delving deeper into the new rules governing inheriting and taking required distributions from tax-advantaged accounts—with tips for updating your financial plan, as well.

Q: Who can take advantage of delaying required minimum distributions, or RMDs, from tax-deferred retirement accounts?
If you were born after June 30, 1949, you can wait until you are 72 years old to start required distributions from your traditional IRA and 401(k).

Of course, you can always take money out before turning 72. But soon after your 72nd birthday, the law requires you to withdraw a set minimum amount annually, or face a 50% excise tax on the amount you should have taken. (To determine your

RMD, divide your traditional IRA and 401(k) balances as of the previous Dec. 31 by your life expectancy in the IRS Uniform Lifetime Table.)

Delaying RMDs is advantageous because more money can accumulate tax-deferred.

Those born before July 1, 1949, have to stick with the old rules, which require RMDs to start soon after 70½.

The transition means that if **“one spouse was born on June 30, 1949, and the other was born a day later on July 1, 1949, their RMDs would start two years apart,” said Ed Slott, an IRA consultant in Rockville Centre, N.Y.**

Q: What are the deadlines under the new rules for the first and second RMDs?
As with the old rules, account owners must take their first RMD by April 1 of the year following the year in which they turn the age to start required distributions, or 72 for those born after June 30, 1949. Someone who turns 72 in 2022 must take his or her first RMD by April 1, 2023.

The second RMD is due by Dec. 31 of that same year—or 2023 in the above example. The deadline for all subsequent RMDs is Dec. 31.

Q: What are the new rules for people who inherit IRAs or 401(k)s?
Under the old rules, people who inherited Roth and traditional accounts were often permitted to stretch required withdrawals—and make associated tax payments—over their own lifetimes to maximize growth in these accounts. Those who inherited 401(k)s and IRAs before 2020 can still use this technique, known as the “Stretch IRA.”

The new law generally requires those who inherit after Dec. 31, 2019, to take the money out and pay the taxes within a decade. Some beneficiaries, including surviving spouses and disabled heirs, can continue to use the Stretch IRA rules.

Q: Are 401(k), 403(b), and 457 retirement accounts treated the same under the new law?
Yes, but 403(b) and 457 plans for government workers and the Thrift Savings Plan for federal employees have two extra years in which to comply with the new law's Stretch IRA elimination. That means that if you inherit one of these accounts from someone who dies before Jan. 1, 2022, you can take required distributions—and make the associated tax payments—over your lifetime.

Q: What advice can you give heirs who must take taxable distributions over 10 years?
The 10-year deadline allows beneficiaries to decide when, over the decade, to take the money out and whether to do so in installments or a lump sum.

"They should adjust the distributions to best suit their tax situation," said Mr. Slott.

For example, a beneficiary who incurs a deductible business loss in year one might want to take out at least enough from the inherited IRA to use the loss to shield the distribution from tax. An heir who plans to retire in five years might want to wait until he or she is in a lower tax bracket to take withdrawals.

Q: What if I left my IRA to a trust?
Some IRA owners leave their accounts to trusts to prevent heirs from spending it all. Many of these trusts restrict annual payouts to the RMD. But with the Stretch IRA gone, some will be forced to distribute the money to the beneficiaries within a decade.

Owners can change the terms to allow the trust to retain control of the money for longer. But that leaves the trust on the hook to pay the income tax due when the IRA is liquidated. Trusts are taxed at the highest 37% rate once their annual income exceeds $12,950. In contrast, individuals don't reach the 37% bracket until their income exceeds $518,400.

For people who want a trust, a solution may be to convert a traditional IRA to a tax-free Roth account, said Mr. Slott.

The account owner will pay income tax on the IRA assets he or she converts. But once the money is in a Roth, the trust can take tax-free IRA withdrawals and retain control over the money.

Q: With the elimination of the stretch IRA, what are alternatives to leave to heirs?

One solution is for the account owner to use the IRA for living expenses or charitable contributions and leave other assets to heirs, such as stocks, bonds, and real estate that receive a step-up in basis at death. (This raises the asset's tax basis to the market value on the date of death, eliminating the capital-gains tax on the appreciation during the deceased person's lifetime.)

The IRA owner can also give the IRA to a spouse, who can stretch distributions over his or her lifespan. For example, a 70-year-old widow could take payouts over a 27-year life expectancy and then leave the account to younger heirs.

Life insurance is a tax-efficient way to transfer money to heirs, said Mr. Slott.

Buyers purchase these policies with after-tax dollars and need to be aware of the fees.

But the proceeds are free of income tax, and can be set up to avoid estate taxes. The insurance money can also be placed in a trust to keep it protected.

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