

Nonspouse beneficiary payout rules for IRAs and nonqualified annuities after the SECURE Act

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The Setting Every Community Up for Retirement Enhancement (SECURE) Act was passed in late 2019 and brought many changes to IRAs and qualified retirement plans. One of the most significant changes was to the inheritance rules for these types of arrangements; and, while the SECURE Act did not change the beneficiary payout rules for nonqualified annuities, because nonqualified annuities are popular retirement accumulation and income vehicles, a review of their beneficiary payout rules is warranted as well to provide a complete picture of the options available to beneficiaries in both situations.

In this paper we will examine the beneficiary payout rules for both IRAs and nonqualified annuities and provide examples to educate financial professionals on how these payout rules work so they can help their clients understand the full range of payout options available.

NONQUALIFIED ANNUITY BENEFICIAL PAYOUT RULES AFTER THE SECURE ACT — NO CHANGES

The SECURE Act did not change the payout rules for beneficiaries of nonqualified annuities (both deferred and immediate). This means that nonspouse beneficiaries of nonqualified deferred annuities may continue to use their life expectancy or the five-year rule to take out their required minimum distributions (RMDs).

Example 1 — Death of nonqualified deferred annuity owner

A nonqualified deferred annuity owner dies in 2020. The owner's daughter is named as beneficiary. The daughter may use her own life expectancy (as determined by the Single Life table) to take out the RMDs. The first minimum life expectancy-based payment must be taken within one year of the owner's death and every year thereafter. The daughter may also utilize the five-year rule to liquidate the inherited annuity which requires that the entire annuity be distributed within five years of the owner's death.

Any gain in the policy will be distributed first and will be taxable income to the beneficiary. Distributions from the inherited annuity are not subject to the 10% tax on pre-59½ distributions because of the death of the owner.

The beneficiaries of nonqualified immediate annuities or annuitizations can continue to use the selected payout option.

Example 2 — Death of nonqualified immediate annuity owner

A nonqualified immediate annuity owner purchased, with cash, and started payments from the annuity in 2020. They chose a life with 20-year term certain payout option. The owner's son was named as beneficiary. The owner dies in 2022. The son may elect to continue receiving payments for the remaining 18 years of the term certain or take a commuted value of the remaining payments if permitted by the contract. The gains portion of the payments will be taxable income to the beneficiary, once all the remaining cost basis is recaptured.

IRA BENEFICIAL PAYOUT RULES FOR DEATHS AFTER 2019

10-year rule

The SECURE Act changed the payout rules for nonspouse beneficiaries of IRA owners who die after December 31, 2019. Under the Act, nonspouse beneficiaries have 10 years (specifically December 31 of the 10th calendar year after the owner's death) to liquidate the entire IRA, unless an exception applies permitting life expectancy-based payouts. There is no annual distribution requirement. See *example 3*.

If an original beneficiary dies within the 10-year period their successor beneficiary assumes the same 10-year period, they do not restart their own 10-year period. See *example 4*.

Example 3 — Death of IRA owner in 2021

An IRA owner dies in 2021. Their adult daughter is named beneficiary of the IRA. She is not eligible for an exception permitting payouts based on her life expectancy.

Under the new IRA beneficial payout rules, the daughter has until December 31, 2031 to liquidate the entire IRA. The daughter may immediately liquidate the entire IRA, wait until December 31, 2031 to liquidate the entire IRA, or she can take partial distributions in any amount until the end of 2031.

The entire amount distributed to any beneficiary from an inherited IRA will generally be taxable as ordinary income to the beneficiary but will not be subject to the 10% premature distribution tax because the distribution is being taken due to the death of the owner.

Example 4 — Death of original beneficiary after 2020

An IRA owner dies in 2020 leaving the IRA to their adult daughter, who is not eligible for an exception permitting life expectancy-based payouts. The original beneficiary, the daughter, dies in 2022. Her son (the grandson of the IRA owner) is named as successor beneficiary. In this situation the successor beneficiary will have until the end of the original beneficiary's 10-year period, here December 31, 2030, to liquidate the entire inherited IRA.

EXCEPTIONS TO THE 10-YEAR PAYOUT RULE

Spouses

The spousal inheritance rules have not changed, so spouses will still be able to use their own life expectancy to take out RMDs from IRAs they have inherited instead of the 10-year rule.

Which RMD method a surviving spouse uses will depend on how they elect to treat the IRA they have inherited.

Spousal re-registration

If a surviving spouse re-registers an IRA they have inherited into their own name they will use their Uniform Table life expectancy factor each year to calculate RMDs once they reach their required beginning date (RBD) which is currently age 72.

This option may make sense when the surviving spouse is over age 59 ½ and younger than the deceased spouse.

Spousal inherited IRA

However, a surviving spouse who has inherited an IRA may also elect to leave the IRA in the name of the deceased spouse, often referred to as a spousal inherited IRA.

In this situation RMDs must begin when the deceased spouse would have reached their RBD and the Single Life table life expectancy factor of the surviving spouse is used each year, the so-called recalculation method, to calculate RMDs. It's important to note that the surviving spouse may re-register the IRA into their own name at any time, which means the surviving spouse may subsequently re-register the spousal inherited IRA into their own name at any point in the future.

The spousal inherited IRA option may be an option to consider for a surviving spouse that is under age 59 ½ so they can access the inherited IRA free from the 10% premature distribution tax or if the surviving spouse is older than the deceased spouse to delay RMDs until the deceased spouse would have reached their RBD.

NONSPOUSE BENEFICIARY EXCEPTIONS TO THE 10-YEAR RULE

Minor children of the IRA owner

A minor child of the IRA owner may use their life expectancy to take out beneficial RMDs. Once the minor reaches the age of majority, as determined by applicable state law, they will then have 10 years to liquidate the entire inherited IRA. See *example 5*.

If the minor child dies while still a minor their successor beneficiary will have 10 years to liquidate the inherited IRA. See *example 6*.

If the original beneficiary who is no longer a minor dies during their 10-year payout period, then their successor beneficiary must liquidate the inherited IRA by the end of the original beneficiary's 10-year required timeframe. See *example 7*.

It is important to note that this rule applies only to minors who inherit an IRA from their parent; it does not apply to other minors who inherit an IRA from a nonparent, for instance from grandparents or other family members. In those situations, the minor would use the 10-year rule.

Also note that the following rules are used to determine and calculate the life expectancy-based payments for any non-spouse beneficiary of an IRA:

- *Life expectancy-based payments for all non-spouse beneficiaries must begin by December 31 of the year following the year of the IRA owner's death*
- *The original beneficiary's initial life expectancy is determined using the Single Life table and for every year thereafter one is subtracted from the previous year's life expectancy factor to calculate the RMD, this is the so-called fixed term or minus one method of RMD calculation*
- *The original beneficiary's initial life expectancy factor is determined by the beneficiary's age on December 31 of the year following the year of the owner's death*

Example 5 — Minor as beneficiary

An IRA owner dies in 2021 leaving the account to their daughter. The daughter is 12 years old and lives in a state where the age of majority is 18. Because the daughter is under age 18 at the time of the owner's death, she is considered a minor and can use her life expectancy to take out RMDs from the inherited IRA until she reaches 18 years of age.

The life expectancy-based payments must begin by December 31, 2022, and then every year thereafter until she reaches the age of majority – in our example 18. When the daughter reaches age 18 in 2027, she has 10 years to liquidate the entire remaining value of the inherited IRA - December 31, 2037.

Example 6 — Minor as beneficiary who dies while still a minor

The facts are the same as in example four except the minor beneficiary in this example dies in 2024 while they are still taking life expectancy-based payments. In this situation the successor beneficiary would have until December 31, 2034 to liquidate the inherited IRA – 10 years from the original minor beneficiary's year of death as a minor.

Example 7 — Minor as beneficiary who dies after reaching age of majority

The facts are the same as in example four except the original beneficiary dies in 2032 after they have reached the age of majority. In this situation the successor beneficiary would have until the end of the 10-year period established when the minor beneficiary reached the age of majority, December 31, 2037, to liquidate the inherited IRA.

DISABILITY

A beneficiary, regardless of age, who is "disabled" within the definition provided in Internal Revenue Code (IRC) Sec. 72(m)(7) will be able to utilize their life expectancy to take RMDs.

An individual will be considered "disabled" under Sec. 72(m)(7) "if he/she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long continued and indefinite duration."

If the disabled beneficiary dies during their life expectancy payout schedule, then their successor beneficiary must liquidate the inherited IRA by the end of the 10th year following the year of the original beneficiary's death.

CHRONIC ILLNESS

A beneficiary, regardless of age, who is "chronically ill" as defined by I.R.C. Sec. 7702B(c)(2) will be able to utilize their life expectancy to take RMDs.

An individual will be considered "chronically ill" under Sec. 7702B(c)(2) if he/she is unable to perform at least two of six activities of daily living without assistance for ninety days or if he/she requires substantial supervision to ensure such individual's safety from threats to their health and safety due to severe cognitive impairment.

If the chronically ill beneficiary dies during their life expectancy payout schedule, then their successor beneficiary must liquidate the inherited IRA by the end of the 10th year following the year of the original beneficiary's death.

Beneficiary who is older or not more than ten years younger than the deceased IRA owner

A beneficiary who is older or who is less than 10 years younger than the IRA owner, will be able to use their life expectancy to take out RMDs, instead of using the ten-year rule. *See examples 8, 9 and 11.*

Please note, if the IRA owner dies after the required beginning date for RMDs (currently age 72) and the beneficiary is older than the IRA owner then the owner's remaining life expectancy is used to stretch out the beneficiary's RMDs not the beneficiary's life expectancy, because the owner's remaining life expectancy is the longer of the two life expectancies. *See example 10.*

If the original beneficiary dies during their life expectancy payout schedule, then their successor beneficiary must liquidate the inherited IRA by the end of 10th year following the year of the original beneficiary's death.

Example 8 — Beneficiary is less than 10 years younger than the IRA owner and the IRA owner is under RMD age

An IRA owner dies in 2021, at age 58, leaving the account to their unmarried partner, age 55. Because the beneficiary was not married to the deceased IRA owner, the beneficiary is considered a nonspouse beneficiary and cannot use the spousal inheritance rules. However, because the beneficiary is less than 10-years younger than the deceased IRA owner, they can use their life expectancy to take annual RMDs from the inherited IRA. The life expectancy-based payments must begin by December 31, 2022.

Example 9 — Beneficiary is older than the IRA owner and the IRA owner is under RMD age

An IRA owner dies in 2021, at age 66, leaving the IRA to their older sister (68). Because the beneficiary is older than the IRA owner and the IRA owner died prior to the RBD (currently 72) the beneficiary may use their life expectancy to take out annual RMDs from the inherited IRA. The life expectancy-based payments must begin by December 31, 2022.

Example 10 — Beneficiary is older than the IRA owner and the IRA owner is over RMD age

An IRA owner dies in 2021, at age 75, leaving the IRA to their older cousin (78). Because the beneficiary is older than the IRA owner and the owner died after their RBD (currently 72) the beneficiary must use the remaining life expectancy of the owner (as established by the Single Life table) to take out annual RMDs from the inherited IRA because it is the longer of the two life expectancies. The life expectancy-based payments must begin by December 31, 2022.

Example 11 — Beneficiary is less than 10 years younger than IRA owner and the IRA owner is over RMD age

An IRA owner dies in 2021, at age 80, leaving their IRA to their younger sister (75). Because the beneficiary is less than 10 years younger than the IRA owner, even though the owner died after their RBD, the beneficiary must use their life expectancy to take out annual RMDs from the inherited IRA because their own life expectancy is the longer of the two. The life expectancy-based payments must begin by December 31, 2022.

ADDITIONAL IRA PAYOUT RULES AFTER THE SECURE ACT

Annuitized IRAs

The 10-year payout rule also applies to IRAs annuitized after December 31, 2019. Meaning that the nonspouse beneficiary of an annuitized IRA would have no more than 10-years to take out any residual amount, whether as continuing payments or as a commutation value.

Example 12 — Death of an annuitized IRA annuity owner, annuitized after 2020

An individual annuitized an IRA in 2020 with a life and 20-year term certain payout option. Further assume the owner died in 2022 and the owner's cousin is named as beneficiary. The cousin must take all remaining payments by December 31, 2032 or sooner because the IRA immediate annuity payout was started in 2020 meaning the beneficiary is subject to the 10-year payout rule.

Designated beneficiary trust as IRA beneficiary

After December 31, 2019, when a trust is the beneficiary of an IRA and if the trust can be considered a designated¹ beneficiary then that trust will have ten years following the owner's death to liquidate the entire IRA, unless an exception applies permitting life expectancy-based payments.

Estates, charities, and non-designated beneficiary trusts as IRA beneficiaries

After December 31, 2019, when an estate, non-designated beneficiary trust or charity, is the beneficiary of an IRA those entities will have until either:

- December 31 of the fifth year following the year of the owner's death to liquidate the entire IRA if the IRA owner died prior to their RBD; or,
- The owner's remaining life expectancy if the IRA owner died after their RBD.

IRA BENEFICIAL PAYOUT RULES FOR IRA OWNER DEATHS PRIOR TO 2020

Life expectancy payouts may continue

If an IRA owner died prior to 2020, then the original beneficiary can continue using the life expectancy method or any other payout rule they were using prior to the passage of the SECURE Act.

Example 13 — Death of IRA owner in 2018

An IRA owner died in 2018 and left the IRA annuity to their son. The son may use his life expectancy to stretch out the inherited IRA because the IRA owner died prior to the effective date of the SECURE Act (January 1, 2020). The son had until December 31, 2019 to take out his first life expectancy-based payment. Every year thereafter the son must take out the minimum life expectancy-based amount, but he can always take more.

Original beneficiary dies in 2020 or thereafter

If the owner died prior to 2020 and the original beneficiary dies in 2020 or thereafter the successor beneficiary has until December 31 of the 10th year following the original beneficiary's death to liquidate the inherited IRA.

Example 14 — Death of original beneficiary after 2020

The facts are the same as in example 15, but the original beneficiary dies in 2023. Further assume that the original beneficiary's nephew is named as successor beneficiary. In this situation the nephew, as successor beneficiary, would have until the end of the 10th year from the year of the original beneficiary's death, December 31, 2033, to liquidate the entire amount remaining in the inherited IRA. Even though the IRA owner died prior to the SECURE Act, the beneficiary's death occurred after 2019 so the 10-year rule applies to the successor beneficiary.

Pre-2020 IRA annuitization

A beneficiary who inherits an IRA that was annuitized prior to January 1, 2020 will not be required to use the ten-year payout rule; instead, they will be able to continue to use the selected payout option.

Example 15 — Death of an annuitized IRA owner, annuitized prior to 2020

An individual annuitized an IRA in 2018 with a life and 20-year term certain payout option. Then in 2022 the owner dies, and the owner's niece is named as beneficiary. The niece may either continue to receive payments for the remaining 16 years of the term certain or take a lump sum commutation value of the remaining payments (if the contract allows) because the IRA immediate annuity payout was started prior to 2020.

CONCLUSION

The SECURE Act has brought significant change to the beneficiary payout options of IRAs and other qualified accounts, but it does not affect nonqualified deferred annuities. Advisers should be aware of these changes and be ready to discuss and implement the new rules to help their clients meet their wealth transfer goals. For the beneficiaries of nonqualified annuities, the potential wealth transfer effectiveness of life expectancy-based payments is still a tool that they can use to meet their inheritance planning goals.



This material is not a recommendation to buy or sell a financial product or to adopt an investment strategy. Investors should discuss their specific situation with their financial professional.

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¹ To be considered a designated beneficiary a trust must meet the following requirements:

- The trust beneficiaries must be individuals clearly identifiable (from the trust document) as designated beneficiaries as of September 30 following the year of your death.
- The trust must be valid under state law; a trust that would be valid under state law, except for the fact that the trust lacks a trust "corpus" or principal, will qualify.
- The trust must be irrevocable, or (by its terms) become irrevocable upon the death of the IRA owner or plan participant.
- The trust document, all amendments, and the list of trust beneficiaries (including contingent and remainder beneficiaries) must be provided to the IRA custodian or plan administrator by the October 31 following the year of your death.