PG Calc

YOUR PARTNER IN PLANNED GIVING SUCCESS

The New IRS Rules on Inherited IRAs Could Increase Attractiveness of Charitable Giving

PG Calc Featured Article, October 2022 eRate

By Kara Morin, PG Calc Director of Client Services

Solicitations for testamentary gifts from IRAs are often an easy ask. The donor can name a charity (or charities) to benefit from all or just a fraction of their IRA account without revising their will (and paying their attorney's fees). Because of the ease of the ask and the prevalence of IRA holdings by donors, fundraisers should be aware when changes to IRA regulations might sway a donor towards an IRA gift.

Earlier this year, the IRS released proposed regulations that take a new position affecting required minimum distributions (RMDs) for inherited IRAs and the considerable financial penalty (up to 50%!) for failure to take an RMD. But don't be misled by the word "proposed," unlike proposed Federal regulations, proposed IRS regulations immediately go into effect. The upside of the IRS's position is that it also enhances the attractiveness of testamentary charitable gift annuities (CGAs) and charitable remainder trusts (CRTs) funded by IRAs.

To begin, it may be helpful to understand this evolution in the regulations governing inherited IRAs. Prior to the SECURE Act passing in December of 2019, both a spouse and a non-spouse could draw down the funds in an inherited IRA over the course of their life expectancies as determined in an IRS table. Depending on the age of the beneficiaries, that timeline could be decades, and during that time the IRA's principal would continue to grow tax-free. This practice was commonly referred to as a "stretch IRA."

The passage of the SECURE Act left intact a surviving spouse's ability to stretch out an IRA's distributions over their life expectancy but capped at ten years the distribution time frame for other individual beneficiaries (with a few exceptions – such as minor children, beneficiaries who are disabled, and individuals who are not more than ten years younger than the deceased IRA owner). Shortening this time frame increased tax revenue – after all, the tax you pay the IRS this year is more valuable to the IRS than the same amount of tax paid ten years from now.

This change in the distribution rules caused financial planners to scramble their carefully calibrated schedules of IRA withdrawals while at the same time creating a new incentive for gift planners to propose testamentary life income gifts. If a donor had envisioned their children drawing down an inherited IRA over their lifetimes, a CRT or CGA funded by the IRA at the donor's death instead became an attractive life income alternative. Past tax rulings confirmed that the transfer would not trigger an income tax "haircut" at the time of withdrawal, and the gift plan would provide the children payments for life.

While many testamentary gifts were successfully closed with this approach, just as many potential donors decided to leave their plans "as is." One reason was that most practitioners read the new rules to mean that an individual who inherited an IRA did not have to take any RMDs as long as the IRA was empty by the end of the tenth year. While the heirs could not spread withdrawals over their lifetimes, at least they could defer withdrawals for ten years, during which time the IRA's principal would continue to grow tax-free.

However, this spring the IRS released new guidance in IRS Publication 590-B that derails those plans. This guidance reflects the rules laid out in the proposed regulations mentioned earlier; non-spouse inheritors must take annual RMDs every year of the ten-year term if the deceased IRA owner died on or after April 1 of the year following turning age 72. This effectively transfers to the non-spouse beneficiary the owner's responsibility to take RMDs, regardless of the non-spouse beneficiary's age. While it is possible that the IRS could revise this interpretation of the SECURE Act, it seems more likely that the final regulations, which are still pending, will retain the rules contained in the proposed regulations. Most importantly, the IRS expects taxpayers to follow the proposed regulations and begin drawing down their RMD.

Even if your donor plans to name their six-month-old grandchild as the inheritor of their IRA, IRS Publication 590-B shows you how to calculate that infant's RMD each year. In April, the IRS released life expectancy tables that begin with year zero. To find the RMD, simply divide the value of the IRA by the child's life expectancy found in the IRS table. Once the child turns 21, however, the ten-year rule will also come into effect.

In the case of multiple beneficiaries, the age of the oldest beneficiary governs the RMD calculation for all the other named beneficiaries. To go back to the six-month-old heir, if that grandchild and the child's 42-year-old mother are both named beneficiaries of 50% of a $500,000 IRA, this year each of them must withdraw $5,708, the RMD based on the mother's age. The infant's RMD would be $2,955 if it were based on the infant's age.

This being the IRS, there is an exception to using the older person's life expectancy. If the named non-spouse inheritor is older than the deceased IRA owner, the deceased owner's age is used to calculate the RMD. This appears to be the only part of the newly released guidance that doesn't have the effect of increasing tax revenue.

However the RMD is determined, the non-spouse beneficiary must take their RMD annually until the end of the ten-year term or the principal is completely withdrawn, whichever happens first. Failure to make the required withdrawal would result in an excise tax of up to 50% of the RMD not withdrawn. The cost of not taking an RMD, or failing to withdraw the entire amount of the RMD, can be very high.

This spring's addition of RMDs to the IRA equation effectively removes one reason for not doing a testamentary gift: the opportunity to grow the IRA's principal tax-free for a decade after the donor's death. Alone, this change is not persuasive enough to sway an uninterested donor, but if you have a committed supporter with an IRA, this change does add to the case for a testamentary gift.

When drafting a gift proposal, try to determine what piece of the lost "stretch IRA" your donor might miss the most and align your proposal accordingly. For instance, if your donor liked the idea that their heir could delay receiving income for more than a decade, consider proposing a testamentary Flexible Gift Annuity. After an initial year of deferral, the heir could delay income until they wanted to receive it, and the longer they wait, the higher their annuity rate will be.

Careful planning is always needed when funding a testamentary gift. In the case of a CRT, a "dry" trust should be in place to accept the IRA's funding, and for a CGA, the contract should be signed by the donor ahead of time.

In addition, if your donor decides to fund a charitable gift with only part of their IRA, leaving the balance to an individual who is not their spouse, they should be aware that doing so may shrink the window for the individual inheritor's IRA withdrawals from ten years to five years. This acceleration happens if the IRA custodian drags its feet on the charitable distribution. Under current regulations, if the charity doesn't receive its funds by September 30th of the year following the owner's death, the individual beneficiary(ies) will be forced to make their withdrawals within the five-year term that applies to entities like charities, estates, and revocable trusts.

If your donor is worried about their custodian's ability to fulfill their contractual obligations in a timely manner, peace of mind can be gained by splitting their single IRA into two IRA accounts, one for the individuals and one for the charity(ies). This frees up the individuals to make withdrawals over ten years, while keeping the charity in the five-year distribution window.

Lastly, if your donor has inherited an IRA and is facing the problem of RMDs, they should know that if they are age 70 ½ or older, they can use the IRA qualified charitable distribution, or QCD, during the ten-year term to fulfill the RMD without increasing their taxable income. The rules limit the QCD to outright gifts made directly to the charity from the custodian, and while a donor can benefit multiple charities with a QCD, the total gifts cannot exceed $100,000 in a calendar year.