

# SECURE 2.0 Penalty Protections May Not Be As Good As Thought

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There is confusion over RMD rules, and advisors must step up to the plate to help clients.

## RMD Penalty Overview

The penalty for missing a required minimum distribution (RMD) is one of the largest in the Tax Code. For years it was 50 percent of the amount that should have been taken but was not.

That penalty was so severe that the IRS has rarely assessed it and has waived it in most cases – as long as the IRA owner made up the RMD shortfall and filed IRS form 5329, citing a reasonable excuse for not taking the correct RMD (or not taking it at all). These reasons include confusion over the RMD rules, incorrect advice from an advisor or financial institution, illness or family medical issues, disability, or death.

## RMD Penalty Relief Provisions Under SECURE 2.0

The SECURE 2.0 law reduced the 50 percent penalty to 25 percent (and to 10 percent if the missed RMD was made up within two years and the 10 percent penalty was paid). This reduction was effective as of 2023. The IRS has suggested that a complete penalty waiver is still available by taking the same steps as before.

In SECURE 2.0, Congress also addressed the statute of limitations (SOL), which determines how far the IRS can go back and assess the RMD penalty. A regular income tax return generally has a three-year SOL. However, the SOL is six years when the return understates more than 25 percent of actual gross income, and there is no statute at all in cases of fraud or a willful attempt to evade taxes.

Before SECURE 2.0, there was effectively no SOL for the IRS to assess the RMD penalty. Simply filing an income tax return (form 1040) each year did not initiate the SOL period when it came to the RMD penalty. The only way to get the statute running for a missed RMD penalty before SECURE 2.0 was to file form 5329. Form 5329 was considered a separate tax return with its own SOL.

The problem was that most IRA owners did not know they either missed taking an RMD or took too little. Since those people saw no need to file form 5329 to request a penalty waiver, the SOL period was never initiated. This left the IRS assessment period open-ended. The IRS could go back indefinitely for years of missed RMD penalties, plus interest, at the old 50 percent penalty amount. That could add up to a huge chunk of an IRA being lost.

## Changes Brought by SECURE 2.0

Congress attempted to fix this problem in SECURE 2.0 (effective as of 2022) by allowing the filing of the regular income tax return (form 1040) to initiate the SOL period even if no form 5329 is filed. (SECURE 2.0 didn't do away with the SOL available by filing form 5329.)

While this was a welcome change, the provision is not retroactive, according to a recent Tax Court case, so old years (before 2022) subject to the old 50 percent RMD penalty may still be open for the IRS to assess back-year penalties.

## Is the New Statute of Limitations Three Years or Six Years?

That's a good question. SECURE 2.0 says the SOL for missed RMDs (for 2022 and subsequent years) is three years from the original (April 15th) due date of the income tax return, or from the actual filing date if the return is on extension.

But upon further reading of the tax law [Code s. 6501(e)(3)], the SOL is increased to six years if the amount of penalty reported omits more than 25 percent of the eventual penalty. So, even if Form 5329 is filed for a tax year showing zero RMD penalty (because the IRA owner, in good faith, thought they took the right amount), the IRS will still have six years to assess any penalty for that year. That's because more than 25 percent of any missed RMD penalty (even if only \$1) would have been omitted. A six-year SOL is certainly better than no statute, but not as good as a three-year SOL.

The IRA owner could still request a penalty waiver, but missed RMDs would have to be made up first, eventually going back six years. (Since the new SOL provision only began in 2022, no one has gone six years yet.)

## Statute Relief is for IRAs Only

Besides not being retroactive, the SECURE 2.0 SOL change applies only to missed RMDs from IRAs, not from 401(k)s or other employer plans [Code s. 6501(l)(4)]. This may not affect many people since most employees don't take RMDs from their 401(k)s due to the "still working" exception where plan RMDs can be delayed until retirement, or because plan funds have either been distributed or rolled over to IRAs upon retirement. Plan participants with missed RMDs will still have to file form 5329 to get the statute period running.

## The RMD Penalty Fix

There is one way to retain the three-year SOL for a tax year: by providing information to the IRS about that year's RMD through an attachment to form 5329. The attachment should disclose how the RMD was calculated, listing all the retirement accounts owned, the balances subject to RMDs, the age, and the computation of the RMD. That should lock in the three-year statute (again, only for missed RMDs beginning in 2022 and later years). In this case, if the IRS waives the penalty, only three years of missed RMDs would have to be made up, rather than six.

Here's the problem with the above solution: Very few people will do it. Even the more cautious tax preparers who file form 5329 every year showing a zero RMD penalty (to get

the SOL period running) will not qualify for the three-year statute unless they add the attachment. But if they do not, their clients will be stuck with a six-year SOL.

Since SECURE 2.0 is still new, we'll have to see how this develops and exactly how rigid or liberal the IRS will be in assessing or waiving the RMD penalty for back years.

The best solution, of course, is for advisors and tax preparers to step up and help clients calculate the correct RMDs each year and to make sure they are taken. That way, this whole SOL/form 5329 mess can be completely avoided.