

# An Inherited IRA

IRAs are among the largest assets left to heirs and beneficiaries, and deciding what to do with an inherited IRA is among the most important decisions facing many heirs. So, let's discuss the decisions you'll want to ponder if you find yourself on the receiving end of an IRA account from a loved one who has passed away.

You can, of course, elect to receive the entire balance immediately in a total distribution. But, unless you need the money immediately, it's generally better to leave it in the IRA as long as possible to defer taxation and prolong the period of tax-deferred growth.

Did you even know that you have choices if you are the beneficiary of an IRA account? The IRA distribution options available generally depend on whether the IRA owner dies **before or after** April 1st of the year following the year in which he or she turned age 70 1/2. That's when the owner would have been required to start taking minimum distributions from the account. We'll refer to that date as the "required beginning date."

## Options for the Estate

If the IRA owner didn't name a beneficiary or named his estate as beneficiary, there is little room for distribution planning. If the IRA owner dies **before** the required beginning date, the balance will be distributed to his estate (or other beneficiary, as prescribed in the will) according to the five-year rule.

The five-year rule basically requires that the entire amount in the IRA be distributed no later than December 31st of the fifth year after the IRA owner's death. In this case, the only question is when and how to take the distributions during the five-year period. Waiting until the end maximizes the tax deferral, but spreading distributions out over all years avoids bunching income for the recipient.

On the other hand, if the IRA owner dies **after** the required beginning date, the balance must be distributed over the remaining term elected by the IRA owner. Or, if the owner elected to recalculate his life expectancy, the balance must be distributed by the end of the year following the year of his death.

## Options for the Non-Spouse Beneficiary

Assume that you're not the surviving spouse of the deceased IRA owner, but this person was kind enough to name you as the beneficiary of the IRA. Now what happens?

### IRA Owner Dies *After* Required Beginning Date

If the IRA owner had *already begun to receive* minimum required distributions, the remaining distributions generally must be paid out **at least as rapidly** as they would have been under the method of distribution in effect before his/her death.

This means that the options available to you are limited, because you generally can't lengthen the distribution schedule selected by the IRA owner on his required beginning date. Instead, with a few exceptions, if the IRA owner was receiving distributions over your collective life expectancies on the required beginning date, you must continue to take distributions over this period. If the IRA owner was recalculating the life expectancy each year, you must take the distributions over your **own** life expectancy (since the life expectancy of the IRA owner is now, sadly, zero).

If, on the other hand, the IRA owner was receiving distributions over his own single life expectancy (whether or not recalculated), the IRS has ruled that you can take distributions over your **own** life expectancy.

### IRA Owner Dies *Before* Required Beginning Date

If the IRA owner dies *before* the required beginning date, you have a few more options. The general rule is that the entire balance of the IRA must be distributed under the five-year rule discussed above.

But, you can take advantage of an exception to the five-year rule and elect to receive distributions over a period not exceeding your life expectancy -- a better option for most people. If you decide to take this option, it's vital that you elect a method of distribution and that you take the initial distribution by the end of the year following the year of the IRA owner's death. Why? Because, unless the IRA agreement provides otherwise, distributions to a non-spouse beneficiary must be made under the five-year rule if no election is made. If you fail to make the election and take the appropriate distribution at the appropriate time, you'll lose this option and will be required to take distributions using the five-year rules. In effect, if you snooze, you lose.

One option **not** available to non-spouse beneficiaries is rolling over the inherited IRA account into an existing IRA they own. (**Only** spouses have this option, and we'll discuss it in a bit more detail below.) If a non-spouse beneficiary **does** roll over the inherited IRA into his or her own existing IRA, the rollover is treated as a distribution, and the proceeds must be included in the beneficiary's income in the year the rollover occurs.

## Using Separate Shares for Multiple Beneficiaries

Multiple beneficiaries of an IRA can elect individually to apply the five-year rule or one of the exceptions when the IRA owner dies before beginning to receive distributions. In other words, each beneficiary can decide how quickly to receive distributions. That's the good news.

The bad news is that generally the individual having the shortest life expectancy must be used to determine the required distribution amount. Given this restriction, there may be little advantage to naming multiple beneficiaries if there are vast age differences among them. The *younger* beneficiaries will be required to take distributions based on the life expectancy of the *oldest* beneficiary.

But, there's a way around this. If *separate* IRA accounts or *segregated shares* are maintained for each beneficiary, each beneficiary can take his or her own distributions based on his or her own life expectancy.

The separate shares or accounts can be set up in two ways. First, the IRA owner may set up separate IRA accounts, naming different beneficiaries for each. This is advisable, but can't be done retroactively after the death of the IRA owner. But, the account *can* be segregated after the IRA owner's death, as long as the necessary actions are taken no later than the time by which distributions are required to begin, and the division is retroactive to the time of the IRA owner's death.

The separate shares are created by having the IRA trustee or custodian set up sub-accounts within the original IRA, and then account for gains, losses, and distributions separately for each sub-account. This division does not affect the tax-deferred status of the IRA and is not treated as a taxable distribution to the beneficiaries. The individuals can then, if they wish, have the sub-accounts transferred in a trustee-to-trustee transfer to separate IRA accounts, as long as the accounts remain in the decedent's name.

The result, according to several IRS rulings, is that each individual's distribution is calculated using each individual beneficiary's account balance and life expectancy. So, even if you discover you are one of many beneficiaries, don't overlook the possibility of creating sub-accounts and controlling your own destiny.

## Options for Surviving Spouses

A surviving spouse who is named the beneficiary of an IRA generally has the same options available to non-spouse beneficiaries... and then some. A surviving spouse has an additional option -- he or she can avoid the post-death minimum distribution rules *completely* by electing to treat the inherited IRA as his or her *own* IRA.

If this election is made, the surviving spouse is treated as the IRA owner for all purposes and becomes subject to the minimum distribution rules only after reaching age 70 1/2. The surviving spouse also has the opportunity to name another beneficiary and receive distributions based on the joint life expectancy with the new beneficiary, under the general rules applicable to all IRA owners. Sweet.

## Surviving Spouse Strategies

The election to treat your spouse's IRA as your own after his/her death should probably be made when the IRA owner is receiving distributions under the recalculation method. Why? Because if you, the surviving spouse, don't elect to take the IRA as your own, the IRA will have to be distributed in a lump sum if you die before the entire balance is distributed. This could cause a real hardship to your beneficiaries.

In addition, this election should be made whenever the surviving spouse is much younger than the deceased IRA owner. Why? Because it allows the surviving spouse to leave the funds invested tax-deferred until after he/she reaches age 70 1/2. If the election is *not* made, the surviving spouse will be required to receive distributions based on the deceased IRA owner's age.

On the other hand, a surviving spouse who is much older than the deceased IRA owner generally should elect to receive minimum distributions beginning after the decedent's death or after the decedent's attainment of age 70 1/2, whichever is later. Nevertheless, even an *older* surviving spouse can use the election to treat the decedent's IRA as his or her own to name a new beneficiary and begin receiving distributions over their joint lives. This might well lead to a longer payout period.

The election to treat an inherited IRA as one belonging to a surviving spouse can be made by filing an election on a form supplied by the IRA trustee or custodian. But, the election can also be made without filing any forms -- by simply by not taking required distributions, or by making a contribution to the IRA.

Another option for a surviving spouse is a rollover. Unlike other beneficiaries, a surviving spouse can roll over an inherited IRA into an IRA of his or her own. This has the same result as the election to treat the IRA as belonging to the spouse -- in fact, many IRA trustees and custodians prefer or even require the surviving spouse to change the ownership of an inherited IRA by rolling the account over to a new account.

### **Disclaimer Option**

The beneficiary named by the decedent may be able to disclaim an interest in an inherited IRA, resulting in the distribution going directly to the next beneficiary in line. The disclaimer is effective for both income tax and estate tax purposes, so that the original beneficiary will not be taxed on the IRA and the recipient will be treated as receiving the IRA directly from the decedent. This can be a complicated issue and is well beyond the scope of this discussion. It also could have both estate- and income-tax consequences -- both positive and negative -- for the beneficiary. Just know that this option is available and discuss it with a qualified estate-planning pro before you decide to disclaim your interest in an inherited IRA.

### **Paperwork and Administrative Issues**

Whatever option the beneficiary selects, he or she needs to take care of some administrative details. First, a non-spouse beneficiary must make sure that both the decedent's name and the beneficiary's name are on the account. If the account title is modified to reflect only the beneficiary's name, this modification is treated as an immediate distribution of the account and all the proceeds will be included in the beneficiary's income. In addition, the account should reflect the decedent's date of death and the beneficiary's Social Security number. It is safest not to assume that the IRA custodian will take the necessary steps to ensure that the information on the account is complete and correct.