IRA MISSTEPS

A lack of knowledge can lead to problems & disappointments for your heirs.

Be vigilant, and be knowledgeable. Do you want to hand your heirs big tax problems? Would you like to hand the IRS a sizable chunk of your wealth? Of course not. But if you misunderstand the rules when it comes to inherited IRAs, you just might. Here are some missteps that IRA owners and IRA heirs often make – financial choices to regret.

Thinking that a will or a trust can facilitate the transfer of IRA assets. IRAs don't pass to heirs through wills or trusts (a few rare exceptions aside). The beneficiary form takes precedence – the form the IRA owner filled out and signed when opening the account. Problems arise when

- The IRA owner dies without designating a beneficiary
- The designated beneficiary has also passed away
- No one can find the beneficiary form (not even the IRA custodian, i.e., the financial institution that hosts the IRA)

In these circumstances, IRA heirs commonly end up playing by the IRA custodian's rules. The resulting beneficiary may be the IRA owner's estate – a very undesirable tax consequence. It might be a contingent beneficiary – perhaps a very undesirable emotional consequence. The lesson here is to keep the beneficiary form handy and to let your heirs know where it is.[1]

Taking lump-sum distributions. Too often, non-spousal IRA heirs see the inherited assets as money to spend. They withdraw the entire IRA balance in one fell swoop. Bad idea: all that money will be subject to federal income tax. Due to this move, they may lose a third of the IRA assets (or more).[2]

The alternatives? Non-spousal beneficiaries can open an inherited Roth or traditional IRA to house the inherited assets and simply take Required Minimum Distributions (RMDs) from that inherited IRA under the appropriate schedule. Yearly distributions from the inherited IRA must start by December 31 of the year after the year in which the original IRA owner died.

- *If a non-spouse individual is the beneficiary,* these distributions can be scheduled over the expected lifespan of the beneficiary as calculated through IRS tables. This way, invested IRA assets may keep compounding across many years with the added benefit of tax deferral.[3]
- *If an estate is the beneficiary,* things are different. If an estate inherits a traditional or Roth IRA, 100% of those assets must be distributed within five years. There is one exception: if an estate is the beneficiary of an inherited traditional IRA and the former owner was older than 70½ when he or she died, then the distribution rate is based on the age of that IRA owner.[3]

You can also "disclaim" some or all of any inherited IRA assets, which could be a wise move for tax purposes if you don't need the inherited funds.[4]

Not realizing your four options when you inherit your spouse's IRA. If a spouse dies, the surviving spouse that inherits an IRA has some choices. He or she can

- Roll over the assets into a beneficiary IRA
- Convert the inherited IRA into your own IRA
- Take a lump sum distribution
- "Disclaim" up to 100% of the deceased spouse's IRA assets

There are compelling reasons to go with the rollover. The widowed spouse can set up an RMD schedule based on his or her life expectancy. This second point is really important, because the rollover allows the surviving spouse to put off the RMDs that would otherwise soon need to happen. In fact, the

surviving spouse can wait until the year in which the original IRA owner would have turned 70½ to start taking required withdrawals from the IRA.[2]

If you inherit a Roth IRA from your spouse, you may be able to roll the assets into a Roth IRA of your own or treat the Roth IRA you received from your spouse as your own if you are the sole beneficiary. This is worth noting, as Roth IRA owners will never have to make mandatory annual withdrawals from their IRAs.[4]

Incidentally, there is no such thing as an early withdrawal penalty from an inherited IRA. Inherited IRA withdrawals are never hit with the 10% early distribution penalty as the funds are categorized as death proceeds. To certify this, the IRA custodian or trustee needs to report these withdrawals as "death distributions" in Box 7 of Form 1099-R.[5]

If the spouse converts the IRA into his or her own IRA, the surviving spouse can name a beneficiary for the inherited assets, keep contributing to the IRA, and potentially avoid RMDs until he or she turns 70½.[6]

Alternately, a surviving spouse who doesn't really need inherited IRA assets can "disclaim" them, meaning that they will go to a contingent beneficiary. Sometimes this can be a wise move for tax purposes.[7]

Non-spousal heirs fail to retitle an inherited IRA. If this isn't done in the year following the year in which the original IRA owner passed, then there can be no direct rollover of the inherited IRA assets and no "stretch" for those assets.[2,8]

What happens if a non-spouse beneficiary just rolls the inherited IRA assets into an IRA they own, one that isn't retitled? Then it is not a direct rollover. The IRS treats those inherited IRA assets like a fully taxable cash distribution – 100% of it is subject to income tax.[8]

Ask for help, and don't be afraid to ask questions. Many families and couples have only a hazy understanding of the rules governing IRAs, and few really know all the options. Make sure your IRA beneficiary form is up to date, and speak with the financial professional you know and trust about how to handle the transfer of IRA assets when the time comes.

Citations.

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