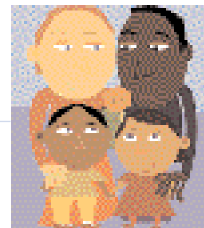
Inherited IRAs



Planning Tips for Non-Spouse Beneficiaries of IRAs, 401(k)s

By Joyce L. Franklin, CPA, CFP

A young woman came to me recently looking for help in sorting out her investments after her mother's death. Her mother was diagnosed with a terminal illness in 2000 and died in 2002. Unfortunately, the mother's overall financial planning was inadequate and resulted in major restrictions faced by her heirs.

The rules in this article relate to IRAs and retirement plans inherited by non-spouse beneficiaries; spousal beneficiaries are subject to different rules.

The Starting Point

My client and her sister each inherited 50 percent of three retirement accounts: a traditional IRA, a Roth IRA and a company-sponsored 401(k). The mother was not married at the time of her death.

The default rule for withdrawal from these plans by non-spouse beneficiaries is to begin minimum required distributions by Dec. 31, 2003, the year after the account owner's death. The alternative is to withdraw the balance of the account's assets within five years of the date of death.

For each option, income tax (but no penalty) will be due on the amount withdrawn from the IRA and 401(k) accounts. Roth IRA distributions are subject to special rules, which are detailed below.

We split each of the retirement accounts into two more accounts with the prior custodian, effectively transferring the ownership to my client and her sister. My client complied with the minimum required distribution rules and took the first distribution from her inherited retirement plans in 2003. She will continue to stretch out the retirement plans over her lifetime until the accounts are exhausted.

Calculating IRA Minimum Required Distributions

The beginning MRD for each retirement account is determined by the non-spouse beneficiary's age in the year after the account owner's death.

In this case, we divided the Dec. 31, 2002 balance in the IRA by 51.4, the factor for a 32-year-old from the Single Life Table [Section 1.401(a)(9)-9, A-1].

My client's 50 percent share of the IRA balance was $160,000 on Dec. 31, 2002, therefore her first year distribution in 2003 was $3,171.21.

A non-spouse must determine the life expectancy factor from the Single Life Table in the year following death and reduce it by one in each subsequent year. My client's 2004 factor is 30.2, which is divided into the Dec. 31, 2003 IRA value.

Distributions from the traditional IRA will be taxable at my client's marginal tax rate. Any after-tax IRA contributions must be allocated proportionately to each distribution and will avoid tax.

Generally, the best time to take distributions from an IRA is late in the year to maximize the deferral. But be careful—if distributions are requested too close to Dec. 31, the custodian may not have time to process your request before the end of the year.

The Five-Year Rule for Roth IRAs

There are no minimum distribution requirements on your own Roth IRA. However, a beneficiary must take distributions from an inherited Roth IRA in one of two ways: over the beneficiary's life, allowing the majority of the account to stay intact and grow tax-free, or within five years of the account owner's death.

Since Roth IRA contributions are not tax deductible, qualified distributions from a Roth IRA will be tax-free. Any funds that remain in the Roth IRA grow tax-free and there will be no tax on "qualified" withdrawals from the account.

Roth IRA distributions are taxed differently than traditional IRA distributions and understanding this rule can save your clients significant dollars.

Distributions from a Roth IRA are income tax free if they are "qualified," which is defined as distributions five years after the contribution was made.

For example, my client's mom funded her Roth IRA only once, with a contribution in 1999. Withdrawals from this Roth IRA are qualified under the five-year rule if they are made on or after Jan. 1, 2004. The time between the contribution date and the qualified withdrawal date is known as the five-year period.

If a distribution is made from a Roth IRA prior to this five-year period, it is a nonqualified distribution. The ordering rules determining the taxability of nonqualified Roth IRA distributions include:

1. Participant "regular" contributions are not taxable;
2. Participant rollover "conversion" contributions are not taxable; and
3. Earnings on contributions (either regular or conversion) withdrawn during the five-year period are taxable at the beneficiary's marginal tax bracket.

To summarize, Roth IRA withdrawals during the five-year period avoid tax as long as they are from contributions. After the five-year period, all Roth IRA distributions are tax-free to the beneficiary.

Planning for an Inherited 401(k)

A mistake my client's mother made before her death was not rolling her 401(k) into an IRA. The 401(k) plan document controls whether or not a non-spouse beneficiary will be allowed to stretch out a retirement plan, and it also controls how the funds will be invested if they are to stay in the plan.

In my client's case, the plan document specified that non-spouse beneficiaries are allowed to stretch out the 401(k), but that assets must be kept in the plan, limited by the investment elections available to company employees.

For as long as my client's money remains invested in the plan, she must

pay attention to changes in the plan, including investment alternatives offered, as plans change fund selections.

My client also must monitor the company's activities, including mergers, which may take some work since she doesn't work at the company and has no other ties. At any time, the management of her mother's former employer may change the 401(k) plan's investment elections and custodian.

Minimum required distributions from a 401(k) generally follow the rules of traditional IRAs explained above. Money withdrawn from a 401(k) plan will be taxable, however, any post-tax contributions made by the employee can come out tax-free if they were contributed before 1987 and the employer has accounted for pre-1987 and post-1986 after-tax contributions separately.

After-tax contributions since 1987 are taxed identically to IRAs because 1987 was the first year that post-tax contributions were allowed to IRAs.

The Case for IRA Rollovers

My client is fortunate. The 401(k) plan could have required that the non-spouse beneficiary take a full withdrawal from the account by the end of the year following her mother's death.

In that case, she would pay tax on the entire account balance when distributed, plus give up the tax benefit of deferring these assets over her lifetime.

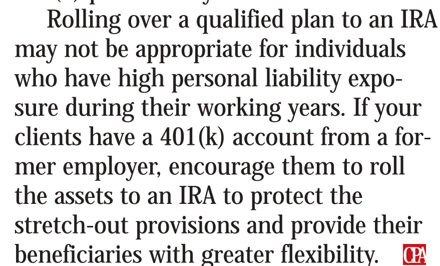
Why would company-sponsored retirement plans force non-spouse beneficiaries, such as children, grandchildren and siblings to withdraw the funds soon after a participant's death? The answer is simple: Because 401(k) plans do not want to be in the custodial business.

The employer incurs service costs to maintain each participant's account. While servicing the employee's account is an accepted cost of doing business, the employer has no obligation to the employee's non-spousal beneficiaries.

Retirement account planning is imperative for single individuals. Married couples should plan for the potential for divorce or death of a spouse.

As part of your planning checklist, remind clients that they can file a new beneficiary designation—both primary and contingent—on their IRAs and 401(k) plans at any time.

Rolling over a qualified plan to an IRA may not be appropriate for individuals who have high personal liability exposure during their working years. If your clients have a 401(k) account from a former employer, encourage them to roll the assets to an IRA to protect the stretch-out provisions and provide their beneficiaries with greater flexibility. CPA



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