INHERITED RETIREMENT ACCOUNTS

Designated vs. Non-Designated Beneficiary

Designated: A named individual or group of individuals that have been named by the IRA owner on a beneficiary form, or by default in the custodial agreement if no beneficiary is named, or by affirmative election by the surviving spouse, or by qualified disclaimer or otherwise identifiably by the determination date (Sept. 30 of the year following the year of the IRA owner's death).

- Susie Smith or "my children to share equally"
- "Your spouse, then your children, then their children, then your estate" is a common default in custodian agreements.
- Surviving spouse can elect to treat the IRA as their own and name a new beneficiary. This can be done at anytime after death.
- Three beneficiaries are named, one disclaims by Sept. 30 of the year following the year of death, so the remaining two become the "designated beneficiaries."
- Two named beneficiaries and one charity are named on the form. The executor cashes out the charity prior to Sept. 30 of the year following the year of death, so the remaining two are "designated beneficiaries."

Trust as Designated Beneficiary:
Certain trusts may qualify as a designated beneficiary. The trust must be:

- Valid under state law,
- Irrevocable or will become irrevocable upon the death of the IRA owner,
- The beneficiaries of the trust are identifiable from the trust instrument either by name, or by membership in a class of beneficiaries (children of this marriage).

The plan custodian must be provided with a full copy of the trust by Oct. 31 of the year following the year of death.

NOTE: Using a trust as the beneficiary of an IRA is a complex planning strategy. It does not yield any tax benefits over naming individuals, in fact it usually reduces the ability to stretch out IRAs over the longest time period. It does provide some measure of control. Certain trust language, if not drafted appropriately, can actually cause adverse tax consequences. Always consult with a knowledgeable attorney. Buckingham does not provide any legal or accounting advice. Clients should seek the counsel of a qualified accountant and/or attorney when necessary."

Non-Designated: Any non-natural entity named on the beneficiary form, or by default in the custodial document, by disclaimer, or otherwise identifiable on Sept. 30 of the year following the year of death.

- Estate of the IRA owner
- Any charity
- Non-qualifying trust

TIMELINE FOR DESIGNATED IRA BENEFICIARIES

By Sept. 30 of the year following the year of death:

Final date for determining the designated beneficiaries of the IRA, if any. **NOTE**: You cannot add beneficiaries, only remove them by disclaimer or paying them out prior to Sept. 30.

Non-designated beneficiaries, such as charities should be cashed out, if possible prior to this date. **Otherwise, ALL beneficiaries will be treated as non-designated.** For practical purposes, create separate IRA accounts for each beneficiary by Sept. 30 to allow the custodian time to calculate and distribute the pro-rata share of the RMD to all the beneficiaries, if required.

If any beneficiaries are going to disclaim their interest in the decedent's IRA, it must be done prior to this date. Beneficiaries can disclaim even if they have already taken the RMD due in the year of death.

By Dec. 31 of the year following the year of death:

Take the Required Minimum Distribution (RMD) for the year of death, if IRA owner:

- Had reached the Required Beginning Date (RBD) (April 1 of the year following the year in which they turned 70½) on or before the date of death, **and**
- Had not taken the RMD for the year of death.

The beneficiaries determined as of Sept. 30 above MUST take the RMD the owner should have taken in the year of death. **NOTE:** The beneficiaries take this distribution, NOT the owner's estate (unless the estate is the beneficiary). It should be reported on the beneficiary's 1040, not the estate tax return.

If there are multiple beneficiaries, they should each be distributed their share of the RMD for the year of death pro-rata to their proportion of the total IRA balance.

Create Separate Shares:

Unless separate IRA accounts are established for multiple beneficiaries by Dec. 31 of the year following the year of death, the life expectancy of the oldest designated beneficiary will be used to determine the RMD.

By separating the IRA into separate IRAs for each beneficiary, no later than Dec. 31 of the year following the year of death, each beneficiary will be considered the sole beneficiary of that share. This is particularly important if the spouse is one of multiple beneficiaries because the surviving spouse is entitled to more favorable treatment than any other beneficiary, but only if they are the sole beneficiary.

For Trusts Only: The trust must establish separate IRA shares BEFORE the owner's death AND the beneficiary form specifically names each separate trust share in order for each beneficiary to use their own life expectancy.

Spouse as Sole Beneficiary

For example, a surviving spouse (by making the Surviving Spouse's Election) can treat the IRA of the deceased spouse as their own IRA, even rolling it over into an existing IRA. This allows the surviving spouse to defer their first RMD to the *later* of their RBD, or the RBD of the deceased spouse, if later. Any distributions taken from this Spousal Roll-Over IRA by the spouse (except the RMD for the year of death) would be subject to the 10 percent penalty if the spouse had not reached age 59½.

If this election is not made, the surviving spouse will be considered as a beneficiary of the deceased owner's IRA and will be required to begin taking RMDs by the *later* of (i) Dec. 31 of the year following the year of death, or (ii) Dec. 31 of the year in which the deceased *owner* would have reached age 70½. These "*Beneficiary"* IRA accounts are sometimes referred to as *Inherited IRA accounts,* although that term is usually associated with non-spouse beneficiaries. The election to become the owner of the IRA can be made at any time, even years after the surviving spouse received RMDs from the IRA as a beneficiary.

Note: These distributions would NOT be subject to the 10 percent tax penalty if the surviving spouse had not reached age 59½. For younger spouses who need funds from the IRA, it may make sense to treat the IRA as a beneficiary IRA until they turn 59½.

INHERITED IRA ACCOUNTS FOR NON-SPOUSE, DESIGNATED BENEFICIARIES

The non-spouse beneficiary of an IRA who wants to take advantage of "stretching" the IRA over their lifetime must establish an *Inherited IRA account.* This is a relatively new type of account registration and must contain the following in some form:

- Name of beneficiary
- Name of original owner/depositor
- Type of account (IRA)
- Name of Custodian or Trustee (Bank, Brokerage, Custodian firm)

Trustee-to-Trustee Transfer Process

The custodian of the original IRA owned by the deceased must be willing to transfer the funds from that IRA to the new inherited IRA via a direct trustee-to-trustee process. The funds can not be made available directly to the beneficiary for any amount of time. If the funds are transferred via check, the check must be make payable to the new custodian, not the beneficiary.

It is common for institutions to refer to this transfer from a decedent's IRA to an inherited IRA as a rollover. It is not a rollover. A rollover occurs when funds distributed from a retirement plan are deposited into an IRA, either directly or by flowing through the owner for no more than 60 days. The other form of rollover is the movement of funds from a SEP IRA or SIMPLE IRA to a traditional IRA, whether directly or via the client within 60 days.

No 60-Day Rollover Allowed

Unlike normal IRA rollovers, the beneficiary is not able to receive the funds from the deceased's IRA and then deposit them back into the inherited IRA. If this occurs, the funds are considered distributed and fully taxable. ***There is no opportunity to undo this.***

NO Five-Year Rule for Designated Beneficiaries — Even Non-Spouses:

A non-spouse designated beneficiary (child, grandchild, parent, friend) will receive the ability to "stretch" the IRA, by default instead of being forced into taking the entire account within five years. If there were multiple beneficiaries, and the account was split prior to Dec. 31 of the year following the year of death, then the non-spouse beneficiary may use their age to determine distributions. If the account was not split by the deadline, then the age of the oldest beneficiary is used for all beneficiaries, even if the account is split at a later date.

The only way the five-year rule would apply would be if the beneficiary elected to distribute all the money within five years or less. Many do, in spite of the tax hit.

Trusts as non-spouse, designated beneficiaries:

A trust cannot own an IRA account. If an owner mistakenly puts his IRA inside a trust while alive, it would become immediately taxable. Some institutions refer to IRAs as IRA trusts, but this is only a reference to the agreement establishing the IRA.

When the IRA owner dies, an inherited IRA is established for the qualifying trust as beneficiary. The registration would be something like: John Doe, deceased, IRA fbo John Doe trust u/a/d 01/01/2000.

The RMD would be paid from the inherited IRA to the trust. The trust pays the income, or full required distribution to the trust beneficiaries, or accumulates the income in the trust, depending upon whether it is a conduit trust or an accumulation trust. The IRA is NOT paid out to the trust, this would be immediately taxable.

As a general rule, there is no separate account treatment for trust beneficiaries, even if the trust splits into separate sub trusts after death. So usually, the age of the oldest trust beneficiary will determine the maximum distribution period. Only in the unique situation where separate sub-trusts exist before the owner's death, and each sub-trust is specifically listed as a beneficiary would separate account treatment be possible.

NON-DESIGNATED BENEFICIARIES

Age of IRA Owner at Death:

The age of the IRA owner at death is the only variable for non-designated beneficiaries. If the owner died ***before*** their RBD (April 1 of the year following the year in which they turned 70½), then the dreaded five-year rule applies. This is the only situation where the five-year rule is the default (unless the underlying IRA custodial agreement required it — and some do!).

If the IRA owner died on or after their RBD, then the IRA can be distributed using the decedent's age at death to determine the life expectancy (Single Life Table). The maximum period is 15.3 years (remaining life expectancy for a 71-year-old).

Estate as Beneficiary:

When the estate is the beneficiary of an IRA (either because it was named or was the default for an IRA with no beneficiary designation on file), it is commonly believed that the IRA must be distributed immediately to the estate in order to close the estate.

However, in 2003, the IRS stated that inherited IRAs could be set up for the beneficiaries of the estate, and the IRA could be distributed and the estate closed. The beneficiaries of the estate will NOT be ever be considered to be designated

beneficiaries. The IRA must be distributed either within five years or the remaining life expectancy of the decedent, ***depending upon the age of the IRA owner at death. (PLR 200343030)***

Charity as Beneficiary:

Since the distribution of IRA assets has no tax implications for a charity, they will take the full distribution immediately.

Non-Qualifying Trust as Beneficiary:

Because of the complexity and skill required to draft a Qualifying IRA trust as beneficiary, this will undoubtedly become an all too common occurrence. Never allow clients to name a trust as an IRA beneficiary without advising them, ***in writing***, to consult with their estate planning attorney first. In this case, the age of the IRA owner at death will determine the maximum period for distribution, as with any other non-designated beneficiary.

INHERITING EMPLOYER RETIREMENT PLAN ASSETS

Spouse as Beneficiary:

The surviving spouse can do almost anything that the decedent could have done with employer retirement plans other than continuing to make contributions. The law allows:

- surviving spouses to leave the assets in the plan as an alternate payee,
- surviving spouses to roll over the deceased's employer balances to their own employer retirement accounts of the same type,
- surviving spouses to roll over the deceased's employer balances to their own IRAs, and
- surviving spouses to take advantage of lump sum distribution opportunities, such as NUA treatment of employer stock, if the advantage would have been available to the decedent.

Non-Spouse as Beneficiary:

The law also allows non-spouse, designated beneficiaries to:

- roll over the distribution from the decedent's retirement plan to an inherited IRA, but ***only*** if accomplished via a direct trustee-to-trustee transfer of assets, and
- take advantage of any lump sum distribution options, such as NUA that would have been available to the decedent.