MANAGING INHERITED RETIREMENT PLANS

Protecting and Passing Wealth to the Next Generation

By Helen Modly, CFP®, CPWA®

Over the next 20 years, baby boomers will stampede toward retirement at the rate of 10,000 per day, taking their share of the $12.6 trillion in individual retirement account (IRA) and defined contribution retirement assets with them.[1] As they pass on, their beneficiaries will be faced with a labyrinth of rules, deadlines, and irrevocable decisions they must navigate to protect and preserve this wealth. Understanding the distribution rules for retirement plans is more important now than ever when advising an owner who is trying to provide a legacy or a beneficiary who has inherited an IRA, Roth IRA, or 401(k) account.

To effectively manage inherited retirement plans, one must understand the nuances of beneficiary designations, decision points and their deadlines, and the rules for determining required minimum distributions (RMD). Unless differences are noted, assume that these IRA RMD rules apply to all employer-sponsored defined contribution retirement plans, including profit-sharing plans, 401(k) plans, 403(b) plans, and 457(b) plans. The same RMD rules apply to traditional IRAs and IRA-based plans such as SEPs, SARSEPs, and SIMPLE IRAs. They also apply to Roth 401(k) accounts. However, the RMD rules do not apply to Roth IRAs while the owner is alive. Figure 1 presents a simplified decision chart to aid in this discussion of managing inherited wealth.

Designating a Beneficiary vs. Having a Designated Beneficiary

As far as the Internal Revenue Service (IRS) is concerned, a designated beneficiary must be a living, breathing natural person or a qualifying trust for the benefit of a natural person. A charity, the estate of the owner, or a nonqualifying trust is not considered a designated beneficiary. The status of the beneficiary (designated or nondesignated) is important because it determines the rules that will apply for the mandatory distribution of the plan assets. A designated beneficiary always will have the ability to stretch out distributions using a life expectancy method, but the options available for a nondesignated beneficiary will depend upon the IRA owner's age at death.

There are multiple ways to designate a beneficiary for a retirement plan or IRA. One or more beneficiaries may be affirmatively elected by the plan owner on the beneficiary form; they could be identified by default in the custodial agreement or plan document if no beneficiary is named; or they may be named by qualified disclaimer or otherwise identifiable by the determination date (e.g., September 30th of the year following the year of the owner's death). The following are some examples:

- Susie Smith and John Smith, 50 percent each
- "All my children to share equally"
- "Your spouse, then your children, then their children, then your estate" is a common default in IRA custodial agreements.
- A surviving spouse can elect to treat the IRA as her own, or roll it into her own IRA and name a new beneficiary.
- Three children are named, one disclaims his interest by the determination date, so the remaining two become the designated beneficiaries.
- Two individuals and one charity are named on the form. The executor cashes out the charity before the determination date, so the remaining two individuals are the designated beneficiaries.

Trust as Designated Beneficiary

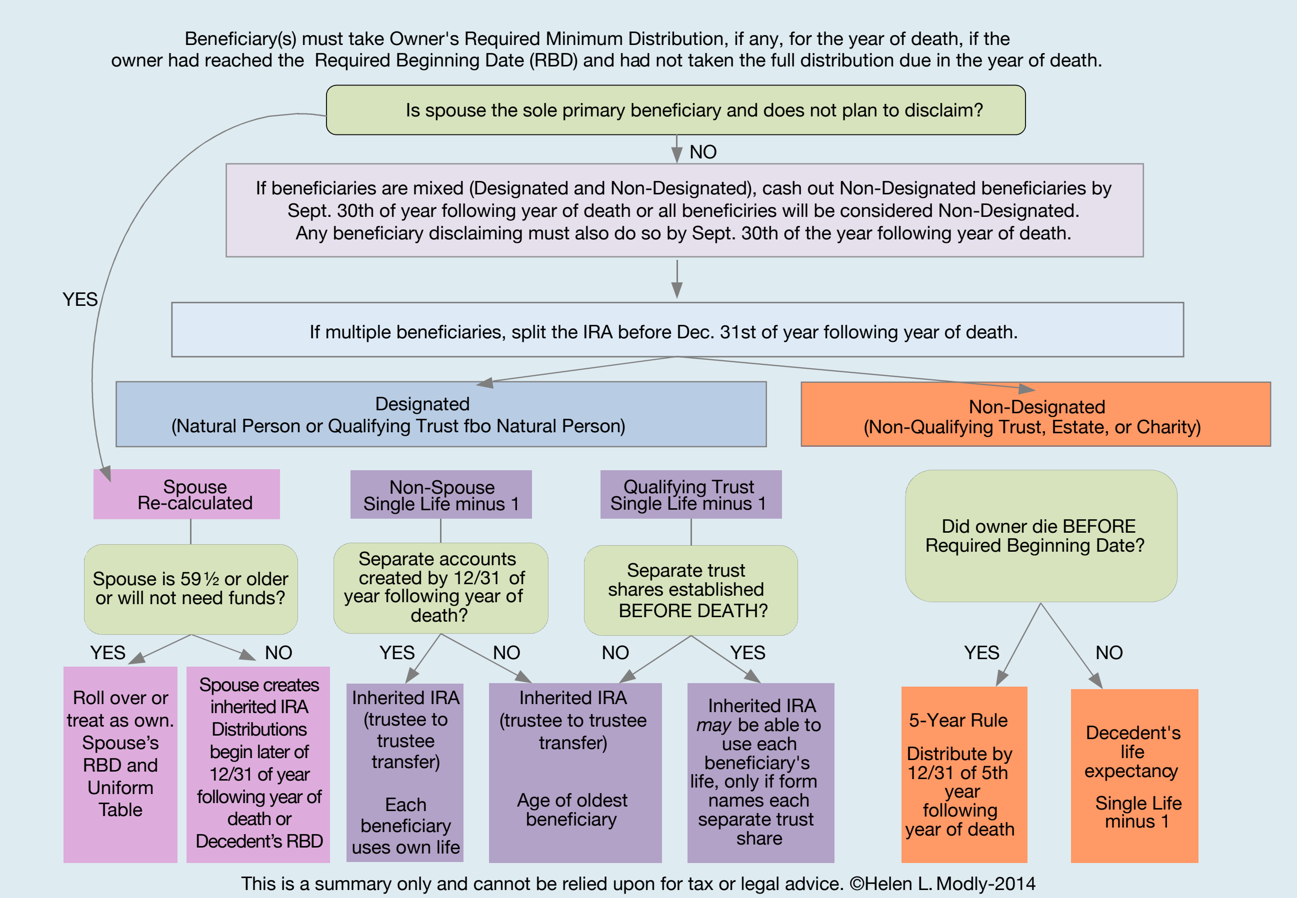
Certain trusts may qualify as a designated beneficiary. The trust must be valid under state law and irrevocable or become irrevocable upon the death of the plan owner; and the beneficiaries of the trust must be identifiable from the trust document either by name or by membership in a class of beneficiaries (e.g., all children from this marriage).

In addition, the plan custodian must be provided with a full copy of the trust by October 31st of the year following the year of the owner's death.

Some institutions, particularly banks, refer to IRAs as IRA trusts, but this is only a reference to the type of agreement the institution uses to establish IRAs. Regardless, never distribute an IRA or retirement plan account balance to a trust or the full amount becomes immediately taxable. Rather, the qualifying trust becomes the owner of an inherited IRA, and the trust will actually receive the RMD each year. This is sometimes referred to a trusteed IRA.

Trusts that qualify as designated beneficiaries are of two main types, conduit trusts and accumulation trusts. A conduit trust will pass through the entire RMD to the beneficiary or beneficiaries according to the terms of the trust. This is the most

Figure 1: Inherited IRA Flowchart



Source: Focus Wealth Management

straightforward option. The balance of the IRA is protected from early distribution to the beneficiaries, and the trust itself usually will not owe taxes on the RMDs if it has been drafted properly to handle RMDs. An accumulation trust on the other hand will accumulate some or all of the RMDs over time and also be the owner of the inherited IRA. Accumulation trusts are much more complex and most likely will owe taxes on the accumulated RMDs at trust tax rates.

Note that using a trust as the beneficiary of an IRA or retirement plan is a complex planning strategy. It may provide some measure of control over the beneficiaries, but it does not yield any tax benefits over naming individuals. In fact, it often reduces the ability to stretch out IRAs over the longest possible time period when multiple trust beneficiaries are involved. Certain common trust language can cause adverse tax consequences when trusts are funded with inherited retirement assets, so never name an existing trust as beneficiary without first consulting a knowledgeable attorney.

Undistributed RMD Deadlines

If the IRA/plan owner was required to take an RMD in the year of death and didn't, then the amount of the RMD not taken must be distributed to the beneficiaries of record before December 31st of the year of death. The beneficiaries take this distribution and report it on their tax returns, not the tax return of the estate (unless the estate is the beneficiary). This is often problematic especially when death occurs late in the year or it was the first year an RMD was required. Also, many owners take RMDs monthly or quarterly, so determining the undistributed amount may take some time for an executor who is unfamiliar with this requirement. To complicate matters further, an RMD due to the deceased in the year of death is calculated as if the deceased were still the living owner and not in the way that beneficiary RMDs are calculated. Receiving some or all of the RMD due to the deceased will not prevent a beneficiary from disclaiming an interest in the IRA/plan before September 30th of the year following the year of death.

Many beneficiaries believe they cannot take any more than the RMD, but they can always take more. Note that the RMD is the required *minimum* distribution; in other words, it is the minimum amount that beneficiaries must take.

Beneficiary Determination Date

Beneficiaries must be determined by September 30th of the year following the year of death. The IRS gives the executor some flexibility in identifying the beneficiaries, including the ability to make some post-mortem beneficiary changes before the determination date. Beneficiaries cannot be added, but they may be removed by qualified disclaimer or by paying them out before the determination date. This flexibility becomes important when multiple beneficiaries are named because the inclusion of just one nondesignated beneficiary, such as a charity, will cause all the beneficiaries to be treated as nondesignated. This can be remedied by having the executor pay out to the charity before the determination date, leaving the natural persons as designated beneficiaries.

If any beneficiary is going to disclaim an interest in the decedent's account, it must be done before the determination date. This can be invaluable if an older person is named along with children as the primary beneficiaries and the older person does not want the asset because life expectancy affects the RMD amount.

Deadline for Separate Accounts

For multiple designated beneficiaries, separate inherited IRA accounts (or alternate payee accounts in the case of an employer plan) should be established before December 31st of the year following the year of death. If separate accounts are created before this deadline, each beneficiary will be considered the sole beneficiary of that share and the distribution period will be calculated for that beneficiary independent of the other beneficiaries. 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 the surviving spouse is the sole beneficiary.

Separate shares for multiple beneficiaries can be created after this deadline but the distribution period for all the beneficiaries will be calculated based on the age of the oldest beneficiary. In the case of qualifying trusts, creating separate accounts for multiple beneficiaries will not affect the RMD calculation; the age of the oldest beneficiary will be the determining age. Only in the rare case where the terms of the trust create separate shares *before* the owner's death *and* the beneficiary election specifically names each separate trust share can each of the beneficiaries use their own ages to calculate their RMDs.

> *"This flexibility becomes important when multiple beneficiaries are named because the inclusion of just one nondesignated beneficiary, such as a charity, will cause all the beneficiaries to be treated as nondesignated."*

In all cases, the only transfer method available for non-spouse inheritors is the direct, trustee (or custodian) to trustee (or custodian) method to an inherited IRA (sometimes called a beneficiary IRA). In the case of qualified plans, an alternate payee account usually is established at the plan and then the funds are transferred directly to an inherited IRA for the beneficiary. Non-spouse inheritors are not allowed to do a 60-day rollover of inherited funds where the funds are distributed directly to them and then re-deposited back into an IRA within 60 days.

IRA Owner Dies before Required Beginning Date

Designated Beneficiaries

Before 2006, non-spouse inheritors of IRAs and qualified retirement plan accounts were forced to distribute the inherited money within five years of the owner's death. Inherited IRAs did not exist. The Pension Protection Act extended many but not all of the benefits that have always been available to surviving spouses to designated non-spouse inheritors. Spouses still have the most flexibility when it comes to inherited retirement accounts if they are considered to be sole beneficiaries. It is a common misunderstanding that the five-year rule is still in effect for all non-spouse beneficiaries.

All designated beneficiaries have two options for taking their RMDs when the original owner dies before the required beginning date (RBD). They may take distribution of the entire balance by the fifth year following the year of death. With this option, no RMDs are due until the fifth anniversary, but then the entire account must be distributed.

Usually a better option is to use the beneficiary's age as of the beneficiary's birthday in the year following the year of death to determine life expectancy using Table I,[2] then reduce by one for each subsequent year. If multiple designated beneficiaries were named and separate shares were not created by December 31st of the year following the year of death, the oldest beneficiary's age will be used for all of them. In either case, distributions must begin no later than December 31st of the year following the year of death.

Note that after-death distributions from a Roth IRA are determined under this rule as well. Because a living Roth IRA owner is treated as not having a RBD, the deceased owner will be considered to have died before his RBD, regardless of age. If the beneficiary is a non-spouse, distributions must begin by December 31st of the year following the year of death. If the beneficiary is a spouse, then the spousal options described below apply, provided the spouse is considered the sole beneficiary of the account.

Surviving Spouse as Designated Beneficiary

The surviving spouse always has the option to treat the IRA/plan as his/her own or roll it into his/her existing or new IRA. This is also true in the case of Roth accounts and is probably the best option in most cases. The surviving spouse becomes the living owner and follows the same rules as any other living owner.

If the surviving spouse does not make the election to treat the IRA as his/her own or roll the IRA into his/her own IRA, then the account is treated as any other inherited account with one major exception. The surviving spouse of an inherited IRA will not need to begin taking RMDs until the *later* of the end of the year following the year of death or the end of the calendar year in which the deceased owner would have reached age 70½. For inherited IRAs, the surviving spouse's life expectancy using Table I is used to calculate the RMDs, but only surviving spouses are allowed to recalculate life expectancy each year rather than subtracting one for each year that elapses as required for non-spouse designated beneficiaries.

In the case where the surviving spouse does not elect to treat the IRA as his/her own or roll it over into his/her own IRA *and* misses a required RMD, the surviving spouse will be deemed to have elected to make the IRA his/her own. In this case, an RMD is not required until the surviving spouse reaches age 70½.

Surviving spouses may not want to make these accounts their own by election or rollover when the surviving spouse has not yet reached age 59½. In this case, withdrawals taken by the surviving spouse from an inherited retirement account would not be subject to the 10-percent premature withdrawal penalty. The surviving spouse who is a sole beneficiary could take withdrawals from the inherited IRA if needed, without penalty, but would not be required to do so until the later of the year following the year of death or the end of the year when the deceased owner would have reached age 70½. Because the surviving spouse can make the election to consider the account her own or roll it into her own IRA at any point after the original owner's death, this strategy works for younger spouses who may need distributions in the early years. Once she reaches age 59½, she can roll it into her own IRA and delay RMDs until she reaches age 70½.

Nondesignated Beneficiaries

In the case of nondesignated beneficiaries (e.g., estates, charities, nonqualifying trusts), this is the one and only time that the five-year rule must be used. No RMDs are required until the fifth anniversary but the entire account must be distributed by then. There has been some confusion as to whether the estate must remain open when named as a beneficiary, but a recent private letter ruling explained that the executor could create inherited IRAs for each of the estate's beneficiaries and then close the estate.[3] In this case, the five-year rule still applies to each beneficiary, as it would have to the estate.

IRA Owner Dies after Required Beginning Date

Designated Beneficiaries

Any designated beneficiary may choose between his/her own age as of his/her birthday in the year of death and the deceased owner's age as of his/her birthday in the year of death to calculate the life expectancy using Table I. This life expectancy would be reduced by one for each subsequent year. RMDs must begin before December 31st of the year following the year of death.

Surviving Spouse as Designated Beneficiary

Surviving spouses may choose to use the deceased owner's age as of the deceased owner's birthday in the year of death to calculate the life expectancy and then reduce by one for each subsequent year. This would make sense if the deceased owner were much younger than the surviving spouse.

Another option available only to surviving spouses who are sole beneficiaries of their shares is to use life expectancy with Table I but recalculate the life expectancy. This allows for a slightly slower distribution of the account balance than reducing the original life expectancy by one each year.

Nondesignated Beneficiaries

Nondesignated beneficiaries can use the deceased owner's age as of the deceased owner's birthday in the year of death to calculate life expectancy using Table I and reduce by one for each subsequent year. Note that the five-year rule does not apply to nondesignated beneficiaries when the original owner died after the RBD. In the case of an estate as the beneficiary, it can be very advantageous to create inherited IRAs for the estate's beneficiaries and close the estate. The beneficiaries must use the RMD rules for nondesignated beneficiaries.

Unusual Situations

Original Beneficiary Dies before the Account is Fully Distributed

This is the thorniest of all the scenarios, especially when non-spouse beneficiaries are involved. When the original owner dies, the beneficiary is determined on September 30th of the year following the year of death. If the non-spouse beneficiary dies after the owner but before the determination date, it does not eliminate that non-spouse beneficiary as the beneficiary. If the non-spouse beneficiary had named his or her own beneficiary before death, then that beneficiary would be considered the successor beneficiary and receive the RMDs.

If the non-spouse beneficiary had not named a successor beneficiary before dying, then the non-spouse beneficiary's estate would receive the RMDs. In both cases, the remaining life expectancy of the first beneficiary would be the calculating life. The five-year rule would not apply even though the estate is the final payee, because the distribution method is determined by the beneficiary that existed on September 30th of the year following the original owner's death.

Essentially, the successor beneficiary will receive the payments, but it is the status of the first beneficiary that dictates the minimum distribution rules. Any contingent beneficiary listed by the original owner would be irrelevant because the primary beneficiary was alive when the owner died.

Penalty for Missed RMDs

At this point it shouldn't be hard for practitioners to imagine a beneficiary missing or miscalculating an RMD due. The penalty for failing to take an RMD when required is 50 percent of the amount that should have been taken. This is steep and it is the same for a living IRA owner or a beneficiary, including a surviving spouse (except as noted above in the case of a missed distribution, when the IRA is deemed to belong to the surviving spouse). Fortunately for people in the real world, Congress realized that these rules are complex and unfamiliar

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to most beneficiaries. Many accountants and attorneys, as well as some financial advisors, are unfamiliar with them, too. As a remedy, the IRS allows IRA owners and beneficiaries to apply for relief by using Form 5329, Additional Taxes on Qualified Plans, to report the missed distribution, offer a brief "mea culpa" explanation, and request a waiver of the penalty.

Before filing the form, the missed distribution amount should be taken and noted in the explanation that it has already occurred.[4] Form 5329 should be filed as soon as practical after discovering the missed RMD; don't wait until the calendar-year filing date. The sooner the form is filed, the sooner the three-year statute of limitations runs out. In our experience to date, the IRS has not denied any reasonable requests submitted on Form 5329. We hope this trend continues.

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Endnotes

1. "U.S. Total Retirement Market as of 1st quarter, 2014," Investment Company Institute, http://www.ici.org/research/stats/retirement/ret_14_q1.
2. See appendix C: Table I (Single Life Expectancy), http://www.irs.gov/publications/p590/ar02.html#en_US_2013_publink1000231217.
3. Private Letter Ruling 201208039, http://www.irs.gov/pub/irs-wd/1208039.pdf.
4. IRS Publication 590, http://www.irs.gov/publications/p590/.

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