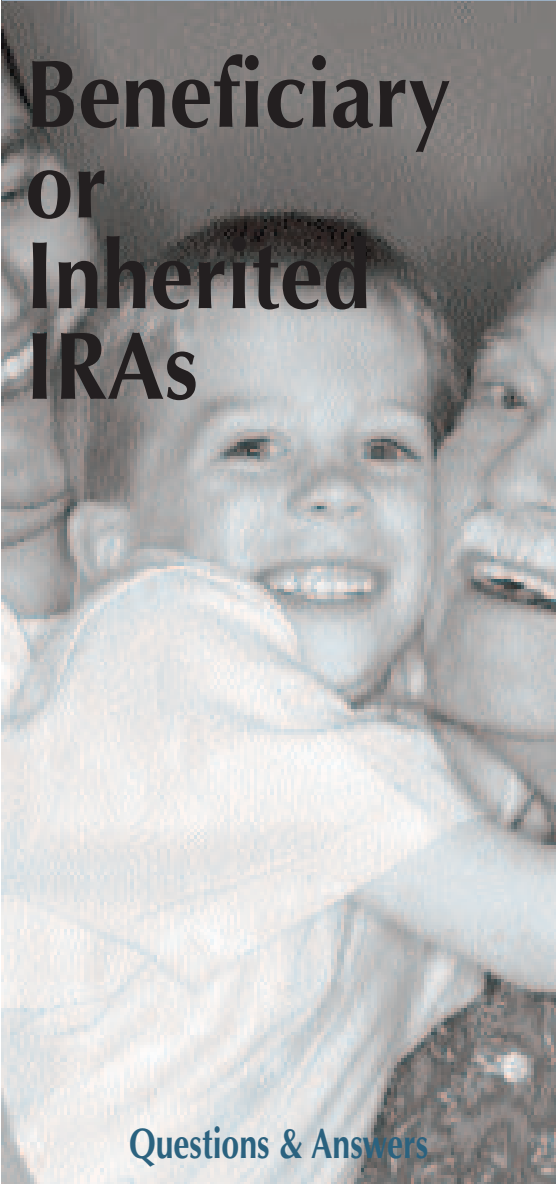




# **IRAs & Roth IRAs**



# **Beneficiary or Inherited IRAs**

**Questions & Answers**

## **Purpose**

The purpose of this brochure is to provide a person who is a beneficiary of a traditional IRA (including SEPs and SIMPLEs) or Roth IRA with a basic understanding of the federal tax rules which govern an inherited IRA. An IRA beneficiary has certain rights and duties.

An IRA beneficiary who acquires an ownership share in an accountholder's IRA upon the death of the IRA accountholder (i.e. inherits) is required by law to commence withdrawing such IRA funds within certain time deadlines. What options, if any, a beneficiary has depends upon the type of IRA, whether the accountholder died before or on/after his or her required beginning date (RBD), and whether or not his or her spouse was the sole beneficiary.

## **When an IRA accountholder dies, who inherits these funds?**

The beneficiary of the IRA, as named by the accountholder on the IRA plan application document or most recent IRA beneficiary document, inherits the IRA funds. If no beneficiaries are named, applicable state law governs, usually naming the estate of the IRA accountholder as the beneficiary.

## **Can the now-deceased accountholder dictate how the money is to be distributed after his or her death?**

Yes! If the distribution instructions are in writing and call for an amount to be distributed, (not less than the amount required by the federal tax laws), the deceased accountholder has the right to dictate the manner of distributions. Most accountholders allow the beneficiary to decide when he or she will take distributions.

## **Do the federal income tax laws mandate that I, as an IRA beneficiary, must be distributed funds from the decedent's IRA?**

Yes. If certain minimum amounts are not distributed to you, then you will owe a 50% excise tax. This tax amount is calculated as follows: 50% times the amount required to be withdrawn but which was not withdrawn. This is determined annually.

## **What is the RMD formula for an IRA beneficiary?**

RMD for Current Year =  $\frac{\text{Balance as of Dec. 31 of prior year}}{\text{Divisor for Current Year}}$

This annual RMD calculation for a beneficiary is similar to the calculation applying to a living IRA accountholder, but there are some differences. The first difference is that the Single Life Table is used rather than the Uniform Lifetime Table or the Joint and Last Survivor Table. The second difference is the way the divisor for each year is determined. Commencing with the year after the IRA accountholder died, an initial divisor is determined from the Single Life Table using the age you attain or will attain in the year after the IRA accountholder died. The divisor for subsequent years is determined by subtracting one for each subsequent year. For example, if you attained age 56 in 2012, the year after the year the IRA accountholder died, then the divisor for the first five years will be: 2012-28.7, 2013-27.7, 2014-26.7, 2015-25.7 and 2016-24.7.

### Single Life Table

Age of IRA Beneficiary	Distribution Period (in yrs)	Age of IRA Beneficiary	Distribution Period (in yrs)	Age of IRA Beneficiary	Distribution Period (in yrs)	Age of IRA Beneficiary	Distribution Period (in yrs)
20	63.0	40	43.6	60	25.2	80	10.2
21	62.1	41	42.7	61	24.4	81	9.7
22	61.1	42	41.7	62	23.5	82	9.1
23	60.1	43	40.7	63	22.7	83	8.6
24	59.1	44	39.8	64	21.8	84	8.1
25	58.2	45	38.8	65	21.0	85	7.6
26	57.2	46	37.9	66	20.2	86	7.1
27	56.2	47	37.0	67	19.4	87	6.7
28	55.3	48	36.0	68	18.6	88	6.3
29	54.3	49	35.1	69	17.8	89	5.9
30	53.3	50	34.2	70	17.0	90	5.5
31	52.4	51	33.3	71	16.3	91	5.2
32	51.4	52	32.3	72	15.5	92	4.9
33	50.4	53	31.4	73	14.8	93	4.6
34	49.4	54	30.5	74	14.1	94	4.3
35	48.5	55	29.6	75	13.4	95	4.1
36	47.5	56	28.7	76	12.7	96	3.8
37	46.5	57	27.9	77	12.1	97	3.6
38	45.6	58	27.0	78	11.4	98	3.4
39	44.6	59	26.1	79	10.8	99	3.1

## What are the beneficiary options upon the death of the IRA accountholder?

If the IRA accountholder has not specified the distribution method, the beneficiary may have some options, and they vary depending on whether it is a traditional IRA or a Roth IRA, and are further differentiated by whether the IRA accountholder dies before or after the Required Beginning Date. Also, spouse beneficiary options differ from non-spouse beneficiary options.

## Who qualifies as an inheriting beneficiary for RMD purposes?

In order to be an inheriting IRA beneficiary for RMD purposes, you must have been a designated beneficiary as of the

time of the accountholder's death and also as of September 30 of the year after the year the accountholder died.

## **What if more than one beneficiary is named?**

The IRA will generally be divided into separate inherited beneficiary accounts, with each account under the control of the individual beneficiary. Each beneficiary can generally make their own choice of payout, unless the decedent mandated the form and timing of payment.

## **What do I do to start distributions?**

Bring a certified copy of the deceased's death certificate to the financial institution. They will give you the forms to complete to choose your election and payment schedule.

## **What rules apply for the year the IRA accountholder dies?**

If the IRA accountholder died before his or her required beginning date, there is no RMD which must be distributed for such year. If the IRA accountholder died after his or her required beginning date, the RMD as determined for the IRA accountholder must be distributed for such year. To the extent this amount was not paid out to the IRA accountholder before his or her death, the beneficiary(ies) will need to be paid their proportionate share of the RMD by December 31, or the 50% tax will apply.

## **What rules apply to me for the years following the year the accountholder died?**

The rules depend upon whether the accountholder died before or after the required beginning date. You, as a beneficiary, will want to understand the following situations. In addition, the IRS has made clear that even though a spouse beneficiary does not have the right to elect to treat the inherited IRA as his or her own because he or she is not the sole beneficiary or for some other reason, a spouse may still roll over a distribution as long as the standard rollover rules are satisfied.

**Situation #1.** If you are the spouse and sole beneficiary, and the accountholder dies before the required beginning date, then you may choose from three options:

Five-Year Payout – Under this option, you must remove all funds from the IRA by December 31 of the year that contains the fifth anniversary of the accountholder's death. As much or as little as you desire can be removed each year, as long as the entire IRA balance is distributed by the deadline.

Election as Own – You are able to elect to treat this inherited IRA as your own IRA.

Life Distribution Rule. If you are the sole beneficiary of the IRA, then you are required to commence distributions over your life expectancy – no later than December 31 of the year the accountholder would have attained age 70½, or December 31 of the following year if the accountholder would die in the year he/she would have attained age 70½.

A special rule applies if your spouse is your sole beneficiary and you die before your required beginning date and then your spouse dies before payments commence to him or her. In this case, the 5-year rule or the life-distribution rule will be applied as if your spouse is the IRA accountholder.

**Situation #2.** If you are the sole spouse beneficiary, and the accountholder dies after the required beginning date, then you may establish a periodic distribution schedule which will be based on your life-expectancy factor as set forth in the Single Life Table as prepared by the Internal Revenue Service — in Internal Revenue Code regulation 1.401(a)(9)-9. Each year's factor is based on your age as of your birthdate for such year.

After you die, there will be a different method of determining the distribution period to govern the required distributions to any subsequent beneficiary(ies) for years after the year you die. This method requires a preliminary factor to be determined from the Single Life Table for the year of your death by using the birthdate you either attained or would have attained for the year of your death. The actual factors to be used for subsequent years are determined by reducing the preliminary factor by one for each subsequent year.

You are, of course, permitted to take more than the required distribution amount.

As discussed in situation #1, you may still elect to treat the IRA as your own.

**Situation #3.** If you are a nonspouse beneficiary or you are a spouse beneficiary but you are not the sole beneficiary, and the accountholder dies before the required beginning date, then you have two options:

Five-Year Payout – All funds must be distributed by December 31 of the year that contains the fifth anniversary of the accountholder's death. As much or as little as you desire can be removed each year, as long as the entire IRA balance is distributed by the deadline.

Life-Distribution Rule – Under this option, the distribution is based on your (the beneficiary's) life expectancy,

using one-year reduction. This is the option which automatically applies unless you elect the five-year payout option on or before 12/31 of the year after the year of death.

**Situation #4.** If you are a nonspouse beneficiary or you are a spouse beneficiary but you are not the sole beneficiary, and the accountholder dies after the required beginning date, then the applicable distribution period for years after the year of the accountholder's death will be based on the remaining life expectancy of the designated beneficiary. The beneficiary's remaining life expectancy is calculated using the age of the beneficiary in the year following the year of the accountholder's death, reduced by one for each subsequent year.

**Situation #5.** If the accountholder did not designate a living person as a beneficiary and the accountholder died before the required beginning date, then the estate or other beneficiary will be required to use the 5-year rule.

**Situation #6.** If the accountholder does not designate a living person as a beneficiary and the accountholder dies on or after the required beginning date, then the applicable distribution period (i.e. the original factor) for years after the year of the accountholder's death is based on the accountholder's age and life expectancy as determined as of December 31 of the year of death and then this factor is reduced by one for each elapsed year.

**Special Exception.** Under Situation #2 or Situation #4, the distribution period will be based on the remaining life expectancy of the accountholder, as determined under Situation #6, rather than that of the beneficiary, if it results in a longer distribution period.

## What if I want to take more than the required distribution?

Unless the IRA accountholder has mandated that you may only take the required minimum distribution, you are able to withdraw a greater amount. If you would want to close out the IRA by taking a lump sum distribution, you may do so.

## Can I designate my own beneficiary(ies)?

Yes. The governing rules allow you, as an inheriting beneficiary, to designate your own beneficiary(ies).

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## **Understanding the Tax Consequences of Distributions from an Inherited Traditional IRA**

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### **What are the tax consequences of my being a beneficiary to a traditional IRA?**

No taxes will be owed until the money is actually distributed to you. If the accountholder received a deduction when the contributions were made, or the funds came from a pension plan that was funded with pre-tax dollars, then the entire distribution will be taxable to you. If the IRA was funded with after-tax dollars, then only the interest, or funds that have never been taxed, will be taxed when withdrawn.

### **How do I determine whether or not the IRA was funded with pre-tax dollars?**

This information can be found on the deceased accountholder's tax forms. If there are after-tax dollars in the IRA, then a tax Form 8606 will tell what portion of the IRA is taxable and what is not.

### **At what tax rate will the IRA distribution be taxed?**

The tax rate for the distribution is determined by the taxable income of the recipient.

### **What tax benefit do I realize by leaving the funds within the inherited traditional IRA?**

Taxation of the earnings is deferred until actually distributed, as is taxation of the original contributions.

### **What tax rate will apply to me if I receive a distribution from an inherited IRA?**

The IRA distribution will be included in your taxable income and you will need to determine your marginal income tax bracket (rate). It is possible that your withdrawal of inherited IRA funds could move you into a higher marginal tax bracket.

### **As a beneficiary, may I transfer my inherited IRA funds to another inherited IRA at a different IRA custodian/trustee?**

Yes. If certain information is furnished and acknowledged by both IRA custodians, then you should be able to transfer the IRA you have inherited to a different IRA custodian.

## **Am I eligible to roll over inherited traditional IRA funds to another traditional IRA?**

No. If you are a nonspouse beneficiary, you are never eligible to take a distribution from an inherited IRA and then make a rollover contribution into either another inherited IRA or your own IRA.

If you are a spouse beneficiary of an inherited IRA, you are able to roll over funds within an inherited IRA to your own IRA. The standard 60-day and once-per-year rollover rules must be met, and any required distribution amount is ineligible to be rolled over.

## **Who is eligible to treat an inherited IRA as his or her own IRA?**

The only person who can treat an inherited IRA as his or her own IRA is a surviving spouse who is the sole primary beneficiary, and who has an unlimited right to withdraw funds from the deceased spouse's IRA.

If you are a spouse beneficiary, you will want to understand the special rules applying to this situation. There is a special brochure on this topic, *A Surviving Spouse's Options With Respect to Their Spouse's IRA(s)*, CWF #155. You may also wish to refer to IRS Publication 590-B, *Distributions from IRAs*. In chapter 1 there is discussion of what if you inherit an IRA.

## **How does a surviving spouse who meets the above requirements make the election to treat the decedent's IRA as their own?**

The surviving spouse will need to give a written instruction that he or she is treating the decedent's IRA as their own.

Such election is also deemed made when, if at any time, the surviving spouse fails to take an RMD within an appropriate time period or contributes any additional amounts to this inherited IRA.

## **What is the effect on a surviving spouse who treats a decedent's IRA as his or her own?**

It becomes their own personal IRA. The IRA is no longer an inherited IRA to which the beneficiary RMD rules apply. The surviving spouse is treated as being the original contributor and the standard distribution rules will apply.

## **When can a qualifying surviving spouse elect to treat the deceased spouse's IRA as his or her own?**



He or she is entitled to make this election at any time.

### **Are there times when a surviving spouse may not want to treat a deceased spouse's IRA as their own?**

Yes. A surviving spouse younger than age 59½ may not want to elect their deceased spouse's IRA as his or her own IRA. For example, David and Rhonda are both age 52. David dies in January of 2007. In this situation, Rhonda may not want to immediately treat David's IRA as her own. The distributions she takes from the inherited IRA (Rhonda as beneficiary of David's IRA) will not be subject to the 10% tax as the distributions are from an inherited IRA. However, if Rhonda would treat David's IRA as her own, and then take distribution prior to age 59½, she would owe the 10% additional tax unless one of the exceptions applied.

### **Am I eligible to roll over or convert inherited traditional IRA funds to a Roth IRA?**

No. Inherited traditional IRA funds are not eligible to be converted into a Roth IRA.

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## **INHERITED ROTH IRA**

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A beneficiary of a Roth IRA will, in general, have the same options available as the beneficiary of a traditional IRA when the IRA accountholder has died before his or her required beginning date. Review the earlier discussion. There is one important difference. The Roth IRA of a deceased person who is married automatically becomes the Roth IRA of the surviving spouse who is the sole beneficiary unless the IRA plan agreement retains the life distribution rule and the 5-year rule as options for the surviving spouse and he or she elects such an option. Remember that a Roth IRA accountholder is not required to take a required distribution.

### **What type of distributions may be made to a beneficiary from an inherited Roth IRA?**

The distribution will be one of two types. It will either be qualified or non-qualified. If the five-year rule has been met, the distribution will be qualified. If the five-year rule has not been met, then the distribution will be non-qualified. A qualified distribution is never subject to being taxed. It is tax-free. A non-qualified distribution may be tax-free or it may be taxable.

A nonqualified distribution from a Roth IRA will be tax-

free as long as the amount being distributed is a return of basis (i.e. contributions) and not the return of earnings.

## **Will all distributions from an Inherited Roth IRA necessarily be tax-free?**

No. If the beneficiary withdraws the income from the Roth IRA and the five-year rule has not been met, the income will be taxable.

## **Will almost all distributions from an inherited IRA be tax-free?**

Yes. The tax rules provide a specific order for the distribution of the contributions and the earnings from the Roth IRA. Annual contributions come out first and then conversion contributions. The earnings come out only after all of the contributions have been distributed. Even though a beneficiary may take some distributions before the five-year rule has been met, these distributions may not be taxable because it is the contributions which will be distributed and these are not taxable.

## **How is the 5-year period determined for an inherited Roth IRA?**

The general rule is that you, as the beneficiary, assume the 5-year period which applied to the account holder. If the account holder had the Roth IRA for three years, then the 5-year rule will be met at the end of two additional years.

There is an exception for a spouse beneficiary. A spouse beneficiary who elects the deceased spouse's Roth IRA as his or her own will determine just one 5-year calculation. His or her 5-year period will end on the earlier of the 5-year period which applied for the decedent or the 5-year period which applies to the surviving spouse's own Roth IRAs.

## **What tax benefit will I realize by leaving the funds within the inherited Roth IRA?**

You will retain the right to continue to realize income which will not be taxed. All future earnings within the Roth IRA will not be taxed if the distribution to you is a qualified distribution. This is a very valuable tax right. By limiting your distributions to the required amount, more funds will remain in the inherited Roth IRA increasing the opportunity to earn more tax-free income.

*The information provided in this brochure is not intended to be legal or tax advice. You should consult your attorney or tax advisor for information that relates to your specific circumstances.*