

The Annuity Advisor

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Inherited IRAs

The two things that are certain in life are death and taxes (although death doesn't get worse each time Congress convenes). But perhaps less obvious is how closely intertwined they are. A prime example is how a traditional IRA is taxed at the death of the owner. In this month's edition, we'll discuss the basics of inherited IRAs and how they are taxed.

Fundamentals

When the owner of an IRA dies, the IRA is included in their gross estate. However, unlike real property that is distributed under the provisions of a will, IRAs are generally distributed to a designated beneficiary named on the IRA account.

IRA distributions after the death of the owner must be made in conformity with the IRS rules regarding inherited IRAs and Required Minimum Distributions (RMDs). These rules depend on a number of things, including the age of the owner at the time of death and who is considered the designated beneficiary.

Date of Death

The date at which an IRA owner must begin withdrawing money from the IRA is known as the required beginning date. The required beginning date is April 1 of the year following the year in which the owner reaches age 70½. RMDs must begin no later than that magic date.

If the owner dies on or after the required beginning date, a RMD has to be made to the extent the RMD has not been satisfied in the current year. For example, if an 80 year old IRA owner dies on January 1, 2009, a RMD must be made in 2009,

calculated as if the owner lived the entire year. Distributions for later years will be discussed later.

Obviously, if death occurs before the required beginning date, no required distributions based on the owner's life are necessary. However, the IRA must be distributed to the beneficiary, and the manner of that distribution is dependent on who is designated as the beneficiary.

Surviving Spouse

If the sole beneficiary is the owner's surviving spouse, he or she generally has three options. The surviving spouse may:

1. Treat the IRA as their own by designating them self as the account owner,
2. Treat the IRA as their own by rolling it into their own IRA or an eligible retirement plan, or
3. Treat them self as the beneficiary instead of treating the IRA as their own.

The surviving spouse will be considered to have chosen the first option if they make contributions to the inherited IRA or if they do not take RMDs for a year as beneficiary of the IRA.

While this sounds a bit confusing, it's really pretty simple. If the surviving spouse chooses not to treat the IRA as their own, they will be required to take RMDs, just like a non-spouse beneficiary (as discussed below).

Individual, Non-Spouse Beneficiary

Distributions to a beneficiary who is not the owner's surviving spouse (or who is the surviving spouse

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but elects to be treated as a beneficiary instead of treating the IRA as their own) depend on whether the owner's death occurs before or after the owner's required beginning date.

- If the owner dies on or after the required beginning date, RMDs to the beneficiary are based on the longer of the beneficiary's single life expectancy or the owner's single life expectancy.
- If the owner dies before the required beginning date, RMDs are based on the beneficiary's life single life expectancy

The single life expectancies are determined from a table provided by the IRS. The expectancy is determined in the year following death, based on the appropriate life, and reduced by one for each year thereafter. In the case of multiple beneficiaries, the individual with the shortest life expectancy is used to determine RMDs for all beneficiaries.

Distributions after the owner's death have to be made to the beneficiary in one of two ways.

1. Over a life expectancy as described above. If made in this manner, the RMDs must begin by December 31 of the year following the owner's death.
2. A total distribution of the entire IRA must be made by December 31 of the fifth year following the owner's death.

If the beneficiary is uncertain of how distributions might impact their future taxes, it may be a consideration to take distributions over their life expectancy, beginning the year following death. They can always take a complete distribution later, but if life expectancy distributions are not begun, they will be forced to take a total distribution in five years. Taking an RMD in each year during the five year period will "keep their options open."

Who Is the Beneficiary?

The options for a surviving spouse discussed earlier are available only if the spouse is the sole beneficiary. However, it is not uncommon to see beneficiary designations that also include children as primary beneficiaries along with their parent. In such a situation, the spouse has to be treated the same as the other, non-spousal beneficiaries.

The regulations provide that the beneficiaries for purpose of RMDs are not determined until September 30 of the year following the owner's death. Any person who was a beneficiary on the date of death but is not a beneficiary in September (as just described) will not be treated as a beneficiary for purposes of determining distribution requirements. Thus, in the situation described, if the children disclaim their entitlement and leave the surviving spouse as the sole beneficiary, the spouse then has the special provisions afforded a surviving spouse at their disposal.

Rollovers and Transfers

As mentioned earlier, a person who inherits an IRA from their spouse as sole beneficiary has the same right to make rollovers and transfers as the decedent. However, if the person inheriting the IRA is not the surviving spouse, rollovers are not permitted.

But, a non-spouse is permitted to make trustee-to-trustee transfers from the IRA to another IRA, just as long as the IRA into which amounts are being transferred is set up and maintained in the name of the deceased owner, for the benefit of the beneficiary. An ownership designation similar to "Sam Smith as beneficiary of John Jones (deceased)" should be sufficient.

Summary

Further information about inherited IRAs can be found in IRS Publication 590. Or, you can call us... we're always happy to help.