

Inherited IRA's – How your IRA can affect your Beneficiaries?

**By
Neil A. Derman, Esq.**

One of the most common assets found in many estate plans is an Individual Retirement Plan (IRA). With an IRA, you can contribute up to \$4,000 a year and allow this money to grow tax deferred. Usually, these accounts are the largest assets left to heirs and beneficiaries. In this article we will look at an IRA from a different perspective. We will view the estate tax and income tax effect from the eyes of the beneficiary. Inheriting such a large asset will have an impact on not only your estate, but your income taxes as well. Both the owner of the policy and the beneficiary should be aware of the impact this bequest will have on all involved at the death of the owner.

There are two things most of us know regarding the treatment of an IRA at death. One, it is included in our estate for determining estate taxes, and two, whatever remains in the IRA will go to the designated beneficiary when the owner dies. The taxable treatment of the IRA distribution is limited by whom the proceeds were left to, and when the owner died (as it relates to the required minimum distributions).

An IRA can be left one of four ways. It could be left to a spouse, to a non-spouse beneficiary, a spouse and non-spouse beneficiary, or not name a beneficiary (in which case it would revert to your estate). Furthermore, treatment varies based on whether the owner died before being able to take their required minimum distributions (RMD's), which is 70 ½, or during the RMD period. Below is an outline of the tax effect on all 5 scenarios available:

Scenario 1: No Beneficiary named; before turning 70½

By not naming a beneficiary all proceeds of the IRA would revert to the estate. Under this scenario the code requires one to follow the five-year rule. This requires the entire amount in the IRA to be distributed no later than the last day of the 5th year following the owner's death.

There are two options available to the residuary beneficiaries or the executor. First, the beneficiary can leave the money in the IRA until the end of the five year term. This maximizes the tax deferral, but can create a large income tax liability upon withdrawal. Alternatively, the beneficiary can spread the distributions out over the five year period. This avoids bunching of income but will minimize the tax deferral, and further growth of the IRA.

Scenario 2: No Beneficiary named; already receiving RMD¹'s

¹ RMD: Required Minimum Distribution. At age 70 ½ one is required to take out a designated amount out of their IRA each year.

In this scenario the beneficiary has no options available to them. The withdrawal rights are predetermined by prior choices made by the now deceased, former owner. Here, the balance of the IRA is distributed over the remaining term elected by the IRA owner. Therefore, if the IRA owner was taking withdrawals over the term of his/her life expectancy², this would be continued by the current beneficiaries.

Scenario 3: Non-spouse Beneficiary; before turning 70½

In this scenario, the owner has named someone other than his/her spouse as the primary beneficiary or named someone in addition to his/her spouse as the primary beneficiary. Generally the IRA must be distributed under the five-year rule (see above). However, the beneficiary can elect to take the distributions over a period not exceeding their own life expectancy. If there are multiple beneficiaries the life expectancy used has to be that of the oldest beneficiary, which results in the shortest life expectancy.

When an IRA has multiple beneficiaries, they have two options available. Each individual can elect to follow the five-year rule, or to take the IRA out over the life expectancy of the oldest beneficiary. Although option 2 would seem more beneficial, it becomes less beneficial the younger the beneficiary is. To avoid this, one may set up separate IRA accounts or maintain segregated shares so each beneficiary could utilize their own life expectancy.

Scenario 4: Non-spouse Beneficiary; already receiving RMD's

Scenario 4 mimics Scenario 2. Both are extremely limited on the options available to the beneficiary. The remaining distributions must be paid out under the same method the owner was utilizing before his/her death. This limits the distribution schedule as it is not able to be lengthened. If the owner was receiving distributions based on his/her life expectancy, then you are able to take distributions over your life expectancy.

Scenario 5: Surviving Spouse

When the only named primary beneficiary is the surviving spouse we have an alternate outcome. A surviving spouse has one additional option to the non-spouse beneficiary. The surviving spouse can follow all options mentioned in Scenario's 3 and 4. Additionally, the surviving spouse is able to treat the IRA as his/her own, or the surviving spouse can rollover the IRA into their own IRA.

A surviving spouse must weigh the benefits of electing to treat the inherited IRA as his/her own. If there is a large age difference between the deceased spouse and the surviving spouse it is best for the surviving spouse to treat the IRA as their own. This increases the tax deferral and growth of the IRA, requiring distribution only when the surviving spouse reaches 70 ½, the required distribution age.

² See IRS Publication 590 "Single Life Expectancy Table in Appendix C" for life expectancy calculations

If, on the other hand, the surviving spouse is much older than the deceased spouse it is better not to treat the IRA as his/her own. One can continue to use the deceased spouse's life expectancy and defer the taxes for a later date than one would have been required to utilize.

A rollover offers the same benefits as treating the IRA as one's own. The surviving spouse would only be subject to the minimum distribution rules after reaching age 70 ½. In addition, the surviving spouse can name a subsequent beneficiary.

As an owner of an IRA, one must take the time to carefully consider the impact on their designated beneficiaries. The beneficiary of an IRA must also be aware of his/her options. A beneficiary may find himself/herself in a new tax bracket or move from a non-taxable to a taxable estate. When inheriting an IRA, one should take some time to meet with both their financial advisor and their estate planner, to ensure that the newly acquired wealth does not adversely effect one's estate plan.