Financial Strategies

INHERITED IRAs: CHALLENGES AND SOLUTIONS

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Individual Retirement Accounts (IRAs) and retirement plan distributions have complicated rules that must be closely followed by physicians hoping to pass on wealth to their heirs. Understanding the required minimum distribution rules is essential and can permit physicians' beneficiaries to defer taxes on IRAs and qualified plans.

WHEN A RELATIVE passes, it is easy to postpone dealing with qualified plans (like 401(k) and profit-sharing plans) and IRAs. Yet often these plans are the single most valuable asset of the decedent.

Ensure beneficiary form accuracy

Most people complete beneficiary designation forms specifying who will receive the plan's assets upon their demise.

An IRA or other qualified plan is considered a contract which provides that the beneficiary designation form controls the disposition of the assets upon the demise of the account holder. Such assets are considered non-probate, which means that they are not controlled by a will. IRAs and qualified plans provide where the funds go if a beneficiary form is not completed; they may go into your probate estate.

It is common to switch accounts within a brokerage firm, for example, from mutual funds to individual stocks, which can result in your being issued a new account number and may invalidate your previously-completed beneficiary designation form. Even switching from a traditional IRA into a Roth IRA can require a new beneficiary designation form.

Your IRA custodian should verify the names of the current designated beneficiaries on file to make sure that their records are consistent with your intentions. You can also give copies of your forms to your designated beneficiaries as a backup.

An IRA or qualified plan can specify that if there is no beneficiary, all proceeds go to your spouse, your children, or another party. This may be inconsistent with your wishes or may require assets to pass under probate.

If assets are subject to probate, there is the risk that a creditor of the estate might make a claim to the assets.

Stretching distributions

A designated beneficiary whom you choose may elect to take a "stretch" distribution over his or her remaining lifetime following your demise.

This means that if you name a younger child, the funds could remain in an IRA or qualified plan for many decades or generations, delaying taxation further. Unlike stocks held in a personal account, IRAs and qualified plans held by the decedent do not receive a "stepped up basis," which means that such pre-tax accounts will be taxed to the beneficiaries upon eventual distribution.

Although a non-spouse beneficiary cannot do a true rollover into his or her own IRA account, the account can be retitled following your death. The re-titled account must specify the name of the decedent, date of death, and the name of the beneficiary who has become the new owner.

You must also withdraw the decedent's year of death required minimum distribution if this did not occur before death and the decedent was at least age 70-½ years old. The new owner of the account can then name his or her own beneficiaries.

Stretching distributions over generations will allow the assets to continue to grow on a tax-deferred basis. However, if beneficiary designations are not recorded with the plan's custodian correctly, this tax

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deferral opportunity can be lost.

Estate tax considerations

Although assets held by the decedent in an IRA or qualified plan are included in the decedent's taxable estate for federal estate tax purposes, because of the current $5.34 million individual exemption, this is not a concern for most taxpayers. The beneficiaries do not pay income taxes on the funds until they are withdrawn.

Distribution deadlines

Although a surviving spouse can do a rollover into their own IRA and possibly delay distributions further, non-spouse beneficiaries must generally start withdrawals by December 31 of the year following the year of death if they want to "stretch" distributions over their lifetimes.

If they fail to take distributions by this date, then all funds must come out of the IRA or qualified plan within five years of the year of death and no stretch is permitted. These rules, referred to as required minimum distributions, carry a 50% penalty if they are not followed, and this penalty would apply on the amount that should have been distributed, but was not.

Even when a designated beneficiary is under age 70-½, he or she must start distributions because the age 70-½ rule allowing delay of distributions only relates to the plan participant, not designated beneficiaries.

The rate of distribution

The rate of distributions is different for beneficiaries than for the original plan participant.

The IRS mandates use of the single life table (found in IRS Publication 590), which requires that you maintain at least a certain rate of withdrawal as a beneficiary. Although the early distribution penalty, which generally applies to distributions before age 59-½, does not apply if the distribution is on account of death, regular income taxes do apply.

With Roth IRA and 401(k) distributions, although there are no required minimum distributions for the original plan participant, Roth beneficiaries must make withdrawals and the speed of withdrawal by such beneficiaries is identical to that of non-Roth accounts. However, such withdrawals are not subject to income tax and the Roth's tax-free status continues after the death of the plan participant.

FOR HEIRS, STRETCHING DISTRIBUTIONS OVER GENERATIONS WILL ALLOW ASSETS TO SNOWBALL ON A TAX-DEFERRED BASIS.

Splitting the account

Following the death of the plan participant, the beneficiaries may split the account so that each has a separate portion to be placed in separate accounts.

When moving funds to a different institution, it is important to ensure that funds are wired directly into the new IRA and that the funds are not directly paid to the designated beneficiary, because that would be considered a distribution.

The new account must be titled appropriately, as stated above. The transfer of assets from one custodian to another should be handled as a "trustee to trustee transfer" which is different from a rollover. It is important to split the account into separate portions to maximize the permitted continued deferral that will be enjoyed by the beneficiaries.

Keeping the funds in one account

If the funds are held together, the IRS tables require use of the life expectancy of the oldest beneficiary, which results in assets being distributed and taxed sooner.

All assets must be divided no later than December 31 in the year following death in order to have beneficiaries enjoy the advantages of delaying distributions based on the beneficiaries own life expectancies. Funds going to charities must be segregated no later than September 30 of the year following the year of the plan participant's death. ■

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