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Inheriting an IRA or Employer-Sponsored Retirement Plan

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What is it?

When the account owner of a traditional individual retirement account (IRA) or employer-sponsored retirement plan dies, the remaining funds in the account pass to the named beneficiary (or beneficiaries). Unlike many other inherited assets, these IRA or plan funds typically pass directly to the beneficiary without having to go through probate. (Probate is the court-supervised process of administering a will and proving it to be valid.)

These funds are usually subject to federal income tax, unlike some other inherited assets. For federal income tax purposes, post-death distributions from an IRA or plan account are treated the same as distributions that the account owner took during his or her lifetime (state income tax may also apply). In both cases, the portion of a distribution that represents pretax or tax-deductible contributions and investment earnings is taxed, while the portion that represents after-tax or nondeductible contributions is not. The difference, of course, is that the beneficiary is the one who must pay the taxes after the account owner has died. For more information, see Income in Respect of a Decedent.

If you are an IRA or plan beneficiary, you might want to leave inherited funds in the account as long as you like. This would allow you to postpone taxable distributions indefinitely, while maximizing the tax-deferred growth potential of the funds. Unfortunately, you are not allowed to do this. You will generally be required to take distributions of the inherited funds at some point, possibly sooner than you would like. However, you may have more than one option for taking distributions, and the option you choose can be critical.

> **Caution:** While the same general rules apply to inherited Roth IRAs, Roth IRAs are unique in that qualified distributions are free from federal income tax.

> **Caution:** This discussion focuses on the general rules regarding options available to a beneficiary that inherits an IRA or employer-sponsored retirement plan. Your IRA or plan may specify the option(s) available to you.

Beneficiary designations

Primary, secondary, and final beneficiaries

Primary beneficiaries are the IRA owner's or plan participant's first choices to receive the funds. By contrast, secondary beneficiaries (also known as contingent beneficiaries) receive the funds only in the event that all of the primary beneficiaries die or disclaim (i.e., refuse to accept) the funds.

Designated beneficiaries

Designated beneficiaries get preferential income tax treatment after your death. Being named as a primary beneficiary is not necessarily the same as being a designated beneficiary. Designated beneficiaries are individuals (human beings) who (1) are named as beneficiaries in the IRA or plan documents, (2) do not share the same IRA or plan account with another beneficiary who is not an individual, and (3) are still beneficiaries as of the final beneficiary determination date (September 30 of the year following the year of the IRA owner's or plan participant's death--the "September 30 next-year date"). The distinction is important because designated beneficiaries generally have greater and more flexible post-death options.

> **Tip:** Are you a designated beneficiary? The answer depends on who the beneficiaries are on the "September 30 next-year date"--not who the beneficiaries are on the date of death. If you inherited an IRA or plan because the owner or participant named you as sole primary beneficiary, you are almost certainly a designated beneficiary. If you are one of several primary beneficiaries for the same IRA or plan account, you are probably a designated beneficiary if all of the other primary beneficiaries are individuals. However, if any of the other primary beneficiaries are nonindividuals (a

charity, for example), you may not be a designated beneficiary. Also, if the IRA or plan funds are coming to you through the owner's or participant's estate, you are probably not a designated beneficiary. If the funds are coming to you from a trust that is receiving the IRA or plan dollars, special rules will apply. Consult a tax or estate planning professional.

Final date for determining beneficiaries

Only beneficiaries remaining on September 30 of the year following the year of the IRA owner's or plan participant's death are considered as possible designated beneficiaries for purposes of post-death distributions from the IRA or plan account.

The September 30 next-year date does two things. First, it allows the IRA owner or plan participant to change beneficiaries any time during his or her lifetime. Second, it creates the opportunity for post-death planning. For example, if an IRA owner dies and the primary beneficiary does not need the money, the primary beneficiary could make a disclaimer up until the September 30 next-year date (note, however, that to be valid for estate and gift tax purposes, a qualified disclaimer--refusal to accept benefits--must be signed by a beneficiary and meet other requirements no later than nine months after a death. Therefore, even though designated beneficiaries are determined on September 30 of the year following the year of a death, a disclaimer may need to be signed much earlier to meet the nine-months-after-death rule). This might allow the funds to pass to a secondary beneficiary with a greater financial need.

Another possibility is that one or more primary beneficiaries could "cash out" their entire share of the inherited funds by the September 30 next-year date. If this is done by the September 30 next-year date, the "cashed out" beneficiaries are not considered as possible designated beneficiaries for purposes of calculating post-death distribution methods. For example, this strategy can be very effective in cases where the primary beneficiaries include both individuals and one or more charities. The charity (ineligible as a designated beneficiary) can take its entire share (income tax free) by the September 30 next-year date, leaving only the individuals as remaining beneficiaries who may qualify as designated beneficiaries.

Caution: 2002 final regulations clarify that a designated beneficiary who dies after the death of the IRA owner or plan participant, but prior to the September 30 next-year determination date, is still treated as a designated beneficiary for purposes of calculating post-death distributions from the IRA or plan account. As discussed above, this is in contrast to situations where a designated beneficiary makes a qualified disclaimer prior to the September 30 next-year date.

Factors that determine post-death distribution options

First, if you have inherited an employer-sponsored retirement plan account, the plan is generally allowed to specify the post-death distribution options available to you. These options may not be as flexible as the options permitted under the final IRS distribution rules. For example, depending on whether a plan participant died before or after his or her required beginning date, some plans may provide a different default payout method than the IRS rules. In such a case, you may not be able to elect another payout method as an alternative to the plan's default method. Your first step should be to consult the retirement plan administrator regarding your post-death options as a beneficiary.

The other factor that determines post-death options is the type of beneficiary. Individual beneficiaries generally have more options and flexibility than nonindividual beneficiaries. For example, post-death options are severely limited if the IRA owner or plan participant dies with his or her estate as a beneficiary. This could occur if the estate is named as a beneficiary, or if there are no named beneficiaries (in which case the estate becomes the "default" beneficiary). The same limited options apply when one or more charities are named as beneficiary. Special rules apply when a trust is named as beneficiary. Under certain conditions, the underlying trust beneficiaries can be treated as the IRA or plan beneficiaries for distribution purposes.

For individuals who qualify as designated beneficiaries, the options available further depend on whether the beneficiary is a spouse or another individual. Depending on plan provisions and other factors, nonspousal individuals will typically have several post-death options. These options generally include using the life expectancy method, receiving a lump-sum distribution, taking distributions under the five-year rule, or disclaiming

the funds. (See below for a description of each.) The life expectancy method is usually the default payout method, and often the most favorable method in terms of providing the longest possible payout period (thereby spreading out income taxes and maximizing tax-deferred growth).

A surviving spouse generally has all of the options available to other designated beneficiaries, plus two additional options. A surviving spouse beneficiary can elect to roll over inherited funds to his or her own IRA or plan account, providing income tax and estate planning benefits. A surviving spouse who is the sole beneficiary may also elect to leave the funds in an inherited IRA and treat that IRA as his or her own account. (This option does not apply to inherited retirement plans.) In most cases, it will be in a surviving spouse's best interest to exercise one of the two additional options.

> **Tip:** Nonspouse beneficiaries can not roll over inherited funds to their own IRA or plan. However, the Pension Protection Act of 2006 lets a nonspouse beneficiary make a direct rollover of certain death benefits from an employer-sponsored retirement plan to an inherited IRA. (See Nonspouse rollover to an inherited IRA--The Pension Protection Act of 2006, below.)

> **Tip:** If a participant died before beginning to take required minimum distributions, a surviving spouse can generally wait until the year the participant would have reached age 70½ to begin taking distributions from the account.

> **Tip:** Once a post-death payout method is in place, the IRA or plan beneficiary is usually allowed to take larger distributions than required (including, in most cases, a lump-sum distribution of the beneficiary's entire share). However, if the beneficiary receives less than required in any year, a 50 percent federal penalty tax will apply to the undistributed required amount. This penalty tax would be in addition to regular income tax.

Post-death distribution options for designated beneficiaries

Remember, only individuals who meet certain requirements can be designated beneficiaries of an IRA or retirement plan account. The post-death distribution options available to designated beneficiaries generally include one or more of the following.

Life expectancy method

This method involves taking distributions over a beneficiary's single life expectancy (or, in some cases, over the deceased account owner's remaining single life expectancy). This is typically the "default" payout method for designated beneficiaries under the final rules, regardless of whether the IRA owner or plan participant died before or after the required beginning date for minimum distributions (unless plan provisions specify otherwise). The distributions must begin no later than December 31 of the year following the year of the IRA owner's or plan participant's death. For more information, see Life Expectancy Method.

Five-year rule

This method involves taking distributions in any amount and at any time within a five-year period. The five-year period ends on December 31 of the year during which the fifth anniversary of the IRA owner's or plan participant's death occurs. If there is no designated beneficiary and the death occurred before the required beginning date, the five-year rule is the default rule under the final regulations. In other cases, the life expectancy method is the default rule. However, a designated beneficiary can often still elect the five-year rule as an alternative payout method. From a tax standpoint, it is usually not as desirable as the life expectancy method. For more information, see Five-Year Rule.

Lump-sum distribution

This distribution method involves withdrawing a beneficiary's entire interest in an inherited IRA or retirement plan account within one tax year. This can take the form of a single distribution of the entire interest, or multiple distributions spread over the one-year period. In most cases, any designated beneficiary can elect a lump-sum distribution of his or her share of an inherited IRA or plan account. However, other post-death payout options are typically available, and will usually be more attractive from a tax standpoint. A lump-sum distribution can have

very undesirable tax consequences. For more information, see Lump-Sum Distribution.

Roll over the remaining interest

This special post-death option is available only to surviving spouses who are designated beneficiaries. It involves "rolling over" the surviving spouse's interest in the inherited IRA or plan account to the spouse's own IRA or plan. A surviving spouse can generally elect this option regardless of whether the IRA owner or plan participant had begun taking lifetime required minimum distributions (RMDs). Once in the spouse's IRA or plan, the funds continue to grow tax deferred, and distributions need not begin until the spouse's own required beginning date. Also, the spouse can name beneficiaries of his or her choice. For more information, see Roll Over the Remaining Interest.

Disclaim the inherited funds

Any designated beneficiary can opt to disclaim his or her share of the inherited IRA or plan account. Disclaiming simply means refusing to accept the inherited funds, allowing them to pass to another individual or entity (i.e., a secondary beneficiary). A qualified disclaimer must be completed within nine months of the date of death. This nine-month deadline usually occurs before the September 30 next-year date. Disclaiming sometimes makes sense for tax and/or personal reasons. For more information, see Disclaim the Inherited Funds.

Post-death distribution options for nondesignated beneficiaries

Charities and estates can be beneficiaries of an IRA or retirement plan account, but they cannot be designated beneficiaries because they are not individuals. In addition, individuals who are beneficiaries of an IRA or plan may not qualify as designated beneficiaries under certain conditions. The post-death distribution options available to nondesignated beneficiaries generally include one or more of the following.

Five-year rule

If an IRA owner or retirement plan participant dies before his or her required beginning date for lifetime RMDs, and there are no designated beneficiaries on the account, required post-death distributions generally must be taken according to the five-year rule. For more information, see Five-Year Rule.

Distributions over the account owner's remaining life expectancy

If an IRA owner or retirement plan participant dies on or after his or her required beginning date for lifetime RMDs, and there are no designated beneficiaries on the account, required post-death distributions generally must be taken over the account owner's remaining single life expectancy (calculated in the year of death according to IRS life expectancy tables, up to a maximum of 17 years). For more information, see Life Expectancy Method.

Lump-sum distribution

As an alternative to either of the above payout methods, a nondesignated beneficiary (just as a designated beneficiary) generally has the option of receiving a lump-sum distribution of the inherited IRA or plan funds. Again, though, this may not be advisable from a tax standpoint. For more information, see Lump-Sum Distribution.

Disclaim the inherited funds

As an alternative to any of the above payout methods, a nondesignated beneficiary (just as a designated beneficiary) generally has the option of disclaiming inherited IRA or retirement plan funds. For more information, see Disclaim the Inherited Funds.

Nonspouse rollover to an inherited IRA--The Pension Protection Act of 2006

A spouse beneficiary can roll over death benefits received from an employer-sponsored retirement plan to either

the spouse's own IRA, or to an IRA established in the deceased's name with the spouse as beneficiary (an "inherited IRA"). In the past, neither of these options was available to nonspouse beneficiaries. While nonspouse beneficiaries still can not roll over inherited funds from an employer plan to their own IRA, the Pension Protection Act of 2006 lets a nonspouse beneficiary make a direct (trustee to trustee) rollover to an inherited IRA, for distributions after 2006.

Qualified plans (like 401(k) plans), 403(b) plans, and 457(b) plans can, but aren't required to, offer this option to nonspouse beneficiaries. If a nonspouse beneficiary elects a direct rollover, the amount directly rolled over is not includible in gross income in the year of the distribution.

The ability to make a rollover to an IRA is significant because employer plans often require faster payouts to nonspouse beneficiaries than the law requires, accelerating taxation for these individuals. IRAs on the other hand generally allow distributions to be spread over the maximum period permitted by law, permitting tax deferral for the longest period of time. The IRS has recently provided guidance on nonspouse rollovers from employer sponsored plans to IRAs. Notice 2007-7 provides that:

- The IRA must be established in a manner that identifies it as an inherited IRA, and also identifies the deceased employee and the beneficiary, for example, “Tom Smith as beneficiary of John Smith.”

- An indirect rollover--where the beneficiary receives the distribution and then rolls the funds over to an IRA within 60 days--is not allowed

- A plan can make a direct rollover to an IRA on behalf of a trust where the trust is the deceased employee's named beneficiary, provided the beneficiaries of the trust can be treated as designated beneficiaries under IRS required minimum distribution (RMD) rules, and the trust is identified as the IRA beneficiary.

- The nonspouse beneficiary can't roll over RMDs to the inherited IRA.

The Notice provides complex rules for determining both the RMDs ineligible for rollover from the employer plan, and the RMDs required from the IRA after the rollover:

1. The employee dies before his or her required beginning date, and the 5 year rule applies. Under the 5-year rule, no amount has to be distributed by the retirement plan to the beneficiary until the end of the fifth calendar year following the year of the employee’s death. In that year, the entire remaining amount that the beneficiary is entitled to under the plan must be distributed. Notice 2007-7 provides that the beneficiary can directly roll over his or her entire benefit until the end of the fourth year. On or after January 1 of the fifth year following the year in which the employee died, no amount payable to the beneficiary is eligible for rollover. Most importantly, Notice 2007-7 provides that if the beneficiary was subject to the 5-year rule in the employer plan, the 5-year rule will continue to apply to for purposes of determining RMDs from the inherited IRA after the rollover.

However, even where the 5-year rule applies, a special rule allows a nonspouse beneficiary to determine the RMD under the employer plan using the life expectancy rule, roll the balance over to an inherited IRA, and continue to take RMDs from the IRA using the life expectancy rule--which provides the maximum tax deferral for the beneficiary. To use this special rule the rollover must occur no later than the end of the year following the year in which the employee dies.

> **Example(s):** Sam, a participant in his employer's 401(k) plan, dies on June 1, 2007. The 401(k) plan provides that beneficiaries must receive their entire balance from the plan under the five year rule. Therefore June, Sam's beneficiary, must receive the entire balance no later than December 31, 2012. June would like to defer taxes on her inherited funds for as long as possible. If she makes a direct rollover to an inherited IRA by December 31, 2008, she will be able to use the life expectancy rule, rather than the 5-year rule, when calculating her RMDs from the IRA. Her rollover must be reduced by the amount of RMDs that would have been required under the employer plan using the life expectancy rule. If June fails to make her rollover by December 31, 2008, then she will still be able to make a rollover to an inherited IRA (no later than December 31, 2011), but will have to continue to use the five year rule when calculating her RMDs from the IRA. That is, she will still be required to receive all the funds in the inherited IRA no later than December 31, 2012.

2. The employee dies before his or her required beginning date, and the life expectancy rule applies. If the life expectancy rule applies, the amount ineligible for rollover includes all undistributed RMDs for the year in which the direct rollover occurs and any prior year. After the rollover, the life expectancy rule continues to apply in determining RMDs from the inherited IRA. RMDs are determined using the same applicable distribution period as would have been used under the employer plan if the direct rollover had not occurred.

3. The employee dies on or after his or her required beginning date. If an employee dies on or after his or her required beginning date, the amount ineligible for rollover includes all undistributed RMDs for the year in which the direct rollover occurs and any prior year, including years before the employee’s death. After the rollover, the life expectancy rule continues to apply in determining RMDs from the inherited IRA. The RMD under the IRA for any year after the employee's death must be determined using the same applicable distribution period as would have been used under the employer plan if the direct rollover had not occurred.

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