What to Do as a Beneficiary of an IRA

westwoodgroup.com/insight/what-to-do-beneficiary-ira/

So, you are a beneficiary of an IRA. Now what?

The baby boomers are the wealthiest generation in history, but over recent years this aging group has begun the process of transferring substantial assets from their estates to heirs and charities.

A significant percentage of their wealth is held in Individual Retirement Accounts (IRAs). As a beneficiary of an IRA, you will need to be aware of the rules that govern IRA inheritances. Improper planning may expose the account to excess income taxes, penalties or the potential loss of continued growth in the account.

The three primary factors that need to be understood when inheriting IRA assets are the type of IRA, the beneficiary type and whether the deceased IRA owner reached the age of 70½.

IRA types can be divided into two broad categories, traditional IRAs (including Rollover, Spousal IRA, SEP IRA, SIMPLE IRA) and Roth IRAs. As a refresher, traditional IRAs are funded with pretax contributions into a tax-deferred investment account that is fully taxable upon distribution, whereas Roth IRAs are funded with after-tax contributions into investment accounts that are tax-free when distributed, assuming the five-year holding period is satisfied.

Understanding the IRA beneficiary type is simple: a permissible IRA beneficiary is either a spouse, non-spouse or entity. A non-spouse beneficiary is any living person, other than a spouse, and an entity beneficiary is most often an estate, trust or a charity. The reason the beneficiary type is important is that this will determine the minimum amount of assets that must be disbursed from the IRA.

Another important factor is the age of the deceased IRA owner and your age as the beneficiary. These age factors will determine the calculation method used by the beneficiary that provides for the lowest IRA disbursement that must begin the year following the death of the IRA owner. The IRA beneficiary may withdraw funds in excess of the minimum amount anytime during the year but not less. It is important to note that a younger beneficiary will have a lower required distribution amount due to a longer life expectancy as compared to an older beneficiary.

Non-Spouse IRA Beneficiary

A non-spouse IRA beneficiary may have three distribution options for their accounts:

1

Lump-sum distribution option

Distribute all assets at one time

2

Five-year distribution option

All assets must be distributed from the IRA by the fifth year after death of the account owner

3

Life expectancy option

Allows for distributions over the course of the beneficiary's lifetime and is sometimes referred to as a "stretch IRA"

Surviving Spouse

If the IRA owner's spouse is the beneficiary of the IRA, the surviving spouse has two options:

1

Treat the decedent's IRA as their own IRA

2

Transfer assets into an inherited IRA

Transferring the decedent's IRA assets into an IRA in their own name is most common for a spouse that does not have an immediate need to utilize any of the IRA assets or if they prefer to defer IRA distributions for some additional time. However, if the surviving spouse is under the age of 59½ and needs access to some of the funds in the retirement account, then the election of the inherited IRA option would allow for penalty-free distribution.

Important items to note on beneficiary IRAs:

- An error on the setup of an inherited IRA usually cannot be fixed and may result in a

full payout of the IRA over a short period.
- Inherited IRAs cannot be combined into any other IRA.
- Contributions cannot be made into an inherited IRA.
- All funding of inherited IRAs must be direct trustee-to-trustee transfers. A non-spouse beneficiary cannot receive funds by check and then redeposit these funds into an inherited IRA.
- Failure to distribute the minimum amount from any inherited IRA, including a Roth IRA, will be subject to a 50 percent IRS penalty.
- U.S. Courts have ruled that inherited IRAs are not protected retirement funds and may be subject to creditor claims based on the law of the state. As a result, some states have passed bankruptcy laws to provide protection to inherited IRA owners.

Receiving IRA assets from a loved one is a gift and often can be made to last your lifetime with the proper planning. Additional details on inherited IRA and beneficiary distributions can be found in IRA Publication 590B or by contacting your Westwood advisor.

Donald W. Roberts, CFP®

Vice President & Trust Officer, Westwood Wealth Management