Inherited IRAs and the Benefits of the Stretch Provisions

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PART I: IRAs GENERALLY

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What is an IRA?

- An Individual Retirement Account
- Several tax advantages
- Two main types
  - Roth
  - Traditional
- Non-probate asset

Contributions to IRAs

Two main tax advantages:

- Contributions may be fully or partially deductible
- Amounts in IRA not taxed until distributed

Traditional vs. Roth IRAs Limits

	TRADITIONAL	ROTH
Age Limit	70½	No limit
Contribution Limit	May contribute up to: • $5,500 *or* • $6,500 *if* age 50 or older by end of 2015	May contribute up to: • $5,500 *or* • $6,500 *if* age 50 or older by end of 2015
Are contributions deductible?	Yes	No
Form	Form 8606 if you make nondeductible contributions	No

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Traditional IRAs

- Requirements to be valid:
  - Trustee/custodian must be bank, federally insured credit union, savings & loan association, or entity approved by IRS
  - Trustee/custodian cannot accept contributions of more than the deductible amount (exception: rollover contributions).
  - Contributions MUST be in cash (exception: rollover contributions).
  - Must have non-forfeitable right to amount at all times.
  - Money in account cannot be used to buy life insurance.
  - Assets in account cannot be combined with other property.
  - Must begin receiving distributions by April 1 of year following year in which you reach age 70½.

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Traditional IRAs – Contribution Limits

- Community property laws
- Brokers' commissions
- Trustees' fees
- More than 1 IRA
- Filing status
- Less than/more than maximum contributions

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Example of Excess IRA Contribution

Fred, an IRA owner, turns age 68 in the calendar year 2011. He has dividend and interest income of $5,000 during the calendar year 2011 but no earned income. Fred contributes $5,000 to a traditional IRA on October 1, 2011. Fred is single.

Q: May Fred contribute $5,000 to a traditional IRA for the calendar year 2011?

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Distributions

- May withdraw traditional IRA assets at any time, subject to 10% additional tax if withdraw before age 59½
- Generally may make a tax-free withdrawal of contributions *if* you do it before the due date for filing tax return for year in which you made them
- Ordinary income

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Required Minimum Distributions ("RMD")

- RMD by April 1st of the year following the year in which the owner reaches 70½ years old.
- 50% excise tax for failure to take RMD
- May elect to receive distribution earlier
  - Excess distribution does not count towards required distribution for future years

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RMDs Continued

- The birthday matters
  - January-June
  - July-December
- Latter group gets an additional year deferral, as July-Dec. birthdays reach age 70½ in different calendar years.
- April 1 for first year only
- "Bunching" effect

Example of "Bunching" Effect

"You reach age 70 ½ on August 20, 2015. For 2015, you must receive the required minimum distribution for your IRA by April 1, 2016. You must receive the required minimum distribution for 2016 by December 31, 2016. If you do not receive your required minimum distribution for 2015 until 2016 both your 2015 and 2016 distributions will be included in income on your 2016 return."

Calculating the RMD

- Divide the account balance as of close of business 12/31 of preceding year by "applicable divisor"
- What is the "applicable divisor"?
  - Joint and Last Survivor Table I
  - The Uniform Lifetime Table II
  - The Single Life Expectancy Table III

Example – TABLE III

"You own a traditional IRA. Your account balance at the end of 2015 was $100,000. You are married and your spouse, who is the sole beneficiary of your IRA, is 6 years younger than you. You turn 75 years old in 2016. You use Table III. Your distribution period is 22.9. Your required minimum distribution for 2016 would be $4,367 ($100,000/ 22.9)."

PART II: INHERITED IRAs

How to keep funds in the IRA growing and tax-deferred beyond the IRA owner's lifetime

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What If You Inherit an IRA?

- Any person or entity can be a beneficiary of an IRA
- Beneficiaries of traditional IRAs include in their gross income any taxable distributions they receive

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The "Stretch" Concept

- Allows an IRA to be passed on from generation to generation
- Must follow certain rules to avoid excess-accumulation penalties which are caused by failing to take the RMD
- Benefits:
  - Tax deferral
  - Flexibility
  - Benefits for spouses (treat as own or as inherited IRA)

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Three Main Issues

- Who or what is the beneficiary?
- Did they die before or after age 70½ (the required beginning date or "RBD")?
- How do you calculate the RMDs for inherited IRAs?

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Determining the Designated Beneficiary – Overview

- "Designated Beneficiary" vs. Beneficiary
- Determined September 30th of the calendar year following the year the owner dies.
- Must be beneficiary on date of owner's death
- What if beneficiary on date of death but not on September 30th (due to disclaiming interest or received entire benefit)?
  - That beneficiary is *not* counted for determining the beneficiary(ies) of the IRA

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Determining the Designated Beneficiary – Death of a Beneficiary

- Beneficiaries of deceased beneficiary must continue to take RMDs after deceased beneficiary's death *based on the distribution schedule established by deceased beneficiary*

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Who can be a Designated Beneficiary?

- Most IRA trustees/custodians provide IRA owners with specific form to designate beneficiaries
- Some IRA agreements provide that, in the event the IRA owner fails to name a specific beneficiary, the beneficiary will be a certain category of person (such as the surviving spouse of the IRA owner)
- Only individuals (with exceptions of certain trusts)

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Trust as a Beneficiary

Beneficiaries of trust are treated as "Designated Beneficiaries" of IRA if following requirements met:

i. The trust must be valid under state law
ii. The trust must be irrevocable by will, or by its terms, become irrevocable upon the death of the employee
iii. The beneficiaries of the trust must be identifiable
iv. Copies of certain relevant documents must be provided to the IRA plan administrator.

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Trust as a Beneficiary

- If the trust fails 4 requirements → IRA is treated as if no designated beneficiary named
- Subject to "no beneficiary" required minimum distribution rules discussed later
- Will fail 4 requirements if *any* beneficiary of trust is a charity

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DETERMINING REQUIRED MINIMUM DISTRIBUTIONS FOR INHERITED IRAs

Did the IRA Owner die *before* or *after* the required beginning date (age 70½)?

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Distributions in the Year of the Owner's Death

- RMD for year of owner's death depends on whether owner died before the RBD:
  - If *before* the RBD, there is no RMD in the year of owner's death
  - If owner dies *on or after* the RBD, the IRA beneficiaries must determine and distribute the owner's RMD
    - General Rule: Use Table III
    - Exception: If sole beneficiary is SS who is more than 10 years younger, use Table II

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Sole Beneficiary is the Surviving Spouse

- If SS is sole beneficiary, three options:
  1. Treat inherited IRA as his own by designating himself as account owner; or
  2. Treat inherited IRA as his own by rolling it over into his own IRA; or
  3. Treat himself as a beneficiary

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Sole Beneficiary is Surviving Spouse – Treating IRA as Own

- Treat as own → determine the RMD using SS's life expectancy for all year's following year of death of owner
  - Exception: For year of death, use deceased IRA owner's life expectancy
- Deemed to have chosen to treat as own if:
  - You are the sole beneficiary; and
  - You have an unlimited right to withdraw amounts from IRA; and
  - Either (i) you make any contributions to the inherited IRA *or* (ii)you fail to take the RMD for a year as a beneficiary of an IRA

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Owner Died Before RBD

- Three rules:
  - Non-spouse beneficiary
    - General Rule: Single Life Expectancy applies
  - Spouse as sole beneficiary + does not treat as own
  - No beneficiary named
    - 5-Year Rule applies
- Note that if an IRA owner dies after reaching age 70½, but before April 1 of the next year, no minimum distribution is required for that year because the death of the owner occurred prior to the RBD

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Owner Died Before RBD + Non-Spouse Beneficiary

- No RMD for year of IRA owner's death
- RMD must commence under the life expectancy method (described below) in the year following the owner's death
- Life expectancy of non-spouse beneficiary is fixed (i.e., term-certain period) based on the Single Life Expectancy Table determined in the calendar year following IRA owner's death
- This life expectancy number is then reduced by 1 for each subsequent calendar year

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EXAMPLE

- Facts: A, IRA owner, died on June 1, 2012 at age 68 leaving his daughter, B, as beneficiary of his IRA. B's date of birth is October 15, 1973.
- Q1: Over what period of time will B receive the RMDs?
- A1: B uses the Single Life Expectancy Table to determine that her applicable divisor (based on age) is 43.6 years. The RMDs will commence in 2013.
- Q2: What will B's divisor be for subsequent years?
- A2: 43.6 reduced by 1 for each subsequent year

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Owner Died Before RBD + Spouse is Beneficiary + Does Not Treat as Own

- **General Rule:** Use SS's life expectancy to determine RMDs and *re-determine divisor each year (do not reduce by 1 for each year)*
- **Year of First Required Distribution:** If owner died prior to the year in which he/she reached age 70½, distributions to SS do not need to begin until year in which IRA owner would have reached age 70½
- **Death of SS:** If SS dies before 12/31 of the year he/she must begin receiving distributions, the SS will be treated as owner of IRA

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EXAMPLE

- **Facts:** T, who would have attained 70½ in 2012, dies in 2011 and names S (his spouse, age 72 in 2012) as sole beneficiary.
- The surviving spouse is permitted to delay the beginning of the distribution until the later of (i) the calendar year following T's death, which is 2012, or (ii) the calendar year in which T would have attained age 70½ , 2012.
- Once benefits are required to begin distribution, S's life expectancy is re-determined each year from the tables. Thus, for 2012, S's life expectancy is 15.5 years, the divisor for 2012; 14.8 for 2012; 14.1 for 2014; 13.4 for 2015; and so on.

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EXAMPLE

Your spouse died in 2013, at age 65½. You are the sole designated beneficiary of your spouse's traditional IRA. You do not need to take any required mini-mum distribution until December 31 of 2018, the year your spouse would have reached age 70½.

If you die prior to that date, you will be treated as the owner of the IRA for purposes of determining the required distributions to your beneficiaries.

For example, if you die in 2015, your beneficiaries will not have any required minimum distribution for 2015 (because you, treated as the owner, died prior to your required beginning date). They must start taking distributions under the general rules for an owner who died prior to the required beginning date.

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Owner Died Before RBD + No Beneficiary

- 5-Year rule requires IRA beneficiaries to withdraw 100% of the IRA by December 31st of the year containing the 5th anniversary of the IRA owner's death
- NEVER applies if IRA owner died *on or after* his/her RBD
- Applies in all cases where there is no individual Designated Beneficiary

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Owner Died On or After RBD

- Three rules:
  - Non-spouse beneficiary
  - Spouse as sole beneficiary + Does Not Treat as Own
  - No beneficiary named

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Owner Died On or After RBD + Non-Spouse Beneficiary

RMD's for years after the year of IRA Owner's death are based on the **longer of**:

- (i) The beneficiary's single life expectancy as shown on Table I (Single Life Expectancy) for the year after the IRA owner's death **reduced by 1 for each year after the year of death**; or
- (ii) The owner's life expectancy a shown on Table I (Single Life Expectancy) as of his/her birthday in the year of death **reduced by 1 for each year after the year of death**

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EXAMPLE 1

- T (the IRA owner) named his daughter D, as his designated beneficiary.
- Using T's single life expectancy in the year of death (2011) at age 74, the divisor is **14.1** years; using D's single life expectancy in the year **after** T's death (2012) at age 46, the divisor is **37.9** years.
- D's distributions beginning in 2012 will be determined using a divisor of **37.9** years. For each year thereafter, the divisor is **reduced by one year**. In 2012, the divisor will be 36.9, and in 2014, the divisor will be 35.9.

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Owner Died On or After RBD + Spouse as Sole Beneficiary + Does Not Treat as Own

- For the years following the IRA owner's year of death, the SS uses his own life expectancy using the Single Life Expectancy Table
  - The SS recalculates this each year
- How is this different from the Non-spouse rule?
  - IRS allows SS to recalculate applicable divisor each year rather than set the divisor in the year following the owner's death and then simply reduce that by 1 for each following year

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EXAMPLE

- Assume T (IRA Owner) named his spouse (S), born in the same year as T, as his sole designated beneficiary.
- T's single life expectancy (Table I) in the year of death (2011) at age 74 is **14.1** years, while S's single life expectancy in the year after T's death (2012) at age 75 is **13.4** years.
- Beginning in 2012, S will use her own life expectancy of 13.4, and recalculate her life expectancy in subsequent years in lieu of reducing the 13.4 by one for each subsequent year.

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EXAMPLE CONTINUED

- Although T's life expectancy in 2011 is 14.1, if S were to use *his* life expectancy beginning in 2012, she would not have been able to recalculate his life expectancy.
- Rather, she would have had to reduce T's life expectancy determined as of the date of his death, reduced for each year since the calendar year of his death. Under this scenario, the divisor would have been 13.1, which is slightly smaller than her life expectancy of 13.4 in 2012.

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Owner Dies On or After RBD + No Beneficiary

- If no beneficiary (either one is not named or a trust that fails the 4 requirements is named) → distribution period is determined according to single life expectancy (Table I) of **IRA Owner** as of his/her birthday in year of death
- And for every subsequent distribution beginning after IRA owner's death, the "applicable divisor" is based on that life expectancy **reduced by 1** for each subsequent year

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EXAMPLE

- Facts: J, an IRA owner, died at age 74 in 2010. J's date of birth was October 15, 1936. The beneficiary of J's IRA was J's estate.
- Q1: How is the RMD for 2010 determined?
- A1: Divide the account balance by the Uniform Life Table (Table III) divisor found using J's age in the calendar year 2010.
- Q2: How are future RMDs calculated?
- A2: Using the divisor found for calendar year 2010, reduced by 1 for each subsequent year.

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Multiple Beneficiaries

- If more than 1 beneficiary as of September 30 of year following year of owner's death → use beneficiary with shortest life expectancy to determine applicable divisor.

EXAMPLES

- Facts: H, the IRA owner, dies at age 60 in 2010. H's birthdate was June 1, 1950, and his date of death was October 15, 2010. Sole beneficiary of is IRA is W, his SS. W's birthdate is May 1, 1955 and she is age 55 in 2010.
- Q1: Must W commence RMD from the IRA in 2010?
- A1: No. If IRA owner dies *before* RBD & sole beneficiary is SS, the SS must receive RMD by the later of:
  - (1) December 31st of calendar year following calendar year of owner's death; or
  - (2) December 31st of calendar year in which IRA owner would have attained age 70 ½

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EXAMPLES

- Facts: Assume same facts as before except W died on September 1, 2012 and did not designate a successor beneficiary to the inherited IRA.
- Q2: Who is the beneficiary of H's IRA?
- A2: The estate of W (although this is based on state law).
- Q3: When must the RMD commence?

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EXAMPLES

- A3: W had until December 31, 2020 to begin receiving the RMDs. Why? Because that is when H would have reached 70½. Since W died during this "gap period" when no RMDs are required and W failed to name a successor beneficiary, the five-year period applies. W's estate *must* receive the balance in H's IRA no later than December 31, 2017.

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EXAMPLES

- Note: Even if B was the sole beneficiary of W's estate, the estate is unable to use B's life expectancy and thus must distribute the IRA assets in accordance with the 5-Year period.
- In the following example, B may "stretch" the distributions out over his lifetime.

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EXAMPLES

- Q4: What if W had designated her son, B, as the successor beneficiary of H's IRA?
- A4: B must use the Single Life Expectancy Table to calculate his applicable divisor for the year following the year of death of W. For each subsequent year thereafter, B must reduce that divisor by 1.

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Summary

- An estate is a beneficiary but not a "designated beneficiary"
- A trust is a beneficiary but not a "designated beneficiary" *unless* certain requirements are met
- If IRA owner dies *on or after* RBD with his estate as the beneficiary → 5-Year rule DOES NOT apply
  - 5-Year rule ONLY applies if IRA owner dies *before* his RBD with no designated beneficiary
- Special rules for SS

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Questions?

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