

Inheriting IRA's Is Like a Box of Chocolates

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Remember the quote from Forrest Gump, "Momma always said life is like a box of chocolates, you never know what you're gonna get." I think your IRA should also be like a box of chocolates, not because of its irresistible confectionary surprises, but because if you are like me you would like that box of chocolates to last as long as possible. Unlike myself, my wife has the discipline to eat one piece each day and make that box last for months. If an inherited IRA is like a box of chocolates, we should all take a cue from my wife. We should want to make it last as long as possible.

It appears to me that today, Americans are accumulating a significant portion of their wealth in retirement plans, such as 401(k)s and IRAs. As IRA owners die, their money is typically transferred to their spouses and non-spouses, such as children or brothers and sisters. However, many people today who are inheriting IRAs are not aware of the ramifications of their decisions or their options, and are making choices that are costing them thousands of dollars in lost potential earnings and additional taxes.

So if you are inheriting an IRA from someone who has died, here is what you need to know to keep as much money working for you as long as possible and keep the tax man happy.

If you are a spouse who has inherited an IRA, you have three choices. The first is to cash in the IRA and pay income tax on the entire distribution. But if you want to keep the IRA, you can leave it in the deceased partner's name, or you can roll it over into your own name. The choice you make should be largely determined by your age. If you're younger than 59 ½, by leaving the IRA in the deceased's name you can make withdrawals from the IRA without paying the ten percent penalty, although you will have to pay ordinary income tax. However, if you roll the IRA into your own name, and you are younger than 59 1/2, any withdrawals you make from the IRA usually will be subject to the penalty.

If you are older than 59 1/2 it usually makes sense to roll the deceased spouse's IRA into your own, or reregister the inherited IRA into your name. This will allow you to consolidate your accounts and make them easier to manage. You can also use this time to change your beneficiaries and begin the education process that will allow your heirs to maximize the remaining IRA dollars should any transfer to them.

If you inherit an IRA from a deceased spouse who was older than 70 ½ and already taking the minimum required distribution, you must continue to take withdraws based on what would have been the deceased's life expectancy. However if you are younger than 70 ½ you can roll the IRA into your own name and effectively stop the distributions until you turn 70 ½, at which time distributions will begin based on your life expectancy.

If you are a non-spouse your options are more limited but still very powerful. Suppose you were designated as a beneficiary to your grandfather's IRA. You cannot roll his IRA over into your name but you can establish a "beneficiary IRA" where the inherited IRA stays in the name of the deceased but for the benefit of the heir. A typical titling for the IRA might read: "John Doe,

deceased, IRA for the benefit of Granddaughter Jane.” This will allow you to take the minimum withdrawals based on your life expectancy, regardless of whether your grandfather had already started to take required distributions.

This is referred to as a stretch IRA, dynasty IRA, or legacy IRA. Understanding how they work is significant because if you are only required to take a small percentage from the inherited IRA each year the remainder has the potential to grow, tax-deferred, and help pay for next year's required distribution. The annual distributions could possibly continue for decades and end up returning to you significantly more than the amount inherited.

If there are more than one non-spouse beneficiaries to the IRA such as a brother and a sister, they can split the inherited IRA into two separate accounts. If the account is not split then the amount of the minimum distributions will be calculated based on the age of the oldest heir. This is usually not in the best interest of the younger beneficiaries.

Should the IRA have no designated beneficiaries, and the owner had already started taking the required distributions, then the heir must continue taking out distributions based on the owner's remaining single life expectancy at death. If distributions had not started, the heir must take all the money out within five years and pay ordinary income taxes. Fortunately, this distribution is exempt from the early withdrawal penalties even if the heir is younger than 59 ½.

When it comes to inheriting IRAs, getting the right information can potentially save you thousands in interest and taxes. Make sure you consult a financial professional who is very familiar with the IRA inheritance rules, and remember not all IRA custodians allow all of the options we've discussed, even though federal law does (this may be cause to change custodians). In the end, if you manage to show the same patience and discipline as my wife, you can make your box of chocolates last a long, long time.