IRA distribution options for beneficiaries

Wealth Management

As a beneficiary of an individual retirement account (IRA), you are faced with important decisions regarding the distribution of these assets. How you decide to take these distributions will have a considerable impact on your overall tax burden. It is important you understand the rules in order to make the best choice to fit your circumstances.

Your distribution options depend on a number of factors: whether the IRA owner passed away before or after their required beginning date, if the IRA has a designated beneficiary, and your relationship to an account owner.

Required beginning date (RBD)

The RBD is that date that an IRA owner must begin taking required minimum distributions (RMDs)—specifically, April 1 of the calendar year following the calendar year in which an account owner reaches age 70½.

Designated beneficiary

A designated beneficiary is the individual whose life expectancy is used to calculate RMDs after the death of an IRA owner. Beneficiary designations, for distribution purposes, do not become fixed until September 30 of the year following the year of an IRA owner's death. Obviously no new beneficiaries can be named after the death of an IRA owner. But beneficiaries who disclaim or have had their benefits paid out to them in full prior to this date will not be considered when determining death distribution options. An account can only have one designated beneficiary, but if an IRA is divided into separate decedent IRAs[1] after an IRA owner's death and prior to December 31 each decedent IRA[1] could have a designated beneficiary.

A beneficiary can disclaim all or a portion of their inherited IRA benefit. By disclaiming, the beneficiary is giving up rights to the assets, which then pass to the other beneficiaries. A valid disclaimer must meet specific requirements and generally must be executed within nine months of the IRA owner's death.

Trust

Generally speaking, only living individuals can be designated beneficiaries. However, even though a trust is a nonliving entity, a special rule may be applied to trusts. Under this rule, the oldest person who is a trust beneficiary will be treated as the designated beneficiary if the following requirements are met:

- The trust is valid under state law and is irrevocable or will, by its terms, become irrevocable upon the death of the IRA owner
- The trust beneficiaries are identifiable by the language in the trust document as designated beneficiaries as of September 30 following the year of the IRA owner's death
- The IRA custodian is provided with a list of beneficiaries (including contingent and remainder beneficiaries) along with a certification that the list is accurate and the trust is a valid "look through" trust by meeting the above requirements by October 31 of the year following the year of the IRA owner's death
- A copy of the trust instrument is provided to the IRA custodian upon demand

Required minimum distribution

Although you have many options, you may want to reduce your potential income tax liability by taking only the RMD each year. If you take only the RMD, the remaining part of your decedent IRA can continue growing tax-deferred. Keep in mind, you can always take more than the minimum; however, not taking the RMD will result in a penalty of 50% on the shortfall. Distributions you take as a beneficiary are taxable as ordinary income but are exempt from the 10% premature distribution penalty regardless of your age.

Roth IRA beneficiaries

There is no RBD for distributions taken from Roth IRAs because a Roth IRA owner isn't required to take RMDs during their lifetime. A Roth IRA is not subject to RMDs until a non-spouse beneficiary inherits the assets. When a non-spouse beneficiary inherits Roth IRA assets, the distribution options are the same as those available to beneficiaries of traditional IRAs whose owners passed away before their RBD.

Subsequent beneficiary

Upon inheriting an IRA, you can name subsequent beneficiaries. If you die before the assets are fully distributed, your subsequent beneficiary may take a lump sum distribution of the remaining assets or can maximize tax-deferral and growth by continuing to take distributions over your remaining life expectancy. For example, if you are taking RMDs over your life expectancy of 34 years but pass away after 12 years, your subsequent beneficiary can continue receiving distributions over the remaining 22 years.

Beneficiaries of qualified plan assets

A spouse beneficiary can generally roll over death benefits inherited from a qualified retirement plan, such as a 401(k), pension or profit sharing plan, into their own IRA. Keep in mind that if the plan participant was past their RBD when they passed away, their current year RMD must be distributed to their beneficiary(ies) and is not eligible to be rolled over.

If your beneficiary is a living person, or a qualifying trust, they can roll over their inheritance into a decedent IRA. The rollover must be done via a direct rollover. The decedent IRA must be a traditional IRA (unless you inherit Roth 401(k) or 403(b) assets), and will be subject to the required distribution rules applicable to a non-spouse beneficiary.

The ability to do the direct rollover is significant because qualified plans often require faster payouts to non-spouse beneficiaries than the law requires, accelerating taxation. In order for a non-spouse beneficiary to take advantage of the longer payout, it is important that the direct rollover occur in a timely manner, generally by December 31 of the year following the year of the plan participant's death. If you inherit qualified plan assets your first step should be to consult the administrator of the qualified plan regarding your post-death options as a beneficiary.

Conclusion

Making a decision regarding a retirement plan inheritance can seem very overwhelming in the midst of losing a loved one. Your financial advisor along with your tax or legal advisor can walk you through each the above options and help you make the decision that best fits your needs.

Beneficiary distribution options

	Beneficiary	Distribution options
Death before required beginning date	**Spouse**	1. Transfer or roll to own IRA. • RMDs must begin at age 70½. 2. Decedent IRA[1] — Distributions are required to begin by December 31 of the year the account owner would have reached age 70½. • Distributions are based on the single life expectancy of the surviving spouse, redetermined annually. • No 10% penalty. 3. Lump sum distribution.
	Non-spouse — Designated beneficiary	Decedent IRA — Annual distributions must begin by December 31 of the year following the year of the account owner's death. Or the five-year death rule may be used which requires that the account be completely distributed by no later than December 31 of fifth year following the year in which the account owner died. • Separate decedent IRAs are established. • Distributions are based on the single life expectancy of the beneficiary, reduced by one for each subsequent year. • Additional distributions may be taken at any time.
	Non-spouse — No designated beneficiary	Five-year death rule — Discretionary payouts until December 31 of fifth year after the account owner's death. Account must be fully paid out by this date.
Death after required beginning date[2]	**Spouse**	1. Transfer or roll to own IRA. • RMDs must begin at age 70½. 2. Decedent IRA — Annual distributions must begin by December 31 of the year following the year of the account owner's death. • Distributions are based on the single life expectancy of the surviving spouse, redetermined annually. • No 10% penalty.
	Non-spouse — Designated beneficiary	Decedent IRA — Annual distributions must begin by December 31 of the year following the year of the account owner's death. • Separate decedent IRAs are established. • Distributions are based on the single life expectancy of the beneficiary, reduced by one for each subsequent year or the hypothetical remaining life expectancy of the deceased account owner, whichever is longer. • Additional distributions may be taken at any time.
	Non-spouse — No designated beneficiary	Annual distributions must begin by December 31 of the year following the year of the account owner's death. Distributions are based on hypothetical remaining life expectancy of the deceased account owner, reduced by one for each subsequent year.

1. A decedent IRA is also referred to as a beneficiary IRA or an inherited IRA.
2. If an account owner dies after their RBD but prior to satisfying their current year RMD their beneficiaries must satisfy the current year RMD.