FLEISHER
PATTERSON
LAW

ESTATE PLANNING | ADMINISTRATION | PROBATE

Wells Fargo Bank Building
3333 S. Bannock St., Suite 900
Englewood, CO 80110

fleisherpattersonlaw.com

P 303-488-9888
F 303-488-9889

THE IRA BENEFICIARY'S HANDBOOK

(Updated for the SECURE Act effective in 2020)

A Guide to Maximizing the Value of Your Inherited Retirement Plan

It is important to read this guide **BEFORE** you do anything with an IRA or other such plan owned by someone who recently died

--------------------------------- IMPORTANT NOTICE---------------------------------

The "Setting Every Community Up for Retirement Enhancement Act of 2019", herein referred to as the "SECURE Act", was passed by Congress and signed into law by the President in December 2019. The Act significantly changed the laws pertaining to Required Minimum Distributions (RMDs) for most non-spousal beneficiaries. Because certain beneficiaries can still use the "old rules", we have left the remainder of this report unchanged. References to IRAs include 401(k) and similar qualified retirement plans.

Change #1: Previously, IRA owners were required to start taking their RMDs in the year in which they attained 70 1/2 years of age. The SECURE Act changed that to 72 years of age for those turning 70 1/2 years of age after 2019.

Change #2: Upon the death of the plan owner, the designated beneficiaries were previously permitted to take RMDs over their life expectancy. Under the SECURE Act, for plan owners dying after 2019, most beneficiaries will now be required to withdraw the ENTIRE balance of the IRA by the end of the tenth year following the plan owner's death.

This change may significantly reduce the availability of lower income tax rates and compounded tax-deferred growth for most beneficiaries, such as children and grandchildren. Certain "eligible designated beneficiaries" are exempt from this new rule, including surviving spouses, disabled or critically ill beneficiaries, beneficiaries less than 10 years younger than the plan owner, and minor children of the plan owner (until attaining the age of majority).

THE SECURE ACT ESSENTIALLY ELIMINATES THE ABILITY TO STRETCH OUT IRA DISTRIBUTIONS OVER THE BENEFICIARY'S LIFE EXPECTANCY FOR MOST BENEFICIARIES.

Example: Bob's named daughter, Judy, age 40, as beneficiary of his IRA. If Bob died prior to 2020, Judy could have withdrawn the IRA in small amounts annually over 43 years, with the last distribution when she would be 83 years old. But if Bob died after 2019, Judy would be required to withdraw the entire balance of the IRA by the end of the tenth year following the year of her father's death. The good news is that she does not have any required annual withdrawals, other than that the entire account must be withdrawn by the end of the tenth year - when she would only be 50 years old.

If Judy were legally disabled, she could have withdrawn the account over the 43 years, but upon her death, her beneficiary would be required to withdraw the entire account by the end of the tenth year following her year of death.

WE HAVE NOT CHANGED ANY OF THE TEXT THAT FOLLOWS FOR THE CHANGES REQUIRED BY THE SECURE ACT, SO PLEASE KEEP THESE CHANGES IN MIND AS YOU READ THE REMAINDER OF THIS REPORT.

THE IRA BENEFICIARY'S HANDBOOK

If you are named as the beneficiary on an Individual Retirement Account (IRA) or other qualified retirement plan, you can, of course, withdraw the funds immediately upon the death of the owner, but there may be many reasons for not doing so. This guide is intended to help you get the most benefit from your inherited IRA, 401(k), or other such plan.

This guide may seem long, but it covers many common and not so common situations. Often, a question that seems relatively simple requires a lengthy, fact-specific answer. You will probably need only 25% of this guide, but we don't know in advance which 25% will be most relevant to you. Arm yourself with this information and the options available. Learn what you can and cannot do, understand the tax ramifications of each option, and which actions may produce irrevocable adverse tax consequences.

We urge you to work with your investment advisor because integrating inherited IRA planning into your own planning often provides the best results. Nevertheless, we have included the IRS withdrawal tables as Exhibit A and Exhibit B.

Why We Wrote This Guide: We wrote this guide to help you get the most benefit out of your inherited IRA. A properly managed inherited IRA can give you a paycheck for life and even help fund your own retirement. As the beneficiary, you are in complete control.

You can decide when to take distributions (subject to any IRS requirements), you can decide what to invest in, and you can name the beneficiary to receive the funds upon your death. You can even move the inherited IRA to another investment firm.

As an estate planning attorney, we often meet with our deceased client's families several weeks after our client has died. Frequently the IRA beneficiaries have already made irrevocable actions that will cost them thousands, or even tens of thousands of dollars. These actions are often based upon impulse, or their own insufficient research, or their well-intended but not fully informed advisors.

Example 1: When Gary's father died, Gary's mother was properly advised to roll his IRA into hers. When Gary's mother died several years later, Gary rolled her IRA into his IRA. That seemed logical, but the tax law only allows the original plan owner or his or her surviving spouse to make such a roll-over.

The IRS treated Gary's action not only as liquidation of his mother's IRA, but also as an illegal contribution to his own IRA. Gary lost over 50% of the original value of the IRA in taxes and penalties shortly after his mother died.

Example 2: Susan, a young widow, followed her financial advisor's advice and, like Gary's mother above, rolled her deceased husband's IRA over into hers. Because she needed some of the IRA funds to live on, those withdrawals prior to her attaining 59 1/2 years of age were subject to a 10% tax penalty. With proper financial advice, Susan could have treated all or a portion of her husband's IRA as an inherited IRA and avoided that 10% penalty.

Example 3: Allen named his living trust as the beneficiary of his $100,000 IRA. Following Allen's death in November, his son, Fred, the Trustee of the trust, withdrew the IRA funds in December. Fred distributed all trust assets to himself and his two siblings in the following April. As a result of these actions, the IRA withdrawals were taxed to the trust at 37%. The IRS held Fred as Trustee liable for the entire tax bill. Fred's siblings had already spent the money ("You made the mistake, so you pay the tax!"). So, Fred had to pay the entire tax out of his own inheritance. Had the distribution been made timelier, the IRA withdrawals could have been taxed directly to the beneficiaries, and perhaps taxed at much lower rates.

For instance, if the beneficiaries had been in the 15% tax bracket, their tax would have totaled only $15,000 rather than 37% - saving over $20,000 in taxes. Moreover, other options to defer the tax consequences were lost and family relationships were destroyed.

Hopefully, by reading this guide and seeking professional help, you will be able to avoid these and the many other possible mistakes which result in adverse tax consequences when making decisions regarding your inherited IRA. There is a lot of misinformation or incomplete information out there, as well as commission-driven financial "advisors" ("salesmen" might be a better word) who may give you advice based upon their best interests and not yours.

IRAs are one of the few remaining tax shelters. Traditional IRAs offer significant tax deferred investing; Roth IRAs offer tax-free investing. Every time you make a withdrawal, you lose part of that tax shelter. Don't be afraid to seek independent financial or legal advice. Ask for advice but evaluate such advice with the help of this guide.

CAUTION: Except for a beneficiary who is the plan owner's surviving spouse (discussed later), an inherited IRA must remain titled in the decedent's name to avoid immediate taxation.

Example: Mary died with her son, Gary, named as the beneficiary.
Correct titling: Mary Doe, Deceased, Gary Doe, beneficiary.

As discussed above, Gary CANNOT transfer the balance of the inherited IRA into his own IRA. Such a withdrawal from his mother's Traditional IRA would trigger immediate taxation of the amount withdrawn. Had his mother's IRA been a Roth IRA, there would be no taxable income, but Gary would have lost the advantage of tax-free investing for decades.

Once withdrawn from the decedent's IRA, such distribution cannot be returned to the decedent's IRA. Furthermore, as mentioned before, the transfer into his IRA would also constitute an ineligible contribution to his own IRA. There is a 6% penalty on such contributions (and the earnings thereon) which remain in the

IRA at the end of each calendar year. Similarly, although being the beneficiary of a deceased person's IRA does not affect your own ability to contribute to your own IRA, you as beneficiary cannot make additional contributions to an inherited IRA.

You can, however, consolidate (and, also, split into separate accounts) inherited IRAs from the same decedent, but only Traditional IRAs with Traditional IRAs and Roth IRAs with Roth IRAs.

The Greatest IRA Advantage May Be: A very wise tax expert was once asked, "What is the single greatest advantage of an IRA?" Listeners were expecting him to comment on the deductibility of contributions, or the tax deferred growth, or the tax-free income from a Roth.

His answer surprised his listeners: "The greatest advantage for most plan owners is that it restricts the plan owner from spending those assets. Unlike regular savings accounts, the IRA has economic disincentives to withdrawing those funds and spending them. As a result, and even without any earnings or tax benefits, an IRA owner would typically end up with far more savings upon reaching retirement age than those who do not participate in such plans."

To some extent, the same is true of your inherited IRA, 401(k) or other such plan. As a beneficiary of a retirement plan, if you withdraw only the required minimum amounts annually, your inherited IRA can help fund your own retirement. The disincentive to withdrawal is immediate taxation and loss of deferral, or, in the case of a Roth IRA, the loss of tax-free investing.

Different Types of Plans: The IRA concepts discussed in this guide also generally apply to 401(K), 403(b), and other such retirement plans. These plan names are derived from the section of the Internal Revenue Code which authorizes their creation. Although the plans are somewhat different, we will refer to all such plans as "plans" or "IRAs" in this guide unless otherwise distinguished. Because 401(k) plans can now be transferred to an IRA, we will use the term IRA to refer to most such qualified retirement plans.

The "plan owner" is the person who originally created the retirement plan. The "beneficiary” is the person who is named on the beneficiary form on file with the IRA custodian and who inherits the plan on the plan owner's death. The "custodian" (or trustee) is the firm which holds the plan investments - usually a financial institution such as a bank or brokerage firm.

Pensions, sometimes referred to as "defined benefit plans" usually terminate at the death of the plan owner or the plan owner's spouse. This guide may or may not – depending on the plan - also apply to such plans if there is a residuary lump sum benefit after the plan owner's death.

Not controlled by Will: The plan owner's will does not control the disposition of the plan owner's IRA unless the estate is the beneficiary (usually not advisable). The IRA custodian is required to pay to the named beneficiary regardless of what the plan owner's will says. The beneficiary under Ken's will is his son, but the beneficiary named on the form on file with the custodian is his daughter. The IRA will be paid to the daughter.

Traditional IRAs generally are funded by the plan owner with tax deductible dollars, and withdrawals are taxed as ordinary income. **Roth IRAs** are generally funded with after tax dollars (i.e. tax has already been paid on the contribution), and withdrawals are generally income tax free - including any earnings or growth in value. Similar plans (Traditional or Roth) may be available from the plan owner's employer in the form of a 401(k) or other such plan.

Liquidation of a Traditional (taxable) IRA will cause the entire amount withdrawn from the IRA to be subject to immediate taxation, possibly pushing the beneficiary into higher tax brackets, and reducing the amount left for investment purposes. A large IRA could lose 45% or more in federal and state income taxes; but if withdrawn over a number of years by a taxpayer in a low tax bracket, such withdrawals may be taxed at only 15% to 20%.

But, you say, a Roth IRA can be withdrawn tax free. Why not withdraw the balance immediately? By leaving the funds in the Roth IRA for as long as possible, the earnings inside the IRA can also be withdrawn tax free later. If the balance is withdrawn and then invested, the earnings will be taxable each year via the capital-gains tax.

Stretching out an IRA: "Stretching out an IRA" means withdrawing the balance of an inherited IRA gradually over a number of years or even over your life expectancy. However, if an entity such as an estate or trust is the beneficiary on file with the IRA custodian, the period of withdrawal may be much shorter, even though you are the beneficiary of the estate or trust. Even then, some deferral (stretch-out) over several years may be available.

One Year Deferral: Even deferring liquidation for one year can result in significant tax savings.

Example: Mary died in early January and named her son, David, as beneficiary of her $1,000,000 Traditional IRA. If David immediately liquidated the IRA, the tax bite would be $400,000 – assuming a 40% combined federal and state income tax rate. Assuming the remaining $600,000 earned 3.6% after tax (6% pre-tax at the same 40% tax rate), or $21,600, her son would have $621,600 at the end of one year.

But what if, instead, David had waited one year to liquidate the IRA? The full $1 million would have earned 6% tax deferred, or $60,000. Upon liquidation one year later, the tax on the $1,060,000 would be the same 40%, or $424,000, leaving David with $636,000 after tax, or $14,400 more than if he liquidated the IRA immediately after his mother's death!

Life Expectancy Deferral: The difference grows as the deferral period is lengthened. Yes, there are minimum required distributions starting in the year following the plan owner's death, but by pulling out the minimum amount, the owner of even a $100,000 IRA can realize substantially greater benefits for both the deferred taxation and potentially lower marginal tax brackets. For example, if a $400,000 IRA is liquidated in year one, much of it may be 35%, whereas if it were withdrawn at a rate of $40,000 per year, much of it may be taxed at only 24%, for a difference of $44,000. The advantage of income tax deferral was discussed in the prior paragraphs.

Taxation of Retirement Plans: "Traditional Plans" are generally funded with tax deductible contributions (or rollovers from other plans, such as 401(k)s, which were tax deductible. To the extent funded with "pre-tax dollars", all plan withdrawals are fully taxable as ordinary income in the year withdrawn. Such withdrawals are taxable whether withdrawn by the plan owner or by the beneficiary. The tax concept of "step up in basis" (or basis adjustment) on the plan owner's death does not apply to retirement plans.

Occasionally, a traditional plan may contain some "after tax" dollars. This usually occurs when a plan contribution has been made for which no tax deduction was allowed, perhaps because the plan owner's spouse participates in a qualified plan at his or her work. Rather than making such a contribution to a Traditional IRA, the plan owner today should, if eligible, consider making such contribution to a Roth IRA instead as discussed below.

"Roth Plans" are generally funded with non-deductible dollars, and plan withdrawals are generally income tax free. The gains in a Roth plan are generally taxed only if withdrawn by the plan owner or beneficiary within five years after the first day of the calendar year in which the first contribution was made to any Roth plan. Even then, such withdrawals are taxable only to the extent of gain in value.

Traditional IRA Withdrawals are treated as a pro-rata withdrawal of both the deductible and non-deductible portions in all such plan accounts taken together, even if only withdrawn from only one account.

Roth Plan Withdrawals, however, are treated as first coming from the non-deductible contributions (in effect, a return of principal), and only thereafter from the gain, which, if withdrawn five years after the first of the year in which the first contribution was made to any Roth IRA, would then be income tax free.

The 10% Penalty: With certain exceptions, there is a 10% penalty on early withdrawals from an IRA by the plan owner if the plan owner is under 59 1/2 years of age. This penalty does NOT apply to a beneficiary of an inherited IRA after the plan owner's death, even if such beneficiary is under 59 1/2 years of age. (Exception: See surviving spouse roll-overs discussed below.)

Required Withdrawals by Plan Owner: Although plan funds can generally accumulate tax deferred almost indefinitely in most retirement plans (and tax-free in a Roth IRA), the plan owner of a Traditional Plan is required to make certain minimum withdrawals in the year the plan owner becomes 70 1/2 years of age and each year thereafter. There are no required minimum distributions (RMDs) during the plan owner's lifetime for Roth plans.

The first distribution must be taken either by December 31 of that calendar year, or by April 1 of the next calendar year. Thereafter, each distribution must be taken by December 31 of that year. Those who postpone the first distribution into the next calendar year will end up having two required distributions in that year.

There is a 50% IRS penalty on the amount which was required to be withdrawn but was not withdrawn. Accordingly, if you fail to make a required $100 withdrawal from a traditional IRA, the penalty would be $50, but the full $100 would be taxable to you because tax penalties are not deductible.

There are two important withdrawal tables which are included with this guide. The first table (Exhibit A) shows the divisor for the plan owner. Thus, for a plan owner who has or will become 75 years of age this year, the divisor is 22.9. The account value as of December 31 of the previous calendar year is divided by this number to calculate the required minimum distribution for the current year. The plan owner uses the divisor listed for 76 years of age, which is 22.0, for the next calendar year's calculation.

There is a separate table in IRS Publication 590 for plan owners whose spouses are more than ten years younger than the plan owner.

If you withdraw more than the required minimum distribution in one year, that excess cannot be used to offset the required minimum distribution in any following years.

Required Withdrawals by Beneficiaries: On the plan owner's death, the required minimum distribution (if any) for the plan owner must be withdrawn in that calendar year to the extent that it has not been withdrawn prior to his death.

In the following calendar years, the beneficiaries of both Traditional and Roth plans are required to make certain minimum distributions calculated based upon the table in Exhibit B. The 50% penalty applies to the extent that the required distribution is not withdrawn in that calendar year.

This table is used differently than the plan owner's table. Whereas the plan owner goes back to the table each year, the non-spousal/beneficiary uses this table only once, and that is to determine the first year's divisor. That first-year divisor is based upon the age which the beneficiary will become in the year following the calendar year of the plan owner's death. For example, if the beneficiary will become 40 years of age in the calendar year following the plan owner's death, the divisor will be 43.6.

Once the divisor is determined for the beneficiary, each year thereafter 1.0 is subtracted from that initial divisor. The beneficiary does not go back to the table again. In the above example, the divisor to be used in the second year following the plan owner's death would be 42.6 and would be 41.6 for the third year.

Exception: If the Plan Owner is younger than the beneficiary, the beneficiary can use the table in Exhibit B, based upon the plan owner's age in the year of death, and reduce that number by 1.0 in each following year.

Example: Patrick had already turned 43 in the year he died, and he left his IRA to his 73-year-old father. Patrick's life expectancy in the IRS table at age 43 is 40.7 years - See Exhibit B). His father's first required distribution from Patrick's IRA is in the year following Patrick's death, and the divisor would be 39.7 (40.7 less 1.0) of the year-end IRA value in Patrick's year of death.

It is your responsibility to calculate and to withdraw the required distribution each year. Don't rely entirely on the advice of others.

If there is a failure to make the required minimum distribution by either the plan owner or the beneficiary, the taxpayer can request that the IRS waive the 50% penalty on IRS form 5329.
There must be "reasonable cause" AND the withdrawal must be made as soon as the error is noticed. Reasonable cause is more than just not knowing of or forgetting about the required withdrawal. One reason the IRS has accepted with regularity is if death of the plan owner occurs near the end of the year, and if the required amount is withdrawn early in the next year.

If, as a non-spousal beneficiary, you miss taking the required distribution in a timely manner, you can still avoid the 50% penalty by electing the “five-year rule”: You must withdraw the entire IRA before the end of the fifth year following the year of the plan owner's death.

Having an inherited IRA does not affect your rights and obligations with respect to your own IRA which you own as the original plan owner. For instance, as a 65 year old beneficiary you will have required distributed from your inherited IRA the year after the original plan owner dies, but with respect to your own IRA, your required distributions don't start until the year in which you become 70 1/2 years of age.

You cannot satisfy any required distributions from your inherited IRA with distributions from your own IRA, and vice versa. If you inherited IRAs from both your mother and your father, they must be kept separate, and required distributions on your mother's IRA cannot be satisfied by distributions from your father's IRA, and vice versa.

If you inherited both a traditional IRA and a Roth IRA from your father, you cannot satisfy the required distributions from your father's traditional IRA with withdrawals from your father's Roth IRA, and vice versa.

Warning #1 - Don't Submit Forms On-line: It's OK to obtain the forms on-line and print them out to study and complete before mailing them in. You may wish to discuss them with your financial advisor or attorney. If you try to complete them on-line, you may be one click away from a disaster!

Waning #2 - 401(k) Plans: Many 401(k) plans require that upon death of the employee that the balance be withdrawn from the account within five years. This plan requirement does not prohibit you as the beneficiary from transferring the balance to an inherited IRA (or create one for that purpose.) Several years ago, the IRS issued regulations that now require 401(k) administrators to offer this option. Learn your rights and question what others tell you.

What if there is More than One Beneficiary? For the purposes of determining the required minimum distributions, IRA beneficiaries are determined as of September 30 of the calendar year following the death of the plan owner. Assuming all the beneficiaries – as of that date – are individuals (NOT trusts, estates, charities, or other non-living entities), the beneficiaries are required to use the life expectancy of the oldest such beneficiary.

If a named beneficiary disclaims his interest, or fully liquidates such share before that date, such beneficiary will not be treated as a beneficiary for the purposes of calculating the required minimum distribution. But if the beneficiary dies before such date, such deceased beneficiary will still be considered as being a beneficiary for determining the life expectancy of the oldest beneficiary as of that September 30 date.

However, under the "Separate Share Rule", if by December 31 of the calendar year following the plan owner's death, the IRA is divided into separate inherited IRAs for each beneficiary, then each beneficiary can then use his or her own life expectancy. Such division also gives each beneficiary the right to make his or her own investment and withdrawal decisions, and name who will inherit that share of the IRA upon that beneficiary's death.

Example of Separate Share Rule: John and Judy are the beneficiaries of their deceased father's IRA. They timely divide the IRA into two separate inherited IRAs. John may decide to invest his inherited IRA in stocks and perhaps make larger withdrawals in a year he is unemployed. Judy can make entirely separate investment and withdrawal decisions than John, and each has their own privacy as neither has access to the other's account. Furthermore, each beneficiary can name the person or persons who will be entitled to such beneficiary's inherited IRA upon such beneficiary's death.

What if one of the Beneficiaries is not an Individual? If a beneficiary, such as a charity, withdraws its share before that September 30 date, that beneficiary will be disregarded. But if the charity (or estate or other entity) is still a beneficiary on that date, then ALL beneficiaries are required to calculate their required minimum distributions based under the five year/life expectancy rule.

The Five-Year/Life-Expectancy Rule: Unless all the named beneficiaries on the IRA custodian's beneficiary form are individuals (people, not entities) as of September 30 of the year following the plan owner's death, the following rule applies:

If the plan owner died *before* April 1 of the year following the year in which the plan owner attains 70 1/2 years of age, then the IRA must be completely withdrawn by the end of the fifth year following the plan owner's death.

If the plan owner dies *on or after* such date, then each beneficiary is required to use the plan owner's life expectancy as indicated in the "beneficiary" table (Exhibit B) and deduct 1.0 each year thereafter.

Can the Beneficiary of an Inherited IRA name his or her own Beneficiary to inherit later on? Yes, but on the death of the first beneficiary, the second beneficiary still must use the required minimum distribution withdrawal rate applicable to the first beneficiary.

Example: John inherits his father's IRA, names his daughter (or older uncle) as the beneficiary, and later dies. That second beneficiary is required to use John's life expectancy in calculating the required minimum distributions each year.

Surviving Spouse Options: There are additional options and provisions available to a surviving spouse, the most common of which is to treat the IRA as his or her own IRA, at which time the surviving spouse becomes the "plan owner" as described above. This can be accomplished by transferring the balance to his or her own IRA (Note: only a surviving spouse can do this!), or by retitling the existing IRA in the spousal/beneficiary's name.

A 401(k) plan can be transferred directly to a surviving spouse's IRA or an IRA created for that purpose. Traditional Plans can only be transferred to the surviving spouse's Traditional IRA, and Roths to Roths.

Unlike non-spousal beneficiaries, a spouse can also do a rollover under which the spouse receives a check and then deposits up to the same amount of the check into his or her own IRA within 60 days. The amount so deposited is eligible for roll-over status and is not taxed in the year the initial check was received. If not deposited, it's a taxable withdrawal.

The **60-Day Rule** is strictly enforced by the IRS with only a few exceptions. If not timely deposited into the spouse's IRA, the withdrawn amount becomes taxable income in the year of withdrawal and is not eligible to be deposited in the beneficiary's IRA.

Another potential problem with the 60-day roll-over is that you are only allowed one such roll-over in any consecutive twelve-month period.

Accordingly, attempting a 60-day rollover of the amount withdrawn is risky and is strongly discouraged. The usual recommendation is to do a custodian to custodian transfer to avoid any possibility of violating the 60-day rule. There is never a check issued payable just to you. But in case you as a surviving spouse have already received a check, you should be aware of this 60-day rule.

An amount not to exceed the amount withdrawn by check from the plan owner's Traditional IRA must be timely deposited to the surviving spouse's Traditional IRA (or one created for that purpose), and a Roth withdrawal must be timely deposited to the spouse's Roth IRA to retain its tax free status.

Other actions taken (or not taken) may cause the IRA to be treated as the surviving spouse's IRA. The failure of the surviving spouse to take a required minimum distribution, or the surviving spouse contributing to the IRA, will each cause the IRS to treat the IRA as having been transferred to the surviving spouse's IRA.

Once transferred into his or her own IRA, the spousal/beneficiary is then treated as the plan owner, and the usual plan owner requirements apply. For instance, the spouse uses the plan owner's table (Exhibit A) to compute the annual required distribution based upon that surviving spouse's age. The required distribution is almost always lower as a plan owner than as an IRA inheritor if the deceased spouse was over 70 1/2 on his date of death.

But as a plan owner, the 10% penalty will usually apply if the surviving spouse makes withdrawals prior to such spousal/beneficiary attaining 59 1/2 years of age. If the decedent's IRA was a Roth IRA, then if the surviving spouse treats it as his or her own, there would be no required minimum distributions during that surviving spouse's lifetime.

A Young Surviving Spouse? If the surviving spouse/beneficiary is under 59 years of age, and it appears that he or she may need to make withdrawals from the traditional IRA to live on prior to attaining 59 1/2 years of age, such spousal/beneficiary may wish to consider treating the IRA as an inherited IRA to avoid such 10% penalty.

The regulations provide that a surviving spouse/beneficiary can treat an IRA as his or hers at any time. Therefore, upon attaining 59 1/2 years of age, the surviving spouse can then roll any remaining IRA balance into his or her own IRA.

If the Deceased Spouse has not yet attained 70 1/2 years of age: A surviving spouse can always treat the IRA as an inherited IRA. As a surviving spouse/beneficiary of an inherited IRA, distributions are not required until the end of the year in which the deceased spouse would have attained 70 1/2 years of age.

Also, the required minimum distribution is calculated differently than for a non-spousal inherited IRA beneficiary. Required minimum distributions are calculated by going back to the Uniform Lifetime table (Exhibit A) each year and using the factor based upon the surviving spouse attained age in that year.

Usually, but not always, it is advantageous to treat the inherited IRA as the surviving spouse's own at that time. One of the reasons for this is if the surviving spouse dies having an inherited IRA, that surviving spouse's beneficiaries (the children?) are required to use the surviving spouse's life expectancy in calculating their required minimum distributions.

If the surviving spouse had treated the IRA as his or her own, then the children could use their life expectancies in calculating their required minimum distributions.

Example: Harry is age 72 when his wife, age 65, dies. If Harry treats the IRA as his own, then required minimum distributions on that IRA will commence in the following year based upon his life expectancy. But if Harry treats it as an inherited IRA, then the required minimum distributions would not begin until about

five years later, at which time Harry could then treat the IRA as his own and calculate the required distributions based upon his life expectancy using the plan owner's table.
If Harry dies after such conversion, then the beneficiaries may be able to use their own life expectancies, and not Harry's life expectancy, in calculating the required minimum distributions.

What if the Beneficiary is an Estate? This can occur in a number of situations: (1) the plan owner failed to name a beneficiary, which under most plans defaults to the plan owner's estate; (2) the plan owner actually named "My Estate" as a beneficiary; or (3) there is no surviving named beneficiary (example: John named his wife and no contingent beneficiary, and his wife predeceased him.)

If the estate is the beneficiary, then the IRA must be withdrawn under the 5-year/life-expectancy rule discussed above. Many executors of estates typically want to close out the estate as soon as possible and might withdraw the IRA even faster.

Unless the IRA is quite small, the executor might wish to at least consider withdrawing one-half shortly after the plan owner's death, and the remaining half in the first month of the following taxable year (usually January, although an estate can elect any month as the end of its tax year.)

There is one exception: In several private letter rulings, the IRS has permitted a surviving spouse to roll over distributions from an IRA payable to the owner's estate, because the surviving spouse was the executor and only beneficiary with total control over the funds and their disposition. The IRA is liquidated into the estate, a check is issued by the estate to the surviving spouse, who then deposits it to that surviving spouse's IRA, all within 60 days.

What if the IRA Beneficiary is a Trust? The general rule is that a trust is treated as an estate. Neither a trust, nor an estate, can be treated as an individual beneficiary. That means the five-year/life-expectancy rule applies.

However, the beneficiaries of a trust will be treated as the individual beneficiaries (and not the trust) for purposes of determining required minimum distributions after the plan owner's death if ALL the following are true:

- The trust is a valid trust under state law, or would be, but for the fact that there is no corpus.
- The trust is irrevocable or became irrevocable on the owner's death.
- The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the owner's benefit are identifiable from the trust instrument.
- The trustee of the trust provides the IRA custodian or trustee with the documentation required by that custodian or trustee.

The trustee of the trust should contact the IRA custodian or trustee for details on the documentation required for a specific plan, which is typically a copy of the trust as well as information regarding the individual beneficiaries. The deadline for the trustee to provide the beneficiary documentation to the IRA custodian or trustee is October 31 of the year following the year of the owner's death.

Even then, the required minimum distribution is calculated based upon the life expectancy of the oldest trust beneficiary. If the trust names your children and your father as beneficiaries, the trust will be required to use your father's life expectancy.

The separate share rule, discussed earlier, cannot be used by beneficiaries of a trust in calculating the required minimum distributions, even though the IRS permits the IRA to be divided into separate shares for each trust beneficiary. In effect, all trust beneficiaries will have their required minimum distributions based upon your father's life expectancy.

For that reason, we seldom recommend that a trust be named as a beneficiary, though sometimes we will recommend that the separate shares for each beneficiary be named as discussed below.

What if a Trust Beneficiary is Another Trust? If the beneficiary of the trust (which is the beneficiary of the IRA) is another trust and both trusts meet the above requirements, the beneficiaries of the other trust will also be treated as one of the "designated beneficiaries" for purposes of determining the distribution period.

For example, under her father's living trust, the trust share for Sara is not to be distributed outright to her but is to be held in trust until she is 30 years of age. On September 30 of the calendar year following the plan owner's death, Sara is 28 years of age.

If the contingent beneficiary (that is, if Sara were to die on that September 30 date) is her 60 year old uncle, then both Sara and the uncle will be treated as trust beneficiaries for the purposes of determining the beneficiary with the shortest life expectancy. In this situation, the IRA payable to the trust would have to be withdrawn based upon the uncle's life expectancy and not Sara's life expectancy.

But if the contingent beneficiary were the American Cancer Society, then that entity would be treated as one of the beneficiaries, and, because it is an entity, the IRA which is payable to the trust would have to be liquidated under the 5 year/life expectancy rule discussed above.
This result would negatively affect not only the trust share for Sara but would also affect the shares of the other trust beneficiaries whose shares may be distributed outright to them and not held in trust.

The Conduit Trust: There is an exception for a "pass-through trust", sometimes called a "conduit trust." Assume in the above example that Sara's trust share stated that any IRA withdrawals were required to be immediately distributed to Sara and not accumulated in the trust. If her trust share contained that provision, then the contingent beneficiary (The American Cancer Society) could be ignored. Note that a trust requirement to "distribute all of the trust income to Sara" is NOT the same as requiring all IRA withdrawals to be distributed. This is because trust law does not treat all TAXABLE income as trust income.

For instance, IRA withdrawals or cash flow from depleting resources, such as oil and gas, are often treated as 10% income, 90% principal for trust accounting purposes under state law. So even if all the taxable income is distributed to Sara, the IRS requirement is not met because such distribution is not mandated by the controlling document (the trust).

What if the Separate Trust Shares are named on the Beneficiary Designation Form on file with the IRA Custodian? If the individual shares under the trust are named, then each share is treated separately, thus perhaps avoiding accelerated distributions caused by an older beneficiary.

For example, assume the IRA custodian's beneficiary designation read 50% to the trust share for my son George under the Jones Trust, and 50% to the trust share for the benefit of George's daughter Leslie under the Jones Trust. Assume both shares either require outright distribution, or, if held in trust, contain the conduit provision discussed above. The trust share for the benefit of Leslie could be withdrawn based upon Leslie's life expectancy and George's share based upon his life expectancy.

But if Leslie's share is to be held in trust without those conduit provisions, then the life expectancy of the contingent beneficiary would have to be considered in calculating the required minimum distributions with respect to her trust's share of the IRA.

For example, if the contingent beneficiary were her older brother George, then her share of the IRA would have to use his life expectancy; if the contingent beneficiary were the American Cancer Society, then her share of the IRA would have to be withdrawn under the 5 year/life expectancy rule. But because the separate trust shares were named as the IRA beneficiaries, the contingent beneficiary of her share would not be used in calculating the required minimum distributions for George's share.

If a Trust or Estate is the named as the IRA beneficiary, you may want to contact a knowledgeable tax advisor to comply with this complicated area of the tax law.

Will the IRA be taxed in the Estate or the Trust, or to the Estate or Trust Beneficiaries? Taxation of trusts and estates is complex, but here are a few of the general principles. Withdrawals from a Traditional IRA by an estate or trust will be reported on the estate or trust tax return (IRS Form 1041) as income. Taxable income, to the extent of distributions made during the taxable year, are taxed to the beneficiaries, and the estate or trust receives a deduction from its taxable income on its income tax return.

The trust or estate annually files an IRS Form 1041 with a Schedule K-1 for each beneficiary. K-1s are similar to Form 1099's, are furnished to the IRS and the beneficiary, and require the beneficiary to report that share of taxable income on that beneficiary's own tax return. To the extent not distributed to the beneficiaries, the taxable income is likely to be taxed at higher rates than the beneficiaries' marginal tax rates. The top tax bracket for trusts and estates is 37% and applies to income over approximately $12,950 (2020).

Beneficiaries are subject to that highest income tax rate only if their income exceeds $400,000. The 3.8% Obamacare investment income tax does not apply to IRA withdrawals but may cause other income in the trust or of the beneficiary to be subject to that tax. A trust or estate can elect to have any distributions made during the first 65 days of the year treated as having been made in the prior tax year. Beneficiaries should be aware that although estate distributions are generally income tax free, that is not true to the extent of income received from IRAs and certain other assets. Accordingly, beneficiaries should consider the need to make quarterly estimated income tax payments to avoid IRS and state penalties for under withholding.

Example: The estate elects a calendar year as its fiscal year. The executor liquidates a $200,000 Traditional IRA in December 2018 but does not make any distributions to the beneficiaries until March 15, 2019. The $200,000 IRA is taxed to the trust almost entirely at 37% in 2018, assuming no other estate distributions had been made to beneficiaries in 2018. Had the IRA been liquidated in January of 2019, instead of December of 2018, the IRA would have been taxable to the beneficiaries at their individual tax rates - probably at 12% to 22%, potentially saving $40,000 or more in income taxes.

Worse yet, assume that the IRA was the only asset of the estate. When the executor prepares the 2018 tax return, he discovers that the estate owes approximately $80,000 in taxes, but the executor has no money left in the estate. The executor is personally liable to the IRS for this tax and may have great difficulty in getting the beneficiaries to return their portion of the taxes payable.

As you can see, when a trust or estate is the named beneficiary, both the calculation of the required minimum distributions and the taxation are quite complex, and it is suggested that competent legal and tax advice be sought.

As you can see, when a trust or estate is the named beneficiary, both the calculation of the required minimum distributions and the taxation are quite complex, and it is suggested that competent legal and tax advice be sought. Also, you might find IRA Publications 590 (on IRAs) and Publication 559 (for Survivors and Executors) helpful, but unfortunately these publications do not always incorporate the many private letter rulings and other IRS regulations and court decisions involving this area of the tax law, and may not have been updated for changes required under by the SECURE Act.

Wait to complete your tax return: If a trust or estate is the named beneficiary of the IRA, then you are a beneficiary of the trust or estate, you should be aware that you usually are unable to complete your own individual tax returns until the trust or estate tax return has been prepared and you receive your Form K-1 as described above. If you file your return in January, and then receive a K-1 in late March, you will likely have to file an amended tax return (and pay the tax due) by April 15 to avoid a tax penalty.

If the Decedent had a Taxable Estate: IRAs are includible in the taxable estate for federal estate tax purposes of the deceased plan owner. Once inherited, they are also includible in the taxable estate of the beneficiary. An IRA beneficiary (even a contingent beneficiary) is entitled to a federal income tax deduction for the federal estate tax attributable to the inclusion of the IRA in the prior owners' taxable estate, and at the incremental tax rate (40%).

If your decedent's estate was subject to estate taxes, have the accountant provide the necessary information to you to take this deduction as the IRA account is withdrawn.

Common Law Spouses: Colorado is one of the few states that still recognizes common law marriages. If the deceased plan owner which names you as a beneficiary may involve a common law marriage situation, you should discuss that aspect with your legal counsel.

Asset Protection: The federal bankruptcy code generally protects IRAs and other plans if the plan owner files for bankruptcy or, under many state laws, if the plan owner is sued. What about inherited IRAs? The U.S. Supreme Court recently decided this issue and found that inherited IRAs were not quite like a plan owner's IRA, and thus are NOT protected from the beneficiary's creditors in bankruptcy. Plan owners who consider leaving IRAs to asset protection trusts need to balance the need for asset protection against the potentially higher trust income tax rates.

Example: Stacy's father named her as the beneficiary of his IRA. Shortly before he died, she filed for bankruptcy. The bankruptcy trustee obtained a court order that the IRA custodian pay the proceeds to the bankruptcy court. Had Stacy's share been left in an asset protection trust, the IRA could have been protected and used to help Stacy with her living expenses over many years. There is even court precedent that Stacy could serve as trustee of such trust and still enjoy the asset protection aspect. Thus, the plan owner can do something for you that you cannot do for yourself.

If the plan owner is already deceased, it is probably too late to make any changes. But if you are a beneficiary and the plan owner is still living, and asset protection is important to you, consider having the plan owner change his estate plan to leave your inheritance, including any IRAs, in trust for your benefit.

If the plan owner makes the proper changes to his or her estate plan and beneficiary designations, your inheritance can be protected from creditors, predators (divorcing spouses), lawsuits, and the bankruptcy court. The plan owner should discuss this type of planning with his or her estate planning attorney.

======================================

Just a reminder: As discussed at the beginning of this handbook, the required minimum distributions discussed above for non-spousal beneficiaries have been significantly changed by the SECURE Act. With respect to plan owners dying after 2019, most beneficiaries have no annual required withdrawals but must withdraw the entire account by the end of the tenth year following the death of the plan owner. Although the "life expectancy" payout has been repealed for most non-spousal beneficiaries, such as children, there are still significant income tax planning and income deferral planning opportunities during said ten-year period.

For instance, Sally inherited her father's IRA upon his death in 2020. Sally plans to retire in four years, so she decides to postpone any withdrawals until she retires, and then make withdrawals over the remaining six-year period. Meanwhile, the account grows on a tax deferred basis, and Sally's plan will result in most of the later withdrawals being taxed in lower tax brackets.

======================================

Conclusion: We hope this guide will assist you in obtaining the greatest value from your inherited IRA and help you avoid some of the costly pitfalls made by many IRA beneficiaries. Various plans may have specific provisions which differ from the general principles discussed above. Keep in mind that both tax laws and regulations regarding IRAs change frequently and this guide is not intended to give specific legal or tax advice. This guide is intended to be just that - A guide to alert you to the advantages and some of the pitfalls we have observed. As a law firm specializing in probate and trust administration, we would be pleased to meet with you to discuss any questions you may have after reading this publication.