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I cover personal finance for baby boomers.

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Five Rules For Inherited IRAs

Before they inherited $3 million in retirement accounts from their father last year, the three middle-aged siblings didn't know it was possible for heirs to stretch out the tax benefits of such accounts for decades. But what they also discovered after his death is that doing this is tricky–and in some cases impossible–if the original owner of the accounts didn't fill out his beneficiary forms just so. Although their 78-year-old dad was a lawyer, "He may never have realized that it made any difference," says a daughter, who has spent days trying to sort it all out.

Whether you're inheriting an IRA or aiming to protect your own heirs, you've got to dance the IRS jig.

1. First, do no harm.

If you inherit a retirement account, don't do anything until you know exactly what rules apply. With your own IRA you can take the money out and redeposit it in another IRA within 60 days without penalty. Not so an inherited IRA. All movement of money must be from one IRA custodian to another–be sure to specify a "trustee-to-trustee" transfer. Moreover, unless you've inherited from a spouse, you must retitle the IRA, including the original owner's name and indicating it is inherited, e.g., "Daddy Warbucks, deceased, inherited IRA for the benefit of Little Orphan Annie, beneficiary."

If two or more people are named as beneficiaries, ask the custodian to split it into separate inherited IRAs. That avoids investment squabbles and allows a longer stretch-out for the younger heirs.

2. Beneficiary forms rule.

The beneficiary form on file with the custodian of an IRA controls both who inherits it and its ability to be stretched out. If people other than a spouse are named as heirs, they must begin taking distributions from the account by Dec. 31 of the year after inheriting, but they can draw these out over their own expected life spans, enjoying decades of income-tax-deferred growth in a traditional IRA or tax-free growth in a Roth IRA. To give your heirs maximum flexibility, name both primary and alternate individual beneficiaries–say, your spouse as primary and kids as alternates or your kids as primary and grandkids as alternates. Your primary beneficiary then has the option of "disclaiming" or turning down the account, enabling it to pass to the younger alternate.

By contrast, if an estate is named as beneficiary, tax deferral is cut short. If it's a Roth IRA, all funds must be withdrawn within five years. For a traditional IRA the same rule applies unless the former owner was already 70 1/2–the age at which a traditional IRA owner must begin cashing out. In that case the distribution rate for the heir is based on the age of the person who died, notes Rockville Centre, N.Y. CPA Edward Slott.

What if there's no beneficiary form on file? Heirs are at the mercy of the IRA custodian's default policy. Vanguard Group and Ameriprise award an IRA first to a living spouse and then to the estate. Merrill Lynch sends it straight to the estate. Few custodians will pass on an IRA directly to the kids without a beneficiary form.

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3. Employer plans are different.

By federal law the money in a 401(k) goes to a spouse, unless he or she has signed a form waiving rights to it. But some employer plans will allow the funds to go straight to the kids if no spouse is living and no beneficiary form is on file. On the other hand, employers usually won't let nonspouse beneficiaries stretch out 401(k) withdrawals. These beneficiaries should ask the employer to transfer the money into an inherited IRA. They can then divide it into separate inherited iras, says Natalie B. Choate, a lawyer with Nutter McClennen & Fish in Boston.

4. Spouses have more options.

A spouse who inherits–let's assume it's the wife–has an option not available to other inheritors. She can roll the assets into her own IRA and postpone distributions from a traditional IRA until she turns 70 1/2. The catch is, like other IRA owners she may have to pay a 10% early-withdrawal penalty if she takes money before age 59 1/2 from her own IRA. So a young widow should generally wait until after reaching 59 1/2 to do the rollover, says Brooklyn, N.Y. CPA Barry C. Picker. Meanwhile, she doesn't have to take out any money until her late spouse would have turned 70 1/2.

5. Watch for distribution traps.

If the late IRA owner was 70 1/2 or older, beneficiaries must make sure the owner's mandatory distribution for the year of death is withdrawn before doing anything else. When nonspouse beneficiaries take their own payouts, they should be aware of two quirks. First, if the estate paid estate tax, they may be able to take an itemized deduction to offset some IRA income. Second, the minimum is calculated differently than for your own IRA. You take the balance on Dec. 31 of the previous year and divide it by your life expectancy listed in the IRS' "single life expectancy" table, rather than the table used by IRA owners. The next year you use the same life expectancy, minus a year. (With your own IRA, you take a new life expectancy from a table each year.)

Deborah L. Jacobs, a lawyer and journalist, is the author of Estate Planning Smarts: A Practical, User-Friendly, Action-Oriented Guide (DJWorking Unlimited, 2009). To learn more, visit estateplanningsmarts.com.

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