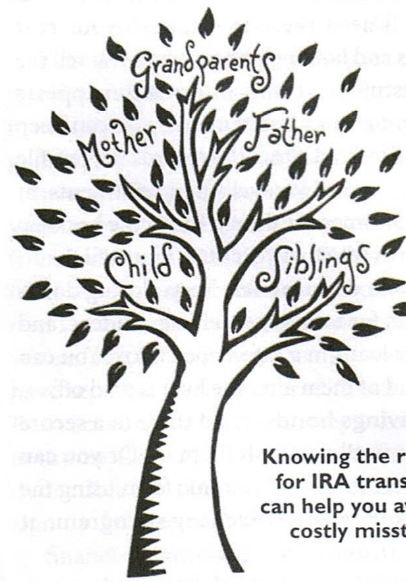
# How to handle an inherited IRA

## If the transfer is managed properly, much of the account's earnings can continue to grow on a tax-deferred basis.




**Knowing the rules for IRA transfers can help you avoid costly missteps.**

**When you inherit an IRA,** you get more than money. Often, you also inherit the opportunity to continue to shelter much of the earnings on that money from income tax. But the rules are complex, and missteps can result in large tax bills and possible penalties. Here's what you need to know to make the right choices.

If you inherit an individual retirement account (traditional or Roth) from your spouse, you can roll it over into your own IRA, name new beneficiaries, and continue the tax deferral. If it's a Roth IRA, which is funded by after-tax dollars and pays out tax-free income if all the requirements are met, you can choose whether or not to take distributions. You're not required to empty the account, which you can pass on to your own beneficiaries when you die. If it's a traditional IRA, you'll need to begin to take required minimum distributions (RMDs) and pay income taxes on them once you reach age 70½.

### NON-SPOUSE BENEFICIARIES

If you're not the surviving spouse of the IRA owner, different rules apply. When you inherit a Roth IRA, you have to take RMDs but you won't owe federal income tax on them as long as it has been five years or longer since the Roth IRA was created.

More likely you will inherit a traditional IRA. Then you'll also have to take RMDs and pay income tax on them. If you're younger than 59½, you won't be subject to the 10 percent early-withdrawal penalty.

RMDs generally must begin in the calendar year after the year of the IRA owner's death, but some beneficiaries may have to take one even sooner. "If the decedent was already subject to RMDs during his life, the beneficiary also has to take out any balance of the year-of-death RMD that the decedent had not yet taken when he died," says Natalie Choate, an attorney with Nutter McClennen & Fish in Boston.

The RMD amounts are determined by IRS tables, which you can find in Publication 590, "Individual Retirement Arrangements (IRAs)." If you take out less than the required amount you'll owe a 50 percent tax on the shortfall. Suppose your RMD for 2010 is $10,000. If you withdraw, say, $3,000, you will be $7,000 below the requirement, so you'll owe a $3,500 penalty tax. Of course, you can take more than the required amount.

### HOW MUCH IS TAXABLE

If the original owner had after-tax money from nondeductible contributions in a traditional IRA, "that would come out tax-free," Choate says. Say you inherit a traditional IRA worth $100,000. The decedent had filed Form 8606, attached to his last income-tax return, showing $12,000 in total after-tax contributions. That's 12 percent of the account, so your first withdrawal would be 88 percent taxable and 12 percent tax-free.

"The fraction changes each year," Choate says. Keep track of after-tax dollars left in the account. The ratio of pre-tax to after-tax dollars determines the taxable portion of subsequent withdrawals.

### IN WHOSE NAME?

Proper titling of an inherited IRA is essential, says Michelle Ward, an attorney and senior consultant with Baker Tilly Virchow Krause, an accounting firm in Appleton, Wis. For example, suppose you're a surviving spouse under age 59½. If you roll your spouse's IRA into your own existing or new IRA but find you need to take distributions for living expenses, those payouts will likely be subject to the 10 percent penalty. But if you keep the IRA in your late spouse's name, you can take distributions right away with no penalty. Once you reach 59½, you can roll the IRA into one in your own name, letting you designate your own beneficiaries.

If you inherit an IRA from someone other than a spouse, you can't roll over the account to your own IRA, but you should retitle it to maximize the tax deferral. If you don't retitle the account, you'll have to continue taking RMDs on the original owner's schedule.

Suppose, for example, Jim Green inherits an IRA from his father, Ken Green. That account might be retitled to an IRA in the name of "Ken Green (deceased) for the benefit of (f/b/o) Jim Green." If Ken dies in 2010, the retitling should be done by Dec. 31, 2011. Then Jim can stretch RMDs over his remaining life expectancy, as determined by the IRS's Single Life Expectancy Table, For Use By Beneficiaries. (To find the table, go to *www.irs.gov/pub/irs-pdf/p590.pdf* and turn to page 94.)

If Jim is 58 years old when RMDs begin, the table will put his life expectancy at 27 years. So Jim must withdraw at least 1/27th of the balance that was in the account at the end of the preceding year (2010 in this example). If the Dec. 31, 2010, account balance is $200,000, for instance, Jim must withdraw at least $7,408 in 2011. In 2012, he will have to withdraw at least 1/26th of the year-end 2011 balance, and so on, for the next 25 years. The IRA custodian, the financial firm holding the account, should be able to make the RMD calculation.

What if Jim simply transfers his father's IRA into a "Jim Green" IRA? That would be a distribution with disastrous results. The entire amount would be immediately taxable to Jim and he would owe a penalty tax of 6 percent each year he kept an "excess contribution" in his own IRA. An excess contribution is the amount above the maximum contribution allowed, $5,000 in 2010 ($6,000 if you're over 50).

## MULTIPLE BENEFICIARIES

Different issues arise when an IRA is left to more than one beneficiary. Suppose, for example, that Ann Black dies in 2010. Ann has named her two children (Chris and Diane) as equal IRA beneficiaries. Chris will be 58 in 2011 and Diane will be 48.

By Dec. 31, 2011, Chris and Diane can each establish separate accounts. That is, 50 percent of the money could be transferred to an IRA in the name of "Ann Black (deceased) for the benefit of (f/b/o) Chris Black." The other half could be transferred into an IRA titled "Ann Black (deceased) for the benefit of (f/b/o) Diane White."

With this plan, Chris must use his 27-year life expectancy for RMDs, while Diane can use a 36-year life expectancy, thus enjoying more potential tax deferral. If they miss the Dec. 31 deadline, Diane will be required to take RMDs according to the 27-year life expectancy of Chris.

In some cases, the IRA owner names a trust as the beneficiary, with one or more people named as trust beneficiaries. In essence, distributions go from the IRA to the trust; then the money can be distributed to the trust beneficiaries. This arrangement puts control of the IRA assets in the hands of the trustee, not individual beneficiaries.

For the trust beneficiaries, it's important to avoid transferring the entire IRA into the trust at the death of the IRA owner. Such a transfer would immediately trigger all the deferred income tax. Instead, the account can be retitled to continue tax deferral. Using the Black family example above, the IRA could be retitled as "Ann Black (deceased) for the benefit of (f/b/o) the Chris Black and Diane White Trust," says Michael J. Jones, a partner in the accounting firm Thompson Jones, in Monterey, Calif. Then the IRA will remain outside of the trust and income tax will not be triggered. The IRA custodian must be provided with information about the trust by Oct. 31 of the year following the IRA owner's death.

Assuming the trust is irrevocable and valid under state law, RMDs can be stretched over the life expectancy of the oldest trust beneficiary. If the IRA remains outside of the trust, the trustee will move at least the RMD amount from the IRA into the trust each year, and then either distribute the funds to the beneficiaries or retain the money in the trust, as indicated by the language of the trust. $