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Pitfalls of Inherited IRAs

If you needed a reminder of just how byzantine the rules are that govern inherited IRAs—and the importance of preparing your family for receiving such an account—the IRS just handed you one.

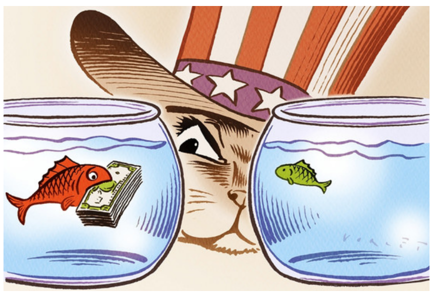
Illustration by Christophe Vorlet

In a surprising move, the agency recently gave a teenager who inherited her father's retirement account permission to undo a lump-sum distribution by her mother and transfer the money into an inherited IRA.

The so-called private-letter ruling was unusual: The Internal Revenue Service rarely allows tax-deferred retirement assets that someone has inherited and withdrawn as a lump sum to later be put into an inherited individual retirement account.

To be sure, a private-letter ruling applies only to the taxpayers who ask for it. It includes few specifics, such as names or dollar amounts, and doesn't set a precedent.

Still, the ruling serves as a reminder to parents who have stashed most of their savings in retirement accounts—and the guardians of children who inherit them—that they should take special precautions to make sure those children get the most from their inheritance.

If you are the guardian of a child who inherits such an account, you should consider moving the assets into an inherited IRA for the child rather than simply withdrawing the money and paying a sizable chunk of the inheritance in taxes upfront, says William Schmidt, an estate-planning attorney at Schmidt & Federico in Boston.

Parents—especially those who are single, divorced or remarried—might want to set up a "see-through" trust to protect an inherited IRA's assets and handle annual distributions, says **Bobbi Bierhals**, a partner at **McDermott Will & Emery** in Chicago. With young children, it generally makes sense to wait to make those distributions available at an older age, and to let the trustee use them to help pay for the child's upbringing.

Even if you don't expect anyone in your family to tamper with your plans, inheriting an IRA is much more complicated than you might expect. Here are some ways to handle it smoothly.

Think before you liquidate. Leo Casper, a certified public accountant in Moorestown, N.J., meets with his clients' adult children to show them how much more valuable an inherited IRA could be by leaving it intact and taking annual withdrawals, rather than liquidating it and paying taxes right away.

If you inherit a $100,000 IRA at age 40, "it can easily grow into three, four, five times the amount that was inherited," he says. By contrast, opting for the cash could leave you with only a $60,000 inheritance after taxes.

Move, and retitle, the account correctly. If you inherit an IRA from anyone other than your husband or wife, you can't roll it over into your own IRA. Instead, you have to retitle the IRA so it is clear the owner died and you are the beneficiary. Mr. Casper suggests using this format: "Robert Jones, Deceased (date of death), IRA F/B/O (for benefit of) William Jones, Beneficiary."

If you are moving the account to a new IRA custodian, make sure you do a direct "trustee to trustee" transfer. If the check is made out to you, and you are anyone other than the surviving spouse, the IRS will consider it a "total distribution" subject to tax, effectively ending the IRA.

Meet the deadlines. If the IRA owner dies after 70½, when required withdrawals start, and didn't yet take a withdrawal for that year, the heir must do so by Dec. 31 of the same year, Mr. Casper says. Those who miss the deadline are subject to a 50% penalty on the amount that should have been withdrawn.

The deadline for taking the first required withdrawal from the inherited account is Dec. 31 of the year following the year of the owner's death.

Do the right math. With an inherited IRA, you have the chance to spread distributions across your life expectancy—a big advantage if you have decades left to live. That way, the bulk of the account can increase in value while taxes are deferred.

But you might not realize that the way you have to calculate the minimum IRA withdrawal amount is different from the way retirees calculate required distributions from their own accounts, says Jay Starkman, a certified public accountant in Atlanta.

First, look up your life expectancy on the table in IRS Publication 590 at www.irs.gov. Each year, subtract a year from your initial life expectancy to figure out how much to withdraw. Most IRA custodians will calculate it for you—but you need to make sure they are doing the right math for an inherited account.

Check the code. When you get your 1099 form, which reports distributions you receive, make sure that it includes "Code 4," Mr. Starkman says—the code used to show that it is a distribution on account of death.

Keep your own copy of the beneficiary form. Mr. Starkman nearly missed the deadline for the first required distribution after inheriting his mother's IRA. The reason: It took the IRA custodian more than a year to find the paperwork showing he had been named the beneficiary.

Know the Roth rules. Yes, there are no required minimum distributions for owners of Roth IRAs. But heirs to such accounts are required every year to withdraw a minimum amount specified by the IRS or pay a 50% penalty, Mr. Starkman says.

Still, there is some good news: No tax is due on those required withdrawals.

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