



INHERITED IRA

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We are finding that a number of clients are inheriting IRAs from their parents or spouses which bring up a multitude of issues to consider. This article is meant to be a general overview and does not include many exceptions and details. If you have tax or legal questions you should seek professional counsel for your particular situation.

WHAT TYPE OF IRA DID YOU INHERIT?

The first thing to consider is the type of IRA you inherited. Most people inherit traditional IRAs but more and more Roth IRAs are now being passed on. If you inherited a traditional IRA, then any distributions will be taxable to you as the beneficiary. A Roth IRA must remain in existence at least 5 years before the distributions can be tax free, even if it is inherited. Tax rules for Roth IRAs are different than for traditional. The rest of this article will discuss only the traditional IRA.

ARE YOU THE SPOUSE OF THE DECEDENT?

Spouses have a special status when inheriting an entire IRA (must be sole beneficiary). They are the only ones who can treat the funds as their own and either roll the money over to an existing IRA or set up a new separate IRA. In either case the spouse must follow the same rules as any owner (e.g. deferral until 70 ½, penalty free withdrawals after 59 ½, etc). All other beneficiaries must set up a separate inherited IRA and the distributions must generally begin by the end of the year following the owner's death. One can take the entire amount if desired, take it over 5 years (only in some cases) or defer longer and take annual distributions. The deferred distributions are based on the life expectancy of the beneficiary and referred to as a "Stretch IRA" because distributions can be "stretched" out over what is usually a longer life expectancy than that of the original owner.

For example, a 45 year old son inherits an IRA from his deceased father aged 75. While the father had to distribute funds based on his life expectancy of 21.8 years, his son could defer much more by stretching out distributions over his life expectancy of 38.8 years. These life expectancies are based on a uniform table put out by the IRS

(see IRS Publication 590 <http://www.irs.gov/pub/irs-pdf/p590.pdf>). Although the son is younger than 59 ½, there is no early withdrawal penalty for him to pay because he inherited the IRA.

INCOME TAXES DUE UPON DISTRIBUTIONS, ESTATE TAX?

Many people are surprised to learn that distributions from an inherited IRA are taxable to the beneficiary and such distributions generally must commence no later than the end of the year following the owner's death (unless you are a spouse and elect to treat it as your own, as mentioned above). Unlike most other inherited assets that get a step up in basis at the owner's death, an inherited IRA (and other tax deferred accounts



like 401(k), deferred compensation, etc) does not enjoy this benefit. Any distribution is taxable to the beneficiary at that time. Moreover, if you fail to take the required minimum distribution there is a 50% penalty. Some older adult children who inherit IRA's from their parents find they are receiving income at high income tax brackets when the funds could be better shifted to their children who may be in a lower tax bracket. Moreover, these same adult children may then have an estate tax problem due to the IRA also becoming part of their taxable estate.

WHAT IF YOU DON'T NEED THE MONEY?

In cases where children who have no need for the assets inherit an IRA from their parents and the inheritance creates an estate or income tax planning problem, a solution may be to have the assets go directly to their children (the owner's grandchildren). This can be accomplished only by advanced planning while the owner is still living. The owner should name the child as the primary beneficiary and then list the grandchildren as

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contingent beneficiaries. When the owner dies, the owner's child can disclaim some or all in favor of the contingent beneficiaries (the grandchildren) and skip a generation. This will generally result in income being taxed at the lower rate of the younger beneficiaries over a much longer deferral period and the assets being removed from the parent's estate. Care should be taken however since "kiddie tax" could apply.

In the example above, the 45 year old beneficiary has to take distributions over 38.8 years, but if he disclaimed it in favor of his 20 year old son, the son would have 63 years to take distributions for a greater deferral benefit. The key to this solution is the owner needs to specify contingent beneficiaries in addition to primary beneficiaries. If the primary beneficiary disclaims some or all of the IRA, then the disclaimed portion will go to the contingent beneficiary. A disclaimer must be generally made within 9 months of the original transfer and several formal steps must be strictly followed. If the disclaimant is under 21 then the 9 month date starts after reaching age 21.

HOW DO YOU SET UP AN INHERITED IRA?

If you inherit an IRA and are not the spouse who treats it as his or her own, then you must set up a separate IRA account, titling it as an inherited account. You cannot roll an inherited account into any other existing IRA account. Each inherited account must be separately maintained. Nor can you make new contributions to the inherited IRA account. The inherited IRA must be established by the end of the year following the death of the owner.

RULES ARE COMPLICATED

The rules covering inherited IRA's are complex and have numerous traps for the unwary. The best advice to a current IRA owner or one inheriting an IRA is to consult a financial planner or tax professional. The IRA owner should make sure

that proper beneficiaries are listed (both primary and contingent), and the one beneficiary should choose the distribution elections and/or disclaimers that best fit his or her personal situation in a timely manner.

VANTAGE NEWS

The Vantage team has grown rapidly over the past several years. While we celebrate our newest member this week, we must also announce that Vantage is losing a valued member of our team.

When Neil Dinndorf announced his engagement this spring, it was our hope he and Lisa would take up roots in Chicago. But after much thought Neil has decided to return home to Madison, WI, where Lisa is teaching, to work with a local financial planning firm. He will be leaving Vantage on Aug 13th. We are sorry to see him go, but wish him well with this new chapter in his life.

Jonathan Stano, our newest team member graduated from Central Michigan University this year with a degree in financial planning. He also interned last year for an LPL-affiliated firm in Michigan and is therefore familiar with many of our processes. We are glad to have him aboard!

Speaking of boarding (sort of), the Vantage crew (8 of us anyway) took to the open sea (well, actually Lake Michigan) on a sail boat this month.



Michael (Rohrwasser) won a 4 hour excursion as a high bidder at the Palatine Rotary fundraising event. While we tried to keep our minds off of what happened to Gilligan and his crew on a 3 hour tour we embarked on the great adventure. Captain Olaf..., a seasoned sailor had to deal with a largely unseasoned crew, but we had a great time riding the waves and certainly enjoyed a beautiful view of the city. Wish you had been with us, especially if you knew the difference between the Starboard and Port sides of the boat!

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