Inheriting an IRA: Planning techniques for primary beneficiaries

by Marsha A. Goetting, Ph.D., CFP®, CFCS, Professor and Extension Family Economics Specialist, Montana State University-Bozeman; Kristen G. Juras, Esq. and Adjunct Professor, School of Law, University of Montana-Missoula

MONTANA STATE UNIVERSITY EXTENSION SERVICE
MONTGUIDE
MT200310 HR issued 9/03

When an IRA owner dies, the account balance is distributed to the owner's beneficiaries according to certain rules. In many cases, beneficiaries can use planning techniques—even after the owner's death—to minimize taxes on the IRA.

Individual Retirement Accounts (IRAs) are tax-advantaged savings plans available to people who meet certain eligibility requirements. IRA contributions are placed in custodial accounts at financial institutions, insurance companies, mutual funds or investment brokerage firms.

IRA owners who withdraw money from their traditional IRAs during a tax year should consider the tax implications. Different tax consequences apply depending upon the IRA owner's age—under $59^1/_2$, between ages $59^1/_2$ and $70^1/_2$, or over $70^1/_2$. Other regulations govern the taxation of withdrawals made by beneficiaries after an IRA owner's death.

This MontGuide focuses on the rules about withdrawals from IRAs after the owner dies. It provides several planning techniques for beneficiaries who inherit IRAs. The MontGuide incorporates regulations generally effective Jan. 1, 2003, as a result of the Economic Growth and Tax Relief Reconciliation Act of 2001. Three other MontGuides discuss withdrawals from IRAs:

1. Withdrawals from IRAs when owner is under age $59^1/_2$ (MT200308 HR)
2. Withdrawals from IRAs when owner is between ages $59^1/_2$ and $70^1/_2$, and when owner turns $70^1/_2$ (MT200309 HR)
3. Inheriting an IRA: Planning techniques for successor beneficiaries (MT200311 HR)

Although this MontGuide focuses on the taxation of withdrawals from IRAs, the required minimum distribution rules also apply in general to other IRS qualified retirement plans, such as stock bonus, pension and profit-sharing plans, 401(k) plans, 403(b) annuity contracts or custodial accounts, and 457(d) deferred compensation plans.

Finally, ***review the terms of your qualified plan or your IRA contract***; as those terms may vary from the rules discussed in this MontGuide. Congress changes retirement laws frequently, so view this publication as a general guide.

Required minimum distributions (RMD) after an IRA owner dies

If an IRA owner dies before withdrawing the entire IRA account balance, required minimum distributions (RMD) must continue to be paid to the beneficiaries who inherit the IRA. (RMD are the minimum amounts that an IRA owner must withdraw from his/her IRA account annually.) The calculation of the amounts payable to beneficiaries depends upon the following factors:

(1) whether the sole beneficiary is the IRA owner's spouse;

(2) whether the IRA owner dies *before* or *after* his/her RMD beginning date (in other words, before or after April 1 following the year in which the IRA owner reached age $70^1/_2$); and

(3) whether the IRA owner has designated a beneficiary, and, if so, whether the beneficiary is an individual (or, if there is more than one beneficiary, whether all of them are individuals, as opposed to, for example, a charity).

Beneficiary determination date

The beneficiary is determined as of Sept. 30 of the year following the death of the IRA owner. RMD to the beneficiaries must begin by Dec. 31 of the year following an IRA owner's death. If the IRA owner had already started receiving RMD, the RMD that the IRA owner would have received in the year he/she died must be distributed by Dec. 31 of that year.

Qualified "designated beneficiaries"

If all beneficiaries of an IRA are qualified "designated beneficiaries" (individuals or certain trusts for individuals), preferential rules allow these individual beneficiaries to receive RMD from the inherited IRA based on their own life expectancy.

For younger beneficiaries, this will minimize the impact of state and federal income taxes by stretching out RMD over his/her longer life expectancy.

Additional beneficial rules apply if the sole designated beneficiary is the IRA owner's surviving spouse (see p. 3). The surviving spouse can roll-over the IRA of the decedent (deceased person) into his/her own IRA, which generally provides a longer pay-out period. This process will generate lower RMD, resulting in reduced state and federal income taxes for the surviving spouse.

Non-qualified beneficiaries

If one or more beneficiaries are considered "non-qualified" (a beneficiary *who is not an individual*, such as a charity or the IRA owner's estate), fewer beneficial rules apply.

If the IRA owner dies ***before*** his/her "required beginning distribution date," the IRA account balance must be distributed within five years of the IRA owner's death.

If the IRA owner dies ***after*** his/her "required beginning distribution date" (April 1 of the year after reaching age $70^1/_2$), the IRA balance must be distributed over the fixed remaining life expectancy of the IRA owner. The IRA owner's age at the time of death in the *Single Life Table* (Table 3, p. 4) is used for the calculation.

Example. Henry Jenkins designates his daughter, Susan Randolph, and his church as equal beneficiaries of his IRA. Henry dies on March 30, 2003, at age 68 (before his required beginning distribution date). Because one of the beneficiaries is not an individual, Susan will not be able to use her life expectancy to determine the RMD she receives after her father's death. Instead, Susan and the church must receive their respective shares of the IRA account balance in full within five years (by Dec. 31, 2008).

However, because the determination of "designated beneficiary" occurs on Sept. 30 following the year of Henry's death, through planning techniques the church can receive all of its interest in the IRA before Sept. 30, 2004. This leaves Susan as the only beneficiary on the date when "designated beneficiaries" are determined. Susan could then use her life expectancy to determine the RMD payable from her share of the IRA. Planning techniques are discussed in more detail in a later section.

Beneficiary designation on contract

IRA owners should make a beneficiary designation on their IRAs to maximize the income tax deferral rules available for qualified "designated beneficiaries." IRA owners can designate one or more beneficiaries by name (such as "50 percent to my son, Ted Nelson, and 50 percent to my daughter, Martha Reynolds") or by description (in equal shares to my children).

IRA owners should not only designate one or more primary beneficiaries, but also designate successor beneficiaries (those who would receive the IRA account balance if one of the beneficiaries dies before the IRA owner or before receiving the entire account balance). Seek advice from an attorney, certified public accountant (CPA), or qualified financial advisor for specific recommendations.

No beneficiary designation

If the IRA owner does not designate a beneficiary, or if a designated beneficiary has died before the IRA owner, and no successor beneficiary has been designated, the IRA contract will specify how the IRA is to be distributed. Typically, in the absence of a designated beneficiary, the IRA contract will specify that the IRA be distributed either to the IRA owner's estate, or to the IRA owner's "heirs at law."

If the IRA contract specifies the "estate of the IRA owner," then the proceeds pass to the estate and the money is distributed based on the IRA owner's written will. If the IRA owner has no will, or if the IRA contract specifies "heirs at law" to receive the account balance in the absence of a designated beneficiary, then the account passes to the IRA owner's heirs based on Montana's law of intestate succession.

In Montana, a deceased IRA owner's "heirs at law" generally consist of the spouse and/or children of the deceased IRA owner, and if none, the parents or other close relatives of the deceased IRA owner. *For a description of the Montana laws that govern dying without a will, request MontGuide 198908 HR from your local Extension office or download at http://www.montana.edu/wwwpb/pubs/mt8908.html*

Beneficiaries who receive IRAs because they are named in a will or through state law are not considered by the IRS as *qualified designated beneficiaries.* They will not be able to use their life expectancies to stretch out distributions to minimize state and federal income taxes on an inherited IRA. **For this reason IRA owners should designate beneficiaries on the IRA contract rather than naming them in a will**.

Special roll-over rules for spouses

If an IRA owner dies before or after he/she begins receiving RMD and if a surviving spouse is the ***only*** beneficiary of the IRA, the surviving spouse can take advantage of the spousal roll-over rules. If there are multiple beneficiaries, including the

Table 1: Uniform Lifetime Table

Age	Distribution Period (years)	Age	Distribution Period (years)
70	27.4	86	14.1
71	26.5	87	13.4
72	25.6	88	12.7
73	24.7	89	12.0
74	23.8	90	11.4
75	22.9	91	10.8
76	22.0	92	10.2
77	21.2	93	9.6
78	20.3	94	9.1
79	19.5	95	8.6
80	18.7	96	8.1
81	17.9	97	7.6
82	17.1	98	7.1
83	16.3	99	6.7
84	15.5	100	6.3
85	14.8	101	5.9

spouse, the spouse's account can be separated from the accounts of other beneficiaries and utilize the spousal roll-over rules.

A surviving spouse who is the sole beneficiary of an IRA may roll the deceased IRA owner's account balance into his/her IRA. The surviving spouse could also re-title the deceased IRA owner's account into his/her name as owner. If the spouse takes advantage of these roll-over rules, then he/she is not required to take RMD from the account until he/she reaches his/her required beginning distribution date. In addition, the surviving spouse is entitled to use the *Uniform Life Table* (Table 1) to determine the amount of his/her RMD once he/she does reach his/her required beginning date.

Table 1 uses a joint life expectancy with a hypothetical person 10 years younger than the surviving spouse, which means a longer pay-out period and lower RMD will be generated for most surviving spouses. Furthermore, if the beneficiaries of the surviving spouse's roll-over IRA are all qualified designated beneficiaries, there is more potential for deferring withdrawals by using the life expectancies of those qualified designated beneficiaries.

Death of IRA owner *before* required beginning minimum distribution date

If an IRA owner dies ***before*** his/her required beginning distribution date (April 1 of the year following the year in which the IRA owner reaches the age of $70^1/_2$), the rules for the surviving spouse and other beneficiaries are highlighted below.

Spouse as sole beneficiary

If the surviving spouse is the sole beneficiary and does not roll over the deceased IRA owner's account into his/her own IRA, the following rules apply:

If the spouse is the sole designated beneficiary and if the IRA owner dies ***before*** the owner's required beginning distribution date, special timing rules apply. The surviving spouse is not required to start taking RMD until the later of (1) Dec. 31 of the year the deceased IRA owner would have reached age $70^1/_2$, or (2) Dec. 31 of the year after the year in which the IRA owner dies. In contrast, designated beneficiaries other than a surviving spouse must start taking RMD by Dec. 31 of the year after the year in which the IRA owner dies.

Once the surviving spouse begins receiving RMD, the distributions are based upon the surviving spouse's life expectancy from the *Single Life Table* (Table 3). To determine the RMD, use the IRA balance as of Dec. 31 of the year immediately preceding the year of distribution. This balance is divided by the life expectancy from the *Single Life Table* (Table 3). During the life of the surviving spouse, the RMD is recalculated each year using the spouse's age from the *Single Life Table* (Table 3) as the divisor.

Example: Wayne had not reached his required beginning date before he died in 2004 at the age of 60. His sole designated beneficiary is his wife, Linda, who is age 62. She does not need to start taking RMD until the year in which Wayne would have turned age $70^1/_2$, which is 2014. When she begins receiving RMD, Linda will use her single life expectancy (which, at age 72 is 15.5, Table 3) to determine her RMD for 2014. She divides the balance in the IRA of Dec. 31, 2013 by 15.5.

The *Single Life Table* (Table 3) is used for recalculation of Linda's life expectancy in each subsequent year. In 2015 at age 73, her life expectancy period is 14.8; in 2016 at age 74, 14.1; in 2017 at age 75, 13.4; and so on (Table 3).

If Linda dies at age 76 in 2018, before receiving Wayne's entire IRA balance, RMD will continue to be paid to the successor beneficiaries, based upon the remaining fixed term of Linda's life, computed as of her age in the year of her death (12.7 - Table 3). Wayne's IRA specifies that if Linda dies before receiving the IRA account balance in full, his two children, Jerry and Melissa, shall receive the balance in equal shares.

Assuming that the IRA account balance in 2018 is \$100,000 (and Linda had not received her RMD for 2018), Jerry and Melissa will receive \$7,874, or \$3,937 each, in 2018 (\$100,000 ÷ 12.7 = \$7,874 ÷ 2 = \$3,937). To determine the RMD for 2019, the factor of 11.7 will be used (Linda's life expectancy in 2018, the year of her death, reduced by 1.0).

Single individual beneficiary other than a spouse

If an IRA owner dies ***before*** his/her required beginning distribution date, and if the beneficiary is a single individual (or a certain type of trust for that individual) other than the IRA owner's spouse, the individual beneficiary must begin receiving RMD from the IRA by Dec. 31 of the year following the IRA owner's death.

The amount of the RMD is determined using the life expectancy of the individual designated beneficiary from the *Single Life Table* (Table 3), using his/her own age as of Dec. 31 of the year of distribution.

Example: Rod, a bachelor, died in June 2003 with his sister, Nora, age 35, as the primary beneficiary of his IRA. Nora must begin taking RMD on or before Dec. 31, 2004, the year following Rod's death. Using her age on her birthday in the year following Rod's death (at which time she would be 36), her life expectancy period (47.5 - Table 3, *Single Life Table*) is used for the calculation. This factor is not recalculated each year based on her life expectancy, but remains fixed, and in each subsequent year, her life expectancy factor is reduced by 1.0. For example, in 2005 the factor is 46.5; in 2006, 45.5; in 2007, 44.5; and so on. Each year the IRA balance as of Dec. 31 is divided by the life expectancy factor to determine RMD.

If Nora dies before receiving the entire IRA balance, the successor beneficiary (whom Rod should have designated on the IRA contract) will continue to receive RMD based on Nora's remaining fixed term (and not on his/her own life expectancy).

The beneficiary may, at his/her option, elect to receive the account balance by the end of the fifth year following the IRA owner's death, instead of using the beneficiary's life expectancy.

Multiple beneficiaries—all individuals

If an IRA owner dies ***before*** his/her required beginning date and has ***more than one*** designated beneficiary, ***all of whom are individuals***, the life expectancy of the oldest person is used for determining RMD.

An exception is allowed if the IRA of the deceased owner is divided into separate accounts for the beneficiaries before Sept. 30 of the year following the owner's death. Each beneficiary can then use his/her own life expectancy to determine the RMD payable from his/her separate account.

Example: *Separate accounts not established.* Les died on Dec. 31, 2003 before his required beginning distribution date. His sons, Clark (age 35 in 2003) and Rod (age 40 in 2003), were named as beneficiaries of his IRA. Because Rod is the oldest and has the shortest life expectancy, his age in the year following his dad's death (which would be age 41 in 2004) is used for determining the amount of RMD payable in 2004. The life expectancy used for the calculation is 42.7 (Table 3). The balance in Les's IRA is $120,000 as of Dec. 31, 2003. The RMD for 2004 is $2,810 [$120,000 ÷ 42.7 = $2,810]. Clark receives his half ($1,405) and Rod receives the other half ($1,405) [$2,810 ÷ 2 = $1,405]. Both sons must declare the IRA distributions as income for federal and state income taxation purposes.

The life expectancy period is reduced by 1.0 in each subsequent year for calculating the RMD. In 2005 the life expectancy divisor used on the IRA balance is 41.7; in 2006, 40.7; in 2007, 39.7 and so on.

Example: *Separate accounts established.* If, after Les's death, his IRA ($120,000) is divided into two separate accounts—one for Rod and one for Clark ($60,000, plus one-half of any post-death earnings before Sept. 30, 2004), then the life expectancy of each son is used to determine the first year's RMD from his separate account.

Clark (age 36 in 2004) uses his life expectancy period of 47.5 for the RMD calculation for the first year. In subsequent years Clark's life expectancy is reduced by 1.0. Clark's RMD is $1,263 in 2004 ($60,000 ÷ 47.5) rather than $1,405 from the example above when his older brother's life expectancy was used. A smaller RMD will reduce the amount subject to state and federal income taxation. In subsequent years Clark's life expectancy is reduced by 1.0 to calculate RMD.

Rod (age 41 in 2004) uses his life expectancy period of 42.7 and receives $1,405 the first year ($60,000 ÷ 42.7 = $1,405). In subsequent years Rod's life expectancy is reduced by 1.0 each year to calculate RMD.

No designated beneficiary

If an IRA owner dies ***before*** his/her required beginning distribution date and if any one beneficiary is ***not*** a ***qualified designated beneficiary*** (i.e., is not an individual or a certain type of trust for the individual), then all beneficiaries are considered as "not qualified." In this situation the entire account balance must be distributed on or before Dec. 31 of the fifth year following the year of the IRA owner's death.

However, if the IRA account is divided before Sept. 30 of the year following the owner's death, so that each beneficiary has a separate account, then any individual beneficiary (or certain trusts established for individual beneficiaries) can use his/her life expectancy for calculating the RMD payable for the first year. In subsequent years the life expectancy is reduced by one each year to calculate RMD.

Example: Dave designates the MSU Extension Service and his grandson as equal beneficiaries of his IRA. Dave dies on Jan. 10, 2004. Because one of the beneficiaries is not an individual, Dave's IRA is treated as having "no qualified designated beneficiary." His IRA must be

Table 3: Single Life Table
(For Use by Beneficiaries)

Age	Life Expectancy	Age	Life Expectancy
35	48.5	75	13.4
36	47.5	76	12.7
37	46.5	77	12.1
38	45.6	78	11.4
39	44.6	79	10.8
40	43.6	80	10.2
41	42.7	81	9.7
42	41.7	82	9.1
43	40.7	83	8.6
44	39.8	84	8.1
45	38.8	85	7.6
46	37.9	86	7.1
47	37.0	87	6.7
48	36.0	88	6.3
49	35.1	89	5.9
50	34.2	90	5.5
51	33.3	91	5.2
52	32.3	92	4.9
53	31.4	93	4.6
54	30.5	94	4.3
55	29.6	95	4.1
56	28.7	96	3.8
57	27.9	97	3.6
58	27.0	98	3.4
59	26.1	99	3.1
60	25.2	100	2.9
61	24.4	101	2.7
62	23.5	102	2.5
63	22.7	103	2.3
64	21.8	104	2.1
65	21.0	105	1.9
66	20.2	106	1.7
67	19.4	107	1.5
68	18.6	108	1.4
69	17.8	109	1.2
70	17.0	110	1.1
71	16.3	111+	1.0
72	15.5		
73	14.8		
74	14.1		

distributed no later than Dec. 31, 2009 (the fifth year) in equal shares to his grandson and the MSU Extension Service.

However, if Dave's IRA is divided into separate accounts for each beneficiary before Sept. 30 of the year following Dave's death, his grandson can use his own life expectancy to determine the RMD payable from his separate account. The MSU Extension Service would be required to receive its distribution by Dec. 31, 2008 (the fifth year).

Another way to avoid the five-year distribution rule for Dave's grandson is to distribute to MSU Extension Service before Sept. 30, 2005 its one-half of the IRA account. This process will enable Dave's grandson to be treated as the sole designated beneficiary. The grandson's RMD for the first year would then be determined using his life expectancy in the year 2004 from the Single Life Table (Table 3). In subsequent years the life expectancy is reduced by one each year to calculate RMD.

Alert: In situations where all beneficiaries are qualified designated beneficiaries and they are allowed to use the life expectancy of the oldest IRA beneficiary, the beneficiary must be sure that the first RMD is distributed on or before Dec. 31 of the year following the IRA owner's death.

Death of IRA owner *after* required beginning date of distributions

If the IRA owner dies ***after*** he/she has reached his/her required beginning date (i.e., after April 1 of the year following the year in which the IRA owner reaches the age $70^{1}/_{2}$), the following rules apply for calculating the RMD for the beneficiaries.

Distribution in year of death

If the IRA owner has already reached his/her required beginning distribution date, the RMD that he/she would otherwise be required to receive in the year of death must be distributed by Dec. 31. Generally, the IRA contract requires that this distribution be made to the beneficiary designated by the IRA owner. In the absence of such a designation, the distribution is typically made to the IRA owner's estate or "heirs at law."

Spouse as sole beneficiary

If the spouse is the sole beneficiary, he or she can take advantage of the spousal roll-over rules discussed previously. If the spouse does not roll over the deceased IRA owner's account into his/her own IRA, and the IRA owner dies after his/her required beginning date, the following rules apply.

In the year of death, if the deceased owner had not taken the RMD during that year, the surviving spouse must take out that amount before the end of that year using the *Uniform Lifetime Table* (Table 1) and the age the deceased IRA owner would have been on Dec. 31 of the year of death (Table 1). If the spouse is more than 10 years younger, Table 2 (*Joint Life and Last Survivor Table)* would be used for the calculation.

In the year after the death of the IRA owner, and if the spouse has not rolled over the IRA account into his/her own account, the RMD payable to the surviving spouse is based upon the surviving spouse's life expectancy period, using the surviving spouse's age as of Dec. 31 of the year following the year of death and *Single Life Table* (Table 3). This factor is recalculated each year during the surviving spouse's lifetime based on his/her life expectancy.

Example: Joe dies at age 72 in 2003 after taking his RMD for the year. His wife, Debbie, (age 66 in 2003) is the sole designated beneficiary of Joe's IRA. Because Joe has already taken his RMD for the year of death, no further distribution is required in the year of his death.

For 2004, Debbie uses her age (67) to determine her life expectancy under the *Single Life Table* (Table 3), which is 19.4, to calculate RMD for the year 2004. She divides the balance in the IRA as of Dec. 31, 2003 by 19.4. For the year 2005, Debbie's life expectancy is determined using her age of 68 in 2005 (18.6). She divides the balance as of Dec. 31, 2004 by 18.6. The next year Debbie recalculates RMD based on her life expectancy, at age 69 in 2006 (17.8).

If Debbie dies in 2006 at age 69, and a balance remains in Joe's IRA, the IRA will be distributed to the successor beneficiaries (whom Joe designated on the IRA contract) using Debbie's life expectancy in the year of her death (17.8). For subsequent years, the factor of 17.8 is reduced by 1.0 each year when calculating the RMD for the successor beneficiaries. In the absence of a successor beneficiary designation, the default rules of the contract apply.

Single individual beneficiary other than a spouse

Table 2: Joint Life and Last Survivor Table*

Owner's Age	Beneficiary's Age									
	65	66	67	68	69	70	71	72	73	74
70	24.3	23.7	23.2	22.7	22.2	21.8	21.3	20.9	20.6	20.2
71	23.9	23.4	22.8	22.3	21.8	21.3	20.9	20.5	20.1	19.7
72	23.7	23.1	22.5	22.0	21.4	20.9	20.5	20.0	19.6	19.3
73	23.4	22.8	22.2	21.6	21.1	20.6	20.1	19.6	19.2	18.8
74	23.1	22.5	21.9	21.3	20.8	20.2	19.7	19.3	18.8	18.4
75	22.9	22.3	21.6	21.0	20.5	19.9	19.4	18.9	18.4	18.0
76	22.7	22.0	21.4	20.8	20.2	19.6	19.1	18.6	18.1	17.6
77	22.5	21.8	21.2	20.6	19.9	19.4	18.8	18.3	17.8	17.3
78	22.4	21.7	21.0	20.3	19.7	19.1	18.5	18.0	17.5	17.0
79	22.2	21.5	20.8	20.1	19.5	18.9	18.3	17.7	17.2	16.7
80	22.1	21.3	20.6	20.0	19.3	18.7	18.1	17.5	16.9	16.4

*Complete tables for owners ages 35 to 115 and beneficiaries' ages can be found in IRS publication 590 "Individual Retirement Arrangements." For ages under 35, see IRS Publication 939. Both can be ordered from the IRS at 1-800-829-3676. Or, download from the web at http://www.irs.ustreas.gov.

If an IRA owner dies ***after*** his/her required beginning date, and if the beneficiary is a single individual (or a certain type of trust for that individual) ***other than a surviving spouse***, the following rules apply.

First, the RMD otherwise payable to the IRA owner in the year of death must be distributed (if it has not already been taken by the IRA owner) to the successor beneficiary, calculated using Table 1 (*Uniform Life Table*) and the IRA owner's age on his birthday in the year of death, as if the IRA owner had not died.

For the year following the IRA owner's death, the RMD is calculated using the life expectancy of the individual beneficiary, based on the beneficiary's age as of Dec. 31 in the year following the IRA owner's death. In each subsequent year, this factor is reduced by one.

<u>Example:</u> Mike, a bachelor, dies in June 2003 at the age of 78 with his niece, Kristi, age 35, as the sole beneficiary of his IRA. Mike had not yet taken his RMD for 2003. This amount must be distributed to Kristi before Dec. 31, 2003. The RMD is calculated using the *Uniform Lifetime Table* (Table 1) and Mike's age of 78 in 2003, as if he had not died. For 2004, the RMD is calculated using Kristi's age on her birthday in 2004 (age 36). She divides the balance in the IRA on Dec. 31, 2003 by 47.5 (Table 3). For subsequent years, Kristi's life expectancy is reduced by 1.0 each year. In 2005 the divisor is 46.5; in 2006, 45.5 and so on.

If the designated beneficiary whose life is used to determine the RMD is <u>older</u> than the IRA owner, the IRA owner's life expectancy may be used in place of the designated beneficiary. This will result in a longer pay-out period and lower RMD and reduce the amount subject to state and federal income taxation.

Multiple beneficiaries—all individuals

If an IRA owner dies ***after*** his/her required beginning date and has ***more than one*** designated beneficiary, ***all of whom are individuals***, the following rules apply.

First, the RMD otherwise payable to the IRA owner in the year of death must be distributed (if not already taken by the IRA owner) to the successor beneficiaries, calculated using Table 1 (*Uniform Life Table*) and the IRA owner's age on his birthday in the year of death, as if the IRA owner had not died. For the year following the IRA owner's death, the life expectancy of the oldest beneficiary is used for determining RMD, and this factor is reduced by one in each subsequent year.

An exception is allowed if the deceased owner's IRA is divided into separate accounts for the beneficiaries before Sept. 30 of the year following the owner's death. Each beneficiary can then use his/her own life expectancy to determine the RMD payable from his/her separate account.

<u>Example:</u> *Separate accounts not established.* Tim dies on Dec. 31, 2003 after his RMD beginning date. His daughters, Elizabeth (age 35 in 2003) and Cheryl (age 40 in 2003), were named as beneficiaries of his IRA. Tim had already received his RMD for 2003 before his death. Therefore, no additional RMD were required to be paid in 2003.

Because Cheryl is the oldest and has the shortest life expectancy, her age in the year following Tim's death (age 41 in 2004) is used for determining the amount of RMD payable to the beneficiaries in 2004. The balance in Tim's IRA as of Dec. 31, 2003, $120,000, is divided by 42.7 (Table 3). The RMD for 2004 is $2,810. Elizabeth receives her half ($1,405) and Cheryl receives the other half [$120,000 ÷ 42.7 = $2,810 ÷ 2 = $1,405]. Both daughters declare the RMD as income for federal and state income taxation purposes in 2004 and future years.

The life expectancy period is reduced by 1.0 in each subsequent year. In 2005 the life expectancy divisor used in the RMD calculation is 41.7; in 2006, 40.7; in 2007, 39.7 and so on.

<u>Example:</u> *Separate accounts established.* If Tim's IRA account is divided into two separate accounts before Sept. 30, 2004 then the life expectancy of each daughter is used to determine the RMD from her separate account for the first year of RMD.

Elizabeth (age 36 in 2004) uses her life expectancy period of 47.5 for the RMD calculation for the first year. In subsequent years Elizabeth's life expectancy factor is reduced by one. Elizabeth's RMD the first year is $1,263 in 2004 [$120,000 ÷ 2 = $60,000 ÷ 47.5 = $1,263] rather than $1,405 from the example above when her older sister's life expectancy was used. A smaller RMD will reduce the amount subject to state and federal income taxation.

Cheryl (age 41 in 2004) uses her life expectancy period of 42.7 and receives $1,405 the first year ($60,000 ÷ 42.7 = $1,405). In subsequent years Cheryl's life expectancy is reduced by one to calculate each year's RMD.

Beneficiary older than IRA owner

If the designated beneficiary whose life expectancy is used to determine the RMD is <u>older</u> than the IRA owner, and the IRA owner dies after his/her required minimum distribution beginning date, the IRA owner's life expectancy may be used in place of the designated beneficiary. This will result in a longer pay-out period, lower RMD and reduced state and federal income taxes.

No qualified designated beneficiary

If an IRA owner dies ***after*** his/her required minimum distribution beginning date and if any one beneficiary is ***not*** a ***qualified designated beneficiary***, the following rules apply:

First, the RMD payable to the IRA owner in the year of death must be distributed (if not already taken by the IRA owner) to the successor beneficiaries, calculated using the *Uniform Life Table* (Table 1) and the IRA owner's age on his birthday in the year of death, as if the IRA owner had not died.

To determine the RMD for the year following death, the IRA owner's life expectancy is used, based upon his age on his birthday in the year of death and the *Single Life Expectancy Table* (Table 3). This factor is reduced by one for each year.

Example: *My estate.* Gary designates "my estate" as his beneficiary. Because an estate is not an individual, there is no qualified designated beneficiary. Gary dies in 2003 at age 74. Under Gary's will, the estate's interest in the IRA passes to his only son, Tom. In the year of death, Tom must receive any portion of the RMD otherwise payable to Gary in 2003. For 2004, Gary's life expectancy, based upon his age on his birthday in the year of death (age 74), is found in the Single Life Table (Table 3). The divisor used for the RMD calculation is 14.1. For subsequent years, this divisor is reduced by one each year. If the IRA balance as of Dec. 31, 2003 is $100,000, the RMD for 2004 payable to Tom is $7,092 ($100,000 ÷ 14.1 = $7,092). This is a much higher RMD than if Tom had been able to use his own life expectancy (which he could have done if Gary had named Tom on the IRA contract as the beneficiary of his IRA instead of "my estate").

Example: *Charitable and Individual as IRA beneficiary.* Justin designates his church and his wife as equal beneficiaries of his IRA. Justin dies on Dec. 10, 2003, at the age of 80. Because one of the beneficiaries is not an individual, Justin is treated as having "no designated beneficiary." His IRA must be distributed over his remaining life expectancy, using the *Single Life Expectancy Table* (Table 3) and his age on his birthday in 2003 (80), or 10.2 years. Because his wife is not the sole beneficiary, and because separate shares have not been established after Justin's death, she is unable to take advantage of the roll-over rules or the other spousal rules discussed above, which would have greatly reduced the amount of RMD.

Example: *Separate Accounts*. If, in the above example, Justin's IRA is divided into separate accounts for each beneficiary before Sept. 30 of the year following his death, Justin's wife can roll-over the IRA into her own IRA. Or, if she does not elect the roll-over option, she can use her remaining life expectancy under Table 3 (*Single Life Table)* to determine the RMD payable from her separate account. Justin's church would be required to receive its distribution as described in the example previously, using Justin's remaining life expectancy. (Remember, the church could receive its distributions more quickly; the RMD is the minimum amount required to be distributed each year).

Example: *Distribution to Nonqualified Beneficiary by Sept. 30 of Following Year.* Another way to avoid the required use of Justin's life expectancy for his wife's share of the IRA is to distribute to his church before Sept. 30, 2004 its one-half of the IRA account. This process will enable the surviving spouse to be treated as the sole designated beneficiary.

Planning for beneficiaries who inherit IRAs

Several planning techniques can be used by beneficiaries who inherit IRAs to minimize federal and state income taxes.

Disclaimers. One of the techniques that can be used for minimizing the tax impact of an inherited IRA is a disclaimer. Beneficiaries may disclaim his/her right to receive IRA proceeds. If a beneficiary disclaims his/her interest in an IRA, it is important to examine the IRA contract to determine who will inherit this interest. Persons who disclaim are treated as having died before the IRA owner, and thus if the IRA owner has designated a successor beneficiary, the successor beneficiary will receive the disclaimed interest.

For purposes of determining the designated beneficiary (and measuring life expectancy for required minimum distributions in the year after the participant's death), the disclaimer must be in writing and must be made by the earlier of (1) nine months after the date of death or (2) Sept. 30 in the year following the death of the IRA owner.

Example: Doug named his wife and daughter Lois as equal beneficiaries of his IRA, which had a balance of $100,000 when he died. Doug specified in his IRA contract that if either his wife or daughter died before him or died before receiving her interest in whole, the survivor of the two would receive the balance of the deceased beneficiary's share.

Because the daughter was concerned about her mother having enough money for living expenses, she filed a written disclaimer of her share ($50,000) within nine months after the date of her father's death. The disclaimer causes the daughter to be treated as if she had died before her dad. Because of the language used by Doug in the IRA contract (stating that if the daughter predeceased him, his wife would receive the daughter's share), his wife is entitled to Lois' disclaimed share. His wife will be treated as the sole beneficiary. As such, she can roll Doug's IRA over into her own IRA, but if she does not elect a roll over, she is entitled to the beneficial rules for spouses discussed in MontGuide 200311.

Separation of Accounts. Another method to make more effective use of inherited IRAs is separation of the account. If more than one beneficiary is named on an IRA account, all beneficiaries must be individuals or there will be no qualified "designated beneficiary." If a charity has been named along with one or more individuals, then the account is treated as having no "designated beneficiary," and more restrictive rules will apply in determining the amount of RMD after the IRA owner's death.

If a spouse and one or more other individuals or charities are named as successor beneficiaries, the spouse is not able to take advantage of special rules for spouses (including spousal roll-overs), because those special rules are available only if the spouse is the sole beneficiary.

In these situations, it may be advantageous to place the IRA into separate accounts. If the IRA is divided into separate accounts on or before Sept. 30 of the year following the IRA owner's death (including the proportionate allocation of any post-death earnings), the RMD for each separate account is determined disregarding other beneficiaries of other separate accounts.

Example: Tom designates Montana State University and his son as equal beneficiaries of his IRA. Tom dies on Jan. 10, 2003, before his required beginning date. Because one of the beneficiaries is not an individual, Tom is treated as having "no designated beneficiary." His IRA must be distributed in five years to his son and MSU. However, if Tom's IRA is divided into separate accounts for each beneficiary before Sept. 30 of the year following, Tom's son can use his life expectancy to determine the RMD payable from his separate account, and MSU would be required to receive its distribution by Dec. 31, 2008.

Distribution of Accounts. Another planning technique to consider when the deceased owner had designated a charity, estate or other non-qualified beneficiary, is to distribute to the non-qualified beneficiary its share prior to Sept. 30 of the year following the date of death. If a non-qualified beneficiary receives its share (including any post-death earnings) by Sept. 30 of the year following the IRA owner's death, that beneficiary status will be disregarded, and reference will be made only to the remaining beneficiary or beneficiaries.

Conclusion

The rules for withdrawing funds from an inherited IRA remain complicated even under the *Economic Growth and Tax Relief Reconciliation Act of 2001*. Readers who have other types of retirement plans may find that the terms of their plan further restrict the rules discussed in this MontGuide. One option is to roll over their plan into an IRA. IRA owners and qualified plan participants should seek the assistance of a specialist, such as a Certified Public Accountant (CPA), Certified Financial Planner (CFP®), or an attorney who specializes in taxes to ensure they are following rules established by the Internal Revenue Service.

Further information from MSU Extension

Additional MontGuides on Individual Retirement Accounts are available from the MSU Extension Service.

Types of IRAs and changes resulting from the Economic Growth and Tax Relief Reconciliation Act of 2001: MT 199807 HR *Individual Retirement Accounts*.

Features to consider when *Shopping for an IRA*: MT 200207HR.

Withdrawals from IRAs when the owner is under age $59^1/_2$: MT 2003008 HR.

Withdrawals from IRAs when the owner is between ages $59^1/_2$ and $70^1/_2$ and when owner turns $70^1/_2$: MT 200309 HR.

Inheriting an IRA: Planning techniques for successor beneficiaries MT 2003011 HR.

All five MontGuides are available free from your local MSU Extension Office. Or, send $1 for handling to: MSU Extension Publications, PO Box 172040, MSU-Bozeman, 59717. The publications can also be downloaded without charge from the Web under retirement planning at http://www.montana.edu/extensionecon/publications/confinpub.html or under "Family Financial Management" at www.montana.edu/publications

Further information–Internal Revenue Service

"Individual Retirement Arrangements" (Publication 590) is available from the Internal Revenue Service. For delivery via US Postal Service call 1-800-TAX-FORM (1-800-829-3676). The publication can be downloaded at: http://www.irs.gov. Under **Search Forms and Publications**, type **590** and click GO

Acknowledgment

Representatives from the following have reviewed this MontGuide and recommend its reading by all Montanans.

- Montana Credit Union Network
- Montana Society of Certified Public Accountants

Disclaimer

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File under: Consumer Education

D-28 (Estate Planning)

Issued Sept. 2003 2000903ST