

Understanding Why It Is Critical For an Inheriting IRA Beneficiary To Designate His or Her Own IRA Beneficiary

The purpose of this article is to illustrate the importance of an inheriting IRA beneficiary to designate his or her IRA beneficiary(ies).

There is work involved in administering inherited IRAs and due to the complexities of the rules applying to inherited IRAs there is also the chance for tax mistakes.

For discussion and illustration purposes the following tax situation is assumed. Mary Johnson had had a very successful corporate career. In 2012 when she was age 57 she had retired. She had accumulated \$1,450,000 in her 401(k) plan. She had directly rolled over this \$1,450,000 into three traditional IRAs - \$300,000 with ABC State Bank, 50,000 with Thrive National Bank and \$400,000 with First National Bank. With each IRA custodian she had designated her three children, John, Roberta and Patricia each to receive a 1/3 share. John was age 33 in 2012, Roberta was age 31 and Patricia was age 26. Mary was divorced from Paul Johnson in 1998. All are residents of the state of Minnesota. Mary died on October 20, 2014.

Each child had three inherited IRAs with the three different IRA custodians.

In November of 2014, the IRA representative for ABC State Bank contacted John, Roberta and Patricia regarding taking required distributions from their inherited IRAs and designating their own beneficiary(ies). Each instructed they would be using the life distribution rule and each designated his or her own beneficiary(ies). John and Roberta were married and had children. John designate his spouse as his primary beneficiary and his children as the contingent beneficiaries. Roberta also designated her spouse as her primary beneficiary and her children as the contingent beneficiaries. Both thought these funds would either be used for the kids' college education expenses since the 10% additional tax does not apply to a beneficiary or for their retirement.

Patricia was also contacted. She was not married and she had no children. On December 20, 2013, she designated her boyfriend, Alberto Davis, to be her beneficiary of IRA #1 with a balance of \$100,000.

With respect to the inherited IRAs at Thrive National Bank and First National Bank, John, Roberta and Patricia did not initially designate "new" beneficiaries.

Patricia died in a car accident on February 3, 2015. She died intestate as she did not have a will. With respect to the \$100,000 with ABC State Bank, Patricia had designated Alberto to be her beneficiary. He will be able to continue the required distribution schedule which applied to Patricia as the first beneficiary. Alberto may take larger distributions.

With respect to Patricia's inherited IRAs at Thrive National Bank and First National Bank the situation is much more complicated since Patricia did not designate her own beneficiary.

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What happens with her \$300,000 inherited IRA at Thrive National Bank and her \$100,000 inherited IRA at First National Bank?

Does this money go to Alberto or does it go to Roberta (sister) and John (brother)? Or, does it go to Patricia's surviving parent, Paul Johnson. The Minnesota intestacy law would provide that a certain percentage would go her dad, Paul Johnson.

What if Roberta and John want the funds to go Alberto? What if Paul Johnson wants the funds to go to Alberto?

Remember, IRAs are created under our federal income tax laws and there are severe tax penalties associated with failing to comply with these tax laws. The money within an inherited IRA is generally tax-deferred money. An IRA beneficiary will need to include any distribution in his or her income when it is withdrawn. In general, a person who is an inheriting IRA beneficiary has no right to say "I would rather have someone else get these funds so that he or she pays the appropriate income tax rather than me.

The provisions of the IRA plan agreements with Thrive National Bank and First National Bank must be reviewed and applied. Most IRA plan agreement forms are written to provide that since Patricia survived her mother, she inherited the \$300,000 and the \$100,000 and upon her death her funds will go her beneficiary as designated or to her estate, if she had not designated a beneficiary. Although unlikely, some IRA plans may set forth a different transfer of Patricia's share.

It may well be that the individuals involved do not want Patricia's estate to be the beneficiary. In the above situation, John Roberta, and Paul may well want the funds to go to Alberto. We at CWF suggest that the IRA custodian wants to be furnished a legal/tax opinion by an attorney or tax accountant as to why the funds may go into Alberto's inherited IRA rather than the estate's inherited IRA. It may be the estate would have the right or authority to pass-through its right to receive future distributions to Alberto.

It might be possible that the Thrive National Bank IRA plan agreement provided that in the situation where an inheriting IRA beneficiary dies after the IRA grantor dies that such share will be split by the other primary beneficiaries.

And it might be possible that the First National Bank IRA plan agreement provided that in the situation where an inheriting IRA beneficiary dies after the IRA grantor dies that such share will go to his or her estate, and such estate has the right to pass-through to one of its beneficiaries or a person to be chosen by the personal representative the right to receive the future IRA RMD distributions.

The law provides a 50% excise tax when a beneficiary does not comply with the required distribution rules and there is an excess accumulation due to not withdrawing the required amount.

It is not that surprising, but the IRS has not yet issued any written guidance as to the adverse tax consequences arising when an inherited IRA is set up for person who does

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not qualify to have an inherited IRA. One would think the annual 6% excess contribution tax would apply. In some cases, it may be the IRS would assess both taxes.

In order to avoid difficult IRA beneficiary situations as described above, an inheriting beneficiary wants to designate his or her own beneficiary(ies) as soon as possible.