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ALSO IN THIS ISSUE –

October 1, 2007, — Deadline to Establish a SIMPLE-IRA Plan, *Page 2*

Not All IRA Forms Are Good Forms, *Page 3*

The Administrative Aspects of IRA Fees, *Page 4*

December 31, 2008 — NEW Deadline For Nonqualified Plan Documents, *Page 6*

RMDs and Divorce, *Page 6*

Don't Forget Your Withholding Reminder Notices, *Page 6*

Outdated IRA Plan Agreements and Disclosure Statements, *Page 7*

Special Observation About Roth IRAs and Spouse Beneficiaries, *Page 7*

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Correcting Various Errors Made By the IRA Custodian

The following response was sent to an IRA custodian. The intent of this article is to provide a guideline of what corrections are needed when the IRA custodian paid out the inherited IRA funds to the wrong beneficiary.

You called with the following situation: An individual had a number of accounts with your financial institution. This individual died in 2006. He had designated a trust to receive most of these accounts after his death. Based on this understanding, the IRA funds were paid out to the trustee of his trust. However, he had not designated this trust as the beneficiary of his IRA. He had designated two individuals to be the beneficiaries.

The deceased individual was subject to the required distribution rules. His required distribution for 2006 had not been distributed prior to this death. Error #1 arose because the financial institution deposited the RMD into the decedent's checking account. A 2006 Form 1099-R was prepared listing the decedent as the payee.

Error #2 arose when the IRA custodian paid the remaining IRA account balance to the trust. A 2006 Form 1099-R was prepared listing the trust as the payee.

The trustee of the trust returned the two payments in 2007 after being notified of the mistake.

We discussed the requirement to correct the two incorrect Form 1099-Rs.

Continued on page 2

Upcoming 2008 Law Change–A New Type of Roth IRA Conversion Contribution

As of January 1, 2008, certain individuals in 401(k) plans, profit sharing plans, 403(b) plans and certain other employer-sponsored plans, will be able to use such funds to make a Roth conversion contribution. An individual will need to qualify for the conversion. That is, he or she must have a modified adjusted gross income of less than $100,000, and, if married, must file a joint income tax return. These eligibility rules are repealed as of January 1, 2010, but they still apply for 2008 and 2009. Employer plans will need to be amended to authorize this new type of conversion contribution/direct rollover to a Roth IRA.

What does this law change mean for your financial institution?

Your financial institution currently receives direct rollovers from employer sponsored pension plans. Such direct rollovers have always gone into a traditional IRA. A direct rollover into a traditional IRA is a non-taxable transaction. Commencing in 2008, a direct rollover can go either into a traditional IRA or a Roth IRA. Or, there could be two direct rollovers—one portion going into the traditional IRA and the remaining portion into the Roth IRA.

When the direct rollover conversion contribution is made to a Roth IRA, a taxable event will have occurred. The 10%

Continued on page 2

Correcting Various Errors Made By the IRA Custodian,
Continued from page 1

They need to be zeroed out. The IRA custodian will need to furnish "corrected" forms to both the IRS, and the trustee. It may be necessary to file amended tax returns for the trust and the deceased individual.

You will be making two distributions to the beneficiaries for their respective shares some time in 2007. They will include these amounts in their incomes for 2007.

These two beneficiaries technically owe the 50% tax for 2006. They were not distributed their respective shares of the 2006 required distribution in 2006. These two beneficiaries will wish to discuss this matter with their tax advisors.

We understand the rules to be as follows. Each beneficiary should file an amended 2006 federal income tax return. Each beneficiary would inform the IRS that technically he or she owes the 50% tax, but in this situation (bank error) the beneficiary would state that he or she was not paying the amount because the IRS should waive the tax because of the IRA custodian's error. The IRS has the authority to waive the 50% tax as long as there is good cause.

The beneficiaries would also want to inform the IRS that each had been distributed their entire share in 2007 and would be including this amount on their 2007 income tax returns.

An IRA custodian always needs to double-check that the funds within an inherited IRA are being paid to the correct beneficiary(ies). ◆

October 1, 2007—Deadline to Establish a SIMPLE-IRA Plan

This is the deadline to establish a new SIMPLE-IRA plan for 2007 tax purposes only if the employer has never sponsored a SIMPLE IRA plan. An employer in this instance includes a one person business. The deadline is NOT December 31, 2007.

The deferral limit for 2007 is $10,500 if the person will not attain 50 or older in 2007 and $13,000 if the person will be age 50 or older.

We expect the IRS to issue the new limits for 2008 around the middle of October. ◆

Upcoming 2008 Law Change,
Continued from page 1

additional tax applying to most pre-59½ distributions does not apply to this conversion contribution. The individual is responsible to report the conversion on his or her tax return. The IRS has not yet issued the 2008 Instructions for Forms 1099-R and Form 5498. We at CWF believe the Roth IRA custodian/trustee will be required to report this special direct rollover as a conversion contribution in box 3 of the 2008 Form 5498.

CWF has developed Form #66-R to assist with this transaction. It requests this special type of direct rollover. The CWF Roth IRA plan agreement forms have also been revised to authorize this type of contribution.

If a financial institution does not receive paperwork clearly showing whether the direct rollover is going into a traditional IRA or a Roth IRA, then it will want to confirm that the direct rollover of pension funds or assets are going into the proper type of IRA.

At this point in time it is unclear if this conversion transaction can be done either as direct rollover or as a rollover. The title of the statutory section authorizing this new transaction gives the idea it must be done as a direct rollover. It would seem though that an individual could withdraw funds from the employer sponsored plan and then contribute them as a conversion contribution to the Roth IRA. This IRS will need to issue additional guidance. The more conservative approach will be to make this conversion contribution via a direct rollover.

The law change does save a step in the "old" conversion process where the 401(k) funds first had to go into the traditional IRA and then be converted to the Roth IRA.

We wish to point out that there are well established rules for handling the situation where a person converts money from a traditional IRA to a Roth IRA and then decides he or she wishes to un-do the conversion by doing a recharacterization either because of being ineligible or just because there are other financial reasons. It should be understood that the rules are not that well settled as to how one would "recharacterize" funds which had come from a 401(k) plan. It would be very doubtful that the 401(k) plan would take the funds back. Presumably, the IRS will be giving additional guidance on this subject. ◆

The Pension Digest

Not All IRA Forms Are Good Forms

CWF was recently asked to review two IRA distribution forms. These forms were part of a large software provider's platform system for loans and deposits, including IRAs.

We at CWF, of course, are biased. We believe we have superior IRA forms. As discussed below, there are times when a financial institution will need to conclude that the IRA forms contained in the large vendor's software are just too weak, from a compliance viewpoint, to be used. To use these large-vendor package IRA forms, places a financial institution at risk for being assessed numerous penalties by the IRS. We have had large software firms tell a financial institution that it is unreasonable to expect that their IRA forms will be as comprehensive as the CWF IRA forms, because the large software vendor was providing an entire platform and not just IRA forms.

Set forth below is our response to a written inquiry. We have used a fictitious name for this software vendor.

You asked that we review two IRA forms as written by Brand X. There were actually three forms to be reviewed since two of the forms contain a third form, An Election for Payees of IRA Payments.

Review of the IRA Distribution Request and Withholding Notice (Form #1) and the Election for Payees of IRA Payments (Form #2).

A. It appears that this form is to be used for a distribution from any type of IRA. This can create confusion since distributions from traditional IRAs are reported so differently than those from Roth IRAs and there is no withholding with respect to Roth IRAs.

B. The form does not indicate from what type of IRA the distribution is being made.

C. There is only one reason category for Roth IRAs. This is insufficient for the proper preparation of Form 1099-R.

D. The form has a section for a "distribution from an Education IRA." As you know, since 2002, there has been no such IRA.

E. There are a number of "reversal" reasons for distributions. There are very, very limited reasons why a distribution can be reversed. This form gives the idea that a reversal is a standard transaction.

F. I have no idea of the difference between a distribution due to a "recharacterized contribution" versus a "recharacterized distribution."

G. There are three reason boxes for an "excess contribution removal." The third one indicates that "the excess is being corrected before the accounting, legal or tax filing due date the contribution was made two years prior." This exception may apply for certain pension distributions. It never applies to IRAs, and if selected by an IRA administrator, would cause a reporting error unless corrected by your department.

H. In the case of withdrawing an excess contribution, the form has no section to gather the interest earned by the excess. As you know, this amount must be reported separately on the Form 1099-R.

I. I have no idea why the form lists a "rollover payment" as a separate reason. The IRS changed the rules for reporting rollovers over 20 years ago.

J. The form appears only to be able to be used by an IRA owner and not by a beneficiary.

K. The form does contain a section for "Tax Withholding Notice" at the bottom of the form. This subject is discussed in the following paragraphs.

Tax Withholding Notice—CWF Election

As we discussed, there are two aspects to the withholding duties of an IRA custodian. First, a proper notice must be furnished. The IRS has the authority to assess a penalty of $10 for each "noncomplying" withholding notice.

Secondly, the form must provide the recipient with the ability to instruct the IRA custodian to do one of three things. The first option is to instruct the IRA custodian to have no withholding. The second option is to have 10% withheld. And the third option is to have an additional amount withheld.

Tax Withholding Notice—Brand X Approach

Brand X has adopted a different approach. It is discussed in the next paragraph. We are unaware of any IRS authority which authorizes Brand X to adopt this approach. We would be very surprised if Brand X has something in writing from the IRS authorizing its approach.

Continued on page 4

Not All IRA Forms Are Good Forms, Continued from page 3

Form #1 and Form #3 (as discussed below) both take the approach that the IRA custodian will withhold 10% of the amount being distributed unless a separate form, Form #2 is completed and returned to the IRA custodian. Note that Form #1 and #3 instruct that there will be withholding of 10%. Form #2 allows the recipient to elect to not have any withholding. Form #2 does not allow the recipient to have an additional amount withheld.

Comments. We believe any IRA custodian using these two forms is subject to being fined $10 per distribution by the IRS for furnishing a noncomplying withholding notice and election form. We believe the instruction for "no withholding" can't be on a separate form. The fact that Form #2 references the IRS Form W-4P does not save these forms.

The form certainly does not "inform" any one that the withholding rules do not apply to Roth IRA distributions. The form is just wrong to tell a recipient of Roth IRA funds that the bank must withhold 10% unless they return Form #2 to have no withholding. An IRA custodian which withholds 10% of a Roth IRA distribution could have significant legal problems since the IRS has made it clear that there is almost always no withholding with respect to Roth IRA distributions.

IRA 70½ Distribution and Tax Election Form (Form #3) and the Election for Payees of IRA Payments (Form #2)

A. It appears this form was written in 2002.

B. Under the rules finalized in July of 2002, the IRA accountholder no longer instructs or elects that he or she wants their RMD calculated based on a single or joint life expectancy. Brand X should modify the form to make it clear the accountholder no longer makes instructions regarding the calculation of the RMD amount, only as to how much is distributed and when.

C. The IRA accountholder may certainly elect to withdraw an amount greater than his or her RMD. He or she may certainly set up a periodic distribution.

D. The same comments made above with respect to Form #1 apply to Form #3. We are aware of no authority which allows the IRA custodian to require the recipient to complete a separate form (Form #2) in order to avoid having 10% withheld. The notice portion of Brand X's form is so brief that it is inadequate.

Conclusion. There will be times a financial institution will not want to use the IRA forms contained in large software providers total forms platform. In the case of the two/three IRA distribution forms as written by Brand X, we believe a financial institution using these two forms subjects itself to being fined for furnishing noncomplying forms. ◆

The Administrative Aspects of IRA Fees

An IRA custodian has the right or ability to charge reasonable fees as long as the IRA accountholder agrees to pay such fees. Fees may create an excellent revenue stream. Federal income tax law is silent on the subject of what fees may be charged by the IRA custodian/trustee. The charging of fees is a contract issue to be negotiated by the two parties.

First things first, however. For fees to be charged, the IRA plan agreement must authorize them. It would be rare indeed if a plan agreement did not authorize them. If the plan agreement does not authorize fees, it would need to be so amended. Then, all possible IRA fees must be clearly disclosed by the IRA custodian/trustee to the IRA accountholder. When establishing an IRA, if a financial projection is required as part of the financial disclosure, all possible fees must be reflected in the schedules.

There are numerous types of fees and service charges: (1) annual administrative fees; (2) transfer fees; (3) establishment fees; (4) close-out fees; (5) distribution fees; (6) rollover fees; (7) any and all fees related to buying, selling, or administering the investments; (8) fees for additional investments; (9) fees for additional investment subaccounts; (10) property manager fees; (11) fees for the printing of additional statements; (12) fees for form preparation; (13) recordkeeping and accounting fees; (14) taxes, and tax preparation fees, etc.

The Administrative Questions

Who is to pay the fee? Is it the IRA, itself, or will the IRA accountholder be able to use personal funds to pay the fees? The federal income tax laws contain contribution limits on IRA contributions. For 2007, the

Continued on page 5

The Pension Digest

The Administrative Aspects of IRA Fees, Continued from page 4

contribution limit is the lesser of: $4,000 or the amount of a person's earned income. Those individuals, age 50 or over, as of 12-31-07, are allowed to make an additional contribution of $1,000 or less.

What contributions count against the contribution limits? The law states that ALL contributions count against the maximum limit, except for those contributions which the law and/or the IRS has stated need not be counted. The following contribution types are not counted:

a. Transfers
b. Rollovers
c. Recharacterizations
d. SEPs, and
e. Certain fees as defined by the IRS.

IRS guidance on IRA fees is not as extensive as one would think. The IRS has issued Revenue Ruling 84-146 and Revenue Ruling 86-142. These were issued over 20 years ago. Revenue Rulings are formal pronouncements of IRS policy and they bind the IRS. The IRS has also issued a number of Private Letter Rulings (PLRs). The party to whom the PLR was issued has the right to rely on the ruling, but other taxpayers do not. The point being—the existence of two revenue rulings, over a 23-year period, is an indication that the IRS has adopted, in general, a restricted policy as to fees. That is, the individual, in general, will not be able to pay the IRA fees with personal non-IRA funds. To do so creates a way for an individual to contribute more than the maximum amount authorized by the federal income tax laws.

Revenue Ruling 84-146: Annual Administrative Fees

With respect to trustee's administrative fees, the IRS ruled in 1984, in Revenue Ruling 84-146, that such fees are not subject to the contribution limit and that amounts paid by the IRA owner for trustee fees will be deductible under Code section 212, to the extent such fees are ordinary and necessary, but that capital expenditures and disguised IRA contributions will not be deductible.

Such fees are not subject to the annual contribution limits, are not considered taxable or penalized distributions, and can be charged directly against the IRA account balance or be billed directly to the IRA owner. If these fees are charged against the IRA balance, the IRA owner cannot reimburse the IRA for the fees except by way of a valid, eligible contribution subject to the regular annual limits.

They can also, at the prerogative of the IRA custodian/trustee, be billed directly to the IRA accountholder to be paid with non-IRA funds. If billed directly to the IRA owner, the fees must be paid with non-IRA assets.

Revenue Ruling 86-142

With respect to brokers' commissions paid in connection with a traditional IRA, in 1986 in Revenue Ruling 86-142, the IRS ruled that such commission fees or expenses are subject to the contribution limit and they are not deductible under section 212. The IRS ruled that brokers' fees were not recurring administrative or overhead expenses incurred in connection with the maintenance of the IRA. Rather, broker's commissions were intrinsic to the value of the IRA assets (i.e. part of the cost of the purchase and the cost of the sale).

Such a fee is either part of the cost of the purchase of the asset becoming part of the asset's cost basis, or it is a reduction in the selling price of the IRA asset. Therefore, the IRA owner could not be billed for them and these fees cannot be paid with non-IRA funds. In addition, the IRA could not be reimbursed for these fees. Any attempt to do so would require the contribution to be reported as a regular contribution and count against the annual limit.

There have been a number of PLRs where the IRS did rule that the fee, or service charge, was an "administrative" expense or an "overhead" expense and thus was to be treated in the same way as an annual administrative fee. Examples are: service charges for additional investments, the printing of additional statements, form preparation fees, recordkeeping and accounting fees, IRA investment subaccounting fees, one-time start-up or termination fees, close-out fees, and transfer and rollover fees.

We do wish to point out that many of these fees appear to be "transactional." Distribution fees are transactional as are close-out and transfer fees.

A 2005 IRS Private Letter Ruling (PLR200507021) again made the fee subject a very hot topic. In this

Continued on page 6

The Administrative Aspects of IRA Fees,
Continued from page 5

PLR, the IRS ruled that a flat fee based on a percentage of assets could be paid by the individual with personal funds (i.e. the IRA would not be required to pay this fee) and such payment would not count toward the contribution limit. Presumably, such a flat fee charged by a securities firm is very similar to the fee charged by a trustee.

The IRS' ruling was very favorable for the IRA owners who have their IRAs with the securities firm, as discussed below. By not having to have their IRAs pay the annual fee, these IRA accountholders will be able to accumulate more wealth in their traditional IRAs and Roth IRAs.

What is the result if an IRA custodian/trustee has billed transaction fees to the IRA owner, allowing him or her to pay the fees with personal, non-IRA funds? The IRA custodian/trustee will not like the results. First, all non-complying transactional, non-administrative fees incorrectly billed directly to the IRA owner must be reported as an IRA contribution in and for the year in which they were billed. They are reported like any other IRA contribution on IRS Form 5498. If this "deemed" contribution results in an excess for the year, it must be dealt with accordingly as any other excess IRA contribution. All IRS taxes and penalties for the excess "deemed" contribution apply.

Since the IRA custodian/trustee reporting will likely be late, all penalties for incorrect and/or late contribution (Form 5498) and distribution (Form 1099-R) reporting also apply. Again, because of the usual lateness of this reporting, the IRA accountholder could also be assessed IRS penalties.

Conclusion: When in doubt as to whether a particular type of fee can be billed to the IRA owner or not, the safe answer is always charge the IRA.

If your financial institution wishes to adopt a policy of allowing the IRA accountholder to pay for certain fees and service charges with non-IRA funds, you will want to discuss this subject with your legal counsel. The IRA plan agreement will need to authorize the fees and the procedures for charging and paying for the fees. In some cases, you may wish to obtain a private letter ruling from the IRS. ◆

December 31, 2008 — New Deadline for Nonqualified Plan Documents

The IRS has recently announced that it is extending the compliance deadline for businesses who have sponsored a nonqualified plan to amend and restate their plan(s) in accordance with the final regulations under Code section 409A. The deadline is now December 31, 2008, and not December 31, 2007.

If your institution needs help with updating your nonqualified plan(s), please consider CWF as we do work with nonqualified plans. ◆

RMDs and Divorce

Simply put, a divorce doesn't receive special treatment or change the RMD laws or regulations.

Joshua Trujillo is age 77. His IRA balance as of 12-31-06 was $154,000. His RMD for 2007 is $7,264.15 ($154,000/21.2).

Joshua and his wife, Rosella, age 73 were divorced on June 15, 2007. The judge issued an order that $77,000 was to be transferred from Joshua's IRA at IRA Custodian #1 to Rosella's IRA at IRA Custodian #2. Rosella has established a new IRA with IRA Custodian #2. She does not have any other IRA.

At the time of the divorce, Joshua had not been paid any portion of his RMD for 2007. Years ago he had instructed IRA Custodian #1 to pay him his RMD amount on December 1 of each year.

$77,000 will need to be transferred to Rosella's IRA with IRA Custodian #2. Rosella is not required to withdraw any RMD amount for 2007. She did not have an IRA balance as of December 31, 2006.

May Rosella and Joshua, as part of the divorce settlement, agree to a 50%/50% split of the RMD amount? Could the court rule that the two parties were to each assume responsibility for 50% of the RMD amount? The answer to both questions is "no."

A state court has no authority to change federal income tax laws or regulations. Joshua is required to be paid a minimum distribution of $7,624.15 for 2007. If he was only paid the amount of $3,632.08

Continued on Page 7

THE Pension Digest

**RMDs and Divorce,
Continued from page 6**

because his attorney or the judge thought the parties had the right to negotiate this amount, then he will owe the 50% excise tax on the other $3,632.08. It would not matter if Rosella took a distribution of $3,632.08. Neither Joshua, Rosella, nor the state judge have the authority to change what the federal income tax laws require. These laws require that the RMD amount be paid to Joshua, since it is he who had the balance as of December 31, 2006. The law and regulation could have been written to allow a modification of the calculation in the situation of a divorce. Presumably, for simplicity reasons, the law and regulations do not authorize such a modification. The parties and the court could grant some sort of “credit” to Joshua from other assets since the law requires him to take the full RMD amount for 2007. ◆

Don’t Forget Your Withholding Reminder Notices

It is the end of September and November and December will soon be here. This is when most IRA custodians make the majority of their RMD distributions.

One task quite often forgotten by IRA personnel is to furnish a complying withholding “reminder” notice and election form PRIOR to making the RMD payment.

The federal income tax law contains a number of withholding requirements. There are certain rules for withholding from wages. There are certain laws for withholding with respect to distributions from pension plans. And there are other laws for withholding with respect to distributions from IRAs. These laws are very different. They were enacted at different times.

There are two types of IRA distributions: nonperiodic (i.e. nonscheduled) and periodic (scheduled with distributions lasting more than one year.)

The general rule is that the IRA custodian must withhold 10% of the amount of the IRA distribution. However, the recipient has the right to elect to have no withholding or to have more than 10% withheld.

The federal income tax laws require the IRA custodian to furnish a withholding notice PRIOR to making the distribution. The recipient is notified the withholding laws. We are are all familiar with the IRS warning: you may be penalized if you fail to have withholding or you fail to make estimated tax payments. The IRS may fine the IRA custodian for failing to furnish a complying withholding notice. The IRS may assess a $10 for each failure.

In the case of a nonperiodic distribution, the IRA custodian must furnish the withholding notice immediately once the individual asks to take a distribution. For this reason, most IRA distribution forms will incorporate a withholding notice.

In the case of periodic distributions (i.e. RMD distributions), there are two sets of rules. If the person is receiving four or more distributions per year, then the IRA custodian is required to furnish only one withholding notice per year. If the person is receiving one or two distributions per year, then the IRA custodian is required to furnish the withholding notice and election form a reasonable amount of time before the payment and any notice furnished more than 6 months in advance of the payment is never reasonable.

Most RMD distributions fall under this second category. There are one or two distributions. **A withholding notice needs to be furnished a reasonable amount of time prior to the payment.** CWF has what we call a withholding reminder notice. The gist of the form is to describe the IRA withholding rules, remind the individual of what he or she had previously instructed and that the IRA custodian will continue to follow that instruction unless the individual would return the form furnishing a new instruction.

An IRA custodian could certainly draft its own notice and election form. Such form should rely heavily on the IRS W-4P. You want the form to be simple and concise, but yet give a comprehensive explanation of the IRA withholding rules. We would hope you would use one of CWF’s versions. ◆

Outdated IRA Plan Agreements and Disclosure Statements

In order for a person to have an IRA and to receive the related tax and non-tax benefits, there must be a written IRA plan agreement. It must be "current." One cannot use an IRA form written in 1982 to establish an IRA in 2007. One also cannot use an IRA form written in 2002 to establish an IRA in 2007. We all know how tax laws and other laws change. An IRA plan agreement is a legal document. It matters what is written within the document. What the document might have been written to say does not matter. IRA plan agreements needed to be updated for the law changes which occurred in 2005 and 2006.

For similar reasoning, the IRA Disclosure Statements must be revised to include the 2005 and 2006 law changes. Most of the financial institutions using CWF forms have furnished a comprehensive IRA amendment to their IRA accountholders and are using updated IRA plan agreements, but some are not.

We recommend that every financial institution be using "current" IRA plan agreement forms. A financial institution which has failed to furnish IRA amendments or to use updated IRA forms to establish new IRAs is assuming a risk. The IRS may fine the financial institution $50.00 for each failure to furnish a complying IRA plan agreement and/or disclosure statement. It may be small, but there is also a risk with respect to your customers. Somebody may take an action based on "old" provisions and become disgruntled. ◆

Special Observation About Roth IRAs and Spouse Beneficiaries

The general planning rule is that a surviving spouse will want to treat the deceased spouse's IRA as his or her own IRA. This rule applies to both traditional IRAs and Roth IRAs.

There will be times when a Roth IRA spouse beneficiary will not want to treat the deceased spouse's Roth IRA as his or her own.

For illustration purposes it is assumed that John is age 65. John has had his Roth IRA for 9 years. He dies in 2007. His wife, Ramona, age 56, is his designated beneficiary. Should she immediately treat this Roth IRA as her own? Must she treat this Roth IRA as her own?

Probably not. She is not yet age 59½. If she treats the Roth IRA it as her own, any distribution will not be "qualified" since the distribution will not be on account of death. The five year rule has been met, but the second requirement (one of 4 reasons) most likely will not be met until she attains age 59½.

Any distribution from the inherited Roth, "Ramona as beneficiary of John's Roth IRA," will be qualified and tax-free since he had met the five year requirement and the distribution would be on account of his death.

Remember that because Ramona is a sole spouse beneficiary, she is not required to commence distributions until December 31st of the year John would have attained age 70½.

Whether or not the surviving spouse may maintain this Roth IRA as an inherited Roth IRA depends on how the Roth IRA plan agreement has been written. The IRS has written its Model Roth IRA forms to provide that the Roth IRA of the decedent automatically becomes the Roth IRA of the surviving spouse. However, the IRS has ruled that the Roth IRA plan agreement may be revised (i.e. written) so that the spouse is not required to treat such a Roth IRA as his or her own. CWF has written its Roth IRA form to provide a surviving spouse with this option.

If you do not use CWF Forms, you may wish to review your forms to see if a surviving spouse would have this option. ◆