

HANDLING IRA PROCEEDS:

WHAT BENEFICIARIES SHOULD KNOW

By The Vanguard Group

Each primary beneficiary you have named for your IRA can decide independently how to handle his or her share of the IRA proceeds—but they need to understand all the options.

After years of saving and investing, your individual retirement account (IRA) assets may have grown to a significant sum. As you plan for the future, you will want to ensure that the individual named as your beneficiary is aware of the decisions—and understands all of the options—that he or she will face at some point.

This article can assist you in providing guidance to your beneficiary about the decisions he or she will face in handling the proceeds of your IRA. Because of this, you may find it helpful to share this article with your beneficiary or keep it with your financial records so that your beneficiary can find it when it is needed.

If you have named more than one primary beneficiary for your IRA, you should be aware that each primary beneficiary can generally decide independently how to handle his or her share of the IRA proceeds.

THE OPTIONS WHEN AN IRA CHANGES HANDS

If your beneficiary is an individual rather than a trust, a charity, or your estate, he or she must choose among the following irrevocable alternatives allowed by the federal government:

- **Assume the IRA.** This option, available only to the surviving spouse of an IRA owner, allows your spouse to move the assets into an IRA of his or her own. In other words, your IRA becomes the IRA of your surviving spouse. Note, however, that in the case of a Roth IRA, the surviving spouse can assume the IRA only if he or she is the sole primary beneficiary.
- **Inherit the IRA.** Whatever your beneficiary's relationship to you, this option permits him or her to have the IRA assets moved into an account registered in both your and your beneficiary's names, then depleted over a fixed period.
- **Disclaim the IRA assets.** For estate planning purposes, your beneficiary may want to disclaim (refuse) your IRA assets. In such a case, the decisions about handling your IRA assets would fall to your alternate beneficiary (if you have named one and you have no other primary beneficiaries). If all of your beneficiaries disclaim your IRA assets, your estate becomes the beneficiary of your IRA.

Because an individual who disclaims IRA assets is relieved of any further decisions regarding the disposition of those assets, the remainder of this article will focus on the two alternatives that do require decisions by a beneficiary: assuming and inheriting an IRA.

As you read more about these alternatives, remember that your beneficiary can continue to benefit from the power of tax-deferred or tax-free growth by delaying withdrawals from an assumed IRA or inherited IRA for as long as possible.

For a quick summary of the alternatives available to your beneficiaries, see Table 1.

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TABLE 1. IRA BENEFICIARIES: COMPARING THE ALTERNATIVES

| Assuming an IRA | Inheriting an IRA | Disclaiming an IRA |
|---|--|--|
| Available <i>only</i> to the surviving spouse of IRA owner. (For a Roth IRA, available only if the surviving spouse is the sole primary beneficiary.) | Available to any beneficiary (including a surviving spouse). | Available to any beneficiary (including a surviving spouse). |
| Your spouse moves the assets into an IRA of his or her own. | Your IRA is registered in your <i>and</i> your beneficiary's name, and your beneficiary must deplete the assets over a fixed period. | Your beneficiary renounces any claim to your IRA assets and has no say in their disposition. |
| Your spouse can make additional contributions (as long as he or she has earned income). | Your beneficiary cannot make additional contributions. | If all of your beneficiaries disclaim your IRA assets, your estate becomes your beneficiary. |
| Federal income tax and a 10% penalty tax may apply to distributions taken before your spouse reaches age 59½. | Your beneficiary may owe federal income tax on distributions, but no penalty tax applies to distributions taken before your beneficiary reaches age 59½. | |
| Your spouse can transfer assets between financial institutions, including a rollover of assets.* | Your beneficiary can transfer assets between financial institutions, but cannot roll these assets over into another IRA.* | |
| Your spouse can name his or her own beneficiary. | Your beneficiary can name his or her own beneficiary. | |
| If you had a traditional IRA, your spouse does not have to begin taking required minimum distributions until after he or she reaches age 70½. | If you had a traditional IRA from which you had not begun taking required minimum distributions, or a Roth IRA, your beneficiary can choose to take distributions based on his or her life expectancy <i>or</i> by December 31 of the fifth year after the year of your death. | |
| If you had a Roth IRA, required minimum distributions do not apply. | If you had a traditional IRA from which you had begun taking required minimum distributions, your beneficiary generally must deplete the IRA's assets at least as rapidly as under the distribution method you were using. | |
| *A rollover is a transfer of assets between financial institutions in which the IRA owner takes possession of the assets as part of the transfer. | | |

HOW AN ASSUMED IRA WORKS

An IRA can be assumed only by a beneficiary who is the surviving spouse of the IRA's original owner (and with a Roth IRA, only when the surviving spouse is the sole primary beneficiary). With this alternative, your IRA actually becomes the IRA of your spouse. Should your spouse choose to assume your IRA, all of the standard

rules governing IRAs apply. This includes the ability to:

- Keep the assets fully invested on a tax-deferred basis until the mandatory age to begin required minimum distributions from a traditional IRA—generally April 1 of the year after reaching age 70½. (Because required minimum distribution rules do not apply to Roth IRAs, your spouse will never have to take required minimum

distributions from an assumed Roth IRA.)

- Make penalty-free withdrawals after age 59½ (from a traditional IRA).
- Make tax-free withdrawals (from a Roth IRA) subject to age and holding-time requirements.
- Make additional contributions subject to age and earned-income requirements.
- Designate a beneficiary.

HOW AN INHERITED IRA WORKS

If your beneficiary inherits your IRA, he or she must deplete the assets. The method for these distributions depends on whether you had a Roth IRA, or you had a traditional IRA and were age 70½ or older.

If you had a Roth IRA, or if at the time of your death you had not yet reached the date for beginning required distributions from your traditional IRA, your beneficiary must choose between the following two irrevocable distribution options:

- **Lifetime distributions.** Your beneficiary can establish an installment distribution plan to redeem the balance of the inherited IRA assets based on his or her life expectancy. Distributions generally must begin by December 31 of the year following your death. An exception exists if your beneficiary is your surviving

spouse, in which case distributions can be delayed until the year in which you would have reached age 70½.

- **Five years for distribution.** Your beneficiary must redeem the entire balance of the inherited IRA assets no later than December 31 of the fifth year following the year of your death.

If you had a traditional IRA and began taking required minimum distributions because you reached age 70½, your beneficiary must continue taking these distributions. In this case, your beneficiary generally must deplete the IRA assets *at least as rapidly* as under the distribution method you were using.

Note: If you have more than one primary beneficiary, special rules may apply.

Keep in mind that a beneficiary who inherits either a traditional IRA or a Roth IRA can begin taking distributions before age 59½ without penalty. This is because federal law

exempts inherited IRAs from a 10% penalty tax that is generally levied on IRA distributions when the owner is younger than age 59½.

POINTS TO REMEMBER

Whether your beneficiary inherits or assumes your traditional IRA, the following two federal tax rules govern each distribution:

- Ordinary income tax at your beneficiary's tax rate generally applies to any assets that were not already taxed.
- A 50% federal penalty tax applies to any shortfall in any calendar year in which your beneficiary fails to satisfy minimum distribution requirements.

Keep in mind that, depending on the circumstances surrounding the change of ownership, the transition can be complex. Therefore, you and your beneficiary may want to consult with a professional tax or financial adviser. ♦

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