JOURNAL OF BUSINESS
Serving Spokane & Kootenai Counties

Reprinted from the April 17th, 2008 issue of the Journal of Business, Spokane, Washington.
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Leaving retirement money in 401(k) not always best

Sometimes, transferring funds to an inherited IRA would be the better option

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Special to the Journal of Business

Putting money away in your company's retirement plan, such as a 401(k), is a smart way to save for the future, especially if your employer provides matching contributions. Under certain circumstances, however, keeping the funds in a 401(k) plan isn't necessarily the best choice.

I know of a situation in which an employee (I'll call him John) had to quit his job for medical reasons.

His health was such that he could have lived another 25 years or he could have died within a week. Six months after quitting his job, John died at the age of 54.

His wife (I'll call her Sue) is 52 years old and the primary beneficiary of John's 401(k). Sue's income, plus any other monies coming in, wasn't sufficient to cover her expenses. After being presented with some financial options, Sue chose to remain a beneficiary and to transfer John's 401(k) funds into an inherited IRA.

Normally a 10 percent penalty is assessed on the IRA owner if withdrawals are made before the owner turns 59 ½ years old, but since Sue was to remain a beneficiary, and she was planning to establish an inherited IRA, she would be allowed to withdraw money without penalty.

She still would have to pay taxes on the amount withdrawn, but she wouldn't have to pay the penalty.

But even though the IRS allows spouse beneficiaries of 401(k)s to transfer the funds to an inherited IRA, John's company plan prohibited such a transfer. His company plan would allow the funds to be transferred to Sue's IRA, if she had one, or a new IRA established in Sue's name, but not to an inherited IRA.

Sue's only choice was to transfer John's 401(k) funds to a newly established IRA in her name and set up a 72(t) schedule (a less favorable option) to gain access to the funds without paying the 10 percent penalty.

If John had transferred his 401(k) to an IRA after he quit his job and named Sue as the primary beneficiary, this problem could have been avoided. Sue could have remained a beneficiary and established an inherited IRA. Transferring John's 401(k) to an IRA would have allowed Sue to do what she needed and to make other choices available to her.

One option would be for Sue to do a rollover/direct transfer to her own IRA. John's IRA would become Sue's IRA and would be treated as if it always had been hers. Sue then goes from beneficiary to owner and, thus, must follow the normal IRS rules for IRAs. But Sue needs the money now, so that wouldn't be the best option.

She is younger than 59 ½ years old, so choosing the rollover option would require her to pay the 10 percent early-withdrawal penalty for funds withdrawn.

Another option would be to treat John's IRA as if it were her own. This would involve changing the name and Social Security number on his IRA to hers. To do that, however, Sue must be the sole primary beneficiary of John's IRA. If she is not, his IRA can be split into multiple IRAs, one for each primary beneficiary. This would make Sue the sole primary beneficiary on just one of the IRAs. She then could treat that IRA as if it were her own. This would give her two separate IRAs—her original IRA, if she had one, and the newly created one from John. The normal IRS rules for IRAs then would apply, so again that wouldn't be the best option because of the 10 percent early-withdrawal penalty.

> Don't assume that your company plan will allow what an IRA allows. Check it out.

A third option for Sue is the one I've already discussed and the best one for her situation: She could remain a beneficiary and open an inherited IRA. It's important, however, that inherited IRAs are set up correctly. IRS regulations require that the name of the deceased remain on the IRA: John XXXXXX IRA (deceased October 26, 2007) FBO Sue XXXXXX, beneficiary.

As the spouse, Sue has multiple options for withdrawing funds. If she needs the money, and in her situation she did, she could begin withdrawing the funds once the inherited IRA is opened and the funds from John's IRA are transferred. For a non-spouse beneficiary, withdrawing the funds, (the required minimum distribution) must begin the year after John's death.

Even though Sue chooses to withdraw funds immediately after inheriting John's IRA, she isn't required to do so until she turns 70 ½ years old or when John would have turned 70 ½ years old, whichever is later. Withdrawals, whether by a spouse or a non-spouse beneficiary, aren't subject to the 10 percent early withdrawal penalty, but are subject to ordinary income taxes (if the IRA wasn't a Roth IRA). If after a few years Sue no longer needs the money, she could change her option midstream and do a rollover/direct transfer and make it her own IRA. The normal IRS rules for withdrawing IRA funds once again would apply.

Whether Sue chooses the first, second, or third option, she should name both a primary and secondary beneficiary on the IRA beneficiary form.

When company retirement plans are established, nuances are built into the plans so as not to create an administrative burden for the employer. Regular IRAs and inherited IRAs likewise have many such nuances. What does your company plan allow? Would it allow you to do a transfer to an inherited IRA if you are the spouse beneficiary? What does it allow if you are the non-spouse beneficiary?

Don't assume that the company plan will allow what an IRA allows. Each company plan has a document called the Summary Plan Description (SPD), and it's important to read it to know what the plan allows before making any decisions. Then plan a course of action that fits your personal needs and financial situation.

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