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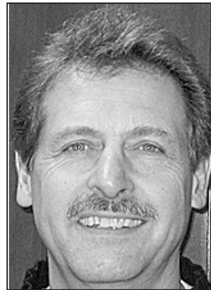
Clock ticking for non-spouse retirement plan beneficiaries

They only have a couple of months left to do direct transfer to inherited IRA

By Dennis Roginski
SPECIAL TO THE JOURNAL OF BUSINESS

Are you a beneficiary who inherited a company retirement plan from someone other than your spouse, and did the original owner die in 2006? Are the funds still in the deceased's company plan, and does that plan require that you either empty it within five years or take a lump-sum distribution?


Dennis Roginski

If you answered yes to these questions, be alerted that the plan might allow you to do a direct transfer to an IRA, which you would have to set up as an inherited IRA while following the rules carefully. Transferring the funds to this newly formed inherited IRA would allow you to "stretch" the withdrawals over your life expectancy, which could result in hundreds of thousands of dollars in additional withdrawals. You have until Dec. 31, to transfer the funds, but if you miss the deadline, you could be forced to abide by the distribution rules of the company plan. (For subsequent years, the beneficiary has until Dec. 31 of the year following the original owner's death to transfer funds to the inherited IRA).

Here's the deal. The Pension Protection Act of 2006 was signed into law over one year ago. This 900-page document contains numerous provisions created to protect company pensions for employees and to strengthen the federal pension insurance program.

Beginning this year, the Pension Protection Act will allow funds in a company retirement plan to be transferred directly to a Roth individual retirement account. Previously, company funds had to be transferred to a traditional IRA first and then converted to a Roth IRA. In both instances, income tax still has to be paid on the amount converted to the Roth IRA, but now one step has been eliminated.

Additionally, the act will allow non-spouse beneficiaries of pre-tax company retirement plans to make direct transfers to inherited IRAs. (Or Roth company retirement plans to inherited Roth IRAs) This will allow those beneficiaries to stretch distributions from those assets over their life expectancies. Previously, only a spouse beneficiary could transfer funds from a company retirement plan to an inherited IRA. If the non-spouse beneficiary leaves the funds in the company plan—and is forced to follow its distribution rules instead of transferring the funds into an inherited IRA—the difference in the amount of the withdrawals could run into the thousands of dollars.

Let's look at a hypothetical situation and then draw two scenarios. Here is the situation: Assume that at the end of 2007 Jane Doe, the non-spouse beneficiary, is 30 years old. The account is worth $100,000, and the company plan requires that these funds, if they remain in the plan, be withdrawn in their entirety by the fifth year following the employee's date of death (2006). Let's also assume that the account earns 8 percent annually.

In our first scenario, Jane keeps the funds in the company plan and withdraws 20 percent of the account value at the beginning of the first year, then withdraws an additional 20 percent each year until 2011. By that time, Jane has withdrawn a total of $112,726 and the account is empty.

> Such a transfer could result in hundreds of thousands of dollars of additional available withdrawals.

In our second scenario, Jane decides to transfer the money directly from the company plan to an IRA, which would be set up as an inherited IRA. She does this in November, giving herself plenty of time before the Dec. 31, 2007 deadline. According to the IRS life expectancy table, Jane has 53.3 years of life remaining, and each year she withdraws only the required minimum distribution (RMD). After 53 years, Jane has withdrawn a total of $1,385,415—a difference of $1,282,689 compared with our first scenario in which she withdrew all of the funds over a five-year period. Jane could have withdrawn the entire amount after she inherited the assets in the company plan and set up the inherited IRA, but wisely she chose to stretch the funds in the newly-formed inherited IRA over her life expectancy.

In order for Jane to do that, though, she must follow strict IRS rules. If she breaks any of those rules, the stretch could be lost, and the funds from the company plan might be subject to the distribution rules of that plan.

Here are some of the rules: First, the transfer from a company plan to the inherited IRA must be a direct trustee-to-trustee transfer and not a rollover. The distribution is considered a rollover if a check is made out and sent to Jane Doe.

If Jane Doe had been the original owner of the company plan and receives a check made out to her for the amount of her retirement funds, she would have 60 days from the date of the check to deposit the funds into an IRA account to avoid being taxed on the rollover distribution. However, in our example, Jane Doe is the non-spouse beneficiary, so she receives a check from the company plan for the distribution. This is considered a rollover and would not afford her the luxury of having 60 days to deposit funds into an IRA. Therefore, the stretch would be lost, and she would be taxed on the entire amount of the distribution.

Second, if the original owner of the IRA is older than 70½ and had begun taking his RMD from the company plan, but had not taken it for the year of his death, Jane must first withdraw the RMD based on the original owner's life expectancy. Then she can do a trustee-to-trustee transfer to an inherited IRA at another company. Once the transfer is complete, she must begin taking her annu-

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al RMDs based on *her* life expectancy, beginning in the year following the date of the original owner's death.

Third, if the original owner dies before reaching 70½ years old, then Jane can do the trustee-to-trustee transfer and not worry about first taking the RMD. Once the account is transferred to an inherited IRA, however, she must begin taking her RMD in the year following the death of the original owner. Her RMDs would be based on her life expectancy.

Fourth, the inherited IRA's account title must include the name of the original owner. For example, "Jeffrey Doe (deceased, May 25, 2006) IRA, FBO, Jane Doe as beneficiary of Jeffrey Doe IRA." Once the inherited IRA is set up, Jane Doe should immediately name primary and secondary beneficiaries.

Fifth, owners of traditional IRAs normally face a 10 percent penalty for any withdrawals made before the owner reaches 59½ years old; beneficiaries, however, aren't subject to the early-withdrawal 10 percent penalty rule, so the beneficiary's age doesn't matter. Jane would only be taxed at her ordinary income tax rate on any withdrawals. But if Jane were to fail to take her RMD, or didn't take enough, the IRS could impose a 50 percent tax on the shortfall.

IRS laws are complicated. A simple mistake can be very costly and normally is irrevocable. If you recently have inherited a retirement account, contact a financial adviser who also is a retirement specialist.

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