

Practice Tips on How to Avoid an Expensive Beneficiary Blunder

Summary Advisors often deal with clients who have inherited or will inherit IRAs. IRA beneficiary distribution rules can be complicated. Financial advisors can play a key role in helping IRA beneficiary clients avoid penalty tax traps. The following paragraphs outline one approach an advisor might use to work with an IRA beneficiary to help him/her avoid unnecessary penalty taxes.

Client Profile An individual who has, or will, inherit an IRA.

Apply the Rules Beneficiaries of IRAs have choices regarding when and how their inherited IRA funds will be distributed. The IRA plan agreement spells out what options are available.

If a beneficiary fails to timely choose a distribution option, the beneficiary default option (also detailed in the plan agreement) generally will call for a series of life expectancy payments, usually taken over the life of the beneficiary, although some exceptions apply. In most cases, the beneficiary must take his/her first payment by December 31 of the year following the year of death, and each subsequent year until the account is depleted. If the beneficiary is the spouse, and the death of the IRA owner occurs before his/her required minimum distributions have begun at age 70 ½, then the surviving spouse beneficiary may delay taking his/her first life expectancy payment until the year the IRA owner would have turned 70 ½.

If an annual distribution is missed, the beneficiary is subject to a 50 percent penalty tax on the amount that should have been taken.

The default distribution rules for IRA beneficiaries changed somewhat in 2002. Under the previous rules, under certain circumstances, the default option allowed the beneficiary to do nothing for five years. Many clients (and their advisors) are unaware the five-year option is no longer available.

Ask a key question Advisor: Are you the beneficiary of an IRA?

Client: *Yes, my sister recently passed away, and I am the heir to her IRA.*

Advisor: I am sorry to hear of your loss. Are you aware of the 50 percent IRS penalty that could apply to beneficiaries of IRAs?

Client: *No, what do you mean?*

Advisor: IRA beneficiaries, such as you, typically must begin distributions from their inherited IRAs in the year after the year of death to avoid penalty taxes. Were you aware of this?

Client: *No—this is the first I have heard of it.*

Advisor: Perhaps we should contact your tax advisor and discuss your options and requirements.

Example

Sam, age 50, died in 2004 with \$100,000 in his IRA. Sam named his sister, Margaret, age 45, as the beneficiary of his IRA.

Margaret assumed she had five years to decide what do with the funds in the inherited IRA.

In 2006, Margaret met with Sarah, her new financial advisor. During their initial meeting Sarah asks Margaret if she has inherited any IRA assets. Margaret responds by saying she is the beneficiary of her brother Sam's IRA, and explains that Sam died in 2004.

Sarah explains the IRA beneficiary rules, and the possibility of the 50 percent penalty tax. Sarah also suggests they meet with Margaret's tax advisor to review the situation.