The Kitces Report
Advancing knowledge in financial planning...
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Maximizing The Stretch IRA And Required Minimum Distribution Rules After Death

Executive Summary

- The Federal government provides substantial tax incentives to encourage saving towards retirement. In fact, the tax-preferences associated with retirement accounts are the Federal government's second largest tax expenditure, behind only the income exclusion for employer-paid health insurance. Consequently, Congress has limited the extent to which those retirement account tax preferences can continue after the death of the original owner, by establishing required minimum distributions for the beneficiaries of both traditional and Roth-style accounts.

- The pace at which an inherited retirement account must be liquidated depends on the type of beneficiary. Designated beneficiaries (i.e., living, breathing human beings) have the option to stretch the distributions out over their life expectancies. By contrast, "paper beneficiaries" (also known as "non-designated beneficiaries"), such as trusts, estates, and charities, must liquidate the account under either the 5-year rule or the decedent's life expectancy (if the decedent was already over age 70 ½ at the time of death).

- Surviving spouses as the designated beneficiary have special rules that provide even-more-favorable treatment. Specifically, spouses have the option of leaving the retirement account as an inherited account and enjoying penalty-free distributions and a potential delay until distributions must even begin, or completing a "spousal rollover" of the inherited retirement account into his/her own account, deferring RMDs until the surviving spouse reaches age 70 ½.

- Employer retirement plans are not required to allow designated beneficiaries to stretch over their life expectancies, and can require the 5-year rule. However, surviving spouses can always roll over to their own name, and since 2010, inherited employer retirement plans must at least allow the account to be transferred to an inherited IRA (which can subsequently be stretched).

- Although a trust is normally a paper beneficiary (not eligible for designated beneficiary treatment), certain trusts may qualify as a designated beneficiary, such that the inherited retirement account can be stretched by "seeing through" the trust to its underlying beneficiaries (and using their life expectancies). However, trusts as beneficiaries of retirement accounts typically have less favorable income tax treatment (due to compressed trust tax brackets).

- When multiple beneficiaries are involved, the standard rule is that all beneficiaries must take post-death RMDs based on the oldest beneficiary with the least favorable life expectancy. However, if the inherited retirement account is split by December 31st of the year after death, then beneficiaries can each calculate and take their post-death RMDs based on their own individual life expectancies – which in practice is what virtually always occurs, as long as the accounts really *are* split by the required deadline!

- Completing the post-death RMD process requires first re-registering the inherited retirement account from the original account owner's name into an inherited retirement account (labeled as such) that includes the name of the decedent *and* the name of the beneficiary. Once retitled, the account can then be transferred to another financial institution as a trustee-to-trustee transfer, though notably an inherited retirement account *cannot* be rolled over once distributed.

- The income tax treatment of inherited retirement accounts follows the same rules that otherwise apply to such accounts, including that pre-tax accounts distribute contributions and gains pro-rata, Roth accounts distribute principal first, and Roth growth is still tax-free (but must still meet the 5-year rule to qualify).

About the Author

Michael E. Kitces, MSFS, MTAX, CFP®, CLU, ChFC, RHU, REBC, CASL, is a Partner and the Director of Wealth Management for private wealth management firm Pinnacle Advisory Group (www.pinnacleadvisory.com), located in Columbia, Maryland. In addition, he is an active speaker, and publishes *The Kitces Report* and his blog "Nerd's Eye View" at his website www.kitces.com.

Introduction

The Internal Revenue Code provides a number of tax-preferences for retirement accounts, as a means of encouraging – and outright subsidizing – saving for retirement. From the tax deduction on traditional IRA and employer retirement plan contributions, to annual tax-deferred growth on all types of retirement accounts, and the tax-free distribution of Roth-style accounts, the Office of Management and Budget estimates that in the 2017 fiscal year alone, retirement account tax-preferences will "cost" the Federal government more than $184 billion in foregone revenue. In the aggregate, this makes our Federal tax expenditures for retirement saving second only to our tax subsidies for health insurance (with the income exclusion for employer-paid health insurance topping out the list at more than $200 billion per year).

As a result, Congress has taken steps over the past several decades to limit the Federal government's financial exposure to tax-preferenced retirement accounts, from imposing contribution limits on how much can be contributed *to* retirement accounts, to limiting the duration of those tax-preferences by forcing elder savers to begin taking distributions from the accounts (the so-called "Required Minimum Distribution" rules).

In addition, Congress further limits the benefits of tax-preferenced retirement accounts by requiring that, after the death of the original account owner, the account must at least begin its liquidations. In other words, tax-preferences for retirement accounts are meant to be for retirees, not for their heirs who happen to inherit the unused portion of the account balance.

In this month's newsletter, we explore the rules for post-death required minimum distributions of inherited retirement accounts, how the obligation of beneficiaries to take post-death withdrawals varies significantly depending on the type of beneficiary (and whether they are a "designated" beneficiary or not), steps to take to comply with the various obligations that beneficiaries face when inheriting such accounts, and strategies for retirement account owners to consider – before death – to minimize how much beneficiaries are obligated to withdraw in the future, allowing them to maximize and "stretch", to the extent possible, the ongoing tax-deferral benefits of (inherited) retirement accounts.

Post-Death RMDs From Inherited Retirement Accounts

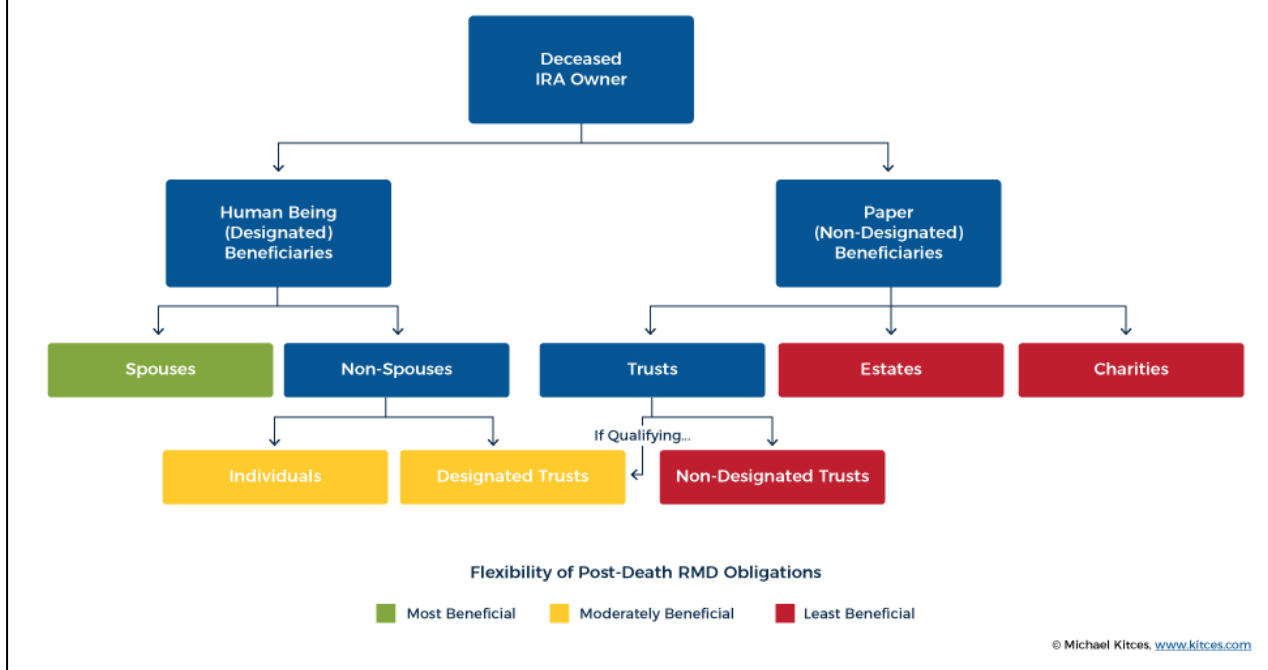
Tax-preferenced retirement accounts are subject to "Post-Death Required Minimum Distribution" rules that require the heirs who inherit such accounts to, in virtually all circumstances, begin liquidations of any remaining account balance after the death of the original retirement account owner.

Notably, these rules apply to all types of tax-preferenced retirement accounts, including both individual IRAs and employer retirement plans like 401(k)s, 403(b)s, and profit-sharing plans. And the rules apply equally to both traditional and Roth-style inherited retirement accounts. Of course, the tax treatment *of* those post-death RMD obligations from traditional vs Roth accounts will generally be different, as traditional distributions are fully taxable as ordinary income, while Roth distributions are generally tax-free. Nonetheless, the obligation to take the distributions *from* the accounts remains the same, and once distributed, those assets will then be subject to taxation in every *future* year as well (to the extent they're not immediately spent).

However, in the interest of not-too-adversely impacting the heirs of retirement accounts, the Internal Revenue Code, in sections 401(a)(9) (for employer retirement plans) and 408(a)(6) (for IRAs), prescribes a series of sometimes-complex rules to determine exactly *how fast* a tax-preferenced retirement account must actually be liquidated after the death of the original owner.

At a high level, the post-death RMD rules break prospective heirs into multiple categories (as shown in Figure 1, next page), depending on whether they are individual human beings, or various types of non-human entities (e.g., estates, charities, and trusts, which only exist because a piece of paper says they do). The individual human being beneficiaries (known as "designated beneficiaries") are allowed to take retirement distributions more slowly (and stretch out the tax-preferences of the retirement account), with especially favorable treatment when a spouse is the beneficiary, while the "paper beneficiaries" (also known as "non-designated beneficiaries") have less beneficial treatment and must liquidate the retirement account more quickly after the death of the original owner (with the exception of certain designated trusts, as discussed further in a later section).

Figure 1. Flowchart Of Post-Death RMD Beneficiary Types



Post-Death RMDs For Human (Designated) Beneficiaries

Under IRC Section 401(a)(9)(B), the standard rule is that any remaining retirement account balance after the death of the original owner that is payable to a designated beneficiary shall be distributed "over the life expectancy, or over a time period not extending beyond the life expectancy" of that designated beneficiary. For the purpose of these rules, a "designated" beneficiary is defined in IRC Section 401(a)(9)(E) as "any individual designated as a beneficiary" – the key point being an *individual* (i.e., a human being that has a pulse and, thus, a life expectancy over which distributions *can* be stretched).

The requirement that distributions shall be payable "over a time period not extending beyond the life expectancy" of the designated beneficiary effectively sets a minimum floor on the amount of money that *must* be distributed from the inherited retirement account every year – thus why it is considered a "required minimum distribution" to that beneficiary.

Notably, though, the required minimum distribution is just that – a required *minimum* distribution – and the tax rules do nothing to prevent a beneficiary from liquidating the account more rapidly than what the RMD rules would prescribe. In other words, the (designated) beneficiary can always withdraw *more* than the RMD obligation amount… just not less. However, to the extent that the beneficiary *does* take the minimum amount available, stretching out the distribution obligation over a period of years or even decades, significant additional tax-preference growth can be achieved… and thus why the strategy is often called a "stretch IRA" (or "stretch 401(k)", as discussed further in a later section).

The first post-death RMD is due in the year *after* the retirement account owner passed away (although if the original account owner had already reached lifetime RMD phase, the decedent's RMD itself must still be

Figure 2. Formula For Calculating Post-Death RMDs

$$\text{Post-Death RMD} = \frac{\text{Prior-Year 12/31 Balance}}{\text{Applicable Distribution Period}}$$

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withdrawn for that year of death, if it hadn't been already).

To calculate the actual first post-death RMD amount under Treasury Regulation 1.401(a)(9)-5, Q&A-3, -4, and -5, the account balance at the end of the *prior* year is divided by an "applicable distribution period", as shown in Figure 2 (prior page). This is similar to the calculation of the annual RMD obligation during the original account owner's lifetime as well, but for post-death RMDs, the "life expectancy" used for the applicable distribution period is determined using the Single Life Table in Appendix B of IRS Publication 590, as shown in Figure 3 below (whereas for lifetime RMDs, it's basic on the Uniform Life Table). As with lifetime RMDs, the correct age to use when identifying the life expectancy factor is the age that the beneficiary will be reaching on the beneficiary's birthday *in* the first RMD year (which in this case, is the year *after* the original retirement account owner died), as shown in Figure 4 (next page).

Example 1. Charlotte, age 68, died on April 27th of 2016 with an IRA worth $400,000, and left the entire account to her then-44-year-old son Andrew (who had turned 44 in March of that year). By the end of 2016, the December 31st account balance was up to $421,000, and as of August of 2017, a further bull market rally had increased the account value to $446,000.

Since Charlotte died in 2016, Andrew's first RMD will be due by December 31st of 2017. To calculate the RMD, Andrew will take the *prior* year-end account balance ($421,000 as of 12/31 of 2016), and divide by his life expectancy based on the age he will turn *in* 2017. Although he was 44 when Charlotte died, Andrew *turns 45 in 2017*, and as a result he will use the life expectancy factor for a 45-year-old, which according to the Single Life Table I

Figure 3. Single Life Expectancy Table For Post-Death RMDs

Single Life Expectancy Table - For Use By Individual Retirement Account Beneficiaries

Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy
0	82.4	28	55.3	56	28.7	84	8.1
1	81.6	29	54.3	57	27.9	85	7.6
2	80.6	30	53.3	58	27.0	86	7.1
3	79.7	31	52.4	59	26.1	87	6.7
4	78.7	32	51.4	60	25.2	88	6.3
5	77.7	33	50.4	61	24.4	89	5.9
6	76.7	34	49.4	62	23.5	90	5.5
7	75.8	35	48.5	63	22.7	91	5.2
8	74.8	36	47.5	64	21.8	92	4.9
9	73.8	37	46.5	65	21.0	93	4.6
10	72.8	38	45.6	66	20.2	94	4.3
11	71.8	39	44.6	67	19.4	95	4.1
12	70.8	40	43.6	68	18.6	96	3.8
13	69.9	41	42.7	69	17.8	97	3.6
14	68.9	42	41.7	70	17.0	98	3.4
15	67.9	43	40.7	71	16.3	99	3.1
16	66.9	44	39.8	72	15.5	100	2.9
17	66.0	45	38.8	73	14.8	101	2.7
18	65.0	46	37.9	74	14.1	102	2.5
19	64.0	47	37.0	75	13.4	103	2.3
20	63.0	48	36.0	76	12.7	104	2.1
21	62.1	49	35.1	77	12.1	105	1.9
22	61.1	50	34.2	78	11.4	106	1.7
23	60.1	51	33.3	79	10.8	107	1.5
24	59.1	52	32.3	80	10.2	108	1.4
25	58.2	53	31.4	81	9.7	109	1.2
26	57.2	54	30.5	82	9.1	110	1.1
27	56.2	55	29.6	83	8.6	111 & over	1.0

Source: IRS Publication 590, Appendix B, Table I

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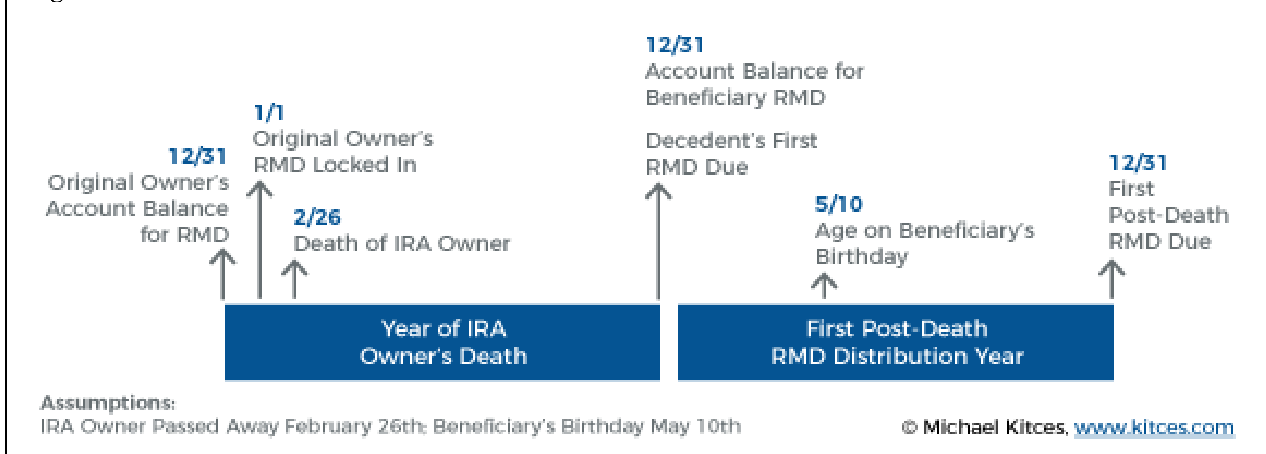
Figure 4. Timeline For The Onset Of Post-Death RMDs



of Publication 590 is 38.8 years.

Thus, Andrew's first RMD in 2017 will be $421,000 / 38.8 = $10,851, which must be taken from the account by December 31st of 2017.

Planning Tip: Don't forget to take the decedent's lifetime RMD for the year of death, if he/she died after lifetime RMDs had begun (i.e., after the Required Beginning Date), and hadn't already taken the RMD amount before death. This year-of-death RMD is still due by December 31st – regardless of the fact that the account owner died – and should be taken by the executor and distributed to the beneficiary (not the estate).

In each subsequent year after the first post-death RMD is taken, the applicable distribution period (the denominator of the RMD fraction) for determining the annual RMD is reduced by 1, and the end-of-year account balance is updated for the following year.

Example 1b. Continuing the prior example, at the end of 2017, Andrew's account balance finishes at $439,000 (including growth for 2017, and reduced by the $10,851 RMD that Andrew took in 2017).

As a result, his 2018 RMD will be based on the 12/31/2017 account balance of $439,000, and the applicable distribution period will be 38.8 – 1 = 37.8. Which means Andrew's RMD for 2018 will be $439,000 / 37.8 = $11,614.

Notably, the fact that the applicable distribution period is reduced by 1 in each subsequent year means the account *will* be fully liquidated in the 39th year, when the applicable distribution period is reduced below 1.0. This process ensures that, consistent with the requirement of IRC Section 401(a)(9)(B)(iii)(II), the inherited retirement account *will* be distributed over a period not extending beyond Andrew's life expectancy (as of when the retirement account was originally bequeathed to him).

However, inherited employer retirement plans – e.g., 401(k) plans – may be subject to more limited rules for designated beneficiaries (see sidebar, next page).

Stretching After The Death Of The Designated Beneficiary

Since the post-death RMD rules make it possible to "stretch" the inherited retirement account as far out as the life expectancy of the designated beneficiary, there is a non-trivial probability that the beneficiary themselves will pass away before the entire inherited account is liquidated (i.e., if the designated beneficiary passes away before his/her *own* life expectancy).

In such situations, Treasury Regulation 1.401(a)(9)-5, Q&A-7(c)(2) stipulates that the subsequent successor beneficiary actually has the right to continue the applicable distribution period of the original beneficiary. The successor beneficiary simply continues to take withdrawals, following the same process, and continuing to reduce the applicable distribution period by 1 in each subsequent year.

Example 2. Continuing the earlier example, assume that Andrew passes away of an untimely death in the year 2022.

Since Andrew's original applicable distribution period in 2017 was 38.8 years, his applicable

distribution period in 2022 (5 years later) will be 38.8 – 5 = 33.8.

If Andrew now leaves his account to his son Zachary, then Zachary will simply continue the annual RMD process for the inherited account, taking Andrew's RMD in 2022 (if he hadn't already) based on the 33.8 year applicable distribution period, and then taking another RMD in the following year based on a 32.8 year period, then a 31.8 year period, etc.

Planning Tip: Because the successor beneficiary of the original retirement account beneficiary can continue the stretch, it is crucial to ensure that *even an inherited retirement account has a properly executed beneficiary designation form*. However, since the successor beneficiary must *always* just continue the stretch of the original beneficiary, the successor's ability to continue stretching is the same regardless of whether the successor beneficiary is older or younger, human or paper!

Special Rules For Bequests To Older Designated Beneficiaries

As noted earlier, the standard rule when a retirement account is bequeathed to a designated beneficiary is that the beneficiary may stretch over his/her life expectancy.

However, if the decedent passed away after the Required Beginning Date – which is April 1st of the year *after* the original owner would have turned age 70 ½ (i.e., the due date of the first lifetime RMD) – then the beneficiary has the option to take distributions based on the life expectancy of the *decedent* instead. In such situations, the stretch period is based on the life expectancy of the decedent *in his/her year of death*, where the beneficiary must first take the RMD for *that* year (since by definition, the decedent had an RMD due, as he/she was past the Required Beginning Date). In each subsequent year (of post-death RMDs), the RMD stretch period is reduced by 1.

Notably, under Treasury Regulation 1.401(a)(9)-5, Q&A-5(a)(1), this rule *only* applies if the original

Post-Death Stretch Limitations For 401(k) Plans

While the standard rule for inherited retirement accounts is that a designated beneficiary may "stretch" the account over his/her life expectancy, Treasury Regulation 1.401(a)(9)-3, Q&A-4 permits an employer retirement plan (e.g., a 401(k) plan) to eliminate the stretch option, and instead require all beneficiaries to follow the 5-year rule. In the case of a spousal beneficiary, he/she could still roll over the account to his/her own IRA, but in the case of non-spouse designated beneficiaries, the end result was that inheriting a 401(k) or other employer retirement plan meant being *stuck* with the 5-year rule.

The original purpose of the rule was fairly straightforward: employer retirement plans didn't want to face the risk of being saddled with 50+ years of administrative costs to facilitate stretches for young beneficiaries, just because the former employee had left an account balance in the plan. Especially since the beneficiary might stretch the account for years or decades longer than the original employee had ever worked for the company in the first place… which, cumulatively across thousands of employees (with multiple beneficiaries each) could add up to substantial administrative costs for the plan. By "forcing" the inherited retirement account balances out to beneficiaries under the 5-year rule, employer plans were relieved of the prospective burden.

However, the loss of a stretch was a substantial disadvantage for the employee themselves, who may have *wanted* to offer a stretch to a beneficiary, and in some cases *couldn't* roll out the money to an IRA (that might be stretched instead), because the employee was still *working* for the employer and was actively contributing to the plan!

To resolve the issue, Section 829 of the Pension Protection Act created the new IRC Section 402(c)(11), which provides that employer retirement plans can offer non-spouse designated beneficiaries the option to complete a trustee-to-trustee transfer to an inherited IRA (and under Section 108 of the Worker, Retiree, and Employer Recovery Act of 2008, was made a *mandatory* option starting in 2010).

The upshot of this new rule is that while employer retirement plans may still be able to "require" the 5-year rule and limit the ability of non-spouse designated beneficiaries to stretch *from the plan*, the non-spouse beneficiary *must* be allowed to do a trustee-to-trustee transfer to an inherited IRA, from which the stretch can occur (and as noted earlier, a spouse could already do a spousal rollover to his/her own IRA). Thus, the end result is that non-spouse designated beneficiaries *are* now assured of a stretch for an inherited employer retirement plan, though they may be required to first do a trustee-to-trustee transfer to an inherited IRA to facilitate it.

account owner was already in the lifetime RMD phase (such that he/she had passed the Required Beginning Date), and is only relevant if the beneficiary is *even older* than the original decedent (such that the younger-decedent's life expectancy would be a longer and more favorable time period to stretch).

While not common, for a subset of situations where older retirees bequeath retirement accounts to ever-older beneficiaries, this rule may help to reduce the magnitude of RMDs and improve the length of the stretch period.

> *Example 3*. Brian passed away in 2016 shortly after his 75th birthday, and left his $575,000 retirement account to his 81-year-old older brother Sam.
>
> Sam's first obligation is to complete Brian's required minimum distribution for the year of death, which is based not on the account balance on the date of death ($575,000), but the account balance at the end of the *prior* year. Assuming the 12/31/2015 (end-of-prior-year) value of the IRA was $552,000, then based on Brian's age of 75 in 2016 (year of death), there would have been an RMD factor of 22.9, for an RMD in 2016 of $552,000 / 22.9 = $24,105.
>
> In 2017, Sam the beneficiary turns 82, and as a result his first post-death RMD would be based on an applicable distribution period of 9.1 (the single life expectancy of an 82-year-old under Table I of Appendix B of IRS Publication 590). Assuming the retirement account had grown to $586,000 by the end of 2016 (including growth, and after the year-of-death RMD), the first post-death RMD in 2017 would be $586,000 / 9.1 = $64,396.
>
> However, since Sam (the beneficiary) was older than Brian (the decedent), and Brian passed away after his own Required Beginning Date (as at age 75, Brian had already been taking RMDs for several years), then Sam has the option of stretching the retirement account over *Brian's* life expectancy instead. Since Brian passed away in 2016 and would have been age 75 that year, his stretch period would be 13.4 years. Although since the first actual post-death RMD year is 2017 (one year later), the first post-death RMD would be based on 13.4 – 1 = 12.4 years. Nonetheless, this would result in a lower (more favorable) post-death RMD of $586,000 / 12.4 = $47,258.
>
> Thus, Sam's post-death RMDs would be reduced by $64,396 - $47,258 = $17,138 by taking advantage of the option to use Brian's remaining life expectancy, instead of Sam's own as the beneficiary!

Planning Tip: Always verify whether a designated beneficiary might have actually been older than the original decedent who bequeathed the account. If so, it will be better to stretch based on the *decedent's* life expectancy, and not the beneficiary's!

Spousal Rollovers Of Inherited Retirement Accounts

While designated beneficiaries have the opportunity to stretch an inherited retirement account over their life expectancies, IRC Section 401(a)(9)(B)(iv) provides special (and even more favorable) post-death RMD rules in situations where a surviving *spouse* is the designated beneficiary of the retirement account.

Specifically, when a surviving spouse is named as the designated beneficiary, he/she has the option to *roll over* the inherited retirement account into his/her own individual IRA (or Roth IRA, in the case of an inherited Roth account), and continue the account as though he/she was the original owner. Which means the surviving spouse will not even need to begin taking RMDs until he/she turns 70 ½ and reaches his/her own required beginning date. And upon reaching that date, the surviving spouse will be eligible to use the standard Uniform Life Table that applies to lifetime RMDs (rather than the less favorable Single Life Table that applies to beneficiaries of inherited retirement accounts).

Alternatively, a surviving spouse can still *choose* to leave an inherited retirement account as such – an inherited retirement account in the name of the original decedent, for which he/she is simply the designated beneficiary. In such situations, though, Treasury Regulations 1.401(a)(9)-3, Q&A-3(b) also provides more favorable

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treatment than that typically available to designated beneficiaries – specifically, that the surviving spouse doesn't need to start taking post-death RMDs in the year after death, and instead *can wait until the year the original decedent would have reached age 70 ½* (or the year after death, if later). And in fact, under Treasury Regulation 1.408-8, Q&A-5(b), the inherited IRA for the spouse will *automatically* be deemed a "rollover" if the surviving spouse fails to begin post-death RMDs in a timely manner (or if he/she adds any new annual IRA contributions to the account).

Once post-death RMDs *do* begin for a surviving spouse, they are based on surviving spouse's age using the Single Life Table, *but are annually recalculated in each subsequent year* (rather than simply reducing the applicable distribution period by 1 in each subsequent year) under Treasury Regulation 1.401(a)(9)-5, Q&A-5(c)(2). As a result, the surviving spouse will be able to stretch the inherited retirement account even longer than other similar-aged designated beneficiaries.

> *Example 4.* Fred passed away at age 62 in 2016, leaving a $400,000 IRA to his 60-year-old wife Ethel.
>
> Under the normal rules for post-death RMDs to a designated beneficiary, Ethel would be required to take her first post-death RMD in 2017 (the year after Fred's death). However, since Ethel is a surviving spouse beneficiary, she has the option to wait until the year Fred would have turned age 70 ½ (i.e., 2024) before taking her first RMD. And at that time, her applicable distribution period would be 18.6, based on her Single Life Expectancy as a 68-year-old, her age in that first future RMD year.
>
> Alternatively, Ethel could also roll over Fred's inherited IRA into her own individual IRA, and simply treat the account as though it was hers from the start. As a result, Ethel would not be required to begin taking RMDs until she turned age 70 ½ (in 2026), and would be able to take advantage of the Uniform Life Table (which at age 70 has a first applicable distribution period of 27.4 years).

In addition to the above options, if the original retirement account owner passed away after his/her required beginning date, there is still an option to take post-death RMDs based on the decedent's life expectancy, rather than the beneficiary's. As with any individual designated beneficiary who is older, this may potentially provide the surviving spouse a more favorable stretch period.

Early Withdrawal Penalties & Spousal Rollovers

One important caveat to the decision of whether a surviving spouse should roll over an inherited retirement account, or not, is that once the account is rolled over, it is treated entirely as though it was the surviving spouse's account to begin with. Which means RMDs don't begin until age 70 ½, and will then use the favorable Uniform Life Table. But it also means that if the surviving spouse is under age 59 ½, the 10% early withdrawal penalty will apply to any distributions from the account!

By contrast, if the inherited retirement account is *left* (in the name of the decedent) and *not* rolled over, any money withdrawn from the inherited account will *not* be subject to the 10% early withdrawal penalty (as "distributions after death of the original owner" is an exception to the early withdrawal penalty under IRC Section 72(t)(2)(A)(i)). Thus, a surviving spouse who is under age 59 ½ will often prefer to leave the inherited retirement account as such – and *not* roll it over – to avoid any potential early withdrawal penalties.

Fortunately, though, there is no deadline on *when* a spousal rollover must occur, and it is possible to do so many years after the surviving spouse originally inherits the account. As a result, younger surviving spouses (under age 59 ½) may wish to simply leave the account as inherited until reaching age 59 ½, and *then* roll over the account into his/her own name once the early withdrawal penalty no longer applies (in order to obtain more favorable RMD treatment thereafter).

> *Example 5.* Richard passed away at age 74 in 2016, leaving his $350,000 IRA to his 78-year-old wife Lucille. First and foremost, Lucille will be required to take Richard's 2016 RMD in the year of death (if he hadn't already before he died).
>
> The first post-death RMD (as a beneficiary) from the inherited IRA will be due in 2017, and can be taken based on either Richard's life expectancy factor (an applicable distribution period of 14.1 based on his age in 2016, reduced by 1 to 13.1 in 2017), or Lucille's life expectancy factor (an applicable distribution period of 10.8, based on her then-recalculated age of 79 in 2017). If the 12/31/2016 balance of the IRA was $365,000, this would result in an RMD of $33,796 based on

Lucille's life expectancy, versus $27,863 based on Richard's (more favorable) life expectancy.

However, in practice the opportunity to use either the decedent's single life expectancy (reduced by 1 each subsequent year) or the beneficiary spouse's life expectancy (recalculated each year) is a moot point, because the spousal beneficiary *also* has the option to roll over the IRA into his/her own name, which uses the *Uniform Life Table* that has even more favorable life expectancy factors (as it is based on the hypothetical joint life expectancy of the IRA owner and a 10-years-younger beneficiary, not just a single individual's life expectancy).

Example 5b. Continuing the prior example, Lucille can also choose to simply roll over Richard's inherited IRA into her *own* individual IRA.

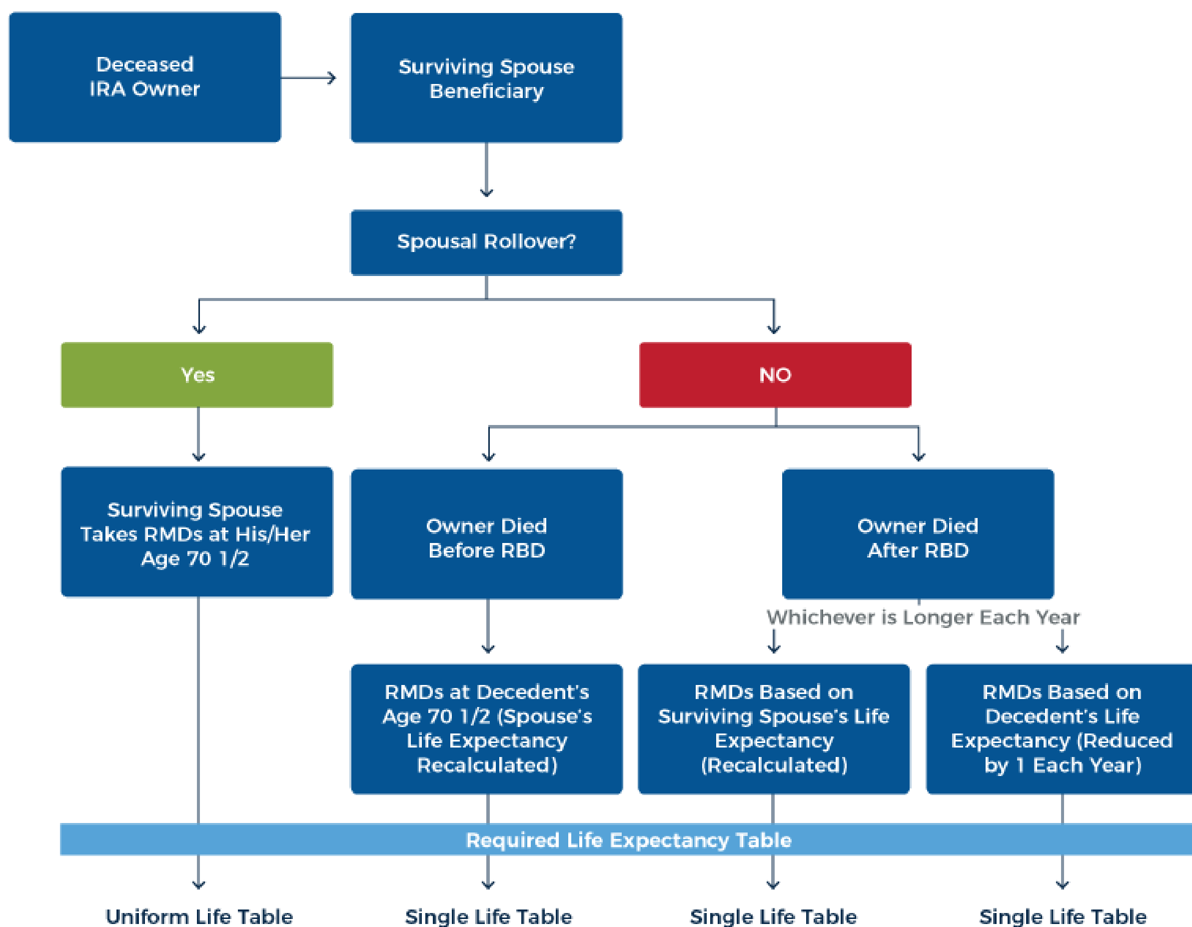
As her own IRA, Lucille will be subject to RMDs based on the Uniform Life Table in 2017, which at her then-age 79 would be 19.5 years, resulting in an RMD of only $18,718.

In fact, because a spousal rollover uses the Uniform Life Table (based on joint life expectancies) while an inherited IRA only uses single life expectancy tables, it will virtually always be more favorable to roll over the inherited retirement account rather than leave it as an inherited IRA for stretch purposes (as shown in Figure 5), unless the beneficiary spouse is *much* older than the original owner (such that the older surviving spouse's *joint* life expectancy is still less favorable than the deceased spouse's individual life expectancy).

However, younger surviving spouses (under age 59 ½) must consider the potential impact of the early withdrawal penalty if younger than age 59 ½ (see sidebar, prior page).

Planning Tip: Surviving spouses who are younger than age 59 ½ will often prefer to retain the inherited retirement account as such,

Figure 5. Spousal Beneficiary Options For An Inherited Retirement Account



as distributions from an inherited account are not subject to the early withdrawal penalty. However, since there is no deadline for a spousal rollover, the surviving spouse can always choose to wait and then, *after* reaching age 59 ½, complete the rollover of the inherited retirement account into his/her own IRA, and obtain the even-more-favorable RMD treatment from that point forward. However, to retain the right to penalty-free distributions in the meantime, the surviving spouse *must* begin post-death RMDs on time (as required), and *not* add any new contributions to the inherited account, or it will automatically be deemed a spousal rollover at that point!

Notably, to qualify for the "surviving spouse" treatment, the surviving spouse must actually be named directly as a beneficiary of the retirement account (not just payable to a trust or estate for the benefit of the spouse). In addition, since the *United States v. Windsor* Supreme Court decision, and the subsequent Revenue Ruling 2013-17, same-sex spouses will also be recognized as surviving spouses for post-death RMD and rollover purposes, as long as the same-sex marriage was legal at the time and place it was performed.

Subsequent RMDs Upon The Death Of Surviving Spouse

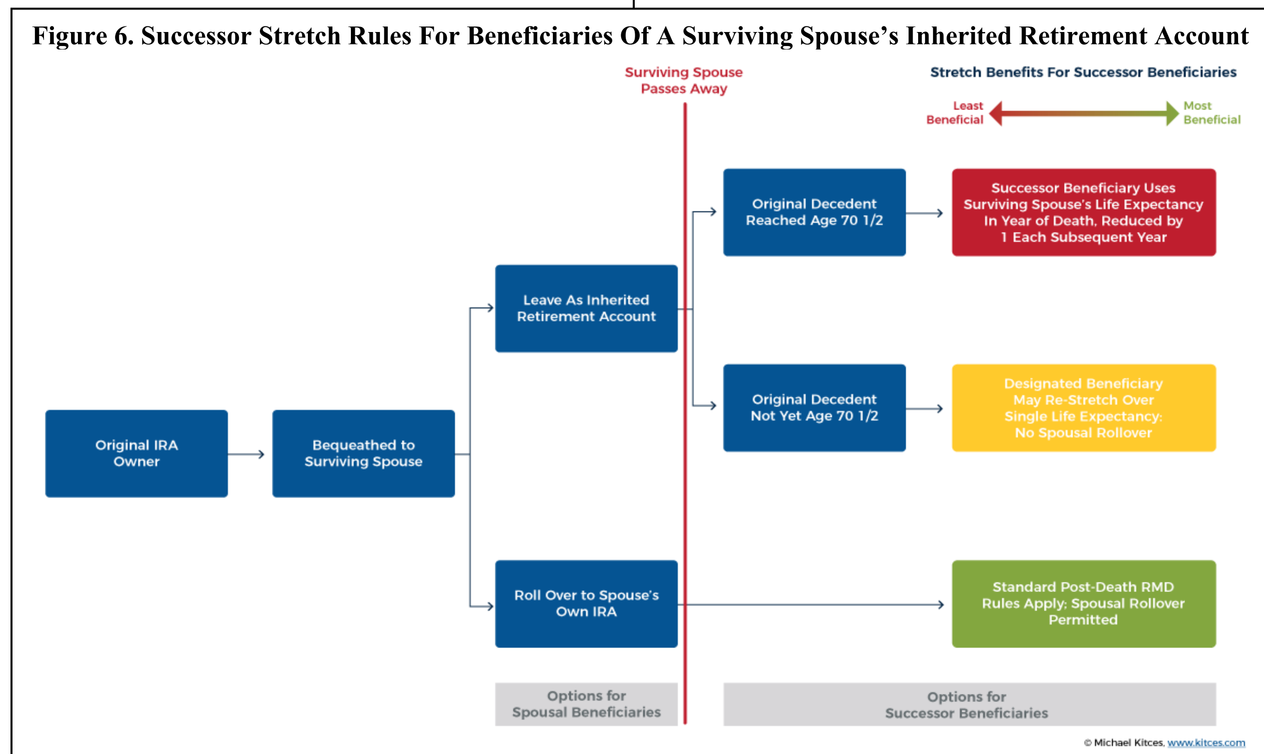
As discussed earlier, in the event that the beneficiary of an inherited IRA passes away, the successor beneficiary simply continues the RMD schedule of the original beneficiary, and continues to reduce the applicable distribution period factor by 1 in each subsequent year.

In the case of a surviving spouse beneficiary, though, the situation is more complicated (as shown in Figure 6), with the rules varying depending on whether the surviving spouse themselves had rolled the account over (or not), and if not whether the surviving spouse had themselves begun to take post-death RMDs yet (or not).

In the event that the surviving spouse kept the inherited retirement account, but was already taking post-death RMDs (i.e., because the original decedent was already over age 70 ½, or the surviving spouse had already waited until he/she would have been), then under Treasury Regulation 1.401(a)(9)-5, Q&A-5(c)(2), the surviving spouse's life expectancy is last recalculated (one last time) in the year of death, and from that point forward the successor beneficiary simply reduces that applicable distribution period by 1.

However, if the surviving spouse kept the inherited retirement account, and was still waiting to take post-death RMDs until when the *original decedent* would have turned age 70 ½, then the rules are different. In this situation, Treasury Regulation 1.401(a)(9)-3, Q&A-5 permits the surviving spouse to be substituted in as though he/she were the original owner (even though the

Figure 6. Successor Stretch Rules For Beneficiaries Of A Surviving Spouse's Inherited Retirement Account



account was not rolled over), and any successor beneficiaries can *reset* the stretch period based on his/her own designated beneficiary life expectancy. However, if the surviving spouse remarried, that subsequent new spouse cannot roll over the re-inherited retirement account themselves.

On the other hand, if the surviving spouse actually already rolled over the inherited retirement account to his/her own name, then all of the rules are applied as though he/she was the beneficiary to begin with. Which means not only can designated beneficiaries stretch the inherited account based on their own life expectancies (or the decedent's life expectancy, if death occurred after the Required Beginning Date), but a new spouse can then re-roll over the surviving spouse's rolled-over retirement account as well.

Planning Tip: Given that post-death RMDs for successor beneficiaries are more favorable in rollover situations, *especially* if the surviving spouse remarried (and wants to allow the new spouse to re-roll-over the originally inherited retirement account), it may be beneficial to consider a "deathbed rollover" in situations where the surviving spouse has an inherited retirement account and becomes terminally ill.

Non-Designated Beneficiaries Of Inherited Retirement Accounts

In the case of a "paper beneficiary" – a non-human-being beneficiary like an estate, a charity, or a trust, that is treated as a "non-designated" beneficiary for tax purposes – the post-death RMD rules are significantly less favorable, and the inherited retirement account must be distributed more rapidly. Though the exact pace at which a non-designated beneficiary must liquidate the account depends on the age that the original account owner was upon passing away.

If the original retirement account owner had not yet reached the Required Beginning Date – April 1st of the year following the one in which the account owner turned 70 ½ – then the paper beneficiary must liquidate the account by the end of the 5th year after death. Notably, in this case, there is no *annual* distribution requirement; IRC Section 401(a)(9)(B)(ii), and the supporting Treasury Regulation 1.401(a)(9)-3, Q&A-2, simply require that the account be liquidated (i.e., the account balance be reduced to $0) by December 31st of the 5th anniversary year after death.

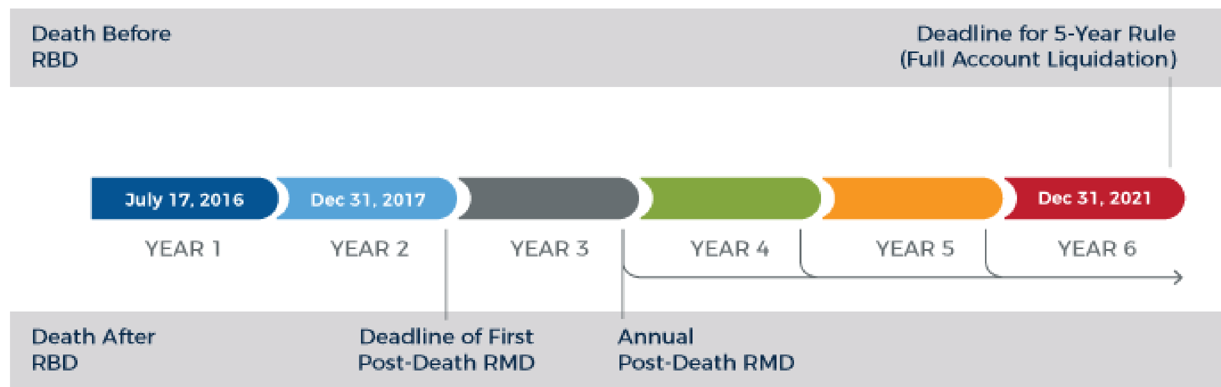
> *Example 6*. Jeremy passed away unexpectedly at the age of 47 on July 17th of 2016, and having named no other beneficiary for his IRA, left the account to his estate by default.
>
> Accordingly, the estate as a paper (non-designated) beneficiary will be subject to the 5-year rule, since Jeremy had not yet reached the age when his lifetime RMDs would have begun.
>
> Thus, the estate will be required to liquidate the account by December 31st of 2021 (the end of the fifth year after death), but can choose whether to take funds out evenly across all 5 years, unevenly based on the needs of the estate (e.g., withdraw some in the first year for estate settlement needs, and then delay the rest to 2021), or simply delay the entire distribution until 2021.

In the case of retirement account owners who pass away *after* the beginning of their lifetime RMD phase (i.e., those who died *after* their Required Beginning Date), Treasury Regulation 1.401(a)(9)-5, Q&A-5(c)(3) requires that the paper beneficiary take post-death RMDs based on the life expectancy of the *decedent* (based on the age he/she would have been at the end of the year of death, and reduced by 1 for each subsequent year), with the first distribution due (as usual) in the year after death.

> *Example 6b*. Continuing the prior example, if Jeremy instead had been age 77 when he died (and had already had his birthday that year), the estate as a paper beneficiary would be required to distribute post-death RMDs based on the decedent's life expectancy of 12.1 years. Since Jeremy died in 2016, the first RMD would be due in 2017, and would be based on an applicable distribution period of 12.1 – 1 = 11.1 years.

Notably, the fact that the decedent's life expectancy can only be used in scenarios where the original retirement account owner died *after* the Required Beginning Date means that at best, the paper beneficiary will be able to stretch for 17 years (the life expectancy of a 70-year-old individual). Which means in practice, as shown in Figure 7 (top of next page), the death of the retirement account owner subjects the paper beneficiary to either the 5-year rule, or a not-much-better-than-5-years stretch alternative if the beneficiary was already taking lifetime RMDs.

Figure 7. Post-Death RMD Obligations For Non-Designated Beneficiaries



Planning Tip: While death before the required beginning date requires the 5-year rule, in practice a paper beneficiary will have 6 years to spread out the tax consequences of an inherited retirement account. The reason is that not only is there an opportunity to stretch out distributions over each of the 5 subsequent years after death (until the December 31st deadline at the end of the 5th year), but the year of death itself is a 6th "partial" tax year – in which a taxable distribution can be taken – and generally runs from the date of death until the end of that calendar year (unless the executor elects a non-calendar fiscal year for the estate instead, and then the partial year will come at the end of the 5-year period).

Qualifying A Trust As A Designated Beneficiary

In practice, the adverse rules requiring a faster liquidation of an inherited retirement account for a paper beneficiary as not always a problem.

After all, charities will rarely want to stretch an inherited retirement account anyway; instead, they typically just liquidate the account immediately upon notification, and accept the charitable bequest (which has no adverse tax consequences to the charity anyway, given that it is a tax-exempt entity).

And while an estate-as-beneficiary does have to deal with the tax consequences, most estates are closed out within a year after the decedent's death, and assets payable to the estate are simply liquidated anyway. (Or alternatively, under PLRs 200436017 and 20052004, the estate may potentially just assign the inherited retirement account to the underlying beneficiary, where he/she can at least try to "stretch" the dollars out under the 5-year rule.)

However, when it comes to trusts as beneficiaries (of retirement accounts, and other assets), there often *is* a desire for the trust to remain in place for an extended period of time. After all, many common trust planning situations, from the use of a bypass trust, to asset protection trusts for beneficiaries, are predicated on the goal of *not* liquidating and distributing the trust assets to the beneficiary for the foreseeable future!

Fortunately, though, while the general rule is that a trust is a "paper beneficiary" (i.e., a non-individual human being), and therefore is treated as a non-designated beneficiary, Treasury Regulation 1.401(a)(9)-4, Q&A-5 *does* permit certain trusts to qualify as designated beneficiaries, where the applicable distribution period for the trust is based on the life expectancy of the *underlying* beneficiary of the trust.

In order to qualify as a designated beneficiary, the trust must meet four specific requirements:

1) **The trust must be a valid trust under state law**. In other words, the trust must be properly signed and executed, including witnesses and/or notarization where required under state law.

2) **The trust must be irrevocable, or become irrevocable upon the death of the retirement account owner.** Fortunately, an individual revocable living trust becomes irrevocable at death, as do any testamentary trusts created upon a Will (as the Will cannot be changed after death). Alternatively, some estate plans simply create a

standalone irrevocable trust to serve as the beneficiary of the retirement account, to ensure this requirement is satisfied. Beware joint revocable trusts, or spousal/marital trusts, though, as they may remain revocable (by surviving spouse) after death, and therefore fail to qualify.

3) **The trust's underlying beneficiaries must [all] be identifiable and eligible to be designated beneficiaries themselves.** If the trust is going to stretch based on the life expectancies of the underlying beneficiaries, all the underlying beneficiaries must be clearly identifiable as designated (individual) beneficiaries with a life expectancy to stretch across in the first place. A "class" of beneficiaries (e.g., "my children" or "my descendants") is permitted, as they will be identifiable as of the Beneficiary Designation Date after death (see sidebar). Beware charities that are beneficiaries under a trust, though, as they may disqualify the entire trust from being a designated beneficiary!

4) **A copy of "trust documentation" must be provided to the retirement account custodian/administrator by October 31st of the year after death.** "Trust documentation" is typically just a copy of the trust document itself. Some retirement account providers may accept a list of all trust beneficiaries and a summary of trust instead, along with a certification (or signed affidavit) by the trustee that all the pertinent information in the trust has been provided. The requirement is simply meant to ensure that the IRA custodian or plan administrator *knows* who the proper beneficiaries are, so that they can comply with their role in making (and reporting) post-death required minimum distributions.

If the four requirements are met, the trust must still take post-death RMDs from the retirement account, but the stretch will be based on the life expectancy of the trust's underlying (designated) beneficiary, rather than being subjected to the far-less-favorable 5-year-rule-or-decedent's-life-expectancy requirement that applies for non-designated beneficiaries.

Example 7. Trevor, age 72, passed away in 2017 and left his $800,000 IRA to a testamentary trust for the benefit of his 42-year-old daughter Melissa. Because Melissa has had financial problems in the past, the trust limits her access to the money, and instead stipulates that distributions from the trust to Melissa for her needs will be based solely on the discretion of an independent trustee. Any unused proceeds of the trust at Melissa's death will be distributed outright to Melissa's daughter (Trevor's granddaughter).

Presuming that the Will (and therefore the testamentary trust it created) was validly executed under state law, and that a copy is provided to the IRA custodian by October 31st of 2018, the trust should qualify as a designated beneficiary, as it became irrevocable at Trevor's death, and the

The Beneficiary Designation Date For Inherited Retirement Accounts

While determining "who is the beneficiary" of a retirement account may seem rather straightforward, it's not as simple as just looking at the list of names on the beneficiary designation form as of the date of death.

First and foremost, that is because a beneficiary might disclaim their interest, which can be done up to 9 months after the date of death. Thus, Treasury Regulation 1.401(a)(9)-4, Q&A-4 stipulates that the designated beneficiaries (for stretch purposes) are determined as of September 30th of the year *after* the year of death (thereby ensuring that even if the decedent passed away on December 31st of the current year, that the 9-month disclaimer period will have just passed before the deadline).

However, this "Beneficiary Designation Date" of September 30th of the year after death matters because technically, *any* beneficiary who is designated as such on the date of death but is *not* still a beneficiary on the designation date is excluded when determining the applicable distribution period for post-death RMDs. Which means any beneficiary who disclaims by the deadline is excluded from consideration. But so is any beneficiary who simply takes their respective share, such that their interest is extinguished by the deadline.

Thus, if a retirement account is payable 95% to a child and 5% to a charity, then the presence of a paper beneficiary (even if only for 5% of the account) might render the retirement account ineligible for a stretch at all. However, if the charity's share is simply paid out by September 30th of the year after death, such that on the Beneficiary Designation Date, the only remaining – and now sole – beneficiary is the child, then the child-as-sole-beneficiary will be eligible to stretch based on his/her life expectancy.

beneficiaries are individuals (Melissa and her daughter).

Since Trevor died after his required beginning date, the trustee must take his 2017 RMD (presuming he hadn't taken it already), based on Trevor's 72-year-old life expectancy under the Uniform Life Table (25.6 years).

In 2018, the trustee must then begin ongoing post-death RMDs, which will be paid to the trust (not Melissa), but can use Melissa's individual life expectancy of 40.7 years (based on the age 43 that she will attain in 2018). In 2019, the RMD will be based on 40.7 – 1 = 39.7, and the applicable distribution period is further reduced by 1 each subsequent year.

Notably, in the example above, the annual RMDs from the IRA are simply paid from the IRA *to the trust*, and will be reported on the trust's tax return. Whether the trust subsequently pays those RMDs through to Melissa is still subject to the trustee's discretion. In other words, while the trust can stretch the IRA by "seeing through" to Melissa's life expectancy, the IRA distributions themselves still go to the trust itself, and may or may not actually be distributed to Melissa (based on the terms of the trust).

Unfortunately, one important caveat of the trust-as-beneficiary rules for retirement accounts is that while it is possible to "see through" the trust to stretch based on the life expectancy of the underlying beneficiaries, because the RMDs themselves are still paid to the trust, they are reported on the trust's tax return. As a result, they are subject to the trust's compressed tax brackets, with a top tax bracket of 39.6% kicking in at just $12,500 of taxable income.

On the other hand, *if* the RMD actually is distributed through to the underlying beneficiary in the year it is received, the trust may receive a Distributable Net Income (DNI) deduction, reducing its taxable income (to zero, if all of its taxable income is distributed), with that income subsequently reported by the beneficiary (via a Form K-1) on his/her own tax return (and at his/her own individual tax rates).

However, in practice this favorable pass-through of the tax consequences of RMDs payable to trusts is often not available, as the whole *point* of using a trust as beneficiary is typically to limit the beneficiary's access to the funds (and therefore *not* automatically pass them through).

Planning Tip: To ensure that the trust being designated as the beneficiary of a retirement account is an "irrevocable trust" – to satisfy the rules – many estate planning attorneys simply create a standalone irrevocable trust to be the beneficiary, separate from any testamentary trusts created under the Will, or via a revocable living trust. The good news of this approach is that subsequent changes to the Will or revocable living trust won't risk distorting or adversely impacting the trust-as-IRA-beneficiary (e.g., if a charity is later added as a sub-beneficiary). The bad news, though, is that the standalone trust is irrevocable. *However*, because the retirement account's beneficiary designation form itself can still be changed any time before death, in practice an "irrevocable" trust intended to be the retirement account beneficiary is still fully revocable before death – as the retirement account owner simply needs to create a new trust, and change the beneficiary designation form to disinherit (and thus eliminate) the old irrevocable trust, and name the new irrevocable trust instead!

Multiple Beneficiaries And The Separate Accounts Rule

While the standard rule is an individual (designated) beneficiary can stretch post-death RMDs out over his/her life expectancy, the rules are somewhat more complex in the case of *multiple* beneficiaries.

Treasury Regulation 1.401(a)(9)-5, Q&A-7 stipulates that whenever there are multiple beneficiaries, the *oldest* beneficiary with the *least favorable* (i.e., shortest) life expectancy must be used. In other words, *all* beneficiaries are stuck using whichever beneficiary provides the least favorable stretch period.

However, Treasury Regulation 1.401(a)(9)-8, Q&A-2 allows multiple beneficiaries to *split* an inherited retirement account into separate accounts for each beneficiary. If the accounts are split by December 31st of the year after death – i.e., by the deadline for the first post-death RMD – then each beneficiary is permitted to calculate their subsequent post-death RMDs based only on their own individual life expectancy, and *not* consider the other beneficiaries. However, the separate account rule only applies to RMDs in *subsequent* years, and not the year of the split itself, under Treasury Regulation 1.401(a)(9)-8, Q&A-2(a)(2).

Example 8. Anthony passed away in early 2017 at the age of 68, leaving his $700,000 IRA to his children, 34-year-old Nancy and 38-year-old Doug.

By default, both Nancy and Doug will be required to take their post-death RMDs based on Doug's (shorter) 38-year-old life expectancy.

However, if Nancy and Doug split their share of the account by the end of 2017, then each may use his/her own life expectancy when calculating their first post-death RMD in 2018.

Notably, the deadline to split accounts for favorable post-death RMD treatment is by the end of 2018 (i.e., December 31st of the year *after* death). However, if Doug and Nancy actually split the accounts in 2018, they *each* must still take their 2018 post-death RMD based on Doug's life expectancy (the oldest beneficiary with the shortest life expectancy). The separate accounts rule only allows Doug and Nancy to use their own individual life expectancies in *subsequent* years after the split (i.e., for their post-death RMDs in 2019 and beyond).

On the other hand, if Doug and Nancy do not actually complete the split into their own respective inherited retirement accounts until 2019 (i.e., beyond the December 31st due date of the year after the original retirement account owner's death), then even if each has his/her own separate account, they will each be required to stretch their post-death RMDs based on Doug's life expectancy again. As even if the split is done, because the deadline has passed, they will not be eligible to use their individual life expectancies.

While these rules are helpful to allow multiple beneficiaries to each maximize the post-death RMD stretch period based on their life expectancies, the separate accounts rule is especially helpful when one or more beneficiaries are *non-designated* paper beneficiaries. Because if the accounts are split in a timely manner, the non-designated beneficiary's share can be isolated from the rest, ensuring that the non-designated beneficiary (which cannot stretch beyond the 5-year rule or decedent's life expectancy) does not limit the ability of the other (human) designated beneficiaries to stretch over their own life expectancies. On the other hand, even the separate accounts rule is limited for multiple beneficiaries of a single trust (see sidebar).

Planning Tip: The post-death splitting rules for separate account treatment apply for all types of beneficiaries. Thus, in the event that one of the (multiple) beneficiaries is a surviving spouse, it's still necessary to split the inherited

Separate Accounts & Multiple Trust Beneficiaries

When it comes to multiple beneficiaries named in a retirement account's beneficiary designation form, the separate accounts rule is rather straightforward to apply – simply split the accounts by December 31st of the year after death, and each beneficiary, whether spousal or not, designated or paper, can apply the rules individually to their own share.

In the case of a single trust with multiple beneficiaries, though, the rules are far more limited. The reason is that even if a trust has multiple beneficiaries, if the *retirement account itself* names only one beneficiary – i.e., "100% to the [family or other] trust" – there is no way to split 100% to a single beneficiary. Even if it's a trust that itself has multiple *underlying* beneficiaries.

Thus, if an IRA beneficiary designation reads "100% to the family trust for the benefit of Joe and Jane", and the family trust subsequently provides income (or not) to Joe and/or Jane at the trustee's discretion, then the trustee will have to take post-death RMDs based on the older beneficiary (Joe or Jane). And this would be true even if the family trust itself stipulates "this trust will be split into separate trusts, one for Joe, and the other for Jane", as the *beneficiary designation* form simply says "100% to the family trust" (which happens to split later).

In order for trust beneficiaries to split the account and receive the separate accounts treatment, *each trust must be named in the beneficiary designation form itself*. If the beneficiary designation stated "50% to Joe's trust, and 50% to Jane's trust, established as sub-trusts under our family trust" then splitting would be permitted, as in this case the retirement account's beneficiary designation form itself states 50/50 shares to two beneficiaries.

In practice, though, there's often little value to actually splitting separate accounts for multiple trust beneficiaries, because each trust itself provides for the other beneficiaries anyway. For example, in the aforementioned situation, if Joe's trust also had a provision that stated "to the extent this trust is not used, its remainder will go to Jane", and Jane's trust similarly stated "to the extent this trust is not used, its remainder will go to Joe", then even with separate accounts for separate trusts, both trusts would *still* be required to use the older sibling's life expectancy. Because Joe and Jane are *both* beneficiaries on *each* trust – an income beneficiary for one, and a remainder beneficiary for the other (and vice versa), which makes separate account treatment moot!

accounts by the deadline to receive the more beneficial treatment for surviving spouses – i.e., being able to wait until the original decedent would have turned age 70 ½ to start post-death RMDs. On the other hand, the spousal rollover rule does remain available even beyond the post-death account splitting deadline for the surviving spouse's share (although if the accounts were not split earlier, *other* beneficiaries' shares may still be required to take distributions over the surviving spouse's life expectancy!)

Properly Executing The Post-Death RMD Process

When a retirement account owner passes away, the first obligation is to determine whether he/she was past the Required Beginning Date where lifetime RMDs would have been due. If the deceased was in lifetime RMD phase, then it must be determined whether that lifetime

Post-Mortem Planning To "Fix" Beneficiary Mistakes On Stretch Inherited Retirement Accounts
The most generous rules for stretching an IRA (or other inherited retirement account) after the death of the original owner are available for designated (human) beneficiaries. But unfortunately, sometimes the original retirement account owner didn't name the optimal (or potentially any) individual designated beneficiaries in the first place, and the problem isn't discovered until after death. Fortunately, though, there are potential options to "fix" problematic beneficiary designation forms, even on a post-mortem basis (i.e., after death).

The first option to "fix" retirement account beneficiaries is to have one or more of them *disclaim*. Of course, disclaiming an inheritance means the beneficiary doesn't *get* that money, and so in many cases disclaiming isn't feasible, simply because the beneficiary actually does want or need the money. However, in some family planning situations, there is more flexibility about disclaiming and shifting assets, especially in the case of a surviving spouse who doesn't need (or due to estate tax exposure, doesn't even want) to inherit retirement account assets.

As long as the disclaimer is executed in a timely manner (generally within 9 months of the date of death), the disclaimer not only shifts the assets to the other named or contingent beneficiaries, but since the disclaimer would be completed before the Beneficiary Designation Date, also removes that beneficiary from consideration for stretch purposes. This may be helpful in cases where a spouse wants to disclaim to allow children to immediately inherit the retirement account (and stretch over their life expectancies), or in scenarios where a "problem" beneficiary would limit the ability of others to stretch (especially in the case of a trust with an older or non-designated beneficiary).

In some cases, disclaiming may even be helpful to change the beneficiary to another family member where no contingent beneficiary was named at all, depending on what the IRA adoption agreement specifies as the beneficiaries in the event there are none named. In many cases, the IRA becomes payable to the estate, which is undesirable, but in other cases, the IRA adoption agreement directs the account to be paid to other surviving family members directly, allowing for a stretch to them even if they weren't named originally.

The second option for a post-mortem "fix" for problematic beneficiary designations is to leverage the timing of the Beneficiary Designation Date, by simply paying out "undesired" beneficiaries by the deadline to eliminate them from consideration for stretch purposes. This can be especially helpful in the case of a trust that has multiple beneficiaries, including ones that would limit (or entirely eliminate) the ability to stretch, such as a charity that is named as a partial beneficiary of the trust. If the charity is *paid* in full by the Beneficiary Designation Date, the charity gets its share, but it will no longer be a non-designated beneficiary for stretch purposes. Although unfortunately, this option usually isn't feasible if the charity is the trust's *remainder* beneficiary (as the charity wasn't going to be paid until other beneficiaries passed away, long after the Beneficiary Designation Date).

The third and final post-mortem "fix" is simply to split the inherited retirement account by the December 31st deadline of the year after death (or ideally by the end of the year *of* death, to ensure that even the first post-death RMD permits each beneficiary to use his/her own life expectancy). In the past, this actually wasn't even an option, and if the retirement account owner didn't split accounts *before* death, there wasn't any way to "fix" the situation after the fact. Fortunately, updated Treasury Regulations finalized in 2002 created the post-death separate account rule, and in practice today, separate account splitting is so common, it's not even considered a fix. But technically if it's *not* done, *all* beneficiaries will be required to use the life expectancy of the oldest beneficiary (with the shortest stretch period). Thus, while it's a common post-mortem fix, it *is* still necessary to utilize the separate accounts rule to actually ensure that each beneficiary gets their maximal stretch period!

RMD was actually taken for the current tax year, and if not, the RMD amount must be distributed *by the end of the current calendar year*. The executor is responsible for completing the post-death distribution of the decedent's last lifetime RMD, though notably, the final lifetime RMD should be paid out to the named beneficiary (or split amongst multiple beneficiaries based on their respective shares), *not* paid out to the decedent's estate. Accordingly, the tax consequences of the final lifetime RMD distribution go to the beneficiaries that receive the amount, not the decedent's final income tax return (nor the estate's income tax return, unless the estate was actually the beneficiary of the retirement account).

Next, it's necessary to re-title (or "re-register") the deceased's retirement account as an inherited retirement account. Some IRA custodians will require this to be done *before* the executor can make the distribution for the decedent's final lifetime RMD to the beneficiaries, while others will allow it to be done at the same time, or shortly thereafter.

Re-registering the inherited retirement account entails changing its title from the original – typically as "<owner's name>, IRA" into something that recognizes both the original (now-deceased) retirement account owner *and* the beneficiary, such as "<original owner's name>, inherited IRA For Benefit Of <beneficiary's name>, beneficiary". Some inherited account registrations will abbreviate "For Benefit Of" down to "FBO", and some will look to include the owner's date of death in the registration as well. Because the beneficiary (or multiple beneficiaries) are typically named directly in the registration of the inherited retirement account when it is re-registered, the inherited retirement account is often split into separate accounts for each beneficiary at the time this re-registration process occurs (though it may be done later instead, if so desired).

The next step is to determine how post-death RMDs will be handled for the beneficiaries, and whether there were any "mistakes" in how beneficiaries were designated for stretch purposes, that might be fixed after death through some combination of disclaimers, separating accounts, and leveraging the Beneficiary Designation Date rules (see prior sidebar on page 13).

Once the beneficiaries are affirmed, it's time to actually calculate what the applicable distribution period(s) will be for the inherited retirement account(s). Is there a non-designated beneficiary where the 5-year rule will apply? Is there a spouse who must decide whether to leave the account as an inherited retirement account, or roll it over to his/her own retirement account? Are there other designated beneficiaries who must begin their post-death RMDs next year? And do those beneficiaries want to transfer

Beware Rollover: Splitting Or Transferring Of Inherited Retirement Accounts

The process of handling inherited retirement accounts involves not only re-titling the deceased's retirement account into an inherited one, but also subsequently (or concomitantly) splitting it into multiple separate inherited accounts. And in many cases, there's also a desire to move an inherited retirement account to another financial institution (e.g., to be managed by another financial advisor, or simply for a beneficiary to consolidate with other existing accounts).

However, it's crucial to recognize that under IRC Section 408(d)(3)(B), *an inherited retirement account is not eligible to be "rolled over" to an IRA*, where the recipient takes a distribution and re-contributes it to a rollover account within 60 days. In other words, once an *inherited* retirement account is distributed, it is *irrevocably distributed* and cannot be unwound or "put back" into that (or another) retirement account!

Notably, this doesn't prevent an inherited retirement account from being *moved* to another financial institution. But it means the move *must* be done as a trustee-to-trustee transfer of the inherited retirement account, with the transfer payable directly to the properly titled inherited account at the new IRA custodian. (This is also why it's necessary to re-title the account as inherited before transferring it – because the receiving custodian will want to register the account as inherited, and the transferring custodian typically won't release it if the receiving account has a different registration.)

But the bottom line is to remember that an inherited retirement account, once distributed, is irrevocably distributed. A surviving spouse may still roll over such a distribution into his/her *own* retirement account – under the spousal rollover rules – but even a surviving spouse cannot roll over an inherited retirement account back into another inherited IRA account.

So be certain if that an inherited retirement account is meant to be transferred – and stay intact as an inherited retirement account – that it be done *only* via a trustee-to-trustee transfer to a new inherited retirement account, and into one with a matching (inherited retirement account) registration, and not a taxable account by mistake!

their accounts to other institutions, now that their share has been re-titled into an inherited IRA in their name (i.e., for their benefit)? (See sidebar on prior page for further issues to be aware of when splitting or transferring inherited retirement accounts.)

Ultimately, the final step of the process is to ensure that the post-death RMD rules themselves are complied with, typically beginning in the year after death (the year that the first post-death RMD is due for designated beneficiaries). As with traditional retirement accounts prior to death, the obligation to take an RMD is just that – an obligation – and failure to take the RMD, whether during life or after death, can result in a 50% penalty under IRC Section 4974(a) (or the beneficiary can try requesting a waiver of the penalty by filing Form 5329 and providing an explanation of why it was not completed in a timely manner in the first place).

Tax Treatment Of Post-Death RMDs

The tax treatment of post-death distributions from inherited retirement accounts are ultimately no different than the standard rules for any distribution from a retirement account, with specific rules for both pre-tax ("traditional") and tax-free Roth retirement accounts.

Inherited Pre-Tax (Traditional) Retirement Accounts

Inherited traditional IRA (and other pre-tax inherited retirement account) distributions are taxed as ordinary income, as is standard for any pre-tax retirement account. Similarly, to the extent there are any after-tax (i.e., non-deductible) contributions in the account, they are distributed on a pro-rata basis (as they are before death to the original account owner as well). With an inherited retirement account, the income is taxable to the beneficiary that receives the distribution.

Planning Tip: If the beneficiary of an inherited IRA (and it must be an IRA, not an inherited employer retirement plan) is over age 70 ½, then under IRS Notice 2007-7, Q&A-36, post-death distributions from pre-tax IRAs are eligible for the Qualified Charitable Distribution (QCD) rules as well (allowing the distribution to be made directly to the charity, tax-free, and satisfy any annual RMD obligations in the process), subject to the standard limits on QCDs ($100,000 annual maximum).

If a trust receives an (inherited) retirement account distribution, it is taxable to the trust, though the taxable income may ultimately be shifted to the underlying beneficiary (with the trust receiving a distributable net income deduction) if the IRA distribution is passed through to the beneficiary in the same tax year it is received. If a charity receives the IRA distribution, it is technically taxable, but since the charity itself is a tax-exempt entity, the net tax consequence is still zero. (And as a result, charities are especially "efficient" as a pre-tax retirement account beneficiary, as discussed further in a later section.)

The 10% early withdrawal penalty never applies to an inherited retirement account, as "distribution after death (of the original account owner)" is an exception to the penalty, and by definition an "inherited" retirement account will be making distributions after death of the original owner. (Though as noted earlier, if a spouse completes a spousal rollover into his/her *own* retirement account, it is no longer treated as an inherited retirement account, and the early withdrawal penalty may be applied based on the surviving spouse's age for his/her own retirement accounts.)

On the other hand, it's notable that beneficiaries of an inherited pre-tax retirement account may be eligible for a so-called "Income in Respect of a Decedent" (IRD) deduction under IRC Section 691(c). The IRD deduction provides an *income tax* deduction for any Federal estate taxes that were triggered by the IRA in the decedent's estate. The IRD deduction can be as much as 40% of the entire pre-tax IRA balance, and is claimed by the beneficiary on a pro-rata basis as distributions occur to that beneficiary. (See sidebar for further detail.)

Planning Tip: Given the potentially substantial impact of the IRD deduction, it's a good idea to ask *anyone* who has an "inherited" retirement account whether the person who bequeathed the account to them paid any Federal estate taxes. While most beneficiaries won't know the details of the estate tax liability, *if* there was any Federal estate tax on the decedent's estate, they will likely at least *know* if Federal estate taxes were paid. And if there were, then there will be at least some IRD deduction, and the advisor can then dig further to obtain the necessary information from the executor to calculate the actual IRD deduction for the beneficiary.

The Income In Respect Of A Decedent (IRD) Deduction For Retirement Account Beneficiaries
The IRD deduction is designed to limit any "double taxation" of a pre-tax IRA (or other pre-tax assets) held at death. Without it, there would be a risk that the combination of estate taxes (at death) and income taxes (of the beneficiaries after death) could add up to more than 100%, such that the tax liability on the IRA would be greater than the account value itself!

To avoid this outcome, the IRD deduction provides beneficiaries an *income* tax deduction for any additional *Federal estate* taxes caused by the pre-tax IRA (or any other type of pre-tax retirement account).

For instance, Christina died with an estate worth more than $15M, which included a $1M pre-tax IRA. Given that the marginal Federal estate tax rate would be at 40% for an estate of Christina's size, the $1M IRA effectively caused $400,000 of Christina's total estate tax liability. (In other words, if Christina hadn't had that IRA, and her estate was only $14M instead, her estate taxes would have been $400,000 less.) As a result, the beneficiary of Christina's IRA will receive a $400,000 income tax deduction, and will only be required to pay income taxes on the net $600,000 value. The IRD deduction applies regardless of whether the estate tax liability is actually paid *from* the IRA itself or not; the mere fact that the IRA as a pre-tax asset *existed* in the estate, and increased the value of the estate (and the total estate tax liability) is sufficient to yield an IRD deduction.

The IRD deduction itself is claimed as a miscellaneous itemized deduction *not* subject to the 2%-of-AGI floor (which also means it is not subject to AMT adjustment), and is claimed by the beneficiary on a pro-rata basis as IRA distributions are received. Thus, if the IRA beneficiary took a $100,000 distribution after inheriting the account (10% of the account balance), then the beneficiary would get $40,000 (10%) of the IRD deduction, resulting in net taxable income of just $60,000 (though technically the IRA distribution is still claimed as above-the-line income, while the IRD deduction is a below-the-line itemized deduction, and consequently may not perfectly offset). If the beneficiary stretches the inherited IRA distributions over time, the IRD deduction is stretched out over time as well (again, on a pro-rata basis).

Notably, pre-tax retirement accounts (IRAs, 401(k)s, etc.) are not the only type of asset that produces an IRD deduction. Technically, any pre-tax asset in the estate qualifies for an IRD deduction, including deferred compensation, final bonuses and paychecks from an employer, non-qualified stock options, non-qualified deferred annuity gains, and even accrued investment income (e.g., bond interest). Although given the sheer size of pre-tax retirement accounts, they often produce the largest share of the IRD deduction.

An inherited pre-tax IRA is also not eligible for a Roth conversion after the death of the original retirement account owner, although notably an inherited traditional 401(k) (or other traditional employer retirement plan) *is* able to be converted to an inherited Roth IRA (see sidebar, top of next page).

Inherited Roth Retirement Accounts

In the case of an inherited Roth account, all the post-death RMD obligations to take distributions still apply, though the distributions themselves continue to qualify for the standard treatment of Roth accounts. This includes the ordering rules that distribute principal (prior contributions and conversions) first, and gains second. And gains themselves are still eligible for the standard tax-free treatment for gains in a Roth account as "qualified" distributions, *as long as* the 5-year rule (that some Roth IRA of the original Roth owner must have been in existence for at least 5 years) for qualified distributions is met. Though the 5-year rule for Roth conversion principal to be penalty-free does not have to be satisfied, as that 5-year rule is only necessary to avoid the early withdrawal penalty on distributions of Roth principal, which is a moot point when the early withdrawal penalty is already exempted as a distribution after death of the original account owner.

> *Example 9*. Christopher created his first Roth IRA in 2015, as a Roth conversion of his existing $250,000 pre-tax IRA into a Roth. Christopher had had no other Roth IRAs previously.
>
> Christopher died the following year, in 2016, at the age of 57, leaving what was then a $275,000 Roth IRA to his 32-year-old daughter Brenda. Christopher's daughter will be eligible to stretch the inherited Roth account over her life expectancy (51.4 years), with the first post-death RMD due in the year after death (2017).

Roth Conversions Of Inherited Employer Retirement Plans
Technically, a Roth conversion is an IRA rollover that happens to land in a Roth account, such that the rollover "converts" the pre-tax account into a Roth. However, the IRC Section 408(d)(3)(C) prohibition on rollovers of inherited retirement accounts effectively prevents a Roth conversion of an inherited IRA. While an inherited IRA can be transferred (via a trustee-to-trustee transfer) to another financial institution, it can't be rolled over (and converted) into a Roth.

However, IRC Section 402(c)(11)(A)(i), as created under the Pension Protection Act, allows (and now, mandates) that an inherited employer retirement can be transferred to an inherited IRA, and treats the trustee-to-trustee transfer from an inherited employer retirement plan to an inherited IRA as an "eligible rollover distribution". Which means the trustee-to-trustee transfer could go to an inherited IRA, *or to an inherited Roth IRA*.

In other words, an inherited employer retirement plan actually *can* be converted into an inherited Roth IRA by the beneficiary after death of the original owner, even though an inherited IRA unequivocally *cannot* be converted to an inherited Roth IRA, nor can an inherited employer retirement plan be converted if it has *already* been transferred to an inherited IRA.

Ironically, though, the fact that a beneficiary *can* convert an inherited employer retirement plan to an inherited Roth IRA doesn't necessarily mean it's a good idea to do so. The reason is that the inherited Roth IRA (after conversion) will still be subject to post-death RMDs for the beneficiary, as would any other inherited Roth retirement account; by contrast, if the beneficiary simply converted any *other* pre-tax retirement account he/she already owns (i.e., his/her own individual IRA or 401(k) plan), it would be converted into a normal Roth IRA, which has no lifetime RMDs for the beneficiary at all.

Which means in practice, converting an inherited employer retirement plan to an inherited Roth IRA would at best be a last resort only after all *other* retirement accounts had already been converted to a standard Roth IRA. Nonetheless, it is important to recognize that it *is* at least possible to convert an inherited employer retirement plan into a Roth, as long as it is done via direct trustee-to-trustee transfer from the plan to the inherited Roth IRA!

Since the distributions are occurring after the death of the original Roth account owner (Christopher), any withdrawals that Brenda takes will not be subject to the early withdrawal penalty, even though the 5-year Roth conversion rule has not been satisfied, since distributions after Christopher's death are automatically exempt from the early withdrawal penalty.

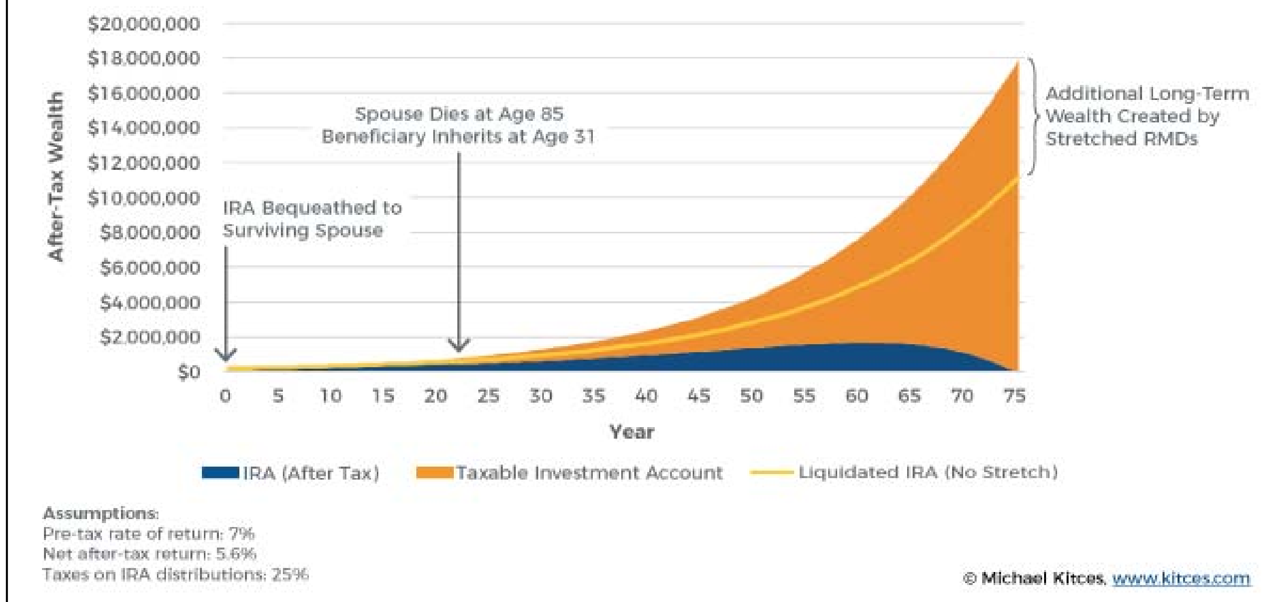
However, since Christopher had only established his first Roth account in 2015, then when Brenda takes her (first) distribution in 2017, any Roth *gains* will *not* be tax-free, and instead will be taxable as ordinary income as a non-qualified Roth distribution (since the 5-year rule for qualified distributions of tax-free gains had *not* yet been satisfied).

Notably, since distributions from a Roth account are automatically deemed to be from principal (i.e., contributions and conversions) first, the fact that post-death distributions may not be qualified is not necessary a problem. After all, in the above example, the first $250,000 of distributions from the Roth would still be tax- (and penalty-) free first, providing more than enough for Brenda to cover her post-death RMD obligation (which initially is barely 2% of the account balance). Thus, the 5-year rule for tax-free growth would still be satisfied *long* before Brenda's annual post-death RMDs fully deplete the principal and dip into gains anyway.

Nonetheless, if Brenda quickly takes out *more* than the original $250,000 of (conversion) principal, any gains *would* be taxable, if the 5-year rule for qualified distributions hadn't been satisfied yet. Which means Brenda couldn't fully liquidate the inherited Roth account tax-free until 2020 (which would be 5 years after Christopher originally established his first Roth account).

Planning Tip: To minimize the risk that the 5-year rule for tax-free gains may be a complication in the future, any client who has never established a Roth IRA should create one, even if with just a nominal dollar amount (e.g., $1,000 or less) just to start the 5-year clock. Those who are above the annual income limits may not be able to contribute to a Roth IRA, but can still complete a small conversion of a traditional IRA (as there are no longer any income limits on Roth conversions since 2010) in order to

Figure 8. Long-Term Wealth Impact Of A Stretch IRA



initially fund the account with some dollar amount to begin satisfying the 5-year rule for tax-free gains.

Proactive Planning For Stretch Inherited Retirement Accounts

Tax-deferred compounding growth can be powerful, especially over long periods of time. As a result, when designated beneficiaries "stretch" an inherited retirement account for what may literally be decades, and take only the minimum post-death RMD obligation, while allowing the rest of the assets to remain growing (and compounding) on a tax-deferred basis, the net result can be a *substantial* increase in long-term wealth accumulation.

For instance, assume a 65-year-old retiree passes away from an untimely death, leaving his account to a 62-year-old spouse, who rolls the account into her own name. The surviving spouse lives another 23 years (until age 85), and then leaves the account to her then-32-year-old grandchild, who stretches the account for another several decades. Figure 8 (above) shows the relative difference in wealth between the scenarios, assuming that the spouse and later the grandchild take *only* the minimum RMD obligation each year (allowing the rest of the account to grow at 7%/year for the long term), compared to the spouse liquidating the inherited account and simply reinvesting the proceeds (at a net after-tax return of only 5.6%).

Taxes are assumed to be 25% on all IRA liquidations (including annual RMD distributions).

As the results of Figure 8 reveal, the benefits are substantial. Tax deferral from the 65-year old retiree's IRA was able to be prolonged for an additional 75 years beyond their death. And over this time period, the added benefit of tax-deferred compounding growth resulted in nearly $18.9 million of after-tax wealth under the stretch strategy, compared to only $11.8 million when the IRA was immediately liquidated (and subsequently grown in a taxable account)!

The caveat, however, is that the decision about whether to stretch an inherited retirement account or not is a *choice*. It's a choice of the beneficiary, who can also always *choose* to withdraw more than the minimum amount in any particular year, including fully liquidating the inherited retirement account at any time. *Ensuring* that the inherited retirement account will be stretched, or "forcing" that result, requires additional planning steps.

Using A Trust (Or Annuity) To Require An Inherited IRA Stretch

Because an inherited retirement account belongs to the beneficiary, and he/she has the right to do whatever the beneficiary wants with the account – including liquidating it more rapidly. "Forcing" the beneficiary to stretch the account necessitates not actually *leaving* the

account directly to the beneficiary in the first place… but to a trust instead.

An "IRA Beneficiary Trust" of this nature must comply with all of the requirements necessary to qualify the trust as a "designated beneficiary" – such that the trust can "see through" to the underlying beneficiary and use his/her life expectancy as the applicable distribution period. But if the IRA is payable to the trust, and the trustee is someone *besides* the beneficiary themselves, then the beneficiary may be the measuring life for the stretch, but does not actually *control* the dollars being paid out from the inherited retirement account (not how quickly they're paid out, nor what happens to them once they're paid out). Control rests with the trustee, who may either choose, or be mandated by the terms of the trust, to stretch out the inherited retirement account.

The bad news of this trust strategy, though, is that as discussed earlier, when an IRA is payable to a trust, the distributions will generally be taxed at the trust's tax rates, which reach 39.6% at "just" $12,500 of taxable income. Fortunately, if the trust passes the annual RMDs through to the underlying beneficiary, the trust receives a Distributable Net Income (DNI) deduction, and the tax consequences flow through to the beneficiary and his/her tax return.

However, in many cases, the whole point of the trust is to limit the beneficiary's access to the trust assets – including the IRA – such that the trust *is* expected to retain each RMD (at its high tax brackets). In such cases, it may still be better to "lose" nearly 40% of each RMD to taxes, than to risk losing 100% of it to an irresponsible beneficiary and/or his creditors.

Annuities With Restricted Payout Beneficiary Designations

One alternative to consider for restricting a beneficiary – to "force" a stretch – without using a trust, is to use an annuity *inside* the retirement account.

The reason an annuity can be effective for this purpose is that ultimately, an annuity is a contract, and as a contract it can provide contractual limitations on what the beneficiary can and cannot take (as long as the limitations do not violate the post-death RMD requirements of the tax code itself). As a result, some annuities make available a "restricted payout beneficiary designation" form, that determines not only who the beneficiary will be, but also contractually limit their ability to take withdrawals beyond the post-death RMD obligation.

For instance, the restricted payout beneficiary designation might stipulate that the beneficiary can take the annual post-death RMD, but *only* the RMD amount, and nothing more. Or it might stipulate that the beneficiary gets post-death RMDs, and only receives access to the remaining principal upon reaching a specified age (e.g., 50% at age 35, and the remaining 50% at age 45). In all cases, the restricted payout form *must at least* distribute the annual post-death RMD amount – as mandated by the Internal Revenue Code – but it may limit the beneficiary to *only* those amounts, with no further access to the remaining principal (until a specified age, or "ever" beyond waiting for the RMD stretch period to end).

The upside of using an annuity with a restricted payout beneficiary designation is that when there's no trust as an intermediary, there's no risk the RMDs will be taxed at trust tax rates, as shown in Figure 9 (top of next page). Instead, they'll be taxed directly to the beneficiary (since they're paid to the beneficiary) at his/her own individual tax rates. And while not all annuity companies offer restricted beneficiary designation forms, those that do typically provide them as a free option – while drafting a trust has a hard dollar cost up front that is typically at least a few thousand dollars.

On the other hand, if the retiree doesn't otherwise *need* the annuity or its guarantees, paying for an annuity "just" to get the restricted beneficiary designation form simply means turning a fixed upfront cost for a trust into an ongoing expense ratio cost for the annuity – where the latter may actually add up to far more in the long run, especially for a sizable account and a multi-decade time period. In addition, if there is already a willingness to distribute all annual RMDs to the beneficiary – and just limit access to the remaining principle – then a trust could likely still be used without adverse tax consequences, as the taxation of the RMDs generally passes through to the beneficiary (via the DNI deduction) if the RMDs themselves are passed through each year anyway. And if there's a desire to be *more* restrictive – e.g., to limit the beneficiary's access to not just the inherited retirement account principal, but also the RMDs themselves – then a restricted payout beneficiary designation form cannot fully achieve the goal.

Nonetheless, for smaller retirement accounts in particular, where the ongoing cost of an otherwise-low-cost annuity may not add up to much (and the upfront

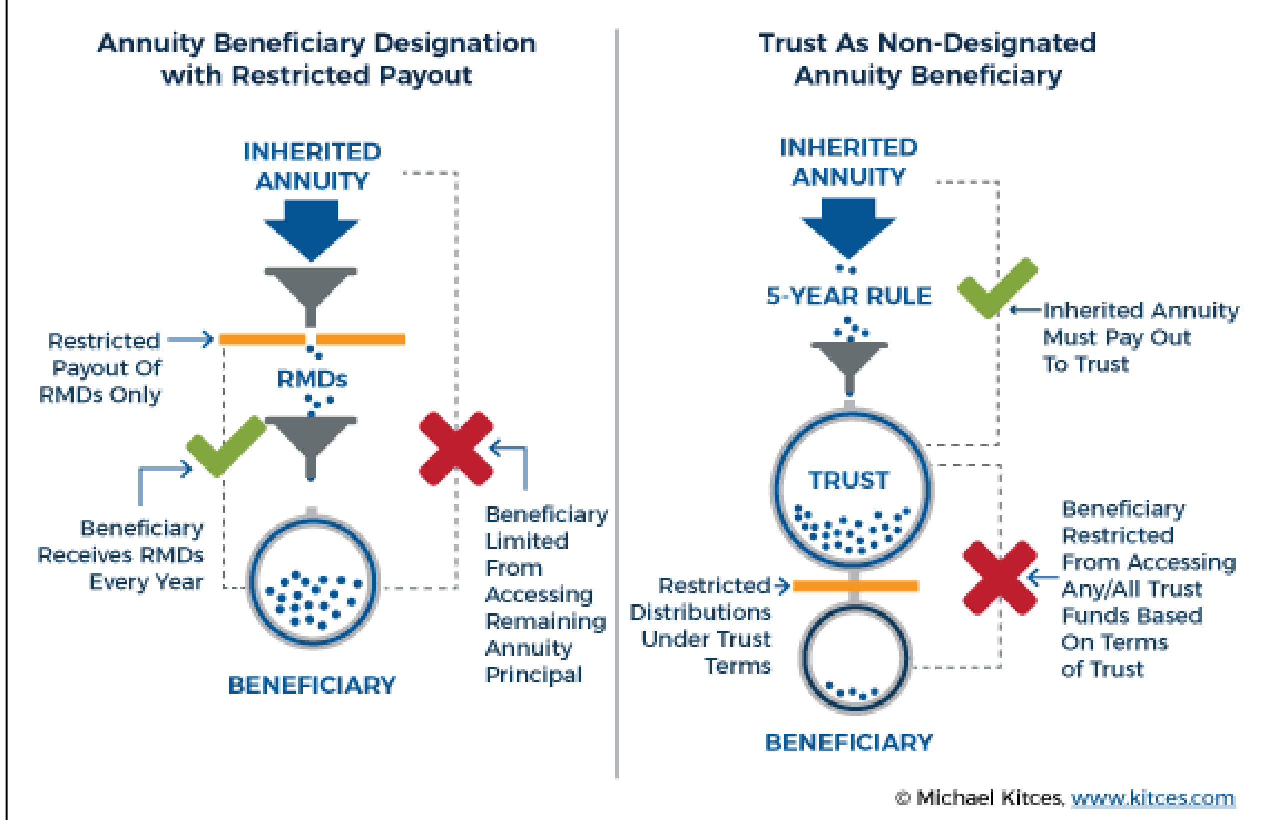


Figure 9. Forcing An IRA Stretch: Trusts Vs Restricted Annuity Payouts

cost of a trust may seem sizable in comparison), the restricted beneficiary designation form can be an appealing option. For larger retirement accounts, though, the greater flexibility of a trust – combined with the fact that RMDs can be passed through to mitigate tax consequences, and that the cost is a "flat fee" for the trust document itself – tends to win out over an annuity-based alternative (unless, of course, there are *other* non-tax reasons for using an annuity inside the retirement account anyway).

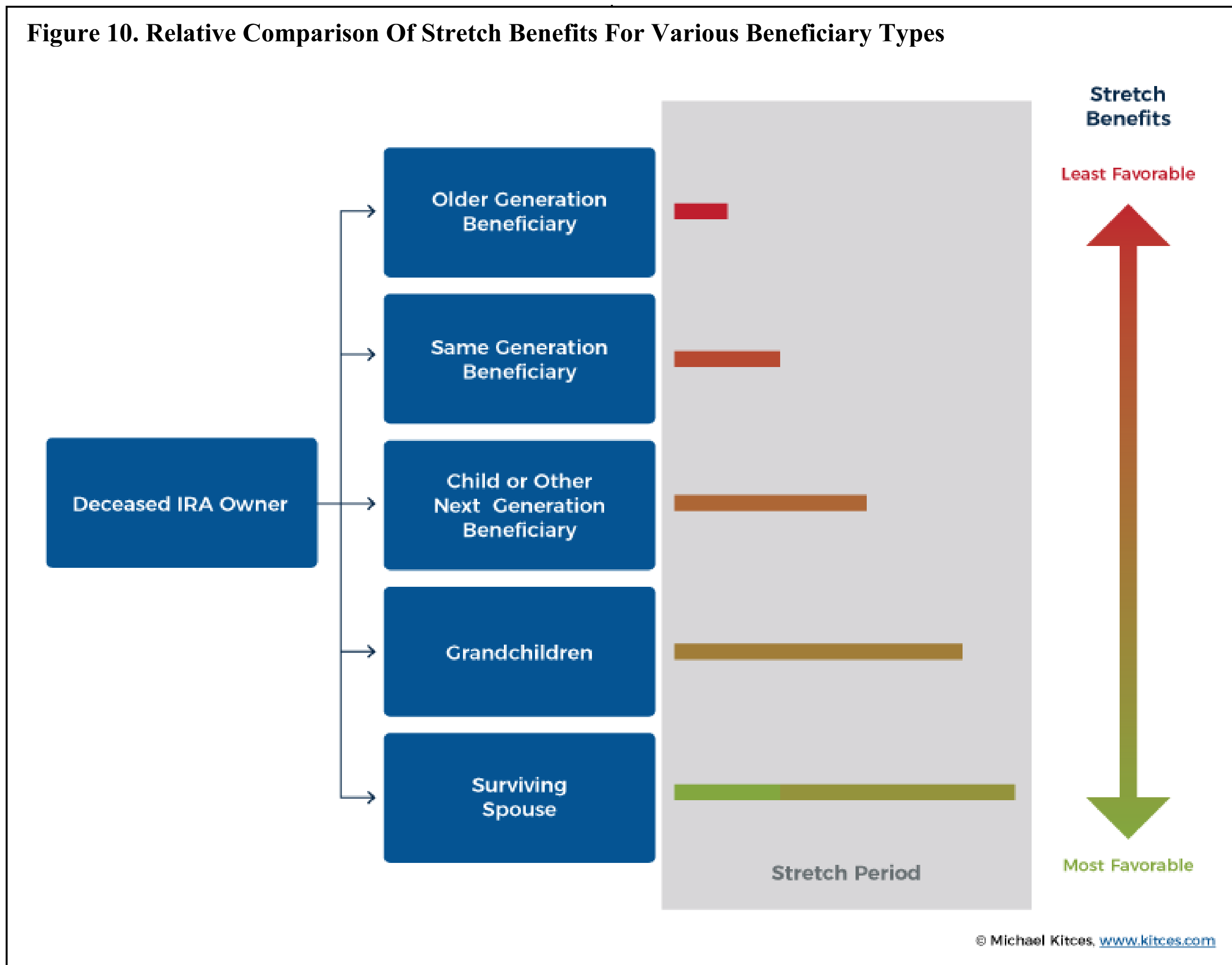
Optimizing Selection Of Inherited Retirement Account Beneficiaries

Given that the primary benefit of a stretch IRA (or other stretch inherited retirement account) is the opportunity to take *only* the minimum required distributions after death, and allow the remainder of the inherited retirement account to continue to compound tax deferred, in general the "optimal" selection of beneficiaries simply means selecting those who are the youngest and will have the longest life expectancies (and therefore the longest stretch periods, and the smaller post-death RMDs).

Thus, bequeathing an inherited IRA or other retirement account to a grandchild offers a longer stretch than leaving it to "just" a child, which in turn provides a more favorable stretch than leaving the retirement account to siblings or (similar-aged) friends, and especially older generations (e.g., surviving parents). The younger the generation of the beneficiary, the longer the prospective stretch period, and the smaller the post-death RMD obligation.

The primary exception to this general rule is leaving an inherited retirement account to a surviving spouse, given the even-more-favorable rules that apply to spouses – in particular, the ability to roll over the account to his/her own IRA, delay RMDs until the surviving spouse would have turned age 70 ½, and then be able to use the more-favorable (joint-life-expectancy-based) Uniform Life Table for lifetime RMDs, instead of the Single Life Table generally applicable to inherited retirement account beneficiaries. And of course, a surviving spouse still gets the opportunity to name new beneficiaries – e.g., children or grandchildren – to whom the remaining retirement account balance can be "re-stretched" over their life expectancies *after* the death of the surviving spouse, as shown in Figure 10 (top of next page).

Figure 10. Relative Comparison Of Stretch Benefits For Various Beneficiary Types



Notably, though, there is one beneficiary type that is generally deemed even more beneficial than a surviving spouse: a charity. The upside of naming a charity as the beneficiary of a retirement account is that while the charity is a paper beneficiary subject to the 5-year rule, the charity is a tax-exempt entity, which means it doesn't *need* the stretch and can liquidate the account tax-free anyway. Which means for an estate that has multiple assets of various types – e.g., both IRAs and other pre-tax retirement accounts, and other (taxable) investment accounts, and real estate and other assets – typically the most efficient allocation is to designate pre-tax retirement accounts to charities, and allow all the *other* types of investments/assets (which are eligible for a step-up in basis anyway) to go to other family beneficiaries (along with any Roth-style accounts).

Example 10. Russell died with a $2,000,000 estate, including $1,000,000 in a traditional IRA, and $1,000,000 in various ETFs and mutual funds in a taxable brokerage account. Russell has a desire to leave $200,000 (10% of his estate) to charity, with the remainder to his daughter Rose.

If Russell leaves $200,000 to the charity in his Will, where the bequest is satisfied from the investment account, then Rose will inherit a $1,000,000 IRA and an $800,000 investment account (where the latter has received a step-up in basis). Assuming Rose is subject to an average tax rate of 25%, the net value of the IRA to her will be $750,000 (though she could stretch out that taxation over time), and her total after-tax inheritance would be $1,550,000.

By contrast, if Russell leaves 20% of his IRA to the charity, and the other 80% to his daughter Rose, along with all of his other assets, then Rose will inherit a $1,000,000 investment account that is worth $1,000,000 after-tax (given the step-up in basis at Russell's death), and a pre-tax IRA worth $800,000 that is still worth $600,000 after-tax

(again assuming a 25% tax rate), for a total value of $1,600,000.

The net result is that by leaving the pre-tax IRA to the charity, and *other* assets to Rose, her net after-tax inheritance increases by $50,000 – which is the 25% in taxes on the $200,000 charitable bequest that "disappears" when the IRA is used to satisfy the bequest (as the charity receives it tax-free).

Of course, the reality is that it's still important not to *disinherit* beneficiaries who otherwise were intended to receive an inheritance. For instance, while leaving assets to grandchildren may be more tax-efficient than leaving them to children, in many cases family circumstances dictate a need to leave the money to the children first and foremost. Similarly, leaving a retirement account to a surviving spouse may be more tax-efficient, but if it's a second marriage, there may still be a desire to leave at least some assets – including retirement account assets – directly to the children of a first marriage, and not all to the surviving spouse. And leaving the assets to a spouse or children outright is often more tax-efficient than using a trust, but if the beneficiaries are spendthrifts anyway, it's better to lose some value to higher trust income tax rates than even more to creditors and irresponsible spending. And while it's more tax-efficient to use an IRA to satisfy a charitable bequest than other assets, the family still inherits more by just inheriting *all* the money, paying the taxes, and keeping what's left – so allocating an IRA to a charity may be the most tax-efficient way to satisfy the charitable bequest, but the family will still inherit less after-tax than if the charitable didn't receive anything at all.

Thus, actual estate planning dispositive goals should still be the primary driver that guides the estate plan, and to whom the IRA and other retirement accounts are bequeathed. But to the extent there is flexibility to allocate IRA assets – especially in coordination with other assets – amongst the various family members and other beneficiaries, an optimal allocation of the inherited retirement account, in a manner that maximizes the ability to stretch and/or minimizes the tax liability, can still substantially increase the long-term after-tax wealth value of the retirement account.

Legislative Risks To Stretching Inherited Retirement Accounts

Given the substantial tax expenditure cost associated with tax-deferred retirement accounts – second only to the tax preferences for employer-provided health insurance – and looming budget deficits, in recent years there has been a growing scrutiny about whether it's time to change the rules for retirement accounts… and especially for post-death retirement accounts.

After all, a non-trivial portion of the tax expenditure cost for retirement accounts is going to inheritors of the *unused* portion of the retirement account. Which may eventually be part of the assets that future inheritor relies upon for retirement as well. But to the extent the tax preference for retirement accounts is meant to aid retirement of the person who saved the money *for his/her own* retirement, allowing favorable tax treatment to beneficiaries after the fact does not fit well within the original intent of the rules.

Accordingly, several years ago the "Highway Investment, Job Creation, and Economic Growth Act of 2012" first proposed a change that would require most inherited retirement accounts to be distributed more rapidly. Although not implemented into law, the proposal was repeated a few years later in President Obama's 2015 budget request to Congress as a prospective "loophole closer", and was subsequently repeated every year thereafter in the annual Treasury Greenbook amongst the proposed tax policy changes.

Out and About

- Michael will be speaking on "Five Industry Trends Reshaping Financial Advice" for the eMoney Advisor Summit in Scottsdale, AZ, on September 26th

- Michael will be presenting on the "Generating Tax Alpha With Effective Asset Location" at the IMCA Private Wealth conference in Chicago, IL October 16th

- Michael will also be speaking for Schwab IMPACT in Chicago on November 14th on "Advanced Roth Conversion Strategies"

Interested in booking Michael for your own conference or live training event? Contact him directly at ***speaking@kitces.com***, see his calendar at www.kitces.com/schedule, or check out his list of available sessions at www.kitces.com/presentations.

Specifically, the proposed change would require that all beneficiaries – both designated *and* non-designated – be subject to the 5-year rule. Exceptions would apply for a surviving spouse (who would still be eligible for a spousal rollover), and beneficiaries who are already no more than 10 years younger than the original retirement account owner would still be able to stretch over their life expectancies (as their stretch period would be approximately the same as the original account owner anyway). But more-than-10-years younger beneficiaries, including all those of younger generations, would be subject to the 5-year rule, unless already disabled or chronically ill (still eligible for a stretch), or minors (able to keep the inherited retirement account until age 18, and *then* subject to the 5-year rule).

The consequence of such limitations to the stretch rules would substantially limit the benefits of the "most favorable" retirement account beneficiaries. Surviving spouses would continue to be the "best", given the spousal rollover rules. And *very* young beneficiaries who are still minors would at least benefit with *some* years of tax deferral (before they turn age 18), but would otherwise get far *less* tax deferral than before (under current law). Meanwhile, young adults (who are over age 18 and not minors), would lose most of their tax-deferral stretching opportunities, limited instead to just the 5-year rule (and the 6-tax-years it entails, including the partial tax year in the year of IRA owner's death). Which for large inherited retirement accounts, could compress distributions into so few years that it drives up the beneficiary's tax bracket as well (and potentially make partial Roth conversions of the original account owner before death even *more* appealing).

Fortunately, thus far the proposed crackdown on stretching inherited retirement accounts is just that – a proposal – and one that hasn't been revisited at all yet since President Trump took office. Nonetheless, it's important to recognize the risk that the stretch rules could be changed at some point in the future, which may substantially alter the "optimal" tax planning strategies and require significant updates to retirement beneficiary designations at the time. (Though notably, all proposals thus far would have done nothing to alter any *already-existing* stretch IRAs and their ongoing stretch payouts.)

Conclusion

In the end, tax-preferenced retirement accounts are a substantial tax benefit – one so large that the government has, over the years, imposed a series of rules and limitations designed to curtail the extent of tax deferral, by ultimately *forcing* those accounts to self-liquidate and end their ongoing tax preferences.

For those who want and need to use their retirement accounts as such, those required minimum distribution rules are largely a moot point, as they merely force retirees or their heirs to take what they were *already* going to spend anyway.

However, for those who don't need the money – or at least, not right now – there remains a significant opportunity to minimize those RMD obligations, and maximize the extent of tax deferral, by strategically selecting beneficiaries that receive the most favorable status under the rules… especially surviving spouses, and younger beneficiaries in future generations.

Nonetheless, the post-death RMD rules *do* still require that inherited retirement accounts be liquidated, and beneficiaries of all types must be certain to comply with the rules. And it's crucial to remember from the planning perspective that post-death required minimum distributions are just that – required *minimum* distributions – and that maximizing tax deferral begins first and foremost with a *choice* to do so. Or alternatively, mandates the use of a trust (or annuity with a restricted payout beneficiary designation form) to ensure that "stretch" inherited retirement account outcome!

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