



## Considering “Inherited” IRA Rollovers for Non-spouse Beneficiaries

by Mark E. Griffin

After an employee participant in a section 403(b) contract<sup>1</sup> dies, the employee’s entire interest in the plan must be distributed to the employee’s beneficiaries in accordance with the required minimum distribution rules under section 401(a)(9) (the “RMD” rules) and the terms of the section 403(b) plan. However, the distribution requirements of the plan might not be best suited to the needs of the beneficiary. For instance, the terms of the plan might require that the entire interest be distributed to the beneficiary more rapidly than permitted under the RMD rules or might not provide a lifetime annuity payment option that is permitted under the RMD rules. Also, the plan might not include modern benefits and features, such as guaranteed minimum accumulation benefits, annuity benefits, withdrawal benefits, and death benefits.

Depending on the facts and circumstances, the beneficiary might be better off transferring his or her interest in the plan to an “inherited” IRA that offers the more favorable benefits and features, and taking distribution of the interest under the RMD rules from the inherited IRA. Section 402(c)(11) permits a tax-free direct trustee-to-trustee transfer (also referred to generally as a direct “rollover”) of any portion of a distribution from a deceased employee’s qualified plan under section 401(a) to an inherited IRA that is established for the purpose of receiving the distribution on behalf of a “designated beneficiary” [within the meaning of section 401(a)(9)] of the deceased individual and who is not the surviving spouse of the deceased individual.<sup>2</sup> The beneficiary must take distributions of the entire interest in the inherited IRA in accordance with the after-death RMD rules under section 401(a)(9)(B).<sup>3</sup> These non-spouse rollover rules also apply to contracts under a section 403(b) plan,<sup>4</sup> which is the focus of this article.

Before recommending to a non-spouse beneficiary under a section 403(b) contract that he or she transfer his or her interest to an inherited IRA, it is important to determine whether, under the facts and circumstances, the inherited IRA is better suited to the beneficiary’s needs than the plan. In addition, as discussed below, it is important to determine whether and how the tax-free trustee-to-trustee transfer rules apply to the beneficiary. For instance, it must be determined (1) that the amount being transferred does not include any RMD for the year of the rollover or for any prior year, (2) whether the employee died before, or on or after, his or her “required beginning date,” and (3) whether the beneficiary is one of multiple beneficiaries of the deceased employee. If the employee’s beneficiary is a trust, the ability to transfer to an inherited IRA may be limited. Also, there might be circumstances in which the beneficiary can transfer amounts directly to an inherited Roth IRA.

### Background

Prior to 2007, a beneficiary other than the deceased owner’s surviving spouse (or former spouse who is an alternative payee under a qualified domestic relations order) could not roll over amounts tax-free from an eligible retirement plan.<sup>5</sup> The Pension Protection Act of 2006 added Code section 402(c)(11), which permits a non-spouse

<sup>1</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code, as amended (the “Code”).

<sup>2</sup> Section 402(c)(11)(A); Notice 2007-7, 2007-5 I.R.B. 395, 397, Q&A-11-13 (hereinafter Notice 2007-7).

<sup>3</sup> Section 402(c)(11)(A)(iii).

<sup>4</sup> Section 403(b)(8)(B).

<sup>5</sup> The special rules applicable to the treatment of a beneficiary who is the owner’s surviving spouse or former spouse are beyond the scope of this article.

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beneficiary to directly roll over amounts tax-free from an eligible retirement plan [including a section 403(b) contract] to an inherited IRA, effective for distributions after December 31, 2006.<sup>6</sup> For years before 2010, eligible retirement plans were permitted, but not required, to offer non-spouse rollovers to inherited IRAs. Also, a pre-2010 non-spouse rollover was not subject to the requirement that the distributee must receive a notice under section 402(f) explaining the rollover rules.<sup>7</sup>

The Worker, Retiree, and Employer Recovery Act of 2008<sup>8</sup> provided that for plan years beginning after December 31, 2009, eligible retirement plans are required to allow non-spouse beneficiary trustee-to-trustee transfers, and such transfers are treated as an eligible rollover distribution.<sup>9</sup> Hence, the non-spouse beneficiary must receive the rollover notice required under section 402(f).<sup>10</sup>

### The direct rollover requirement

In order for a non-spouse rollover from a section 403(b) contract to be tax free, it must be made directly to an inherited IRA established for the benefit of the beneficiary. If an amount distributed is directly received by a non-spouse beneficiary, the distribution is not eligible for tax-free rollover treatment.<sup>11</sup> It is important to keep in mind that the rules permitting an employee 60 days to make a tax-free rollover of an eligible rollover distribution from an eligible retirement plan<sup>12</sup> do not apply to a distribution made to a non-spouse beneficiary. Hence, if a non-spouse beneficiary actually receives a distribution from a section 403(b) contract and transfers the amount to an IRA, the transfer is treated as an after-tax IRA contribution that is subject to the IRA contribution limitations<sup>13</sup> and the six percent excise tax on excess contributions.<sup>14</sup>

### Establishing an inherited IRA

An inherited IRA is established and maintained for the benefit of the non-spouse beneficiary. In general, an individual who is a designated beneficiary will be the sole owner of an inherited IRA annuity contract. However, an inherited IRA must be established in a manner that identifies it as an IRA with respect to a deceased individual and also identifies the deceased individual and the beneficiary (*e.g.*, in the name of "Tom Smith, as beneficiary of John Smith").<sup>15</sup>

An inherited IRA can be established in a similar manner for a trust that is named as the beneficiary of under a deceased employee's plan in certain circumstances. In particular, if the named beneficiary of a deceased employee is a trust, a direct trustee-to-trustee transfer may be made tax-free to an inherited IRA on behalf of the trust, provided

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<sup>6</sup> Pub. L. No. 109-280, section 829(a)(1), 120 Stat. 780, 1001 (2006).

<sup>7</sup> Section 3405(c).

<sup>8</sup> Pub. L. No. 110-458, 122 Stat. 5092 (2008).

<sup>9</sup> *Id.* section 108(f)(2)(B).

<sup>10</sup> Like any other eligible rollover distribution, a trustee-to-trustee transfer by a non-spouse beneficiary presumably is subject to the 20 percent mandatory withholding requirement that applies if an eligible rollover distribution is not directly rolled over to an eligible retirement plan. However, since a trustee-to-trustee transfer by a non-spouse beneficiary is made directly to an inherited IRA, it appears that the 20 percent mandatory withholding requirement would not apply.

<sup>11</sup> Notice 2007-7 at 397, Q&A-15.

<sup>12</sup> See sections 401(a)(31), 402(c), 403(a)(4)(B), 403(b)(8)(B), and 457(e)(16).

<sup>13</sup> See sections 408(a)(1), 408(b), and 219(b)(1)(A).

<sup>14</sup> See section 4973.

<sup>15</sup> Notice 2007-7 at 397, Q&A-13.

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that the beneficiaries of the trust constitute “designated beneficiaries” within the meaning of the RMD rules.<sup>16</sup> Trust beneficiaries generally will be treated as having been designated as beneficiaries for this purpose if (1) the trust is a valid trust under state law, (2) the trust is irrevocable, (3) the trust beneficiaries are identifiable from the trust document, and (4) certain documentation required under the RMD regulations is provided.<sup>17</sup>

The non-spouse beneficiary may not treat an inherited IRA as his or her own IRA, and thus certain rules that apply to IRAs generally do not apply to inherited IRAs. In particular, the contribution limitations that normally apply to IRAs do not apply to an inherited IRA, so that a non-spouse beneficiary generally may not make any contributions to an inherited IRA other than the tax-free direct rollover from the deceased employee’s eligible retirement plan. Also, the rule that the surviving spouse beneficiary may continue an IRA as his or her own IRA<sup>18</sup> does not apply to an inherited IRA (*i.e.*, if a non-spouse beneficiary dies after establishing an inherited IRA, the beneficiary’s spouse may not continue the inherited IRA as his or her own IRA). In addition, the lifetime RMD rules that apply generally to an IRA do not apply to an inherited IRA. Accordingly, the non-spouse beneficiary must take distributions under the after-death RMD rules as if the deceased employee was the IRA owner and died. Hence, before an amount is rolled over to an IRA by a non-spouse beneficiary, it is important to make sure that the terms of the IRA reflect the inherited IRA rules. In this regard, the Internal Revenue Service has developed model language which reflects the use of an IRA as an inherited IRA.<sup>19</sup>

## Applying the RMD rules to the direct rollover and the inherited IRA

### In general

The RMD that a deceased employee should have taken from his or her section 403(b) contract for a year but did not, including any undistributed RMD for a prior year, is ineligible for direct rollover to an inherited IRA.<sup>20</sup> Also, as noted above, the entire interest in an inherited IRA must be distributed under the after-death RMD rules as if the deceased employee under the plan was the owner of the IRA. For purposes of applying these after-death distribution requirements, it must be determined (1) that the amount being rolled over does not include any RMD for the year of the rollover or for any prior year, (2) whether the section 403(b) contract owner died before, or on or after, his or her “required beginning date,” and (3) whether the beneficiary is one of multiple beneficiaries of the deceased owner.

In general, an employee is required to take an RMD with respect to a section 403(b) contract for each calendar year beginning with the calendar year in which the individual attains age 70½ or, if later, retires.<sup>21</sup> The RMD for this first distribution calendar year can be delayed until April 1 of the following calendar year (*i.e.*, the required beginning date).<sup>22</sup> The application of the after-death RMD rules to an inherited IRA will differ depending on whether the employee dies prior to, or on or after, his or her required beginning date with respect to the section 403(b) contract.

### The employee’s death prior to the required beginning date

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<sup>16</sup> *Id.* at 397, Q&A-16.

<sup>17</sup> Treas. Reg. section 1.401(a)(9)-5, Q&A-5.

<sup>18</sup> Section 308(d)(3)(C); Treas. Reg. section 1.408-8, Q&A-5.

<sup>19</sup> See the Lists of Required Modifications and Information Package (or “LRMs”) for IRAs under section 408 and Roth IRAs under section 408A. These and other LRMs can be found at: <http://www.irs.gov/retirement/article/0,,id=97182,00.html>.

<sup>20</sup> Notice 2007-7 at 398, Q&A-17(c)(1), Q&A-18.

<sup>21</sup> Section 401(a)(9)(C).

<sup>22</sup> *Id.*

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If the employee dies prior to the required beginning date, no amount is an RMD for the year in which the employee dies.<sup>23</sup> The entire interest, including the amount rolled over to an inherited IRA, must be distributed (1) by December 31 of the fifth calendar year following the year of the employee's death (the "5-year rule"), or (2) over the non-spouse beneficiary's life, or over a period not extending beyond the designated beneficiary's life, commencing within one year of the employee's death (the "lifetime payment rule").<sup>24</sup> The RMD under the lifetime payment rule is determined under the RMD regulations.<sup>25</sup> The RMD rules apply with respect to the inherited IRA in the same manner that they would apply with respect to the deceased employee's section 403(b) contract if the direct rollover had not occurred.<sup>26</sup>

If the 5-year rule applies, no amount is treated as an RMD that is ineligible for direct rollover for the first four years after the employee's death, and no amount is eligible for rollover on or after January 1 of the fifth calendar year following the year of the employee's death. If the employee dies prior to the required beginning date and the employee's plan does not provide the lifetime payment rule, a non-spouse beneficiary also must take distributions from an inherited IRA under the 5-year rule, with one exception. A non-spouse beneficiary nevertheless can take distributions from an inherited IRA under the lifetime payment rule if amounts are directly rolled over to the inherited IRA prior to the end of the calendar year following the year of the employee's death.<sup>27</sup> Hence, in determining the type of distributions that may be made under an inherited IRA, it is important to know whether the deceased employee's plan permits after-death distributions to be made under the lifetime payment rule.

Also, it is important to know when an annuity contract might be available and useful as an inherited IRA. If distributions may be made under the lifetime payment rule, an annuity contract is the only instrument that can provide payments for as long as a non-spouse beneficiary lives. If an inherited IRA annuity contract is being considered for making distributions under the 5-year rule, it is important to check whether the contract offers an annuity option under which annuity payments may be made for a term not exceeding the remainder of the 5-year period.

### **The employee's death on or after the required beginning date**

If the employee dies on or after his or her required beginning date, the employee's RMD for the year of death is not eligible for rollover. The RMD for the year after the employee's death, and subsequent years, is determined under the RMD regulations.<sup>28</sup> The amount not eligible for rollover includes any undistributed RMD for the year in which the direct rollover occurs and any prior year.<sup>29</sup> If the employee is receiving annuity payments at the time of death, the extent to which any remaining annuity payments made after the employee's death may be rolled over is unclear. If a non-spouse beneficiary can commute such post-death annuity payments, it is possible that part or all of the commutation proceeds might be eligible for tax-free rollover treatment.

In the case of an employee's death on or after the required beginning date, the RMD rules require that the remaining interest be distributed at least as rapidly as under the method of distribution being used as of the date of the employee's death.<sup>30</sup> If it is determined that the employee died on or after the required beginning date, it is important to know whether distributions at the time of death were being made in the form of annuity payments and, if so, the manner in which such annuity payments were being made. Unless the employee was taking RMDs from the

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<sup>23</sup> Notice 2007-7 at 397-98, Q&A-17(a).

<sup>24</sup> Section 401(a)(9)(B).

<sup>25</sup> See Treas. Reg. section 1.401(a)(9)-5, Q&A-5; Treas. Reg. section 1.401(a)(9)-6.

<sup>26</sup> Notice 2007-7 at 398, Q&A-19.

<sup>27</sup> *Id.* at 398, Q&A-17(c)(2).

<sup>28</sup> *Id.* at 398, Q&A-18; Treas. Reg. section 1.401(a)(9)-5, Q&A-5.

<sup>29</sup> Notice 2007-7 at 398, Q&A-18.

<sup>30</sup> Section 401(a)(9)(B)(i); Notice 2007-7 at 398, Q&A-19.

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plan in the form of life contingent annuity payments (*i.e.*, for the joint lives of the employee and his designated beneficiary), the RMD rules appear to prohibit a non-spouse beneficiary from taking life-contingent annuity payments from the plan or an inherited IRA. Rather, distributions in the form of withdrawals or annuity payments must be made to the non-spouse beneficiary for a period not extending beyond the longer of (1) the remaining life expectancy of the deceased employee, and (2) the remaining life expectancy of the designated beneficiary.<sup>31</sup>

### Multiple beneficiaries

It is possible that the deceased employee might have more than one designated beneficiary under his or her section 403(b) plan. If so, the designated beneficiary whose life expectancy is to be used for purposes of determining RMDs must be determined in accordance with the RMD regulations. In this regard, special rules apply for purposes of determining which designated beneficiary's life expectancy should be used to determine the RMDs,<sup>32</sup> how to determine the applicable life expectancy where the beneficiaries' interests are divided into separate accounts,<sup>33</sup> and how to determine the applicable distribution period if a trust is named as the employee's beneficiary.<sup>34</sup>

As a general rule, if a deceased employee has multiple designated beneficiaries, RMDs are determined by reference to the oldest designated beneficiary.<sup>35</sup> However, if a deceased employee's benefit is divided into separate accounts by the end of the year following the year of the employee's death, and the beneficiaries with respect to one separate account differ from the beneficiaries with respect to the other separate accounts, the after-death RMD rules can separately apply to each separate account.<sup>36</sup> This special rule for separate accounting is not available in the case of a trust named as the employee's beneficiary.<sup>37</sup>

Hence, it is important to know whether the employee named multiple beneficiaries and, if so, whether RMDs need to be determined with respect to the life or life expectancy of the oldest beneficiary or some other period. It is possible that RMDs with respect to one beneficiary's inherited IRA must be determined with respect to the life or life expectancy of another designated beneficiary.

### Multiple inherited IRAs

It is possible (but probably uncommon) for a non-spouse beneficiary to establish multiple inherited IRAs with respect to the same deceased employee. If so, the RMD that is payable to the non-spouse beneficiary from any one inherited IRA may be taken from any one or more of the other inherited IRAs.<sup>38</sup>

### Considering inherited Roth IRA contracts

A Roth IRA under section 408A also can be issued to a non-spouse beneficiary as an "inherited" Roth IRA in certain circumstances. If an individual who owns an IRA dies, it appears that a non-spouse beneficiary is not permitted to convert the inherited IRA contract to an inherited Roth IRA contract. Such a conversion is treated as a distribution from the IRA and a roll over to a Roth IRA.<sup>39</sup> A non-spouse beneficiary is not permitted to make a tax-free

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<sup>31</sup> See Treas. Reg. section 1.401(a)(9)-5, Q&A-5.

<sup>32</sup> See *id.*, Q&A-7.

<sup>33</sup> See Treas. Reg. section 1.401(a)(9)-4, Q&A-5.

<sup>34</sup> See Treas. Reg. section 1.401(a)(9)-8, Q&A-2(a).

<sup>35</sup> See Treas. Reg. section 1.401(a)(9)-5, Q&A-7.

<sup>36</sup> See Treas. Reg. section 1.401(a)(9)-4, Q&A-3; Treas. Reg. section 1.401(a)(9)-8, Q&A-1, Q&A-3.

<sup>37</sup> See Treas. Reg. section 1.401(a)(9)-4, Q&A-5.

<sup>38</sup> Treas. Reg. section 1.408-8, Q&A-9.

<sup>39</sup> See Treas. Reg. section 1.408A-4, Q&A-1(c).

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rollover from a deceased individual's IRA.<sup>40</sup> Presumably, therefore, a non-spouse beneficiary of a deceased IRA owner cannot convert an inherited IRA to an inherited Roth IRA.

However, if an employee has an interest in an eligible retirement plan [including a section 403(b) contract] and dies, a non-spouse beneficiary is permitted to make a direct rollover of his or her interest in the plan to an inherited Roth IRA. The beneficiary generally will need to include the untaxed earnings attributable to the rollover in gross income.<sup>41</sup> As with any inherited IRA, the non-spouse beneficiary's entire interest in an inherited Roth IRA must be distributed in accordance with the after-death RMD rules. Whether it makes sense for a beneficiary to convert an interest in a deceased employee's qualified plan to an inherited Roth IRA will depend on the beneficiary's facts and circumstances. Because a non-spouse beneficiary will need to pay tax in connection with such a rollover to an inherited Roth IRA, it might be that such a rollover is not in the beneficiary's best interest in most cases.

Some questions exist regarding a direct rollover by a non-spouse beneficiary to an inherited Roth IRA of amounts held by the deceased employee in a "designated Roth account" under a plan. Under section 402A, a designated Roth account can be established for an employee under an "applicable retirement plan" [including a section 403(b) plan] and can be funded with part or all of the employee's elective deferral contributions under the plan that are includible in the employee's gross income. Amounts held in a designated Roth account are treated in many respects like amounts held in a Roth IRA. Some uncertainty exists under the tax rules about whether the direct rollover by a non-spouse beneficiary from a deceased employee's designated Roth account to an inherited Roth IRA is subject to the requirement that the untaxed earnings attributable to the transferred interest must be included in the beneficiary's gross income as a result of the rollover.

## Conclusion

As discussed above, a non-spouse beneficiary under a qualified plan of a deceased employee can in certain circumstances transfer amounts in a tax-free trustee-to-trustee transfer to an inherited IRA or inherited Roth IRA. An inherited IRA or inherited Roth IRA might be very attractive because it might offer benefits and features that are not available to the non-spouse beneficiary under the plan. However, before such a transfer is undertaken, care should be taken to determine that the inherited IRA or inherited Roth IRA is suited to the non-spouse beneficiary's needs. In addition, it is important to determine whether and how the tax-free trustee-to-trustee transfer rules apply to the beneficiary.

Although this article focused on the application of the non-spouse rollover rules in the context of section 403(b) contracts, these rules also apply to non-spouse beneficiaries of deceased participants in qualified plans under section 401(a) and governmental 457(b) plans. The ability of a non-spouse beneficiary under these plans to stretch distributions over their own life or life expectancy sometimes does not exist in the plan. Accordingly, advisors will want to be alert to opportunities to assist non-spouse beneficiaries under these plans in taking advantage of the "stretch" opportunities via an inherited IRA.

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<sup>40</sup> See section 408(d)(3)(C).

<sup>41</sup> See section 408A(d)(3)(A).

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