

# IRAs & Roth IRAs

## A Surviving Spouse's Options with Respect to Their Spouse's IRA

Questions & Answers

## Purpose

Your deceased spouse designated you as his or her traditional IRA and/or Roth IRA beneficiary. IRAs are designed to provide benefits to an IRA account holder, and after his or her death, to his or her beneficiary. You as the surviving spouse beneficiary, will need to decide what course of action to take with respect to these inherited IRAs.

The purpose of this brochure is to discuss the federal income tax rules applying to a spouse beneficiary. You may have been the sole beneficiary, or you may have been one of many beneficiaries.

By understanding the tax rules, hopefully you, will make informed decisions and adopt an approach which is best for you. What is best for you will depend upon the particular facts which apply to your situation and your goals for yourself and your beneficiaries. You should be aware that there are other rules which apply to non-spouse beneficiaries.

There are two terms used to describe an IRA after the IRA account holder has died. The first term is a "beneficiary IRA." The second term is an "inherited IRA." Within this brochure the "inherited IRA term" is used. Special rules apply to an inherited IRA. First, an inherited IRA must make required distributions to the beneficiary(ies). Second, there can be no additional contributions made. You will want to consult with your legal or tax advisor. If such distributions are not made by the appropriate deadline, you as a beneficiary are liable to pay a 50% excise tax of the amount required to be withdrawn.

### First Determination

The first step you will want to do is determine what type, or types, of IRAs did your spouse have. Your spouse may have had a traditional IRA and/or a Roth IRA. He or she could have had more than one IRA of each type. You will want to determine the number of IRA plan agreements which he or she had with various IRA custodians/trustees.

There is one set of rules if your spouse had a traditional IRA and another set of rules if he or she had a Roth IRA. For purposes of this brochure, the rules applying to a traditional IRA also apply if your spouse had a SEP-IRA or SIMPLE-IRA.

What you decide to do for the traditional IRA may not necessarily be the same as your election for the Roth IRA.

Your spouse should have a file containing his or her IRA documents. This file should contain his or her IRA plan agreement(s) and the beneficiary designation(s). If you cannot find such a file, you may ask the IRS custodian(s) for the copies in its file.

## My Spouse had a Traditional IRA

### What rules apply for the year the IRA accountholder dies?

If your spouse died before his or her required beginning date (April 1 of the year following the year one attains age 70½), there is no RMD which must be distributed for such year. If the IRA accountholder died after his or her required beginning date, there is an RMD which must be distributed for such year. To the extent this amount was not paid out before his or her death, you will need to be paid your proportionate share of the RMD by December 31, or the 50% tax will apply.

## Elect as Own IRA, or Keep as an Inherited IRA

### What are the three options available to me as a spouse beneficiary?

#### **Option #1. Treat as Own – No Longer an Inherited IRA**

You may treat your spouse's IRA as your own IRA if you were your spouse's sole beneficiary, or you may take a distribution and then roll it over into your own IRA if you were not your spouse's sole beneficiary. This will be the election that most spouse's will make, but there are times when you will wish to elect Option #2 or Option #3.

**General Rule.** When both spouses are age 59½ and older, and relatively the same age, the surviving spouse will normally want to elect to treat the deceased spouse's IRA as their own. The required distribution amount to be made to you as an IRA accountholder, if any, is smaller than the required distribution which must be made to you as a beneficiary.

When you elect to treat your spouse's IRA as your own, there is no longer an inherited IRA. The IRA now will list you, the surviving spouse, as the IRA accountholder or owner. All of the standard IRA rules applying to an IRA accountholder will apply to you. For example, if you take a distribution and are younger than age 59½, then you will generally owe the 10% additional tax.

A spouse beneficiary who is NOT the sole beneficiary of their deceased spouse's IRA (i.e. an inherited IRA) may NOT treat this inherited IRA as his or her own IRA, but may roll it over to his or her own IRA. The net effect is the same. There is no longer an inherited IRA. All of the standard rules applying to an IRA accountholder will apply to you.

You will make this election by indicating on an administrative form or by writing a letter that you wish to treat your spouse's IRA as your own or by doing the rollover.

### **Understanding the Tax Consequences of Distributions from an IRA Which You Treat as Your Own**

You are taxed as if you had been the original contributor. This is your own IRA. Under the tax rules which require a person to aggregate his or her IRAs, you will aggregate this IRA with any other IRA you maintain. The 70½ required distribution rules will apply to you, if applicable.

It is not an inherited IRA any longer. If you take a distribution when you are younger than age 59½, you will owe the 10% additional tax unless an exception would apply. The death exception does not apply. You acquire whatever "basis" your deceased spouse had as of their death.

When funds are withdrawn or distributed from this IRA, you will generally include the full amount in your gross income for federal income tax purposes. The amount of tax you will need to pay because of an IRA distribution will be added to your other income, and you will pay tax at whatever your marginal income tax bracket would require. If your spouse had a nontaxable amount within his or her IRA because he or she had made nondeductible contributions to the traditional IRA, or had rolled over nondeductible contributions from a 401(k) plan or other pension plan, then a portion of that distribution will not be taxed. This subject of nondeductible contributions or basis is beyond the scope of this brochure. You will want to consult with your tax advisor and also perform your own research.

By treating his or her IRA as your own IRA, you do realize the tax benefit that taxation of the earnings is deferred until actually distributed, as is taxation of the original contributions. As with your other traditional IRAs, you may convert these funds to a Roth IRA.

#### **Options #2 & #3. Maintain as an Inherited IRA**

Option #2: Life-Distribution Rule. You, as the surviving spouse, may elect to use the life-distribution rule to comply with the required distribution rules. This means you must take required distributions over your life expectancy. If you are the sole beneficiary, then you must commence distribution by December 31 of the later of: (i) the year your spouse would have attained age 70½, or (ii) the year after the year he or she died. This special rule many times means the surviving spouse is not required to take a distribution for many years. If you are not the sole beneficiary, then you must commence distribution by December 31 of the year after the year your spouse died.

There are times when a surviving spouse will not want to treat a deceased spouse's IRA as their own. For example, David and Rhonda are both age 52. David dies in January of 2007. In this situation, Rhonda who is age 52 may not want to immediately treat David's IRA as her own. The distributions she takes from the inherited IRA (Rhonda as beneficiary of David's IRA) will not be subject to the 10% tax as the distributions are from an inherited IRA. However, if Rhonda would treat David's Roth IRA as her own, and then take distribution prior to age 59½, she would owe the 10% additional tax unless one of the other exceptions applied.

Option #3: 5-Year Rule. You, as the surviving spouse, may elect to use the 5-year rule if your spouse died before his or her required beginning date. This option is unavailable if the IRA accountholder died on or after his or her required beginning date (April 1 of the year following the attaining of age 70½). This election will generally be made the least frequently of the three options. You are required to withdraw all funds within the IRA by December 31 of the fifth year following the year your spouse died. In effect, you may take distributions during six (6) different tax years. There is no requirement to take periodic or scheduled distributions. The only requirement is that all of the IRA funds be distributed by the end of the five-year time period.

This alternative might be selected if you foresee one or two tax years when your taxable income might be smaller than in most years or where you might even have a net loss.

You, as the surviving spouse, may elect Option #2 or #3, and then later elect to treat the inherited IRA as your own.

If you elect alternative #2 or #3, you will want to designate your own beneficiary(ies) so that you designate who will receive these funds after your death. The general rule is: each of your beneficiary(ies) will be required to take a distribution according to the schedule you established, or they may take a larger distribution.

### **Understanding the Tax Consequences of Distributions from an Inherited IRA**

You are required to be distributed certain amounts determined under either the life-distribution rule or the 5-year rule.

When funds are withdrawn or distributed from this inherited IRA, you will generally include the full amount in your gross income for federal income tax purposes. The amount of tax you will need to pay because of an IRA distribution will be added to your other income, and you will pay tax at

whatever your marginal income tax bracket would require. If your spouse had a nontaxable amount within his or her IRA because he or she had made nondeductible contributions to the traditional IRA, or had rolled over nondeductible contributions from a 401(k) plan or other pension plan, then a portion of that distribution will not be taxed. This subject of nondeductible contributions or basis is beyond the scope of this brochure. You will want to consult with your tax advisor and also perform your own research.

You do realize the tax benefit that taxation of the earnings is deferred until actually distributed, as is taxation of the original contributions. You are ineligible to convert these inherited IRA funds unless you would use the rollover approach.

## **My Spouse had a Roth IRA**

The rules requiring a distribution to a beneficiary of a Roth IRA are different than for traditional IRAs. The rules are similar, but the rules are not the same.

### **What rules apply for the year the Roth IRA accountholder dies?**

A required distribution is never required to be made to a Roth IRA accountholder. Since there is no required distribution remaining to be distributed for the year of death, a required distribution is never required to be made to a beneficiary for the year the Roth IRA accountholder dies.

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## **Elect as Own Roth IRA, or Keep as an Inherited Roth IRA**

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### **What are the three options available to me as a spouse beneficiary?**

#### **Option #1. Treat as Own – No Longer an Inherited Roth IRA**

You may treat your spouse's Roth IRA as your own Roth IRA if you were your spouse's sole beneficiary, or you may take a distribution and then roll it over into your own Roth IRA if you were not your spouse's sole beneficiary. As discussed below, under some Roth IRA plan agreements, you as the spouse beneficiary do not have the right to treat your spouse's Roth IRA as your own. Your spouse's Roth IRA becomes your Roth IRA upon his or her death. A surviving spouse will generally treat their spouse's Roth IRA as their own, but there are times when you will wish to elect Option #2 or Option #3.

**General Rule.** When both spouses are age 59½ and older, and relatively the same age, the surviving spouse will normally want to elect to treat the deceased spouse's Roth IRA as their own.

A spouse beneficiary who is the sole beneficiary of their deceased spouse's Roth IRA (i.e. an inherited IRA) may treat this inherited Roth IRA as his or her own Roth IRA. When this treatment is elected, there is no longer an inherited Roth IRA. The Roth IRA now will list the surviving spouse as the Roth IRA accountholder or owner. All of the standard rules applying to an Roth IRA accountholder will apply to the surviving spouse.

A spouse beneficiary who is NOT the sole beneficiary of their deceased spouse's Roth IRA (i.e. an inherited Roth IRA) may NOT treat this inherited Roth IRA as his or her own Roth IRA, but may roll it over to his or her own Roth IRA. The net effect is the same. There is no longer an inherited Roth IRA. All of the standard rules applying to an Roth IRA accountholder will apply to you.

You will make this election by indicating on an administrative form or by writing a letter that you wish to treat your spouse's Roth IRA as your own or by doing the rollover.

The IRS has written the Roth IRA plan agreement to state that if a spouse is designated as a beneficiary, the deceased spouse's Roth IRA automatically, upon his her or death, becomes the surviving spouse's Roth IRA. This may or may not always be desirable. The IRS has stated the Roth IRA plan agreement may be revised to provide that a surviving spouse is deemed to have treated the deceased spouse's Roth IRA as his or her own unless he or she elects one of the other two options.

So, you first want to determine whether the Roth IRA plan agreement gives you the right to elect one of the other two options. In many cases, it will be best for you as the surviving spouse to simply become the Roth IRA accountholder with respect to your spouse's Roth IRA. However, there will be times when you do not want to treat the inherited Roth IRA as your own Roth IRA right away.

### **Understanding the Tax Consequences of Distributions from a Roth IRA Which You Treated as Your Own**

You are taxed as if you had been the original contributor. This is now your own Roth IRA. It is no longer an inherited Roth IRA. For purposes of the five year rule, your time period as the Roth IRA accountholder will be added to the time period of your spouse.

Since you are now the Roth IRA accountholder, there will be no required distribution until after you die. In order to gain the tax free income treatment, you will need to meet the requirements for a qualified distribution. Generally, this means you must be age 59½ or older and the five-year rule must have been met.

### **Options #2 & #3. Maintain as an Inherited Roth IRA**

**Option #2, Life Distribution Rule.** You, as the surviving spouse, may elect to use the life-distribution rule to comply with the required distribution rules. This means you must take the required distribution over your life expectancy. If you are the sole beneficiary, then you must commence distribution by December 31 of the later of: (i) the year your spouse would have attained age 70½, or (ii) the year after the year he or she died. This special rule many times means the surviving spouse is not required to take a distribution for many years. If you are not the sole beneficiary, then you must commence distribution by December 31 of the year after the year your spouse died.

For illustration purposes it is assumed that John is age 65. John has had his Roth IRA for 9 years. He dies in 2007. His wife, Ramona, age 56, is his designated beneficiary. Should she immediately treat this Roth IRA as her own? Must she treat this Roth IRA as her own?

Probably not. She is not yet age 59½. If she treats the Roth IRA it as her own, any distribution to her will not be "qualified" since the distribution will not be on account of death. The five year rule has been met, but the second requirement (one of 4 reasons) most likely will not be met until she attains age 59½.

Any distribution from the inherited Roth, "Ramona as beneficiary of John's Roth IRA," will be qualified and tax-free since he had met the five year requirement and the distribution would be on account of his death.

Remember that because Ramona is a sole spouse beneficiary, she is not required to commence distributions until December 31st of the year John would have attained age 70½.

**Option #3, 5-Year Rule.** You, as the surviving spouse, may elect to use the 5-year method. You are required to withdraw all funds within the Roth IRA by December 31 of the fifth year following the year your spouse died. There is no requirement to take periodic or scheduled distributions.

You, as the surviving spouse, may elect Option #2 or #3, and then later elect to treat the inherited Roth IRA as your own.

## Understanding the Tax Consequences of Distributions from an Inherited Roth IRA

There must be distributions made from an inherited Roth IRA to a beneficiary. You will use either the life distribution rule or the five-year rule to take these distributions.

Most distributions from an inherited Roth IRA will be qualified because the original Roth IRA account holder has died and the five-year requirement will have been met. This means there will be no taxation of any amount distributed from the inherited Roth IRA. This includes both the original contributions and any earnings, already realized or future earnings. Since there are few investments which are not subject to federal income tax, you as the beneficiary may well wish to withdraw only the required distribution amount each year and no more than that amount.

If you were the sole beneficiary of your spouse's Roth IRA, then you are not required to commence distribution until the year your spouse would have attained age 70½. The practical effect of this rule in many cases is that you are not required to take distributions for many years. This will allow you to use the account to earn tax free income.

If you were not the sole beneficiary, then under the life distribution rule you will be required to commence distribution over your life expectancy by December 31 of the year after your spouse died. Even though you are required to take a distribution each year using the formula (preceding year's December 31 balance divided by the life expectancy factor based on your age), your required distribution will be relatively small and your inherited Roth IRA will be able to generate tax free income for many years.

Your spouse should have maintained various tax records with respect to the Roth IRA. You will want to locate the following records:

1. Form 8606 for each year;
2. Form 5498 or similar statements received each year showing contributions made to a Roth IRA; and
3. Form 1099-R for each year a distribution was received.

As the beneficiary, you should find these forms and records and then continue to maintain such forms and records for future years, until the Roth IRA is completely distributed.

## Other Important Considerations for an Inherited Traditional IRA or Inherited Roth IRA

1. You will want to name your own beneficiary(ies) if you are maintaining the IRA as an inherited IRA. Your beneficiary(ies) will use the RMD (Required Minimum Distribution) schedule as calculated using your age. This schedule will require a larger distribution than if you had elected to treat your deceased spouse's IRA as your own.

2. Even if you are younger than age 59½, the 10% additional tax does not apply to any distribution from an inherited IRA.

3. Inherited IRAs which arise from the same original IRA account holder are considered to be like-kind IRAs and may be aggregated for purposes of satisfying the RMD requirement. However, you may not aggregate an inherited IRA from one person with your own personal IRAs, or with an IRA inherited from a different person.

4. An inherited IRA can be transferred to another inherited IRA.

5. A spouse beneficiary can roll over funds from an inherited IRA to his or her own personal IRA as long as the amount being rolled over is not a required distribution.

6. The IRA regulation provides that a surviving spouse who makes a contribution to an inherited IRA, or who fails to take a required distribution by the appropriate deadline, is deemed to have treated it as his or her own IRA.

7. The law mandates the following order for distributions from a Roth IRA: (1) from regular/annual contributions; (2) from conversion contributions on a first-in-first-out basis, and (3) from earnings. A distribution from a Roth IRA is not includable in your gross income even if it is not a qualified distribution to the extent that the distribution, when added to the amount of all previous distributions (whether or not they were qualified distributions from your Roth IRA), exceeds your contributions to all of your Roth IRAs.

*The information provided in this brochure is not intended to be legal or tax advice. You should consult your attorney or tax advisor for information that relates to your specific circumstances.*