MISTAKE #1: Failure to Name a Designated Beneficiary or Failure to Update the Designation Form

If you fail to name a designated IRA beneficiary, it could have unintended consequences. What is a “designated” beneficiary? Aren’t all beneficiaries “designated”? No, they are not the same! A designated beneficiary is a living, breathing, human with a remaining life expectancy. Charities cannot be designated. Estates cannot be designated. Trusts cannot be designated. Your beloved dog cannot be designated. Failure to name a designated beneficiary essentially diminishes the opportunity for individual beneficiaries to maximize the benefits of tax deferred distributions on an inherited IRA.

Life changing events such as marriage, death, divorce, birth and adoption occur regularly and could impact your beneficiary designation decisions. Every IRA owner should conduct a beneficiary form review at least once a year to ensure that IRA assets will pass to the intended beneficiaries.

MISTAKE #2: Beneficiaries Fail to Take Advantage of the Stretch Opportunity and Cash Out the IRA

As an IRA owner, you may have all of the relevant information and knowledge about the incredible opportunities for tax deferred RMDs and minimizing any unnecessary taxation, but do your heirs? Many beneficiaries are in the dark and remain unaware of their options when it comes to inherited IRAs. Some beneficiaries even think the only option is to cash out the inherited IRA, potentially exposing the IRA to heavy, immediate and unnecessary taxation.

MISTAKE #3: Taking the Wrong RMD Amount

Assuming you remembered to take an annual distribution from your IRA, did you confirm that you took the correct minimum amount? Who did the calculation? Was it based on your balance as of December 31st of the prior year? Do you have more than one IRA? Were RMD calculations made from each of those IRAs? Did you add outstanding rollovers/IRA assets in transit and recharacterizations? Did you use the correct life expectancy factor? There is nothing wrong with taking out more than the required minimum,

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however, do not make the mistake of taking too little as the consequences are steep.

If you fail to take out at least the correct minimum distribution each year after your required beginning date, the IRS will impose a 50% penalty on the amount you failed to take but should have!

For the first distribution year only (after an individual turns 70½) the IRA owner has until April 1st of the following year to take his/her very first RMD.

**MISTAKE #4: Failure to Take an RMD on Time**

Do you know when your required beginning date (RBD) is? As stated before, when an IRA owner turns 70½, the owner has until April 1st of the following year to take the very first RMD. After the first distribution, each subsequent RMD must be taken no later than December 31st each year.

Failure to take your RMD by the deadline will subject the undistributed amount to a 50% penalty. Not only will you be responsible for the penalty, you still have to take the RMD and pay the taxes. If your filing date has passed or your tax return has already been processed when an RMD error is discovered, you will need to file an amended return.

**MISTAKE #5: Taking Distributions Out Too Early**

Are you under 59½ but plan to take a distribution from your IRA? The IRS will impose a 10% early distribution penalty on all taxable distributions that are taken before an IRA owner reaches 59½ unless some other exception applies. The basic exceptions for the 10% penalty are death, disability, medical expenses in excess of 7.5% of the AGI (in the year of distribution), qualified higher learning expenses, first time home buyer and health insurance for unemployed owners who have been receiving unemployment compensation for at least 12 consecutive weeks.

An IRA owner may also avoid a 10% early distribution penalty if the distributions qualify under I.R.C. Section 72(t) as part of systematic, substantially equal, periodic payments.

**MISTAKE #6: Not Knowing the Rules for Non-Spouse Beneficiaries of Inherited IRAs**

There are different rules for spouse and non-spouse beneficiaries of an IRA. For example, it is a common (and disastrous) error for non-spouse beneficiaries to think they can “rollover” an inherited IRA into their own IRA... they cannot! Non-spouse beneficiaries can only do trustee-to-trustee transfers, NOT regular rollovers, to a properly titled inherited IRA. Also, there is no 60-day rule for non-spouse beneficiaries. Non-spouse beneficiaries do NOT have the option of treating an inherited IRA as their own.

The first thing non-spouse beneficiaries should do when they inherit an IRA is discuss their options with their advisors. Non-spouse beneficiaries must properly re-title the IRA and submit all paperwork within 9 months of the owner’s death. The first RMD must be taken by December 31st of the year following the owner’s death. One example of a properly titled inherited IRA is: “John Doe IRA (deceased 1/1/2011) F/B/O Jane Doe (SSN: 123-45-6789, DOB: 1/1/1980).” If the IRA custodian permits it, non-spouse beneficiaries should immediately name successor beneficiaries.

**MISTAKE #7: Errors in Disclaiming IRAs**

A disclaimer is a legal document and formal refusal of an inheritance by a beneficiary. Disclaimer rules apply to all IRA beneficiaries. Beneficiaries, are not required to accept an IRA or any portion thereof and may, instead, choose to disclaim all or a portion of their share. To have a valid disclaimer, the beneficiary must not have accepted the IRA assets or property. The only exception to this rule is the year of death RMD for the deceased owner.

All disclaimers must be submitted in writing to the IRA custodian within 9 months of the owner’s death. Disclaimers are irreversible, permanent decisions. Some beneficiaries make the mistake of disclaiming an IRA with the intent of passing on the disclaimed assets to someone else like their child or spouse. Disclaimed IRA assets may only go to the contingent beneficiary designated by the original owner. Disclaiming beneficiaries have zero control over the disclaimed amounts.
MISTAKE #8: Not Knowing the Special Rules for Spousal Beneficiaries

When it comes to IRA beneficiaries, surviving spouses have more options than non-spouse beneficiaries. For tax purposes or other personal reasons, a surviving spouse may wish to disclaim all or a portion of an IRA (s)he inherited from a spouse, causing the disclaimed amount to pass on to the named contingent beneficiary on the deceased’s IRA beneficiary designation form.

What if your spouse is under 59½ when you pass away and needs access to the IRA funds? A surviving spouse can choose to remain as a beneficiary if he or she needs the money but wants to avoid the 10% early distribution penalty. If the young spouse takes RMDs as a beneficiary, this penalty will be avoided because beneficiary distributions are never subject to that penalty. Beneficiary RMDs must begin no later than December 31st of the year following the owner’s death.

If the spouse is over 59½, then there really is no advantage in remaining a beneficiary. The surviving spouse may elect to treat the inherited IRA as his or her own and roll it over. Spousal beneficiaries may choose this option at ANY TIME even if the surviving spouse already began taking distributions as a beneficiary. Once the spouse decides to treat the IRA as his or her own, it is retitled or can be rolled over and the surviving spouse steps into the owner’s shoes. The spouse is now the owner of the IRA and names his or her own beneficiaries, creating an opportunity for the new beneficiaries to stretch RMDs over their individual life expectancies. Once this option is chosen, the spouse cannot revert to a beneficiary status. The IRA will now be treated as if the original owner never existed.

MISTAKE #9: Rollover Errors

Many IRA owners miss the 60-day deadline due to unexpected life events. The 60-day clock for a rollover begins when the owner receives the distribution. Also, you are limited to one rollover per year (every 365 days, not per calendar year). This one year limitation applies to all of your IRAs that have distributed or received rollover funds.

The simplest way to avoid missing the 60-day rollover deadline is to only transfer IRA assets via trustee-to-trustee transfer. This way, you never run the risk of forgetting to complete the transaction or fail to complete the transaction due to an unavoidable event. The additional bonus of using a trustee-to-trustee transfer is that, unlike rollovers, they are unlimited. If you have a custodian that refuses to do a trustee-to-trustee transfer and will only move your IRA assets by issuing you a check, you can ask that the check be made payable to the new IRA for your benefit and this will qualify as a direct rollover. For example, the check may be issued to “New Custodian, F/B/O John Doe.”

If you have more than one account with your new custodian, be sure to confirm that the rolled over IRA assets are placed into the correct account immediately following the transaction as you will only have 60-days to correct an error.

IMPORTANT: IRA beneficiaries cannot do an IRA rollover and they do not have 60-day rule. They need to use trustee-to-trustee transfers.

MISTAKE #10: Assuming a Will Takes Care of Everything

IRAs do not pass through a will, it is that plain and simple. Beneficiary forms on file with the custodian will determine how IRA assets will be distributed upon the death of an IRA owner. Custodial agreements are binding, private contracts between the IRA owner and custodial institution. Regardless of how perfect and well drafted a last will and testament may be, its terms cannot and do not override the terms of a custodial agreement.

MISTAKE #11: Choosing the Wrong Custodian

Just because the IRS allows multi-generational stretching, permitting beneficiaries to stretch RMDs over their remaining life expectancies, does not mean that the custodian is required to offer it. Several custodians require beneficiaries to take distributions within 5 years or require a lump-sum distribution. Multi-generational IRA rules are permissive rules, not mandatory regulations. Many people tend to forget that custodial agreements are individual, private contracts and custodians are the ones who make all of the rules, including any restrictions. Although the IRS allows multi-generational stretching, an IRA custodian does not have to offer this option.
MISTAKE #12: Not Knowing the Downside to Naming a Charity or Trust as an IRA Beneficiary Along With Individuals

Charitable giving is always encouraged but did you set up a separate IRA for this purpose? Do you have a beneficiary who is not capable of handling money so you named a trust as your IRA beneficiary?

Charities cannot be “designated” beneficiaries, period. They have no life expectancy and there is no way around this rule. If a charity’s portion of an IRA is not split or cashed out in a timely manner, the stretch opportunity will be destroyed for other individual beneficiaries. The simple solution is to split the IRA while you are alive to accommodate charitable goals, while preserving the stretch opportunity for your individual beneficiaries.

Like charities, trusts are not “designated” beneficiaries. You may think you have nothing to be concerned about because you paid a lot of money to have a qualifying “see through trust” drafted. You may have also been told that individual beneficiaries can still stretch the RMDs. The fact is, even assuming that a trust is a properly drafted “see through trust,” the individual beneficiaries will be stuck using the life expectancy of the oldest trust beneficiary. This is to the detriment of younger beneficiaries as it eliminates their opportunity to maximize the IRA and receive RMDs over their individual, much longer, life expectancies.

There will naturally be situations where a trust makes sense or is the only viable option, but bear in mind that there is no tax advantage to naming a trust as the beneficiary of an IRA.

About America’s Tax Solutions™

Barry L. Bulakites
Barry joined America’s IRA Centers in 2004 and helped develop and launch America’s Tax Solutions. A frequent contributor to the President’s Council of Economic Advisors, he is highly regarded for his work with Congress and the IRS in developing the concept of Multi-Generational IRAs and in drafting the language in the 2002 Tax Act. Barry conducts hundreds of speaking engagements annually, is considered one of America’s top IRA experts and has appeared on numerous radio and TV programs.

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