NEW ROLLOVER OPTION FOR NON-SPOUSE BENEFICIARIES OF QUALIFIED PLAN ACCOUNTS OPENS UP NEW PLANNING CHOICES

The Pension Protection Act of 2006 introduced several new rollover options for taxpayers, including a key change allowing non-spouse beneficiaries of retirement plan accounts to make rollovers to inherited IRAs, effective for distributions after 2006. This change gives much-needed flexibility to those who inherit retirement plan accounts from a non-spouse (such as a parent or uncle). What's more, the change impacts IRAs as well as qualified plans, codifying a long-standing rulings policy effectively allowing a direct rollover of an inherited IRA to another inherited IRA in the decedent's name.

- **Distributions from inherited qualified plan accounts to non-spouse beneficiaries**

  If a participant in a defined contribution plan (e.g., profit sharing, 401(k) plan) dies before exhausting his plan account balance and named someone other than a spouse as beneficiary of his account, the distribution options to the non-spouse beneficiary depend on whether or not the participant died after or before the required beginning date (RBD). This is the date when required minimum distributions (RMDs) must commence. The RBD for a participant who isn't a 5% company owner is April 1st of the calendar year following the later of the year in which he attains age 70 ½ or the year in which he retires. A 5% owner's RBD is April 1st of the year following the year in which he attains age 70 ½ (the same rule which applies to IRA owners).

  - **Participant dies after the RBD**

    In this case, the Code requires the remaining portion to be distributed at least as rapidly as under the distribution method used before death. Under the regulations interpretation of the statutory requirement, the plan account balance may be paid out over the *longer of*:

    1. The remaining life expectancy of the designated beneficiary, using his attained age in the year immediately following the year of the participant's death, or

    2. The remaining life expectancy of the participant, using the owner's attained age in the year of his death.

    Illustration

    Ann Smith, single with no children, designated her nephew, Al, as the sole beneficiary of her retirement plan account. Ann died at age 73 in 2005, and Al attains age 43 in 2006. The balance in Ann's account can be paid out over Al's life expectancy of 40.7 years (Single Life Table), since his life expectancy is longer than Anne's.

Observation

The beneficiary may accelerate the payout (and even direct that all of it be paid in a lump sum), but that, in turn, would accelerate (and most probably increase) the tax bill and abbreviate the lifespan of tax-sheltered earnings within the account.

- **Participant dies before the RBD**

Here, the balance:

< May be entirely distributed within five years after the plan participant's death, or

< May be distributed to (or for the benefit of) the designated beneficiary, over his life or over a period which doesn't extend beyond his life expectancy.

If the latter (life payout) option applies, distributions must begin no later than December 31st of the calendar year immediately following the calendar year in which the plan participant died.

Illustration

A taxpayer died on February 26, 2005, and the designated beneficiary of his qualified plan account is his niece. If the life payout option is chosen, payments from the account must begin no later than December 31, 2006.

The determination of whether the five-year or lifetime payout rule applies depends on the provisions of the plan. It may be silent as to which rule (5-year or lifetime payout) applies, specify which rule applies or it may allow the owner (or beneficiary) to elect which rule applies.

1. If the plan does not contain one of the optional provisions described in (2) or (3), below, specifying the methods of distribution if a participant dies before required distributions begin, then payouts are made over the life of the designated beneficiary (or over a period which doesn't extend beyond the life expectancy of the designated beneficiary). The lifetime payout also applies if neither the participant nor beneficiary make the choice in (3), below.

2. The plan may adopt a provision specifying either (a) the 5-year payout rule applies to certain distributions even if there's a designated beneficiary, or (b) payouts in every case will be made under the 5-year rule.

3. The plan may allow the owner or beneficiary to choose between a 5-year or lifetime payout and may specify one or the other payout method if the choice isn't timely made.

Observation

The Code doesn't prescribe how the account balance should be withdrawn over the 5-year period. It can be withdrawn in a lump sum, for example, or ratably over five years.

- **New rollover option for non-spouse beneficiaries after 2006**

Effective for distributions after 2006, non-spouse beneficiaries of an inherited qualified plan account are presented with a new option: they may make a trustee-to-trustee transfer of part (or all) of the deceased employee's account balance in a qualified plan to an IRA (or individual retirement annuity) set up “for the purposes of receiving the distribution on behalf of a designated [non-spouse] beneficiary of the employee .”

The trustee-to-trustee transfer has the following consequences:

- The transfer is treated as an eligible rollover distribution.

Observation

Under the Code, a qualified plan *must* permit distributees of eligible rollover distributions to make the transfer to an eligible retirement plan (e.g., IRA) via direct, trustee-to-trustee transfer. Thus, beginning in 2007, qualified plans will have to give non-spouse beneficiaries the option to make the Pension-Act-authorized direct rollover.

- The receiving IRA is treated as an inherited IRA.

Observation

This means required distributions from the inherited IRA must be figured separately from required distributions from the taxpayer's other IRAs, can't accept contributions and can't be rolled over to an IRA in the beneficiary's own name.

The Committee Report on the Pension Act doesn't explain exactly how the receiving IRA is to be titled, and IRS hasn't spoken yet on this, either. It could be that the receiving IRA will be set up in the name of the deceased plan participant, for the benefit of the designated non-spouse beneficiary. That is, it may be set up the same way used currently by a non-spouse beneficiary who wants to transfer funds from one inherited IRA to another (see below).

- The receiving IRA is subject to the RMD rules (other those dealing with a spousal beneficiary), namely the rules dealing with distributions after the participant's death.

Observation

In other words, where the plan participant dies after RMDs commence, post-2006 distributions from the inherited IRA can be stretched out over the remaining life expectancy of either the participant or the non-spouse beneficiary, whichever is longer. Where the participant dies before RMDs commence, distributions can be made over the non-spouse beneficiary's life expectancy.

Illustration

Arthur, who is single, is employed by XYZ, Inc., and participates in its 401(k) plan, to which he has made pre-tax contributions only. He isn't a 5% owner. Arthur's sole beneficiary for the plan account is his nephew, Ken. The plan specifies that if a participant dies before his RBD, and his beneficiary is not a spouse, his plan account balance will be distributed in one lump sum (such a payout is OK since the account is distributed within five years after the participant's death). In 2006, Arthur dies at age 65, while still employed by XYZ.

Results:

Under the Pension Act, Ken may elect to roll over part or all of his inherited 401(k) account balance into an inherited IRA, and withdraw the balance in the inherited IRA over his life expectancy. Ken must start taking distributions from the inherited IRA by December 31, 2007. Under the regulations, Ken's life expectancy is calculated based on his attained age as of his birthday in 2007.

The balance in the inherited IRA on December 31, 2006, is $250,000, and Ken attains age 45 in 2007.

First RMD (in 2007):

Ken's life expectancy at age 45 is 38.8 years. Dividing $250,000 (IRA balance as of December 31, 2006) by 38.8 yields the required distribution of $6,443.

Second RMD (in 2008):

We'll assume the inherited IRA balance as of December 31, 2007, is $256,000 (2006 ending balance less 2007 distribution, plus earnings). Dividing $256,000 by 37.8 (the original life expectancy of 38.8 less one) yields the second required distribution of $6,772.

Ken can take each year's required distribution in a lump sum or in installments during the year.

Observation:

The inherited IRA may continue to generated tax-sheltered earnings even after the non-spouse beneficiary dies. If a designated beneficiary dies before the end of the term over which IRA payments are being distributed, the remaining balance can be distributed to the beneficiary's heirs over what remains of the term.

Illustration:

Arthur died on October 28, 2006. Under the XYZ plan's terms, Ken will get Arthur's plan account balance in one lump sum.

Ken, the non-spouse beneficiary, should ask the plan to defer the payout in order to give him the chance to make a post-2006 rollover election. If his uncle's account balance is distributed to him in 2006, he'll have to pay tax on the full amount in one year.

Observation:

If a plan has already begun making distributions to a non-spouse beneficiary over his lifetime, making a rollover under the new law change wouldn't affect the distribution timing (since an inherited IRA is subject to the same distribution rules as an inherited qualified defined contribution plan account), but it will give the beneficiary new investment choices. If he's not happy with the plan's investments and/or returns, he can roll over the remaining account balance into an inherited IRA and direct its investment himself.

- **Effect of new rollover option for non-spouse beneficiaries of IRAs**

The Pension Act's new rollover rule applies to IRAs as well as to qualified plans, because the Code applies to “any portion of a distribution from an eligible retirement plan,” a category which includes an IRA. However, the change has little practical effect on non-spouse beneficiaries of IRAs. It merely codifies a rollover option that IRS has long sanctioned in private rulings and in its publications. A non-spouse beneficiary can't treat an inherited IRA as his own, but can make trustee-to-trustee transfers to another IRA if the ownership of the new IRA is set up in the same way as the ownership of the old IRA, that is, in the name of the decedent for the benefit of the IRA beneficiary.

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