Nicole L. Maholtz
President & CEO
P.O. Box 3
Cooksburg, PA 16217-0003
(803) 781-9595 opt 1
Nicole@brentmark.com
www.brentmark.com

The IRA Digest

Retirement Account Strategies and Tips

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Avoiding the 10% Early Distribution Penalty: Key Considerations for Spouse Beneficiaries of IRAs and Employer Plans

By: Denise Appleby, MJ, CISP, CRC, CRPS, CRSP, APA

A spouse beneficiary of a tax-deferred retirement account must take precautions to avoid the 10% early distribution penalty if they are under age 59 ½.

Distributions from an IRA or employer-sponsored retirement plan (employer plan) are subject to a 10% additional tax (early distribution penalty) if taken before the owner reaches age 59 ½. This penalty is waived if the distribution qualifies for an exception. One of these exceptions is the *death* exception, which applies to distributions taken from Beneficiary accounts. Spouse beneficiaries often lose qualification for this exception because of making wrong elections for the retirement accounts they inherit.

Some Background

When a spouse inherits a retirement account, they have the option of keeping those assets in a Beneficiary account or moving the assets to their own retirement account. A Beneficiary account is a retirement account that identifies, tracks, and reports the amount as inherited assets. Assets that are moved to a spouse beneficiary's own account sheds the "inherited" characteristics and all rules apply as they would to accounts funded with non-inherited amounts.

A spouse beneficiary who is under age 59 ½ and wants to retain the death exception to the 10% early distribution penalty must keep the inherited amount in a Beneficiary account.

A spouse beneficiary can move a Beneficiary account to another retirement account, providing the receiving account is eligible to accept the assets. Generally, this movement can be done as a transfer or a rollover. Except for direct rollovers of employer plan assets, using the rollover method takes away the option of keeping the assets in a Beneficiary account. Therefore-except for direct rollovers from employer plans, the rollover method must not be used if the spouse beneficiary is under age 59 ½ and wants to avoid the 10% early distribution penalty.

The following covers these and other key considerations for avoiding the 10% early distribution penalty.

A Spouse Beneficiary Should Not Choose the "Own" Option before Age 59 ½

The spouse beneficiary of an IRA may treat the IRA as their own by moving it to their own IRA or by not taking beneficiary required minimum distributions from the amount.

Assets inherited under an employer plan can be moved to the spouse beneficiary's own retirement account under an employer plan in which they are participating or to their own IRA. Moving it to their own retirement account will result in the 10% early distribution penalty applying to any distributions taken before age 59 ½ unless the amounts qualify for an exception.

Example: 45-year-old Janer inherits an IRA from her husband Tim. Janer plans to take a distribution of $100,000 immediately to cover Tim's funeral expenses and pay off some debts.

Scenario 1: Janer transfers the inherited IRA to a Beneficiary IRA and then withdraws the $100,000 from the Beneficiary IRA. When reporting the distribution, the IRA custodian inputs Code 4 in Box 7 of Form 1099-R, which lets the IRS and the tax preparer know that the $100,000 is a death distribution and therefore exempted from the 10% early distribution penalty.

Scenario 2: The facts are the same as above, except that Janer transfers the amount to her own (non-beneficiary) IRA. Distributions from that IRA do not qualify for the death exception. When reporting the distribution, the custodian inputs Code 1 in Box 7 of Form 1099-R, which lets the IRS and the tax preparer know that the amount might be subject to the 10% early distribution penalty. If Janer does not qualify for an exception she will owe the IRS an early distribution penalty of $10,000.

The Rollover Method Should Not Be Used to Move Inherited IRAs

A spouse who inherits an IRA and wants to move it to another IRA within the same financial institution or to another financial institution has two options to do so: **(1)** a transfer, or **(2)** a rollover. The transfer method must be used to retain the Beneficiary IRA status.

With the transfer, the assets are paid by the delivering custodian to the receiving custodian for the benefit of the IRA. With a rollover, the spouse takes a distribution and subsequently rolls over the amount to the receiving IRA. Generally, this rollover must be done within 60 days of receipt and is subject to other restrictions.

A distribution to the account owner cannot be rolled over to a Beneficiary IRA and must instead be rolled over to the spouse beneficiary's own IRA. Therefore, using the rollover method will result in a loss of the death exception.

Example 1: 42-year-old Carrie inherited a traditional IRA valued at $1 Million from her husband Larry. When Carrie claimed the IRA, she instructed the custodian that held Larry's IRA (ABC Custodian) to transfer it to a Beneficiary IRA that she established with them.

Carrie then wanted to move the assets to a different financial institution (XYZ custodian). To ensure that the death exception is maintained, Carrie must establish a Beneficiary IRA with XYZ custodian and coordinate a trustee-to-trustee transfer with the custodians.

Any distribution from the Beneficiary IRA at XYZ custodian will be reported as death distributions (Code 4 in Box 7 of Form 1099-R) and automatically exempted from the 10% early distribution penalty.

Example 2: The facts are the same as in **Example 1**, except that Carrie instructed custodian ABC to process the $1 Million as a distribution to her. Carrie intended to deposit the amount to the Beneficiary IRA she held with XYZ custodian. However, XYZ Custodian refused to deposit the amount to the Beneficiary IRA because the tax code prohibits such rollover contributions to Beneficiary IRAs.

Carrie had no choice but to establish an IRA that was not a beneficiary IRA to which she rolled over the $1 Million. Distributions from this IRA would not qualify for the death exception. Any distribution that she takes from this IRA before she reaches age 59 ½ would be reported with a Code 1 in Box 7 of Form 1099-R and subject to a 10% early distribution penalty unless she qualifies for an exception.

The Indirect Rollover Method Should Not Be Used to Move Employer Plan Assets

A spouse who inherits assets under an employer plan may be able to keep the funds in a Beneficiary account under the plan. In that case, the distributions will always be reported as death distributions.

The spouse beneficiary may also roll over the assets to their own account under an employer plan or roll over the assets to an IRA. Any rollover of the inherited amount to an IRA may be done as a direct rollover where the assets are paid to the receiving custodian for the benefit of the IRA, or as an indirect rollover where the assets are paid to the beneficiary who then has 60 days to roll over the amount to the IRA.

To maintain the death exception, the amount must be moved to a Beneficiary IRA as a direct rollover.

Example: 48-year-old Larry inherited a 401(k) from his wife. Larry wanted to roll over the 401(k) account to his IRA. If Larry wants to continue qualifying for the death exception. Larry must ensure that:

- The IRA that he sets up to receive the rollover is a Beneficiary IRA.
- The amount is paid to the IRA custodian for benefit of the Beneficiary IRA.

If the amount is paid to Larry, the payor must withhold 20% for federal income tax from any taxable portion of the distribution. And, when rolling over any portion of the amount, the rollover cannot be made to a Beneficiary IRA and must instead be made to Larry's own IRA.

Roth IRAs Are Less Susceptible to the Penalty

Generally, Roth IRAs are funded with amounts on which income tax has already been paid. These amounts are tax-free when distributed. Further, the 10% early distribution penalty on pre-age 59 ½ distributions would apply only if the amount is from a Roth conversion that has not been in the Roth IRA for at least five years and do not qualify for an exception.

The earnings portion of a Roth IRA balance will be tax-free if the distribution meets certain requirements that make it qualified. The good news for nonqualified Roth IRA distributions is that the earnings portion is deemed distributed only after other amounts have been distributed. This provides opportunities for penalty-free distributions for beneficiaries who do not withdraw the earnings portion until they are eligible for qualified distributions. We can help you to determine if your Roth IRA distributions would be qualified, and if not, which of the two options is more tax-efficient for you.

A Switch is Permitted: Beneficiary to Own

A spouse beneficiary who moves an inherited retirement account to their own IRA may not change that election. However, a spouse beneficiary may move assets from a Beneficiary IRA to their own IRA at my time. This allows the spouse beneficiary to keep the assets in a Beneficiary IRA while under age 59 ½ and then move it to their own IRA when it is tax-savvy to do so.

Let's Talk Tax Minimization Strategies for Your Own and Your Inherited Accounts

Avoiding the 10% early distribution penalty is only one of the tax considerations for inherited retirement accounts. A tax-efficient approach would help to minimize income tax and maximize tax-deferred growth. We can help to put this strategy in place for you and your beneficiaries. We can also work with your beneficiaries to help ensure a tax-efficient rollout when they inherit your retirement accounts. Please contact us to start the conversation.

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