5 costly inherited IRA mistakes

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Inherited individual retirement account mistakes are expensive and often fatal, meaning they cannot be fixed like some other IRA mistakes can. When an IRA owner dies, and leaves the IRA to a non-spouse beneficiary, (like a child, grandchild or siblings), they must be aware of the rules to avoid a mistake which may cause the end of the inherited IRA along with a monster tax bill.

Here are the most common non-spouse IRA beneficiary errors:

1. Ineligible rollovers - A non-spouse beneficiary cannot do an indirect rollover, meaning a 60-day rollover, where the inherited IRA funds are withdrawn and returned to another IRA within 60 days of receipt. An IRA owner can do this and so can a spouse who does a spousal rollover, but a non-spouse beneficiary cannot. A non-spouse IRA beneficiary can only do a direct transfer to a properly-titled inherited IRA. If the inherited IRA funds are withdrawn, they are taxable and the stretch IRA is lost. This mistake cannot be corrected. The Internal Revenue Service has no authority to provide relief here, so this is a fatal error. If inherited IRA funds need to be moved, only move them as direct trustee-to-trustee transfers.

2. Incorrect account titling - An inherited IRA must be set up with the proper account title. The deceased IRA owner's name must appear in the account title, and it should show as an inherited or beneficiary IRA. For example: "John Smith (Deceased 5-25-16), IRA, FBO Tom Smith, beneficiary." Some institutions are not using this account titling. Instead, they have it recorded in their internal records as an inherited IRA. This can cause confusion and lead to problems. Instead of showing the deceased IRA owner's name, the account is titled in the beneficiary's own name and the beneficiary may treat it as their own, which will nullify the inherited IRA and once again result in the entire account being distributed and taxable (to the extent of pre-tax funds).

3. Disallowed contributions - Contributions cannot be made to an inherited IRA. This can happen when beneficiaries are not aware of the distinction between their inherited IRA and their own IRA. Once a contribution is made to the inherited IRA, the account ceases to be an inherited IRA (since it is now treated as the beneficiary's own IRA) and becomes taxable. This again is a fatal error. It cannot be corrected. Imagine, a beneficiary inheriting a $300,000 IRA and then mistakenly contributing $5,500 to it. The entire $300,000 must be distributed and is taxable. That's a big mistake!

4. Delaying RMDs - Required minimum distributions on an inherited IRA or inherited Roth IRA generally begin in the year after the IRA owner's death. A common mistake is when non-spouse beneficiaries are told that they do not have to begin RMDs until they turn 70 ½. The 70 ½ rule is only for IRA owner RMDs, not for inherited IRAs. Also, inherited Roth IRAs are subject to RMDs even though Roth IRA owners are not.

5. Stretch IRA confusion - Not every non-spouse beneficiary gets to stretch RMDs over their life expectancy. Only beneficiaries who are designated beneficiaries qualify for the stretch IRA. A designated beneficiary is one who is named on the IRA beneficiary form (not in the will) or who inherits through a default provision in the IRA custodial agreement when no beneficiary is named.

If the beneficiary inherits through the estate, he is not a designated beneficiary. In that case RMDs depend on when the IRA owner died. If the IRA owner died before his required beginning date (April 1 of the year after attaining age 70 ½), then the entire inherited IRA would have to be paid out by the end of the fifth year after the year of death (the five-year rule). If the IRA owner died on or after his required beginning date, then the beneficiary takes RMDs based on the IRA owner's remaining single life expectancy had he lived.

Ed Slott, a certified public accountant, created the IRA Leadership Program and Ed Slott's Elite IRA Advisor Group.