What is a Stretch IRA? - Transcript

Tom Mullooly: In Episode 80, we're going to cover what happens if you're the beneficiary of a retirement account. Welcome to the Mullooly Asset Show. I'm your host, Tom Mullooly, and this is episode number 80. Can you believe we've done 79 of these before?

Today we're going to talk about what happens if you're the beneficiary of a retirement account. Doesn't matter if we're talking about an IRA, a pension account, a pension plan, a 401K, a SEP, doesn't matter. The rules are pretty similar across the board.

If you are the surviving spouse and you are named as beneficiary on an IRA, very simple. You're going to roll that account into an account of your own. If your husband or wife passes away, they had an IRA, it's going to be merged into yours or we're going to set one up for you in your own name. The required minimum distributions are, moving forward, are going to be based on your age.

Also it's important to know that in the year that your husband or wife passed away, they're still going to need to take a required minimum distribution. So that covers all the information regarding how to handle a spousal beneficiary. Remember, all of that applies if you are the only beneficiary, and you're the surviving spouse. If there's someone else named as a primary beneficiary with you, as surviving spouse, all of that gets thrown out the window.

Suppose there's no surviving spouse and someone else, you, are named as the non-spouse beneficiary. First thing you got to know is none of this goes by the will. The document that is number one is that beneficiary form that's filled out with that person's 401k, pension plan, SEP, IRA. It all hinges on the beneficiary form, so if there's no beneficiary form, everything is going to go to the estate of the decedent. Now you've been named as beneficiary. You're not the surviving spouse.

What now?

You can now open what's called an inherited IRA. Some firms refer to these as stretch IRAs. It's important to know that if the original owner began taking required minimum distributions, then we have to calculate it based on two lives. If they have not begun taking their required minimum distribution, so they're under 70-1/2, then everything will be calculated off of your beginning date for required minimum distributions.

With inherited IRAs, you will be required to take money out every single year. It's very, very small when these distributions begin, but they get larger as you get older, but it gives you the opportunity to stretch out the life of that IRA. That's why it's often called a stretch IRA or inherited IRA. Things you need to know about inherited IRAs.

You can't merge an IRA that you inherit with your own IRA, or if you got an inherited 401k, obviously you can't merge that into your own 401k. It can't be merged. They're going to be standalone accounts. You will have to take that required minimum distribution, as I mentioned a moment ago, but if you're just starting out, and say you're in your 40s or 50s. You inherited something from your parent, the distributions ... The math is pretty small, so I wouldn't get hung up on that, but you do need to take it every single year.

The account will be titled differently, so it'll say something like Mary Smith, Beneficiary for Sue Jones Decedent IRA. It will have the name of the original owner on the account and you as the beneficiary, and you will need a copy of the death certificate to open the account.

Let's take a moment and just talk about Roth IRAs, since they're becoming more and more popular. With Roth IRAs the first thing, and we say this every time with Roth IRAs, the only kind of money that can go into a Roth IRA always, always, always has to be after-tax dollars. The money has to be taxed first, then you can allocate to a Roth IRA.

So what happens if you inherit a Roth IRA? It's not as simple as you think. The first thing you need to know is with an inherited IRA, you can't do a Roth conversion. You can only do a Roth conversion on your own money, so if you inherit an IRA or a 401k plan, you can't do a Roth conversion. It's just not an option. Okay, maybe someday it will but for now, can't be done.

The other thing that you need to know, this is kind of a surprise for some people, Roth IRAs people think, "Oh, I can just leave them for the next generation or I don't ever have to take required minimum distributions." Not true. Not true.

With inherited Roth IRAs, you will be subject to a required minimum distribution and understand, if you don't take the distribution, there's a 50% penalty. So as I've been saying the same rules apply for IRAs, for pension plan distributions, if you're the beneficiary there, if you're the beneficiary on someone's 401k, on a SEP, a small business retirement plan.

If you're the beneficiary, the same rules pretty much apply. If you get into a situation like this, and you have questions, contact an investment advisor or financial planner. We'd be happy to answer whatever kind of questions you have with this. There's a lot of changing rules that happen with IRAs when people pass away. It's important to be on top of this stuff.

If you've got questions, that's what we're here for.

Thanks for watching Episode 80, and we'll see you on the next one.