

Five Things to Know About Inherited IRAs

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When an IRA owner dies, the IRA proceeds are payable to the named beneficiary--or to the owner's estate if no beneficiary is named. If you've been designated as the beneficiary of a traditional or Roth IRA, it's important that you understand the special rules that apply to "inherited IRAs."

It's not really "your" IRA

As an initial matter, while you do have certain rights, you are generally not the "owner" of an inherited IRA. The practical result of this fact is that you can't mix inherited IRA funds with your own IRA funds, and you can't make 60-day rollovers to and from the inherited IRA. You also need to calculate the taxable portion of any payment from the inherited IRA separately from your own IRAs, and you need to determine the amount of any required minimum distributions (RMDs) from the inherited IRA separately from your own IRAs.

But if you inherited the IRA from your spouse, you have special options. You can take ownership of the IRA funds by rolling them into your own IRA or into an eligible retirement plan account. If you're the sole beneficiary, you can also leave the funds in the inherited IRA and treat it as your own IRA. In either case, the IRA will be yours and no longer treated as an inherited IRA. As the new IRA owner (as opposed to beneficiary), you won't need to begin taking RMDs from a traditional IRA until you reach age 70½, and you won't need to take RMDs from a Roth IRA during your lifetime at all. And as IRA owner, you can also name new beneficiaries of your choice.

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Required minimum distributions

As beneficiary of an inherited IRA--traditional or Roth--you must begin taking RMDs after the owner's death.* In general, you must take payments from the IRA annually, over your life expectancy, starting no later than December 31 of the year following the year the IRA owner died. But if you're a spousal beneficiary, you may be able to delay payments until the year the IRA owner would have reached age 70½.

In some cases you may be able to satisfy the RMD rules by withdrawing the entire balance of the inherited IRA (in one or more payments) by the fifth anniversary of the owner's death. In almost every situation, though, it makes sense to use the life expectancy method instead--to stretch payments out as long as possible and take maximum advantage of the IRA's tax-deferral benefit.

You can always elect to receive more than the required amount in any given year, but if you receive less than the required amount you'll be subject to a federal penalty tax equal to 50% of the difference between the required distribution and the amount actually distributed.

More stretching...

What happens if you elect to take distributions over your life expectancy but you die with funds still in the inherited IRA? This is where your IRA custodial/trustee agreement becomes crucial. If, as is sometimes the case, your IRA language doesn't address what happens when you die, then the IRA balance is typically paid to your estate--ending the IRA tax deferral.

Many IRA providers, though, allow you to name a successor beneficiary. In this case, when you die, your successor beneficiary "steps into your shoes" and can continue to take RMDs over your remaining distribution schedule.

Federal income taxes

Distributions from inherited IRAs are subject to federal income taxes, except for any Roth or nondeductible contributions the owner made. But distributions are never subject to the 10% early distribution penalty, even if you haven't yet reached age 59½. (This is one reason why a surviving spouse may decide to remain as beneficiary rather than taking ownership of an inherited IRA.)

When you take a distribution from an inherited Roth IRA, the owner's nontaxable Roth contributions are deemed to come out first, followed by any earnings. Earnings are also tax-free if made after a five-calendar-year holding period, starting with the year the IRA owner first contributed to any Roth IRA. For example, if the IRA owner first contributed to a Roth IRA in 2014 and died in 2016, any earnings distributed from the IRA after 2018 will be tax-free.

Creditor protection

Traditional and Roth IRAs are protected under federal law if you declare bankruptcy. The IRA bankruptcy exemption was originally an inflation-adjusted \$1 million, which has since grown to \$1,283,025. Unfortunately, the U.S. Supreme Court has ruled that inherited IRAs are not covered by this exemption. (If you inherit an IRA from your spouse and treat that IRA as your own, it's possible that the IRA won't be considered an inherited IRA for bankruptcy purposes, but this was not specifically addressed by the Court.) This means that your inherited IRA won't receive any protection under federal law if you declare bankruptcy. However, the laws of your particular state may still protect those assets, in full or in part, and may provide protection from creditors outside of bankruptcy as well.

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****If the traditional IRA owner died after age 70-1/2 and did not take an RMD for the year of his or her death, you must also withdraw any remaining RMD amount for that year.***