

Inheriting an IRA

Make sure you pay attention to the rules

provided by Jude Wilson RFC, MBA

What do you do when you inherit an IRA? Good question. Most people don't know the rules and regulations pertaining to inherited IRA assets. You should. You, not the IRS, should benefit the most in this circumstance.

Will my income taxes soar this year as a result? Not necessarily. If you roll the assets into an inherited IRA, you have up to five years to either a) withdraw the money entirely or b) withdraw the money over your lifetime according to an IRS life expectancy formula.¹ Many heirs would prefer b) because the tax scenario is better - but some IRA custodians require you to go by the five-year rule.²

What if you don't roll the money into an inherited IRA? What if you just take the balance as a lump sum and spend it? Look out. All that money will be taxed at your regular income tax rate.³ After income and estate taxes eat away at the IRA balance, you may be left with a fraction of the original assets.

Let's look at some options for those who inherit IRA assets. Keep in mind: this brief article discusses only some basic, common scenarios. Tax laws pertaining to inherited IRA assets are complex, with constant "new wrinkles" - so be sure to talk to a financial advisor or tax advisor who is up to speed on IRS rule changes.

What if you inherit your spouse's IRA? The IRS says a surviving spouse can elect to be

treated as the owner of such IRA assets rather than the beneficiary.¹ A surviving spouse can therefore roll this money into his or her own IRA. That makes a lot of sense, especially for younger spouses: distributions can be extended over your lifetime and the lifetime of your beneficiaries.

If you roll over your late spouse's IRA assets into your IRA, they may be able to compound for a long time, as you don't have to take a Required Minimum Distribution from your IRA until you reach age 70 1/2. (If you have a Roth IRA, you don't have to take them at all.) On the other hand, you must take a distribution from an inherited IRA a year after your spouse's death.⁴

You also have other options. If you are younger than 59 1/2 and need the IRA assets for living expenses, you could keep all or part of the money in your late spouse's IRA, whereby you could take penalty-free distributions. Or you could disclaim some or all of the IRA assets if you don't need them (this has to happen within nine months of the original IRA owner's death). Disclaiming them will allow the IRA assets to go to the contingent beneficiaries named by the original IRA owner. This might result in a better estate tax picture for your kids.⁴

You inherit an IRA from someone other than a spouse. Okay, this is complicated. Was the original IRA owner younger than age 70 1/2 at

death? Did he or she turn 70½ last year and die before April 1 this year? If the answer is yes to either question, you have two choices. 1) You can liquidate the inherited IRA by no later than December 31 of the fifth year after the year the original IRA owner dies. This is mandatory for some IRAs. 2) You can take minimum withdrawals over your life expectancy, calculated per IRS tables.²

Did the original IRA owner pass away on or after April 1 of the year after he or she turned 70½? Then forget the five-year rule. You must start taking minimum withdrawals over your life expectancy. Your first such withdrawal has to happen by Dec. 31 of the year after the year the original IRA owner dies.²

The no-RMDs-in-2009 wrinkle. No one has to take a Required Minimum Distribution from an IRA in 2009. What does that mean for inherited IRAs? If the IRA owner died in 2008, you don't have to take a distribution in 2009 and you get six years rather than five to withdraw inherited IRA assets if you would ordinarily go by the five-year rule.

But watch out: if you inherited an IRA from a non-spouse and the original IRA owner named multiple beneficiaries, you still have to split

up the IRA into separate inherited IRAs by the end of 2009 to permit minimum withdrawals over heirs' life expectancies. If you don't, each beneficiary will have to take withdrawals based on the age of the oldest beneficiary, which could be a tremendous blow to tax deferral.⁵

You can't contribute to inherited IRAs. This applies to traditional and Roth IRAs.^{6, 7} However, as mentioned above, surviving spouses can elect to treat an inherited IRA as their own - in IRS eyes, they do so by making any contribution to it.¹

A Roth IRA wrinkle. It is possible to pay taxes on an inherited Roth IRA. Roth IRA earnings can be withdrawn tax-free starting on the first day of the fifth taxable year after the year the Roth IRA was established. So if an inherited Roth IRA was established less than five years ago, an heir may have to pay tax on earnings withdrawals if the original owner's death and the withdrawal both occur within five years of the creation of the account. However, a beneficiary can circumvent this penalty by leaving the earnings in the Roth IRA for the required time period, even if he or she withdraws everything besides the earnings.⁷

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Citations.

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