



Inherited IRAs

It's been 37 years since the IRA, Individual Retirement Account, was introduced. Most of our clients have IRAs, and we're starting to see clients inherit IRAs from their parents. How you must treat an inherited IRA is very different than how you treat your own IRA, so here's a primer.

As you probably know, IRAs transfer at death by beneficiary designation -- at the account owner's death, they go directly to whoever is named on the IRA beneficiary form (just like life insurance does). How you handle an inherited IRA is dependent on what kind of beneficiary you are. Are you the spouse of the deceased? Or a non-spouse (child, sibling, etc)? Or a non-person beneficiary (the deceased's estate, or a charitable organization)?

Spousal Beneficiary

A person who inherits an IRA from their spouse has the most flexibility. They can leave the IRA in the deceased's name, and take distributions from the IRA without a 10% penalty even if they're under 59 ½ (death is one of the exceptions to that penalty). This option might make sense for a young spouse, who needs to draw on the IRA funds to cover living expenses.

If the surviving spouse leaves the IRA in the deceased's name, at some point she will become subject to the Required Minimum Distribution (RMD) rules. Even if she doesn't need the funds, at some point she will have to take a minimum distribution each year. For her, those RMDs must start the year after the death, or the year the deceased would have turned 70 ½ -- whichever date is later.

The surviving spouse has another option. She can roll the IRA she inherits from her husband to her own IRA. So if Jane Doe inherits from John Doe, she can roll John's IRA into her own IRA. It's now subject to all the rules of an IRA she owns: unless she meets an exception, she'll pay a 10% penalty if she takes distributions before 59 ½, and she'll have to start taking Required Minimum Distributions (RMDs) at her age 70 ½.

Confused yet? Now, let's look at beneficiaries who are not spouses.

Children, Siblings, or Friends as Beneficiary

Only a beneficiary who is a spouse has the flexibility to roll an inherited IRA into his or her own IRA. No other type of beneficiary can do that, and that's a key point. Many people like to simplify their financial lives and consolidate their IRAs, but if you've got an inherited IRA, you cannot do that.

If you inherit an IRA from your father, for example, you instead retitle his IRA as an inherited IRA: "John Doe Sr. IRA (Deceased) For the Benefit of John Doe Jr.". This account must

remain separate from your own IRAs, always, and from IRAs you may inherit from someone else -- they cannot be consolidated.

Since death is an exception to the pre-59 1/2, 10% early withdrawal penalty, you are free to take distributions from this inherited IRA regardless of your age. But you are not free to take zero distributions: you become subject to the Required Minimum Distribution rules.

Starting in the first year following the year of death, you must take an RMD from your inherited IRA annually. You can take more, but you cannot take less (the penalty for not taking a required minimum distribution is 50% of the amount not taken - ouch!). The younger you are, the less you have to take; as you age, the IRS tables require larger distributions.

This is what you may have seen referred to as a “stretch IRA”, the idea being that a young person who inherits an IRA can “stretch” that tax-deferred account over their lifetime, taking only the minimum distributions.

Estate as Beneficiary, or No Named Beneficiary

When “my estate” is named as an IRA beneficiary, or there is no beneficiary named, there are only two options:

- If the account owner died *before* April 1 of the year after he/she would have reached age 70 ½ (I know that’s a mouthful), the IRA becomes subject to what is called the “5 Year Rule”: the IRA must be fully distributed within five years following the year of death. The stretch option is lost: the funds must leave the tax-deferred account.
- If the account owner died *after* April 1 of the year after the year he/she reached 70 ½ (you may have to read that twice), the IRA must continue to issue Required Minimum Distributions based on the schedule the deceased was on, slightly accelerated. The stretch option is lost. The RMDs are large as the account owner was at least in his/her 70s at death, and get larger every year. Again, the ability to “stretch” over a young beneficiary’s lifetime is lost.

The above is a simplified version of the rules; there are lots of details not mentioned that matter. If you’re a client with an inherited IRA, we’ll be sure to educate you on the correct treatment so that you don’t run afoul of the complicated rules surrounding these accounts.

-- Karen O’Brien. Posted 05/15/11.