Retirement Education

What you need to know about inheriting an IRA

Taxes are an important consideration.

You've inherited an IRA, or expect to inherit one in the future. The loss of a loved one is an emotional time, so making an informed financial decision may not be your first priority. But just as your loved one saved in a tax-smart way, you want to ensure that you minimize taxes on these savings and, if possible, give that money a chance to keep growing.

Here are the options when you inherit an IRA and what you need to keep in mind when you are deciding what to do with the money.

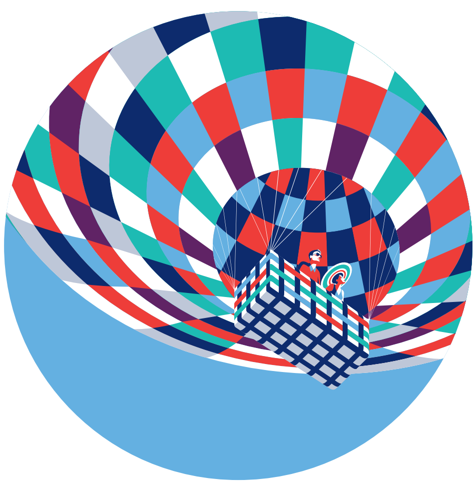
What to keep in mind

Taxation is particularly important if you've inherited a traditional IRA. That's because any withdrawal from one is taxable income; you add it on your tax return in the year of the withdrawal. It may also push you into a higher tax bracket and impact other things that take taxable income into account, like financial aid for college.

Withdrawals from an inherited Roth IRA are tax free as long as the account has been open for five years. If not, the earnings on the contributions to the account are taxable. Roth IRA contributions made by the original owner are never taxable income.

An inherited IRA has tax benefits

IRAs, both traditional and Roth, are tax-advantaged accounts; traditional IRAs grow tax deferred while Roth IRAs grow tax free. That benefit can continue for inherited IRAs too. The longer the money stays in the IRA, the longer it has the potential to grow tax deferred or tax free.



What you can do with an inherited IRA

Non-spouse beneficiaries have two options and spousal beneficiaries have an additional option. The options are the same for an inherited Roth or traditional IRA, but (as noted) withdrawals are taxed differently.

Option 1: Lump sum

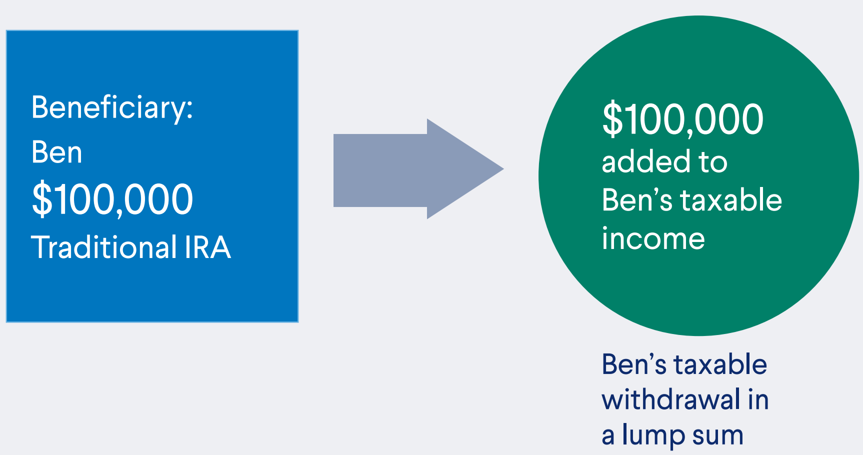
The full amount of the IRA is distributed to the beneficiary. Whether the distribution is taxable income depends on the type of IRA:

- **Traditional IRA—**The full amount is fully taxable, as income, to the beneficiary the year it is withdrawn.
- **Roth IRA—**Withdrawals are tax free unless the Roth IRA is less than five years old at the time of the account holder's death. In that case, contributions are tax free, but any earnings are taxable.

Example

Traditional IRA owner Abby dies in 2021 and has one beneficiary, Ben, for a $100,000 IRA.

He selects the lump-sum distribution method in 2021; $100,000 is added to his taxable income in 2021. Ben pays any taxes due on the money. (If he had inherited a Roth IRA, open at least five years, the $100,000 would be tax free and not considered income.)



Note: As of January 1, 2020, stretch IRAs have been eliminated. The beneficiaries of any IRA owner who dies on or after January 1, 2020, will not have the option of a stretch IRA.

Option 2: Out in 10 years

With this method, the full amount of the account must be withdrawn within 10 years of the date of the death of the original owner. The assets are transferred into an inherited IRA in the beneficiary's name. The beneficiary can withdraw the money when he or she wants within the 10-year period. For instance, a beneficiary can withdraw 10% during each of the 10 years or wait until the 10th year and withdraw it all at once.

This option has tax benefits. In a traditional IRA, the money has the potential to grow tax deferred—and if you take yearly distributions, you can spread the taxable income over 10 years. If the original account owner had a Roth IRA for more than five years, any withdrawals from the account would be tax free.

Example

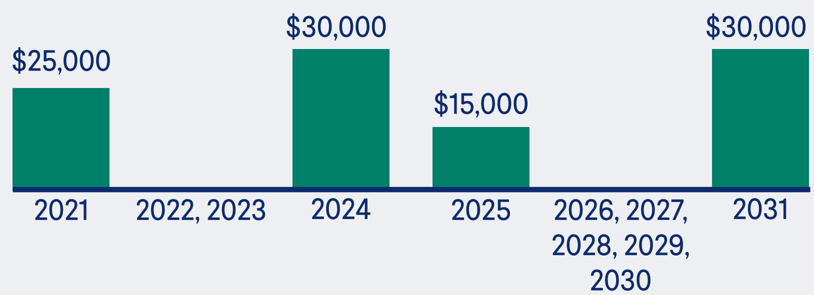
Traditional IRA owner Craig dies on March 1, 2021, and has one beneficiary, Diane, for a $100,000 IRA. Diane selects the out-in-10-years distribution method. She withdraws:

- $25,000 in 2021, which is added to her 2021 taxable income, and pays any taxes due.
- Nothing in 2022 and 2023, so no taxable income from IRA distributions.
- $30,000 in 2024, which is added to her 2024 taxable income, and pays any taxes due.
- $15,000 in 2025, which is added to her 2025 taxable income, and pays any taxes due.
- Nothing in 2026, 2027, 2028, 2029, and 2030.

Diane must withdraw the remaining $30,000 by February 28, 2031, which will be taxable income in 2031. (If she had inherited a Roth IRA that had been open for at least five years, all withdrawals would be tax free.)

Beneficiary:
Diane
$100,000
Traditional IRA

Diane's taxable withdrawals over 10 years:



Option 3: Spousal IRA

When a spouse passes away, if the surviving spouse is the sole beneficiary, he or she can take ownership of the deceased spouse's IRA and treat it as his or her own. Only a spouse can do this. The IRA continues in the name of the surviving spouse, and all regular IRA rules apply (i.e., required minimum distributions at age 72, penalties on distributions before age 59½, withdrawals are taxable income).

Beneficiary:
John, age 69
$100,000
Traditional IRA from spouse

Example

Ida, age 73, and John, age 69, are married. Ida dies, and John inherits her $100,000 traditional IRA.

As a surviving spouse, he chooses a spousal IRA, and the $100,000 IRA is retitled in his name. John doesn't need to take an RMD until he turns age 72. (Note: If Ida did not take an RMD the year she died, John will need to for that year.)

If John inherited a Roth IRA, he could also retitle it in his name. But Roth IRAs do not have RMDs, so he would not need to take them.

Your decision

As you can see, there are tax implications for what you do with your inherited IRA. As always, it is critical to work with a financial professional and tax advisor to help select the option that is best for you.

delawarelife.com

Source: Summarization of IRS Publication 590-B

DGI017INIRA (Revised 02/21) 2021010002 EXP 01/22