What You Need To Know About Inheriting An IRA

David Rae

Setting up an Inherited IRA may take a little extra legwork but the tax savings can be huge

If you are lucky enough to inherit a 401(k) or an IRA, when you don't know what you're doing, you could put your inheritance at risk. The tax rules need to be followed to the T. These IRS inherited IRA rules will vary, depending on who has passed away, and who is inheriting the retirement accounts.

When a loved one, or perhaps a long lost relative, passes away, you probably aren't spending a ton of time thinking about taxes or even tax law. All the same, when you find out that you are the beneficiary of a retirement account, you will need to eventually make decisions about how to handle the money in the Individual Retirement Account (IRA) you will be inheriting.

Being proactive and making informed decisions can help you reach your personal financial goals faster and easier. The wrong choices could cost you a huge portion of your inheritance in taxes and even IRS penalties. I can’t stress enough how important it is to understand the IRS rules surrounding an Inherited IRA, also known as a Beneficiary IRA.

The good news is that assets transferred via beneficiary are not forced to go through the hassle of probate. This typically applies to a retirement account like a 401(k), IRA, SEP-IRA or even a Cash Balance Pension Plan.

I’ve previously written about the five ways you can ruin your inherited IRA benefits. Here I want to share more general information on what you need to know if you find yourself inheriting a beneficiary IRA.

The wrong move could cost you a lot in taxes and penalties, so it's important to understand the rules surrounding inherited IRAs. Here are the most important things you need to know.

Inheriting an IRA from Your Spouse

As the surviving spouse, you will have three options when Inheriting an IRA. The first is to just pull all the money out, and do with it as you wish. Of course, this is after paying taxes. Oh, and the taxes, if you choose this option, the taxes will be miserable if the account is sizable.

The two more practical options for a spouse inheriting an IRA, are to remain as the beneficiary of the existing IRA or to move the assets to a retirement account in your name. Most people will choose to move the money into an IRA in their own name; this is just a simpler solution. Depending on where the money is held, you can just have the account retitled into an IRA in your name, so you are listed as the owner rather than your deceased spouse.

If you are looking to combine these assets within your own existing retirement accounts, you can have the funds transferred to where you wish the money to be held going forward. It is imperative that you transfer any distributed money to the new account in your name within sixty days. This will allow you to avoid taxation on the withdrawals, and let the money continue to grow tax-deferred, just like the money had been in your account the whole time.

There are times when it will make sense to leave the money in the original account, and just use the funds as needed as a beneficiary. For example, when you are under 59.5 years old and transfer the inherited IRA to your own retirement account, you will not be able to access the money without a penalty. That is until you reach 59 ½ years old. Until then, the withdrawals will not only be taxable, but they will also incur an additional 10% IRS penalty.

Bottom line, if you are planning on using the money to live off of now, you should leave the money in a beneficiary IRA. You will have to follow the same rules as children, siblings, or other named beneficiary when making a withdrawal from the account. This will help you avoid the 10% penalty, but not taxation of withdrawals.

Inheriting an IRA from a Non-Spouse

The rules get a bit more complicated when you are inheriting an IRA from someone other than your spouse. At this point, it really doesn't matter whether it is an inherited IRA from a parent, sibling, friend, or some other random person. Unlike an IRA you inherit from a spouse, you will not be able to move this money into your own retirement account in your name alone. To keep the tax benefits of the account, you will need to set up a new Inherited IRA For Benefit of (FBO) your name. Once the account is set up, you can transfer assets from the original account to your beneficiary IRA. While this process makes it seem confusing, a trusted financial planner can guide you through the process of maximizing your inheritance.

A few more things to know, you will not be able to make new contributions to an Inherited IRA. Regardless of your age, you will need to begin taking Required Minimum Distributions (RMDs) from the new account, by December 31st of the year following the original owner's death. For example, if your loved one passed away on September 15th, 2019, you would need to begin taking RMDs from the inherited IRA no later than December 31st, 2020. [The IRS has tables] to help you determine how much you be forced to take out each year.

The Three Distribution Options for a Non-Spouse Inherited IRA

Inherited IRAs come with a few options when it comes to distributions. The first option to take a lump-sum distribution. That means pulling out a large chunk, or even the entire account all at once. You will owe taxes on the entire amount, but will not be hit with the 10% penalty. This will likely result in the highest tax burden.

Your second option to take distributions from an Inherited IRA is the five-year distribution method. This option helps you avoid required minimum distributions each year on your Inherited IRA. However, you will need to have removed all of the money from the Inherited IRA by the end of five years. Not a huge fan of this option. Mostly makes sense, for older beneficiaries, who may need to push off withdrawals for tax reasons.

Typically the most tax-efficient, and in my opinion wisest distribution option is to set up minimum withdrawals based on your own life expectancy. If the original owner was older than you, your required withdrawals would be based on the IRS Single Life Expectancy Table for Inherited IRAs. With this option, you could always take a lump sum later, or pull all the money out over five years, if that became appealing for some reason in the future. In most cases, the goal would be to enjoy tax deferral within the inherited IRA for as long as allowed under IRS rules.

To get a sense of what this looks like, check out the table and look at the life expectancy factor for your current age, then divide the total value of the inherited IRA by that number. For example, if you were 40 years old when you inherited an IRA worth $1,000,000, the life expectancy factor would be 43.6. Do divide one million dollars by 43.6; the result is a required minimum distribution this year of $22,936.

Keep in mind; you can take out more if needed, this is just the required minimum distribution for your beneficiary IRA. The older you are, the more money you will need to take out each year. Don’t forget about RMDs, if you miss them you will get hit with a 50% penalty on the amount that was not withdrawn.

Spouses inheriting IRAs also have an advantage when it comes to required minimum distributions on beneficiary IRAs. They have the option to base the RMD on their own age, or their deceased spouse's age. This could help stretch out the IRA distributions if your spouse was younger than you.

When an Inherited IRA has Multiple Beneficiaries:

If the deceased had multiple beneficiaries on their IRA, each would need to set up their own inherited IRA account. Luckily, they do not all need to handle the funds the same way, but they will need to take necessary steps to transfer the funds to their new inherited IRA accounts.

The required minimum distributions will be unique for each new account, based on that beneficiaries age. The one big exception here is when the assets haven’t been separated by the December 31st deadline, RMDs will be based on the oldest beneficiaries age. This will be the case until the funds are eventually distributed into each to beneficiaries own accounts.

The Rule for Inherited Roth IRAs

Inheriting a ROTH IRA is even better than inheriting an IRA. Whereas withdrawals from a traditional IRA at taxable, withdrawals from a ROTH IRA are tax-free (when handled properly). Similarly, a ROTH IRA is not subject to required minimum distributions, for the original account owner.

When a surviving spouse inherits a ROTH IRA, they will also not need to take required minimum distributions, assuming they retitle the account or transfer the funds into an existing ROTH IRA in their own name.

However, the rules are different for non-spouse beneficiaries who inherit a ROTH IRA. They will be required to take distributions from the ROTH IRA they inherit using one of the three methods described above. (Lump Sum, 5 Year Rule, or Life Expectancy). The good news is that if the money has been in the ROTH IRA for at least five-year, withdrawal from your inherited ROTH IRA will be tax-free. Tax-free withdrawals are why inheriting money in a ROTH IRA is more valuable than the same amount in an inherited Traditional IRA or 401(k).

How you choose to handle your inherited IRA is obviously up to you. Use this windfall as an opportunity to get your financial house in order and set yourself up for the future. Dumb Inherited IRA moves can leave you paying more in taxes than necessary. Smart Inherited IRA moves can help you set yourself up for a retirement income that you won't outlive .