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Inherited IRAs

Understanding your options

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When you inherit assets from a deceased loved one, the litany of tasks and choices that can follow – during what is likely an already difficult time in your life – may seem overwhelming. Different account types require different considerations and actions; and the accompanying rules, terminology and tax implications can be difficult to navigate.

Inherited individual retirement accounts (IRAs) are no exception. To help you navigate rules and next steps, here are answers to questions that may arise if you are the beneficiary of retirement assets.

What are the options when you inherit a traditional IRA from your spouse?

Generally, you have two main options:

1

Treat it as your own IRA by either:

Designating yourself as the account owner;

OR

Transferring the assets into a new or existing IRA, or to the extent it is taxable, into qualifying retirement plans (e.g., 401K, 403(a) and (b), etc.)

2

Treat yourself as the beneficiary by either:

Transferring the assets into an inherited IRA;

OR

Taking a lump sum distribution

Most spouses who are the sole beneficiary chose option one – to treat the assets as their own – but every individual's situation is unique and requires careful consideration.

What are the differences between spouses' options for traditional IRAs?

		ACTION	DISTRIBUTIONS	CONSIDERATIONS
OPTION 1: Treat it as your own IRA		Transfer the assets into a new or existing IRA or other qualifying retirement account (e.g., 401k, 403(a) or (b) plan, etc.) within 60 days from receiving the distribution	▪ You can withdraw money at any time, but a penalty will apply before you reach age 59 1/2 ▪ RMDs are mandatory once you reach age 72 and calculated based on your life expectancy and age according to the IRS's mandated schedule	▪ You can continue to make contributions ▪ You can designate your own beneficiary ▪ RMDs are taxable ▪ Undistributed assets can grow tax free ▪ Can be particularly beneficial for spouses who are younger than their deceased spouse
OPTION 2: Treat yourself as the beneficiary	Inherited IRA	▪ Transfer the assets into an inherited IRA held in your name – by December 31 following the year of death ▪ If your spouse turned 72 in the year they died, take their RMD by 12/31	▪ You can withdraw money at any time, but a penalty will apply before you reach age 59 1/2 ▪ RMDs are mandatory and calculated depending on which of the following two methods you choose **Life expectancy method** ▪ You must begin withdrawing assets by the later of when your spouse would have turned 72 or by 12/31 of the year following their death ▪ Annual RMD amounts are determined either by your age and life expectancy or that of your spouse **10-year method** You must withdraw all assets at any time up until 12/31 of the 10th year after the year in which your spouse died	▪ Contributions to inherited IRAs are not permitted ▪ You can designate your own beneficiary ▪ RMDs are taxable ▪ Undistributed assets can continue to grow tax free ▪ Can be particularly beneficial for spouses who are considerably older than their deceased spouse
	Lump Sum Payment	All assets in the traditional IRA are distributed to you		▪ You will need to pay income tax on the assets all at once ▪ Your tax bracket may increase ▪ You will forfeit any potential future tax-free growth of the assets

Generally, you have two main options:

1. Treat it as your own IRA by transferring the assets into a new or existing IRA, or to the extent it is taxable, into qualifying retirement plans (e.g., 401K, 403(a) and (b), etc.)
2. Treat yourself as the beneficiary by either:
   - Transferring the assets into an inherited IRA held in your name or, if your spouse turned 72 in the year they died, take their RMD by 12/31; or
   - Taking a lump sum distribution

What are your options when you inherit an IRA from someone other than your spouse?

It depends on what type of designated beneficiary you are – eligible or noneligible. To be considered eligible you must be a surviving spouse, a disabled individual, a chronically ill individual, a minor child or an individual who is not more than 10 years younger than the account owner.

If you are a non-spouse eligible designated beneficiary, you can't treat the IRA as your own. But you can open an inherited IRA account or take a lump sum distribution, with rules and considerations similar to those for spouses – albeit with certain nuances, so you should coordinate carefully with your advisors.

If you are not an eligible designated beneficiary, you must withdraw the entire account by the 10th calendar year following the year of the IRA owner's death and pay any income tax associated with the distribution payout. [i]

I've heard that the rules around inherited IRAs have changed several years ago. Why?

The rules for inherited IRAs changed with the 2019 SECURE Act, which included a new 10-year payout rule for non-spousal, noneligible designated IRA beneficiaries. Previously, these individuals could spread out withdrawals over their lifetime (often referred to as "stretch IRAs").

The new 10-year payout rule was interpreted by many to mean that these beneficiaries – often children of the deceased – could wait until year 10 before taking any withdrawals. But in February 2022, the IRS proposed new rules that would require these beneficiaries to take annual withdrawals in cases where the deceased died on or after needing to begin taking their RMDs. In many instances, this would mean that working beneficiaries would inherit – and be subject to taxes on – assets during higher-income periods in their life, leading to larger tax bills than if they could wait 10 years.

Certain taxpayers and industry groups, including the American Institute of Certified Public Accountants, have urged the IRS to eliminate the annual distribution requirement for people who have inherited money since 2019, when the SECURE Act eliminated "stretch IRAs." The IRS in turn has said it is reviewing comments and will respond to them in final rules.[ii]

What if I inherit a Roth IRA?

If you inherit a Roth IRA, your options and the rules around them are similar to those for traditional IRAs, depending on the type of beneficiary you are — spouse, non-spouse, eligible designated beneficiary, etc. Surviving spouses can treat it as their own (and have the added benefit of not needing to take RMDs on Roth IRAs), whereas other beneficiaries must transfer the assets into an inherited Roth IRA or take a lump sum payment. Further, all beneficiaries who are not eligible designated beneficiaries (i.e., spouses, minor children of the deceased, those who are disabled or chronically ill, and those who are not more than 10 years younger than the deceased) must distribute all of the assets within 10 years of the original owner's death.

The main difference, however, is the way Roth IRA distributions are taxed, which applies to Roth IRAs across the board, whether inherited or not. Distributions generally are not taxed so long as they meet certain requirements, including a five-year holding period (for inherited IRAs, beginning when the deceased opened the account).

Can I convert a traditional IRA I inherited into a Roth IRA?

Only if you are the spouse of the deceased. This is accomplished by treating it as your own and then converting the assets into a Roth IRA. Other types of beneficiaries do not have this option.

Generally speaking, Roth conversions may make sense in scenarios where your income tax rate is relatively low (e.g., in retirement), when asset prices are depressed and/or if you don't expect to need your Roth IRA assets during your lifetime.

This is complicated. How can I make this decision/process easier?

Talk to a financial advisor, who can coordinate with your accountant to help you identify the right option and next steps for your unique situation.

We are here to help. If you or someone you know needs help managing inherited assets, please reach out to us.

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[i] Assuming the death occurred after 2019. The SECURE Act of 2019 changed the distribution rules for inherited IRAs and other retirement plans by eliminating the life expectancy payout ("stretch IRA") for most beneficiaries.
[ii] Ebeling, Ashlea, "IRS Changes Guidelines for Inherited IRAs, Causing Confusion and Pushback," The Wall Street Journal, https://www.wsj.com/articles/irs-changes-guidelines-for-inherited-iras-causing-confusion-and-pushback-11659309278. Accessed August 12, 2022.