AN INHERITED IRA

Here are some things to consider.

Presented by Glazer Financial Network

Be sure you understand your options. When the owner of an IRA passes away, his or her heirs must be aware of the rules and regulations affecting the inherited IRA. Ignorance could lead you straight toward a tax disaster.

Please note that this is simply an overview. Rather than use this article as a guide, use it as a prelude before you talk to a financial services professional well-versed in IRA rules and regulations.

First, make sure you have actually inherited the IRA. Your spouse, parent or grandparent may have left their traditional or Roth IRA to you in a will, but that doesn't mean you have inherited it. In all but rare cases, an IRA beneficiary designation form takes precedence over any bequest made in a will or living trust. (The same thing applies with annuities and life insurance policies.)[1]

So your first financial task is to find that beneficiary form.

- *What if I can't find the form?* The financial firm serving as the custodian of the IRA assets will usually have a copy. (If the IRA was opened decades ago, it may not.)

- *What if there is no beneficiary designated on the form?* Then the financial firm supervising the IRA will choose a beneficiary according to its rules and/or IRS guidelines. It may decide that the decedent's estate will be the beneficiary of the IRA, which is often the poorest outcome in terms of taxation.[1]

- *What if I'm not the beneficiary named on the form?* The IRA assets are destined to go to whoever the named beneficiary is. If the named beneficiary is deceased, the IRA assets will be inherited by the contingent beneficiary (if one has been named).

Ideally, the original IRA owner has told you where (or left instructions where) to find the form.

Understand the rules for spousal and non-spousal heirs. If your husband or wife has passed and you are the named beneficiary of his or her Roth or traditional IRA, you have three options.

- *You can roll over the assets into a beneficiary IRA.* This enables you to withdraw money from the IRA based upon your own life expectancy – and you can wait until the year in which the original IRA owner would have turned 70½ to start taking required withdrawals from the IRA.[2]

- *You can convert the inherited IRA into your own IRA.* If you don't have an IRA, you can create one for this purpose. This gives you the ability to name your own beneficiary, and it also allows you to keep contributing to the account and put off required minimum distributions (RMDs) until you turn 70½.[2]
- *You can "disclaim" all or some of the inherited IRA assets.* If you don't want or need the money from the inherited IRA, here is another option. By doing this, the income distribution off the IRA can go to the contingent (or successor) beneficiary. Spousal IRA heirs sometimes do this with the goal of reducing income and estate taxes.[3]
- *If the inherited IRA is a Roth IRA, the surviving spouse may not have to wait so long to get tax-free income distributions off the earnings.* While the original contributions to a Roth IRA can always be withdrawn tax-free and penalty-free, a Roth IRA owner must wait 5 years to avoid income tax on any earnings withdrawn from the account. However, a surviving spouse who inherits a Roth IRA can receive "credit" toward this 5-year waiting period for the years that the deceased spouse owned the IRA. The waiting period ends either a) 5 years after the deceased spouse opened the account or b) 5 years after the surviving spouse has opened his or her own Roth IRA.[4]

Non-spousal heirs often get little or no guidance when it comes to inherited IRAs. Too often, the financial firm overseeing the IRA just asks, "What do you want to do?" Often the IRA heir doesn't know what to do.

- *Ask the financial firm to help you retitle the inherited IRA.* This will enable you to arrange a direct rollover of the inherited IRA assets from the original IRA owner's financial custodian to the financial firm that serves as the custodian of your investments. This has to be done by September 30 of the year following the year in which the original IRA owner passed away. This is also a necessary move to "stretch" the IRA assets. Usually the new title for the IRA is something like "Mary Jones IRA/Deceased 4/8/2010/ FBO (for the benefit of) Thomas Jones as beneficiary." This retitling signifies to the IRS that this is an inherited IRA.[5]
- *You should be made aware of the consequences if you don't retitle the inherited IRA.* Let's say you don't retitle the inherited IRA as above. Instead, you just withdraw the assets from the inherited IRA and deposit them an IRA you have held for some years now. If you do this, the entire inherited IRA balance will be treated as taxable income and your federal tax bill could be huge.[5]
- *You should be made aware that you can name a beneficiary.* All IRA owners and IRA heirs have a right to do this. No named beneficiary, no stretch IRA.
- *If you weren't married to the original IRA owner, you should be told some inherited IRA basics.* Non-spousal heirs of IRAs can't contribute to an inherited IRA and can't put off required minimum withdrawals from an inherited IRA.[5]
- *You don't necessarily have to take a lump sum when it comes to withdrawing the IRA assets.* This is one way inherited IRAs are quickly depleted. A beneficiary can arrange to make smaller required minimum distributions (RMDs)

from the inherited IRA according to his or her life expectancy. These withdrawals must start by the end of the year following the year in which the original IRA owner passed away. If you don't start taking these required withdrawals by December 31 of the following year, you will pay a penalty. Taking smaller withdrawals allows some of the IRA assets to stay invested with tax deferral, and it spreads the income tax liability on the inherited IRA money over a multi-year period.[4,5]

- *You may be eligible for a big tax deduction related to income distribution off the IRA.* Income from an inherited IRA is what the IRS terms "income in respect of a decedent". This means you can take an income tax deduction for the portion of the estate tax attributable to the inherited IRA (this is detailed in IRS Publication 590).[6]
- *If multiple beneficiaries are inheriting the IRA, you should be informed that you might be able to split the IRA up.* When multiple beneficiaries inherited an IRA years ago, they had to share it and make joint investment and withdrawal decisions. Now it is possible to divide an inherited Roth or traditional IRA into multiple IRAs, one for each beneficiary. (Ask the IRA custodian if it will allow this.)[4]

So if you inherit an IRA, read up on the rules. Knowledge is truly an asset when you inherit sizable funds from any kind of retirement account. The more informed you are and the more guidance you have, the better the potential outcome.

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