Taxes and Penalties May Result if Heirs Don't Follow the Rules

How to Handle an Inherited IRA

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In our last column, we looked at the basics of saving in your company's retirement plan. Those plans, along with the individual retirement account, were first created by Congress in the 1970s. Now more than 40 years later, it's increasingly common for retirement accounts to be passed down to heirs at the owner's death.

Although you may be delighted to have inherited retirement plan assets, it's important to understand exactly how to handle this windfall to avoid incurring unnecessary taxes and penalties.

Required Minimum Distributions

To meet your obligations as the beneficiary of an IRA, it's important to understand the required minimum distribution rules that apply to retirement accounts. When you reach age 70½, you're generally required to begin drawing money from your retirement accounts each year.

There are two primary exceptions to this rule. First, if you invest in a Roth IRA, you don't have required distributions during the lifetime of the account holder. Second, in a company retirement plan where you're still working at the company and aren't an owner of 5 percent or more of it, you can postpone distributions until you retire or leave the company.

Otherwise, you're required to take a distribution each year, based on the value of the IRA account on Dec. 31 of the prior year and a life expectancy "factor" based on your age from tables supplied by the IRS. There's a Uniform Life Table used by most IRA holders and a Joint Life Expectancy Table used by IRA account owners who have a spouse who's more than 10 years younger.

For example, let's assume your IRA was worth $100,000 at the end of 2018, you're unmarried and you turn 70½ in August 2019. You'd use the Uniform Life Table, which supplies a factor for your age of 27.4.

To calculate your distribution, you divide $100,000 by 27.4, which gives you a required minimum distribution for 2019 of $3,649.64. You then repeat this process each year.

Although RMD rules are fairly straightforward for current account owners, matters get more complex when you inherit an IRA or company retirement plan.

Inherited IRAs From Your Spouse

If you inherit an IRA from your spouse, you have a special opportunity that other beneficiaries don't have. As a spouse, you can roll the account over into an IRA in your name — either an existing IRA or a newly created one.

If the deceased spouse was over age 70½, the RMD based on his age must be fulfilled in the year of death. If the RMD hasn't been completed at the time of death, it's the obligation of the spouse to take a distribution by year-end, even if she's younger than age 70½.

Once this has been done, you then follow the RMD rules that apply to your own retirement accounts, based on your own age.

A spousal rollover is often the best choice, but not always. For example, if you're a young widow or widower, you may want to leave an inherited IRA in your spouse's name if you intend to withdraw money from it before age 59½. A 10 percent early withdrawal penalty generally applies if you take a withdrawal from your own retirement account before you're 59½, but withdrawals from inherited IRAs are exempt from this penalty.

What If You Inherit an IRA From Someone Other Than Your Spouse?

If you inherit an IRA from someone other than your spouse, you won't have the option of rolling the IRA into your own name. Instead, the inherited IRA must be retitled correctly after the owner's death to avoid immediate taxation on the account's full value. The new account title should include the original owner's name and the owner's date of death as well as your name. The exact format for the title may vary from one IRA custodian to another, but one example would be "IRA for Anne Smith/deceased March 4, 2017, John Smith/Beneficiary."

When you inherit an IRA from a nonspouse, you're required to start taking distributions in the year following the death of the IRA owner.

If the owner died before reaching age 70½, you have three options:

1. Take a lump sum distribution of the entire amount and close the IRA. This sum would be added to your other taxable income for that year.

2. Take the annual required minimum distribution based on the IRS Single Life Expectancy Table for your age. More on this below.

3. Elect the five-year rule — the entire amount of the IRA must be distributed over five years, at whatever frequency you choose.

If you forget to begin distributions in the year following the owner's death, the IRS will assume you've elected the five-year rule. Once this choice is made, the beneficiary must withdraw the entire value of the IRA by Dec. 31 of the fifth year after the owner's death.

The five-year withdrawal can be completed on any schedule, as long as all the money in the account is withdrawn by the end of the fifth year. If you wait until the final year to take any money out of the IRA, you have to withdraw the original amount as well as whatever growth is in the account after the owner's death. The entire amount will be considered taxable at ordinary income rates on that year's tax return.

If all the money isn't taken out by the end of the fifth year, you'll be subject to a substantial penalty of 50 percent of the required distribution.

If the owner died after reaching age 70½, you have two options:

1. Take a lump sum distribution of the entire amount of the IRA.

2. Take the annual required minimum distribution based on the IRS Single Life Expectancy Table for your age. Subtract one year from the table for each year going forward.

To determine the required distribution each year, a beneficiary must use the IRS Single Life Expectancy Table (different from the two tables noted above). The first required withdrawal is calculated based on the table and the age of the beneficiary in the year after the death of the original owner. Each subsequent year the factor, a number on the IRS table that represents life expectancy, is reduced by one. Note that there's no penalty for withdrawing funds under the age of 59½ under the beneficiary IRA.

What if There's More Than 1 Beneficiary?

For IRA accounts with multiple nonspouse beneficiaries, the oldest beneficiary's life expectancy may be used to calculate all the beneficiaries' RMDs from the inherited IRA. But this can be avoided if you create a new account for each beneficiary no later than Dec. 31 of the year after the year the owner died. In the above example, let's assume John is 47 and he has a younger brother, Richard, who's 45, and a younger sister Jane, who's 37.

Assume each inherits one-third of Mrs. Smith's IRA. If Mrs. Smith's account wasn't divided into thirds after she dies, John, Richard and Jane would be required to calculate their initial withdrawal amount based on John's age and life expectancy. In this case, they'd each withdraw the same amount.

If instead separate beneficiary IRA accounts for each beneficiary were created, each would have a distribution based on his or her own life expectancy. Thus, Richard and Jane would have smaller required distributions, as their life expectancies are longer. This would allow them to leave more in the IRA to continue to grow tax-free.

Inheriting a Roth IRA

Although you don't have to take RMDs from your own Roth IRA during your lifetime, beneficiaries do have to take them from a Roth IRA that they inherit. If you're a surviving spouse, you can roll a Roth into your own name to avoid taking RMDs. Other beneficiaries must follow the same rules that apply to traditional IRAs. The good news is that the amounts you withdraw are tax-free.

Nonspousal Rollovers of Qualified Plans

Before 2010, if you inherited a 401(k) or another type of qualified retirement plan from someone other than your spouse, you may have been forced to withdraw and pay tax on the entire amount within five years, or in some cases within one year.

Starting in 2010, the tax law changed and nonspouse beneficiaries were able to rollover a qualified retirement plan to an inherited IRA. This isn't a true rollover in the same way that a spouse can roll over a retirement plan, but it does give nonspouses the ability to stretch out distributions over their life expectancy using an inherited IRA.

Conclusion

The custodian of your account will often automatically calculate your RMD for you each year. But given the complexity of the rules, this number should be independently calculated and checked by your financial adviser.

If you do miss an RMD from a beneficiary IRA, it's crucial to take the distribution as soon as you catch the error and to report it to the IRS using Form 5329, along with a letter explaining the extenuating circumstances. In many cases, they'll waive the 50 percent penalty.

The ability to maintain a legacy of retirement assets can be a tremendous gift, but it's crucial to preserve those assets by meeting all necessary regulations!

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