Inherited IRAs

If you are a beneficiary of an estate that includes an IRA, we have two words for you: It's complicated.

Most estate assets are received without income tax strings attached. Not so for IRAs. Income taxes must be paid on all distributions from traditional IRAs, and both traditional and Roth inherited IRAs are subject to complicated minimum distribution rules. Here are some points to keep in mind:

• *Special rules apply to surviving spouses.* A surviving spouse may roll IRA assets into his or her own IRA. That action permits continued growth in the IRA until the spouse reaches age 70 ½.

• *The 10% premature distribution penalty does not apply to distributions from an inherited IRA.* Accordingly, if the surviving spouse is fairly young and will need the money, the rollover might not be the best idea. Other heirs, who don't have the deferral option, won't have to worry about the 10% penalty tax either.

• *The beneficiary form is crucial.* The person named as the surviving beneficiary of the IRA must begin taking minimum distributions by December 31 of the year after the IRA owner's death. However, the payments may be calibrated to the beneficiary's life expectancy, and so can last a lifetime. This is the "stretch IRA" that has been a topic in the financial press. For the beneficiary of a Roth IRA, these lifetime payments are free from income tax.

• *The five-year rule.* If there is no named beneficiary, or if the estate is the beneficiary, the entire IRA must be distributed over the five years following the owner's death. Generally, one will want to avoid putting that entire lump sum into a single year, as it would likely boost the recipient into a higher tax bracket. A named beneficiary has the option of this approach as well.

• *Multiple beneficiaries.* It is possible to have more than one beneficiary share an inherited IRA. In that event, the IRA may be split into separate inherited IRAs, one for each beneficiary. This gives each beneficiary control over investment decisions and allows the distributions to be geared to each beneficiary's lifetime.

• *Primary and secondary beneficiaries.* Some planners recommend having primary and secondary beneficiaries for an IRA. For example, a spouse could be the primary beneficiary and the children secondary, to inherit only if the spouse does not survive the IRA owner. In addition to building in a backup plan for the spouse's premature death, this approach also creates the opportunity to disclaim the IRA if family financial circumstances warrant it.

The fact that a nonspouse heir can't roll over an inherited IRA may not prevent similar retirement ends from being met with careful planning. For example, let's say that Mary has been saving less than the maximum allowed in her employer's 401(k) plan. She inherits an IRA, but has no pressing need for the money and would prefer to "let it ride" for her retirement. She may be able to increase her 401(k) plan contributions by the amount of the required minimum IRA distributions that she receives. The lower salary will be offset by the new IRA money, which should be roughly a wash for income tax purposes.

(August 2012)

© 2012 M.A. Co. All rights reserved.