The Bottom Line

Volume XV, No. 5

Inheriting an IRA

Laura A. Smith

You have just learned that you are about to inherit a traditional IRA from a parent or a spouse. What do you do? How can you avoid paying extra taxes and penalties on the inheritance? If you are asking these questions, you are not the only one! In this newsletter, I will briefly discuss this issue, and some of the various rules that you must follow in order to get the most out of your inherited IRA.

What Are My Options?

There are a few different ways you can handle your inherited IRA. Let's start by looking at how a beneficiary who is not a spouse can manage the inherited IRA. The following three options are available to you: 1) cash out the account; 2) disclaim the inherited IRA; or 3) remain a beneficiary. If your spouse was the original owner of the IRA, you can roll the assets into your own traditional IRA. I will go into more detail on this below.

The first two options are fairly simple. If the funds are cashed out immediately, they are also taxable immediately. The second option may be useful if you do not need the funds from the IRA. The benefits can be passed on to a secondary beneficiary that was named on the original IRA contract.

Let's take an example of an IRA that names you as the primary beneficiary, and your children as secondary beneficiaries. If you feel that your children would receive a greater benefit from the IRA, you can disclaim the IRA and make your children beneficiaries.

The third option, to remain a beneficiary, gets more complicated. The first piece of information you need to know as the beneficiary of an IRA is whether the decedent was taking distributions on or before the date of his or her death. If not, you as the beneficiary, will be required to immediately begin taking yearly distributions on the IRA based on your remaining life expectancy. If, on the other hand, the original owner was over 70 ½ and had already been taking distributions, the required distribution rate is based on the longer of either your remaining life expectancy or the deceased owner's remaining life expectancy. There are life expectancy tables that are provided from the IRS to use in determining the minimum distribution requirements.

If you have inherited your spouse's IRA, you have the option to roll the inherited IRA into a new or existing traditional IRA account. There are a few benefits to doing this. First, you will be able to continue making contributions to the IRA. Second, you will not be required to take distributions from the IRA until you turn 70 ½. This will allow the funds to continue growing tax-deferred for a few more years before you must start taking distributions.

A Few Things to Note

The goal for many is to keep the required distributions at a minimum for as long as possible. This allows the account to grow tax-deferred over a longer period of time. Also, please note that when you inherit an IRA, you may want to move the funds to the financial institution of your choice. You will now be able to manage the investments, and change the way the money is invested. When you do this, be sure that the account is still in the original owner's name, with your name listed as a beneficiary. If the IRA is put into your name alone, it will become fully taxable in one year.

The required distribution percentages are based on tables provided by the IRS, which can be viewed at www.irs.gov. Unless the IRA is rolled over into your own name, which is allowable only if you are a spouse, distributions must be taken starting the year following the year of death of the original owner.

The exception to this rule occurs when the beneficiary must distribute all funds within five years (as when there is no defined beneficiary for the account, discussed below). In this case, no distributions are required until the fifth year. An inherited IRA does not follow the rules of a traditional IRA in that you do not need to have reached the age of 70 ½ to be required to take distributions. Also, you will not be able to contribute funds to an inherited IRA.

What If There Is More Than One Beneficiary?
What happens when the owner of an IRA names multiple beneficiaries? This does confuse the matter somewhat. If all beneficiaries of the IRA are individuals and the benefit has not been divided into separate accounts or shares for each beneficiary, the beneficiary with the shortest life expectancy becomes the designated beneficiary.

As a result, all beneficiaries are required to take distributions based on the life expectancy of the designated beneficiary. Thus, many of the beneficiaries will be required to take higher distribution amounts than they would have if they had been the sole beneficiary.

However, this can be avoided! Set up separate accounts for each beneficiary of an IRA, and each beneficiary will be able to manage their individual account. This will also allow everyone to take the smallest allowable distribution. The catch? The separate accounts must be set up by September 30 of the year following the year of the owner's death.

Plan Ahead!
Regardless of whether you have inherited an IRA, you can always plan ahead for those who will one day inherit your IRA. This will save your beneficiaries a headache and excess tax payments down the road.

When you complete your IRA contract, be sure you name specific beneficiaries to the IRA. If you depend on your will to distribute the funds or designate a generic beneficiary such as your estate, the IRA will be deemed as having no designated beneficiary. The person who receives the IRA must draw out all funds from the IRA within five years, and must pay the taxes on all withdrawn funds in that five-year period. If the original owner had already started taking distributions, there is an exception to the rule. In this case, the required distribution amount for the beneficiary is based on the distribution plan of the original owner.

No matter what stage of life you are in now, these tips can be useful, whether you are dealing with an inherited IRA as you read this, or planning for the future. These topics can be complex, but you do not need to be overwhelmed with them. We are here to help in whatever situation you may be in; give us a call!

Your Best Financial Resource in a Changing World

Archived copies of this issue and all others published in the past two years can be found at www.adccpa.com.

Thomas G. Ambrosi, CPA, MST, CVA, PFS, ABV • Michael A. Donahue, CPA, MST • Keith N. Congdon, CPA
Karin M. Wilks, CPA, MST • Carol M. Bushnell, CPA • Robert A. Poirier, CPA
Jenny L. Wilson, CPA • Julie R. Avant, CPA
Laura A. Smith • Debra L. McNeil • Edwin R. Cassidy
Linda A. Blake - Paralegal/Financial Services • Robert W. Cleary, MBA – Payroll Services

Ambrosi Donahue Congdon & Co., P.C.
One Harris Street, Newburyport, Massachusetts 01950 USA • Phone 978.462.6674 • Fax 978.465.4756 • email cpa@adccpa.com • www.adccpa.com