Inherited IRA Rules for Spouses, Heirs and Trusts

By Charles Rotblut, CFA

Article Highlights

- The rules regarding inherited IRAs differ not only from traditional and Roth IRAs, but are also dependent on the account's beneficiary(ies).
- Surviving spouses can roll the account over to their own IRA, whereas heirs who were not married to the deceased cannot.
- Beneficiaries must generally take required minimum distributions or withdraw the entire balance within five years. RMDs from a trust are based on the trust's beneficiaries.

Inherited IRAs have unique traits and do not follow all of the same rules as traditional individual retirement accounts and Roth IRAs.

Though some similarities exist, the applicable rules are dependent on whether or not the new owner of the account was married to the deceased. Even when the surviving spouse inherits the deceased's IRAs, the applicable rules are dependent on the designation chosen.

The rules are not overly complicated, but must be paid attention to and followed. If they are not, tax penalties can be levied. In this article, the rules for surviving spouses, non-spouses and trusts are explained. Those seeking further information should read IRS Publication 590-B: Distributions From Individual Retirement Arrangements (IRAs). A consultation with an estate attorney and/or a tax professional is advisable for questions regarding specific situations.

Before discussing the rules, there is one important point to make. Keeping beneficiary information correct and updated is of key importance. Not doing so can cause unintended or unwanted complications for one's spouse and heirs. Even if beneficiaries have previously been named, ensure the information is updated, correct and matches other estate planning documents. (For example, if you've created a trust for the IRA to go into, ensure the trust is correctly named as a beneficiary on the IRA.)

General Rules Regarding Inherited IRAs

Investments held within an inherited IRA grow tax-free. Taxes are levied at the time that withdrawals are made from an inherited IRA; such withdrawals are generally taxed at ordinary income tax rates and are generally not subject to the 10% early withdrawal penalty for beneficiaries. Exceptions include qualified withdrawals from an inherited Roth IRA (not taxed) and an early withdrawal from an inherited IRA that a spouse elects to become the owner of. (Becoming an owner generally makes the IRA subject to the early withdrawal penalty.)

The assets held within the deceased's IRA must be transferred into a new inherited IRA held in the beneficiary's name. The assets must be transferred even if a lump-sum distribution is planned. Surviving spouses have the option of rolling over assets into their own account.

If the owner died during or after the calendar year when he or she turned 70½, the account's beneficiaries must determine and take the deceased's required minimum distribution (RMD) for the year of the death. For example, say a gentleman named Bob was age 72 when he died in 2017 and had yet to take his full RMD. His wife, Jane, must take Bob's full required minimum distribution no later than December 31, 2017. The amount is what Bob would have been required to take had he lived for the entire calendar year.

April 1 of the year following the year a person reaches age 70½ is the "required beginning date" for taking mandatory distributions. If Bob died prior to reaching this age, no RMD would be required in the year of his death.

Individual designated beneficiaries must adhere to one of two deadlines for when they must take distributions beyond the deceased's RMD for the year of death.

Withdrawals from an inherited IRA must begin no later than December 31 following the calendar year of the account owner's death. If the account owner (e.g., Bob) died in, say, May 2017, withdrawals are required to be taken by the beneficiaries no later than December 31, 2018. Distributions are based on the Internal Revenue Service's life expectancy tables. These tables can be found in IRS Publication 590-B, though your broker may do the calculations for you. Beneficiaries can withdraw amounts greater than the required amount, including the full balance.

Alternatively, under the five-year rule, beneficiaries must withdraw the full IRA balance no later than December 31 of the year containing the fifth anniversary of the owner's death (e.g., 2022 for person who died in 2017.) Distributions, including a lump sum of the account's balance, can be taken at any point before the deadline. The deadline for electing to use this rule is the earlier of December 31 of the fifth anniversary or December 31 of the first year the beneficiary must take RMDs based on his or her life expectancy.

The five-year rule never applies if the account owner died on or after his or her required beginning date for distributions. This date is the April 1 of the year following the year the account owner reached the age of 70½.

Failure to take the full required distribution from an inherited IRA can result in a 50% tax being levied against the amount not distributed, as required by the tax code.

Inherited IRAs do not receive the same protections as retirement accounts under the bankruptcy code. In writing the opinion for a unanimous 2014 U.S. Supreme Court decision, Justice Sonia Sotomayor described the funds held within inherited IRAs as being not set aside for retirement and therefore not qualifying as retirement assets. (See "Supreme Court: No Bankruptcy Protection for Inherited IRAs" in the Briefly Noted section of the July 2014 *AAII Journal* for more about the ruling.

Who Is the Beneficiary?

The IRS says the designated beneficiary is generally determined on September 30 of the calendar year following the calendar year of the IRA owner's death. Designated beneficiaries must be listed as a beneficiary as of the date of death. A person who was designated as a beneficiary as of the date of death but disclaimed entitlement prior to the September 30 deadline will not be taken into account for purposes of determining the designated beneficiary. Should the beneficiary die before the deadline without disclaiming, the deceased individual will continue to be treated as the beneficiary for determining how the IRA's funds must be distributed.

In all cases where there is no individual designated beneficiary by September 30 of the year following the owner's death, the five-year rule for withdrawal applies. Similarly, if any beneficiary is not an individual (e.g., the estate is the beneficiary), the five-year rule applies.

What Happens If the Beneficiary Dies?

Should a beneficiary die before the entire sum of his or her inherited IRA is withdrawn, in general, the deceased beneficiary must continue to take withdrawals based on the deceased beneficiary's schedule. If Chris is the beneficiary of an inherited IRA and he dies, the heirs he designated as his beneficiaries will become successor beneficiaries to the inherited IRA. These successor beneficiaries will not be able to recalculate the RMDs, however. Rather, because Chris was already a designated beneficiary of the inherited IRA, the required minimum distributions will continue to be calculated based on his life expectancy.

If the owner of the IRA that Chris inherited died in April 2016 and Chris himself died before September 30 of 2017 without disclaiming his entitlement to the inherited IRAs benefits, the same rule applies. Chris' beneficiaries would become successor beneficiaries and the RMDs will be calculated based on Chris' life expectancy.

The rules differ when the surviving spouse is the one who died. If Jane were to die before December 31 of the year she must begin taking RMDs from her late husband Bob's IRA, she will be treated as if she was the owner of the IRA if she did not make Bob's IRA her own IRA.

In the event the surviving spouse remarries, this rule does not apply to his or her surviving spouse. Rather the surviving spouse of a surviving spouse is treated as a beneficiary instead of an owner of the inherited IRA. Say Jane remarries and names her second husband, Mike, as the sole beneficiary on the IRA she inherited from her first husband Bob. Jane then dies before she is required to begin taking distributions from Bob's IRA. Mike must take distributions from the inherited IRA based on his own life expectancy or elect to fully withdraw all of the assets under the five-year rule.

Inherited Roth IRAs

Distributions from a Roth IRA are qualified if they are taken after a five-year period beginning with the first taxable year in which the contributions were made and those distributions are made to a beneficiary or to the deceased's estate. A distribution would not be qualified if the account holder died before five years have passed since the first taxable year in which the contribution was made or before five years after a Roth IRA conversion occurred.

Non-qualified distributions from an inherited Roth IRA are taxable to the extent they are earnings instead of the recovery of the owner's original contributions, but are not subject to the 10% early distribution penalty.

Surviving Spouse Inherits IRA

If the person inheriting the IRA was married to the deceased, the options for handling the account (assuming the benefit is not disclaimed) are:

- Designate oneself as the account owner;
- Roll it over to one's own IRA or, to the extent it is taxable, into a qualified employer plan [e.g., a 401(k) plan, 403(a) plan, 403(b) plan or 457 plan];
- Treat oneself as the beneficiary rather than treating the IRA as their

Overview of the Options for Handling Inherited IRAs

The choices for what to do with an inherited IRA depends on the account's beneficiaries.

Surviving Spouses

Surviving spouses have the most flexibility when it comes to inheriting IRAs. They can:

- Roll the inherited IRA over to their own IRA;
- Roll the inherited IRA into workplace retirement plan [e.g., a 401(k) plan], if permitted;
- Designate themselves as a beneficiary of an inherited IRA; or
- Take a lump-sum distribution.

Non-Spousal Heirs

Beneficiaries who are not spouses have fewer options. They can:

- Transfer assets into an inherited IRA held in their name, or
- Take a lump-sum distribution.

Qualified Trusts

Trusts must open a new inherited IRA account in the name of the original account owner for the benefit of the trust.

- The trustee is responsible for making distributions to the beneficiaries, and
- The trust can distribute all of the assets as a lump sum.

own; or

- Withdraw the entire balance from the account (taxes and additional penalties may apply).

To simplify the explanation, we'll stick with our fictional couple: Bob and Jane. Bob dies and Jane is the surviving spouse. (If Jane were to die first instead, the same rules would apply to Bob.) Unless explicitly stated otherwise, the IRA discussed is a traditional IRA.

If Jane makes a contribution to Bob's IRAs, or if she does not take the required minimum distribution (RMD) for a year as the beneficiary, she will be considered to be the owner of Bob's IRA. In the eyes of the IRS, Jane will only be considered to have chosen to treat Bob's IRA as her own if she is the sole beneficiary and she has an unlimited right to withdraw funds from it.

As the surviving spouse, Jane has the option to roll over any distribution from Bob's IRA that is not a RMD to her own IRA if she is a beneficiary instead of the owner of the account. Like other rollovers, the distribution must be put into Jane's account within 60 days if a trustee-to-trustee (e.g., broker-to-broker) transfer is not done. The rollover is not a taxable transaction.

Keep in mind that required minimum distributions from any IRA cannot be rolled over or otherwise deposited into another IRA account and are considered to be taxable income.

RMD Rules for Surviving Spouses

As previously stated, if the owner dies on or after April 1 of the calendar year when he or she turned 70½, the account's beneficiaries must take the deceased's required minimum distribution in the year of the death. For example, if Bob dies in 2017 at age 72 and had yet to take his full RMD, Jane must take Bob's full required minimum distribution no later than December 31, 2017.

The rules regarding future required distributions depend on whether the surviving spouse is the owner or the beneficiary of the account.

If Jane is the sole beneficiary of Bob's account and elects to be treated as the owner, the calculation for future RMDs will change to treat her as being the owner beginning with the year she elects or is deemed to be the owner. This does not change what was stated two paragraphs ago, however. Any RMD the deceased would have had to take for the calendar year of death will still need to be taken. In this case, the RMD for 2017 would be what Bob would have been required to take; in 2018, the RMD switches to calculations based on Jane's age. If she is below the age of 70½, as the account owner she will not have to take RMDs until she reaches age 70½. If Jane is below the age of 59½, a 10% penalty will generally be levied on any withdrawals if she elects to be account owner.

If Jane is the sole beneficiary but not the owner of the IRA, then beneficiary rules for RMDs apply. Beneficiaries must take distributions starting the year after the year of the IRA owner's death (2018, if Bob dies in 2017). These distributions must be taken by December 31. The RMDs will be based on Jane's attained age for each year. If she is younger than 59½ and has not rolled over Bob's IRA, Jane would be able to take the distributions from the inherited IRA without incurring the 10% penalty that would otherwise apply to early withdrawals. She still would retain the option to roll over the inherited IRA to her own account after taking RMDs from the inherited IRAs. (The amount eligible for the rollover excludes the RMD for that year.)

Key Dates for Inherited IRAs

There are several deadlines applicable to inherited IRAs. Beneficiaries should pay close attention to not only the day, but also the specific year in which the deadline occurs on.

April 1 of the Year Following the Year a Person Reaches Age 70½: This is the "required beginning date" for taking mandatory distributions (RMDs). The five-year rule for inherited IRAs never applies if the account owner died on or after his or her required beginning date.

September 30 of the Year Following the Year of the Owner's Death: The deadline for determining the designated beneficiaries. The five-year rule applies if there are no designated beneficiaries by this date.

December 31 in the Year of Death: If the account owner dies on or after April 1 of the calendar year when he or she turned 70½, the account's beneficiaries must take the deceased's required minimum distribution in the year of the death.

December 31 of the Year Following the Year of Death: If the account owner dies on or after the required beginning date, beneficiaries must take RMDs based on the longer of their or the account owner's life expectancy by this date. This is also the deadline for establishing multiple accounts if there is more than one beneficiary.

December 31 of the Year the First RMD Must Be Taken: This is the date individual designated beneficiaries must either take their first required minimum distribution based on the life expectancy rules or elect to the follow the five-year rule. The deadline for making this election is the earlier of the year with five-year anniversary or December 31 of the first year the beneficiary must take RMDs based on their own life expectancy.

December 31 of the Year Containing the Fifth Anniversary of the Owner's Death: Beneficiaries following the five-year rule must withdraw all the assets from the inherited IRA no later than December 31 of the calendar year containing the fifth anniversary of the owner's death (e.g., 2022 for a person who dies in 2017.)

Roth IRA Rules for Surviving Spouses

Surviving spouses who are the sole beneficiary of a Roth IRA can elect to treat the Roth IRA as their own. By electing to take ownership, Jane would then be able to combine Bob's Roth IRA with her own Roth IRA. Were Jane to simply stay as beneficiary instead, she would follow the same minimum distribution rules that apply to traditional IRAs.

Surviving spouses who are the sole beneficiary of a Roth IRA can also delay distributions until the decedent would have reached age 70½. Distributions can also be delayed if the surviving spouse treats the Roth IRA as his or her own.

Someone Other than the Spouse Inherits the IRA

There are key differences in the rules for beneficiaries who were not married to the deceased. The tax code gives non-spousal beneficiaries less flexibility than it does surviving spouses. Such beneficiaries cannot treat the IRA as their own. Contributions cannot be made to the inherited IRA. The inherited IRA cannot be rolled over to a beneficiary's IRA. Trustee-to-trustee transfers (e.g., from one brokerage firm to another) must be done in the name of the deceased owner for the benefit of the beneficiary.

More Than One Beneficiary

Splitting the IRA into more than one account has advantages in cases where there is more than one beneficiary. Doing so allows each beneficiary to use his or her own life expectancy for calculating the required minimum withdrawal. It also avoids potential disagreements about how the inherited IRA should be managed.

Each beneficiary must establish their own account under their own name. The accounts cannot be commingled. Once these accounts are established, each beneficiary can choose who he or she wants to list as beneficiaries.

The deadline for establishing multiple accounts is December 31 of the year following the year of death (e.g., December 31, 2018, for an IRA of someone who dies in 2017). If separate accounts are not established by this date and all the beneficiaries are individuals, required minimum distributions for all beneficiaries will generally be based on the life expectancy of the oldest beneficiary. (The shortest life expectancy rule applies when there is more than one beneficiary as of September 30 on the year following the owner's death.)

The separate account rules cannot be used by beneficiaries of a trust.

Non-Spousal Rules for Inheriting a Roth IRA

As is the case with a traditional IRA, inherited Roth IRA assets must either be withdrawn in accordance with the five-year rule or through the same required minimum distribution rules that apply to traditional IRAs.

A Trust Inherits the IRA

The IRS lists specific rules describing what a qualified trust is.

1. The trust must be valid under state

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when they take this year's withdrawal. Doing so alleviates any second-guessing and future procrastination. Though there is a risk of taking money out of equities too soon, the couple would rather incur this risk than chance that a market downturn may occur before they finish shifting their allocation.

They will also fund this year's and next year's withdrawals from their stock and REIT funds. They accomplish this by withdrawing $55,000 out of large-cap stocks (their largest allocation), $25,000 out of small-cap stocks and $25,000 out of REITs. Out of this $105,000 total, $30,000 is taken as a withdrawal and $75,000 is split evenly between cash and bonds. The adjusted portfolio section in Table 1 shows the effect of this change for the first year under the worst-case scenario. Although their commitment to equities is still above the target level, they have managed to reduce their liquidity risk—they could withdraw spending money first from cash, then from the fixed-income fund for four years to ride out a bear market.

Don't Let the Bull Lull You Into Taking Too Much Risk

Major bull markets can cause asset allocation strategies to stray far from their target levels and at the same time cause investors to become overly complacent with their stock holdings—a dangerous combination. Examining your portfolio and seeing how it would fare under worst-case bear market conditions gives you the chance to inject a dose of reality into your portfolio. If you are uncomfortable with what you see, create a plan to put your portfolio back into a balance that is more advantageous to you.

Here are some things to keep in mind when re-examining your downside risk:

- Use the worst-case scenario—the maximum loss for all asset categories—as a guide to how much of a loss you can stomach, as well as any liquidity problems you may run into. The worst returns for a one-year holding period over a long-term time frame are a good guideline.
- When you are withdrawing assets from your savings, make sure you fully understand your liquidity risk—the risk that you may be forced to sell at an inopportune time. You can reduce liquidity risk overall by increasing your investments in cash, which don't face liquidity risk.
- The best way to avoid being overcome by a strong bull market is to rebalance periodically. Rebalancing helps you remain diversified, so that you are not overly dependent on one area of the market for your performance. Furthermore, it provides a discipline in that it forces you to sell "high" and buy "low."
- When you do rebalance, try to do so in the most tax-efficient way possible—for instance, withdrawing spending money from funds to which you are overly committed, or by buying and selling from tax-preferred accounts. ➤

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law, or would be for the fact that there is no corpus,

2. The trust is irrevocable or becomes irrevocable upon the owner's death,
3. The trust's beneficiaries are identifiable from the trust instrument, and
4. The trustee of the trust provides the necessary documents to the IRA custodian or trustee (e.g., the brokerage firm). This documentation must be provided by October 31 of the year following the death of the IRA's owner.

Since a trust cannot be a designated beneficiary, required minimum distributions will be based on the trust's beneficiaries. The trust's beneficiaries will be treated as having been designated beneficiaries in this instance.

Say Bob instructed his broker to name his trust as the beneficiary of his IRA. The trust itself lists Sue as its beneficiary. For estate planning purposes, the IRA goes into the trust. The trust cannot be used for calculating RMDs since it is not allowed to be a designated beneficiary. So instead Sue—the trust's beneficiary—is treated as being the designated beneficiary for purposes of calculating the RMD.

If a second trust is the beneficiary of the first trust and meets the aforementioned rules, the beneficiaries of the second trust will be treated as being designated beneficiaries for purposes of calculating RMDs.

A new inherited IRA account will need to be opened in the name of the original account owner for the benefit of the trust. Note that the beneficiaries of the trust will not be able to open their own inherited IRAs. Rather, they will receive distributions from the trust's trustee.

Questions regarding the trust and the taxes associated with the distributions should be directed to an estate attorney. ➤

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