



# Individual Retirement Accounts

## Inherited IRAs



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### Inherited Traditional IRAs

**Inherited IRA choices.** A designated beneficiary has several choices when inheriting a traditional IRA.

- 1) The beneficiary can cash in the IRA, include the amount in gross income, and pay tax on the distribution.
- 2) If the beneficiary is an individual, the beneficiary can elect to take the entire account balance in the IRA by the end of the fifth year following the year of the participant's death. No distributions need to be made before the end of the fifth year. This election is available only when the participant dies before the required beginning date for the required minimum distribution (RMD).
- 3) The beneficiary can leave the IRA in the name of the deceased participant. RMD is determined as follows:
  - If the decedent was already receiving RMDs at the time of death, the beneficiary can take distributions over the longer of:
    - The beneficiary's own life expectancy based on IRS tables, using the age of the beneficiary as of his or her birthday in the year following the year of the decedent's death, reduced by one for each subsequent year, or
    - The decedent's life expectancy based on IRS tables, using the age of the decedent as of his or her birthday in the year of death, reduced by one for each subsequent year.
  - If the decedent was not yet receiving RMDs at the time of death, the beneficiary must take out the distributions over his or her own life expectancy. If the beneficiary was the surviving spouse, RMDs do not begin until the decedent would have turned age 70½.
- 4) If the beneficiary is the surviving spouse of the deceased IRA participant, the beneficiary can treat the IRA as his or her own. This allows the beneficiary to

make additional contributions to the IRA (including rollover contributions). It also allows the beneficiary to use RMD rules based on the beneficiary's life. Early withdrawal penalty rules apply if the surviving spouse is under age 59½.

- 5) If the beneficiary is the surviving spouse of the deceased IRA participant, the beneficiary can treat the IRA as his or her own by rolling it over to his or her own IRA, or the taxable portion of the IRA can be rolled over to his or her employer-sponsored plan.

Choices 1, 2, and 3 apply to all beneficiaries. Choices 4 and 5 apply only to beneficiaries who are the spouse of the participant.

**10% early withdrawal penalty.** The 10% penalty for withdrawal before age 59½ does not apply to a distribution to a beneficiary on or after the death of the participant. However, if a spouse chooses to roll the decedent's IRA into his or her own separate IRA, any subsequent distribution will be subject to the 10% early withdrawal penalty assuming no other exception to the penalty applies.

**IRA with basis.** Any nondeductible contributions that gave the IRA a basis stay with the IRA after it is inherited by a beneficiary. The basis cannot be combined with the beneficiary's basis in his or her own IRAs unless the beneficiary is the decedent's spouse and chooses to treat the IRA as his or her own.

### Inherited Roth IRA

When a Roth IRA owner dies, the minimum distribution rules that apply to traditional IRAs apply to Roth IRAs as though the Roth IRA owner died before his or her required beginning date.



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**Distributions to beneficiaries.** Generally, the entire interest in the Roth IRA must be distributed by the end of the fifth calendar year after the year of the owner's death unless distributions are spread over the life expectancy of the designated beneficiary using the RMD rules. If distributed over the beneficiary's life expectancy the distributions must begin before the end of the calendar year following the year of death. Distributions from another Roth IRA cannot be substituted for these distributions unless the other Roth IRA was inherited from the same decedent. If the sole beneficiary is the spouse, he or she can either delay distributions until the decedent would have reached age 70½ or treat the Roth IRA as his or her own.

**Combining with other Roth IRAs.** A beneficiary can combine an inherited Roth IRA with another Roth IRA maintained by the beneficiary only if the beneficiary either:

- Inherited the other Roth IRA from the same decedent, or
- Was the spouse of the decedent and the sole beneficiary of the Roth IRA and elects to treat it as his or her own IRA.

**Distributions that are not qualified distributions.** If a distribution to a beneficiary is not a qualified distribution, it is generally includible in the beneficiary's gross income in the same manner as it would have been included in the owner's income had it been distributed to the IRA owner when he or she was alive. If the owner of a Roth IRA dies before the end of one of the following, the ordering rules for Roth IRA distributions determines which part may be taxable.

- The 5-year period beginning with the first taxable year for which a contribution was made to a Roth IRA set up for the owner's benefit, or
- The 5-year period starting with the year of a conversion contribution from a traditional IRA or a rollover from a qualified retirement plan to a Roth IRA,

## Designated Beneficiary Not Determined

If the IRA does not have a designated beneficiary as of the date of death, or the designated beneficiary disclaims his or her interest in the IRA, then the estate can designate one of the estate beneficiaries as the IRA designated beneficiary. The time limit for making this designation is September 30 of the year following the year of the IRA participant's death. By making this designation, the estate can avoid having the IRA distributed under the 5-year rule.

## Beneficiaries of Qualified Plans

Generally, a beneficiary reports pension or annuity income in the same way the plan participant would have reported it. However, some special rules apply.

**Employee's investment in contract.** A beneficiary of an employee who was covered by a retirement plan can exclude from income a portion of nonperiodic distributions received that totally relieve the payer from the obligation to pay an annuity. The amount that the beneficiary can exclude is equal to the deceased employee's investment in the contract (cost).

**Survivor annuity.** If the beneficiary is entitled to receive a survivor annuity on the death of an employee, the beneficiary can exclude part of each annuity payment as a tax-free recovery of the employee's investment in the contract. The beneficiary must figure the tax-free part of each payment using the method that applies as if he or she were the employee.

**Joint and survivor annuity.** Benefits paid to a survivor under a joint and survivor annuity must be included in the surviving spouse's gross income in the same way the retiree would have included them in gross income.

## Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 70½.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of \$5,000.

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