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Inheriting Retirement Accounts: The Other IRAs

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Dealing with the passing of a family member or close friend is never easy. The emotions we feel and the ways we cope with loss can vary dramatically depending on our personality and the relationship with the deceased. However, there is one issue that almost always surfaces: the unpleasant prospects of dealing with the deceased's finances. The challenge of settling an estate in a limited time frame while attempting to preserve assets and minimize expenses can be troublesome simply due to the amount of paperwork and time required.

Inheriting an IRA presents unique challenges. The rules are complicated and mistakes are expensive and irreversible. Regardless of the sum of the inheritance, it is critically important to seek advice on how to manage the IRA assets in a way that minimizes the tax burden and best addresses the goals of the inheritor.

The options for spousal and non-spouse beneficiaries:

- If you are the current spouse: You can remain the sole beneficiary. Or you can re-title the account in your name or merge the account into an IRA you already own. For most folks it makes sense to re-title or merge. However if the beneficiary is younger than 59½ and has immediate cash needs, they can avoid the 10 percent withdrawal penalty by leaving the account in the deceased's name and pay income tax only. If you're over 70½ and older than your deceased spouse you can elect to use the younger spouse's age to reduce the Required Minimum Distributions (RMDs) and extend the life of the account potentially for future generations.

- If you are not the deceased's current spouse: These are slightly more complex scenarios. If you are a beneficiary of someone other than a spouse, you must open a new IRA account that is titled with both parties' names, yours and the deceased's. You are also prohibited from making future contributions to the account beyond the inheritance. Another land mine clients and advisors encounter is determining when and how much needs to be withdrawn from the account to fulfill the required Beneficiary Minimum Distribution (BMD). This must be done by December 31 of the year following the year of the death. Remember that if the deceased was over 70½ and already taking RMDs, you need to take the remaining distribution for the calendar year the person passed away before you start taking BMDs. If you don't, the IRS will impose a 50 percent penalty, half what was required to be withdrawn from the account during that calendar year.

Non-spouses have the option of taking a lump sum payment of the full amount of the IRA, however they will also have to pay income tax on the full amount for the year the funds are withdrawn. Beneficiaries can also spread out the withdrawals over the course of 60 months with no penalties or requirements other than that the balance be liquidated within five years. The most common recommendation is to use the life-expectancy method, which follows the IRS Single Life Expectancy Table requiring a percentage of the account value to be withdrawn based on the beneficiary's age.

Roth IRAs also require BMDs for non-spouses. You can avoid the rarely discussed 10 percent Roth penalty if the funds have been in the account for at least five years prior to withdrawal. It's a somewhat odd rule, but in many cases people miss this requirement which can result in having to deal with an inquiry note from the IRS. Proper planning through the use of what is termed a "stretch" provision can help preserve assets for a far longer period and allows the individual greater control of the funds.

IRS time lines force us to make decisions relative to IRAs that will have significant ramifications on the future of inherited assets. Executors and beneficiaries need expert professional counsel from a financial advisor truly educated on the subject and able to consider the inheritance as part of your comprehensive financial picture. For the elderly, or people in poor health who are at risk of reduced mental capacity it is critically important to work with a knowledgeable advisor to develop an estate plan and review beneficiaries on all accounts. For those inheriting assets it is equally as important to ensure the process is completed as efficiently as possible. The implications can affect all aspects of your financial plan — investments, taxes, insurance and estate planning.

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