Handle an Inherited IRA With Care

An inherited IRA can be a welcome financial windfall. But the rules governing required minimum distributions (RMDs) from these tax-deferred accounts are complex. IRA recipients should familiarize themselves with these rules to avoid potentially costly tax mistakes.

End of the "stretch" IRA

Until relatively recently, IRA beneficiaries were entitled to spread distributions of inherited IRA savings over their life expectancies. These so-called "stretch IRAs" provided an advantage by enabling the IRA's funds to continue growing and compounding on a tax-deferred basis for years or even decades. However, the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 eliminated the stretch IRA for most non-spousal IRA beneficiaries. Now, beneficiaries of IRAs owned by those who died after 2019 must withdraw all funds within 10 years (with certain exceptions).

The tax impact of this change can be significant. The need to withdraw funds more quickly means IRA recipients will be taxed on those withdrawals regardless of whether they need the money. And depending on the size of the withdrawals, they may push recipients into higher tax brackets.

Failure to take an RMD when required can trigger a penalty equal to 25% of the distributable amount, potentially reduced to 10% if the recipient corrects the mistake on a timely basis. (Note: The penalty for missed RMDs had been 50%, but it was reduced to 25% by the SECURE 2.0 Act of 2022.)

Who's subject to the 10-year rule?

Under the SECURE Act, the general rule is that inherited IRAs received by a designated beneficiary must be distributed within 10 years after the original account owner's death. However, there are several exceptions to the "10-year rule":

- The account owner's surviving spouse,
- A minor child of the account owner who hasn't reached age 21,
- A disabled or chronically ill person, or
- A person who's not more than 10 years younger than the account owner.

Recipients who fall into these categories are still entitled to spread RMDs over their life expectancies, with special rules for surviving spouses. (See "Options for surviving spouses" at X.) Minor children may base annual RMDs on their life expectancies until they reach age 21, after which they must withdraw the remaining IRA balance over the following 10 years.

Special rules also apply to IRAs received by non-designated beneficiaries, such as trusts, estates and charities. These rules aren't discussed here, but your estate planning advisor can explain the pros and cons of naming one of these entities as beneficiary of an IRA.

How does the 10-year rule work?

The SECURE Act created some confusion over the application of the 10-year rule. It was unclear whether IRA recipients subject to the rule had to take regular annual distributions over the 10-year period following the original account owner's death or whether they could allow the funds to continue growing and compounding and then empty the account in year 10. The IRS provided an answer in regulations finalized late last year.

The recipient's options depend on whether the account owner died before or after he or she was required to begin RMDs. Currently, most IRA owners must begin RMDs by April 1 of the year following the year they reach age 73. This is the so-called required beginning date (RBD). Note, however, that under the SECURE 2.0 Act, the RBD may differ depending on the year the account owner was born.

Under the final regs, if the account owner died before his or her RBD, a beneficiary subject to the 10-year rule can withdraw the funds at any time so long as the IRA is emptied within the applicable 10-year period. If the account owner died on or after his or her RBD, the RMDs must be spread out over years one through 10.

It's complicated

The rules surrounding distributions from inherited IRAs are complex, and they vary depending on several factors. IRA beneficiaries should consult their advisors to ensure that they comply with the rules and choose the option that best meets their needs.

Sidebar: Options for surviving spouses

Surviving spouses named as IRA beneficiaries generally have two options (apart from taking a lump sum distribution):

Assume ownership of the IRA. Here, surviving spouses step into the shoes of the original account owners — either by naming themselves as owners or transferring the assets to their existing IRAs. Under this option, a surviving spouse can withdraw the funds at any time (subject to a 10% penalty if under the age 59½) and must start required minimum distributions (RMDs) at the required beginning date (RBD).

Open an inherited IRA and name himself or herself as beneficiary. Under this option, the surviving spouse takes RMDs over his or her life expectancy, beginning on the *later* of 1) the year the original account owner would have reached his or her RBD, or 2) the end of the year following the year of the account owner's death. Alternatively, if the account owner died before his or her RBD, the surviving spouse can choose the 10-year rule and withdraw the funds by the end of the 10-year period.

The right option depends on the surviving spouse's circumstances and financial needs. For example, assuming ownership allows the surviving spouse to continue making contributions to the IRA and to defer distributions until RMDs are required. Contributions to inherited IRAs aren't permitted, and distributions may be required sooner than an assumed IRA. If the surviving spouse needs the money right away and is under age 59½, an inherited IRA may be preferable, because distributions from an assumed IRA would be subject to penalties.