Understanding inherited IRAs: Rules, options, and benefits

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Inherited IRAs are retirement savings accounts originally owned by a spouse, relative, or friend who bequeath funds to a beneficiary. Although they are tax-advantaged accounts like traditional and Roth IRAs, an inherited IRA's rules are more complex.

Understanding the rules of an inherited IRA is crucial to getting the most out of one of the best IRA accounts while avoiding IRS penalties. Here is an overview of inherited IRA rules in 2024.

Inherited IRAs are retirement savings accounts of money bequeathed to a spouse or non-spouse beneficiary. kate_sept2004/Getty Images

What is an inherited IRA?

Definition and overview of inherited IRAs

Also known as a beneficiary IRA, an inherited IRA is an account that holds the assets inherited from a decedent's tax-advantaged retirement plan. The money continues to grow with the same tax conditions that applied to the original IRA.

"The rules vary depending on your relationship to the deceased, at what age they died, and what type of beneficiary you are," says Peter Riefstahl, a CPA and owner of On My Way to CPA.

Inherited IRAs can be funded from any type of IRA, including:

- Traditional IRA
- Roth IRA
- SIMPLE IRA
- SEP IRA

Inheritance can also originate from the deceased person's 401(k) plan.

Beneficiaries cannot make additional contributions to an inherited IRA. Although inheritors can manage the assets in the retirement account (including changing the investments and buying and selling different assets), additional deposits are not allowed.

Benefits of an inherited IRA

Opening an inherited IRA account after the original owner passes offers the designated beneficiary several benefits, such as continuing tax-deferred growth for up to 10 years after the original owner's passing and collecting regular distributions to avoid being bumped into a higher tax bracket.

You also have the option to collect the remaining funds at any time without penalty. This can help you afford costly financial goals, such as paying off long-term debt or putting a down payment on a home. However, make sure you are aware of the possible tax implications of withdrawing inheritance as a lump sum.

Rules and regulations for inherited IRAs

Inherited IRA distribution options

Inherited IRAs are intended only to be temporary, and the assets must be withdrawn in a certain amount of time. Therefore, inherited IRA distribution options differ from standard IRA accounts. The timetable for when you must have all assets withdrawn varies by beneficiary. Still, all inherited IRA account holders must empty the account's contents by the designated time to avoid a heavy IRS penalty.

The inheritor won't pay income tax on withdrawals from inherited Roth IRAs unless the account is under five years old. Distributions from inherited IRAs funded with pre-tax money are subject to income tax at the beneficiary's ordinary tax rate.

Spouses have the most flexibility around these rules as they can put the deceased person's IRA in their name or roll the money over into their own IRA. Rolling over an IRA also allows them to continue making deposits. However, if a spouse beneficiary opens an inherited IRA instead, they must withdraw all funds within 10 years of the original owner's passing. This is referred to as the 10-year rule.

Tax implications of inherited IRAs

The tax rules that applied to the original IRA also apply to the resulting inherited IRA. IRAs with taxable withdrawals, such as traditional and SEP IRAs, continue to be taxable when withdrawn from their inherited counterparts. Any amount withdrawn is taxed at your regular income tax rate.

Inherited Roth IRA distributions continue to be tax-free, just like any Roth, as long as the original account is at least five years old. If the account is younger than five years old at the time of the original owner's death, any withdrawn contributions are still tax-free, but any earnings above that are taxable when you take them out.

The IRS does offer beneficiaries one break. If you're under age 59 ½, any withdrawals from a retirement account, such as a traditional IRA or a 401(k), usually incur a 10% penalty. This penalty is waived for inherited IRAs if distributions follow the appropriate rules and regulations.

RMD (Required minimum distributions) requirements

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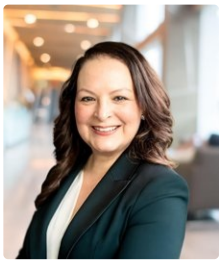

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If a surviving spouse sets up a new inherited IRA and the original owner had already started taking required minimum distributions (RMDs), the beneficiary must take the same distributions the deceased did, or recalculate the amount based on their own life expectancy to receive a new RMD.

If the original owner died before the age of 72, then the surviving spouse doesn't have to start taking distributions until the year the deceased would have turned 72.

Options for beneficiaries

Beneficiaries fall into two categories: designated (people, like a spouse, relative, or friend) and not designated (trusts and estates).

Spouse beneficiaries

Spouses can set up an inherited IRA but don't necessarily have to. It's more advantageous to forgo the inherited IRA and treat the deceased's IRA as their own: putting it into their name or rolling it over into another IRA they already have. This is a special privilege only spouses possess.

On the other hand, suppose you decided to inherit your deceased spouse's IRA rather than transfer it into your own name. If the original owner had not reached RMD age, you can choose to start taking RMDs either by December 31 of the year the original owner would have reached age 73 or the year following their death (whichever is later). The 10-year rule also still applies in this instance.

If the original owner had reached RMD age, a spouse with an inherited IRA must take the subsequent RMDs each year. If the spouse inheriting doesn't wish to take out RMDs and is younger than 73, they can choose to be treated as the IRA's original owner and push back taking RMDs.

If the original owner died before 2020, the IRS requires inheritors to withdraw all earnings within five years instead of 10.

Non-spouse beneficiaries

Non-spouse beneficiaries must set up a separate inherited IRA to assume ownership of a deceased loved one's IRA assets. Beneficiaries may be the deceased's grown children, relatives, or friends.

Unlike an inheriting spouse, a non-spouse beneficiary cannot make additional contributions to the inherited IRA or transfer the inherited funds into an existing IRA account. Instead, non-spouse beneficiaries must cash out the account and pay income tax on the amount withdrawn. Nothing can stay in the original IRA by the IRS deadline.

For IRA accounts inherited after December 31, 2019, non-spouse beneficiaries must cash out the funds within 10 years of the original owner's passing. Otherwise, assets must be withdrawn within five years.

For example, say Joe died on September 1, 2023, bequeathing his IRA to his grown daughter, Jane. Jane sets up an inherited IRA. Her deadline for emptying the IRA is December 31, 2033, and she must withdraw the necessary amount yearly.

Inheritors who are disabled, chronically ill, or whose age is within a decade of the deceased may be exempt from the 10-year rule. Minors who are immediate descendants of the original owner may also be exempt until they turn 18.

Trusts and estates

Trusts and estates can be named as inherited IRA beneficiaries for further account control and legal protection. Some of the most common reasons to do this are to minimize estate tax or work around beneficiary ownership limitations if the heir is under 18.

As a reminder, trusts are legal entities, often part of estate plans, that hold real estate, investment accounts, life insurance policies, and business interests. So, when a trust is named an IRA beneficiary, the inherited IRA becomes a maintained asset of the trust. This offers the original IRA owners increased control over who, when, and how the funds can be accessed.

For example, if the original IRA wants their spouse and child to benefit from the account's assets, they can structure the trust to guarantee that both parties receive funds.

The original owner can also limit the amount a beneficiary can take out at a time or name successive beneficiaries if the original inheritor dies.

Managing an inherited IRA

Setting up the account

You can set up an inherited IRA with almost any bank or brokerage. But the easiest option may be to open your inherited IRA with the firm that held the deceased's account. The person or entity that inherits the IRA can be anyone that the original owner named as a beneficiary in the IRA paperwork.

The account must be named properly and designated as inherited with both parties' names for tax purposes. Typically, the title reads something like [Name of Recipient] Inherited IRA Beneficiary of [Deceased's name].

When opening an inherited IRA, you will need the following:

- A death certificate of the original owner
- The title of the account with your name and the deceased's name
- Documentation of your beneficiary designation
- Application to open an inherited IRA account

Investment strategies for inherited IRAs

Unless you're a spouse, when you inherit a retirement account, your usual best option is to transfer the money into an inherited IRA. Inherited IRAs continue to grow tax-deferred until withdrawals are made. Taxes on withdrawals are treated the same as the original IRA account.

"One could simply defer taking withdrawals for the decade, let the account grow (ideally), and then take it all out in the end," Riefstahl says. "The important caveat is that this will push you into a far higher tax bracket, thereby cutting into those gains that have accumulated over the years."

If applicable, try to withdraw an amount of funds that would keep you in your current tax bracket rather than pushing you to the next one. Keeping money in the account for as long as possible to capitalize on the potential of tax-deferred growth. However, depending on RMDs or your financial situation, this may not be realistic.

You also have the option to turn down your inheritance if you believe that another family member or loved one may benefit more from the money. However, talk with an attorney or financial advisor before doing so.

Avoiding common inherited IRA mistakes

The consequences can be harsh if you don't withdraw funds from an inherited IRA by the deadline. The IRS charges a penalty of 50% of the funds you were supposed to take out. Depending on the size of the IRA you inherit, this can be serious money.

In 2022, the IRS changed the 10-year rule. Previously, you could take out the money from an inherited IRA at your leisure, as long as you did so before the 10-year mark — so you could take it all out in one year if the tax benefits made sense for you. Under the new rule, most non-spouse beneficiaries must take RMDs every year.

This new rule was released amid confusion. So, if you did not take out annual RMDs in 2021 or 2022 when you were technically supposed to, the 50% penalty is waived.

Inherited IRA FAQs

What is an inherited IRA?

An inherited IRA is an individual retirement account that a spouse, relative, or friend can inherit after the original owner's death. There are strict rules and regulations for withdrawing assets from inherited IRAs. This varies depending on your age and relation to the original owner.

What are the distribution rules for an inherited IRA?

Inherited IRA distribution rules vary based on whether you are a spouse or a non-spouse beneficiary. Assets in an inherited IRA typically must be withdrawn or transferred within five or 10 years unless the beneficiary qualifies for an exemption. Beneficiary IRAs are also subject to required minimum distribution (RMD) rules.

Can I roll over an inherited IRA into my own IRA?

If you are the spouse of the original account owner, you can roll over an inherited IRA into your own IRA. If you're a non-spouse beneficiary, you must cash out the assets in the inherited IRA within five or 10 years, depending on which timeline you qualify for. Assets withdrawn from traditional inherited IRAs are subject to income tax.

What are the tax implications of an inherited IRA?

The tax implications for an inherited IRA are the same as those for the original IRA. For example, withdrawals will be taxed as ordinary income if the beneficiary inherits an IRA funded by pre-tax dollars. On the other hand, a Roth inherited IRA is funded by after-tax dollars, so withdrawals are not subject to additional taxation.

How do I set up an inherited IRA?

To set up an inherited IRA, contact the financial institution managing the original owner's IRA and provide the necessary documentation to set up the inherited IRA account. Technically, you may be able to open an inherited IRA somewhere else, but using the same financial institution as the original owner will be a much simpler process.
