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Navigating Inherited IRA Rules

Inheriting an IRA involves many considerations. You have a few options, and your decision will hinge on your immediate needs, but your overarching goal might be to manage taxes effectively. It's crucial to understand each option, as some distribution methods maintain the account's tax advantaged status while others do not. Remember, once you take a distribution from the inherited IRA assets, you cannot roll it over within 60 days, unless you are the surviving spouse. Since the laws regarding Inherited IRAs are complex, we have compiled this information to help you avoid common pitfalls so you can take full advantage of the rules.

Will I Owe Tax?

This question is often top of mind for beneficiaries. Knowing the type of IRA you are inheriting, whether a Traditional or Roth, is the first step to finding your answer.

Generally, when you inherit a Traditional IRA, you will need to pay ordinary income tax on distributions. Remember, the distribution is added to your other ordinary income and could put you in a higher tax bracket. However, if there are after tax amounts, you will follow the pro-rata rule, meaning a portion of the distribution won't be taxable. Find out if the deceased IRA owner filed IRS Form 8606; if so, the amount of after tax will be on that form. While most Traditional IRAs contain only before tax amounts, it is wise to review the owner's tax return to be certain.

Roth IRAs are funded with after tax amounts, so only the earnings might be taxed. This is a concern if the Roth IRA was opened less than five years ago. If the Roth IRA was opened more than five years ago, the distributions are considered qualified and are therefore tax free.

For example, the Roth IRA was first opened and funded in 2023, the five year holding period starts January 1, 2023, and ends December 31, 2027. Qualified distributions begin on January 1, 2028. The five year clock continues in the Inherited IRA. Until the five years are met, you will follow the Roth distribution ordering rules outlined below:

- The first amounts out will be from contributions.
- Second amounts taken are from any converted amounts.
  - Contributions and converted amounts aren't taxable.
- The last amounts distributed, once all contributions and converted amounts are taken, are earnings. You would owe tax on a distribution that includes earnings, if the five year holding period hasn't been met.
  - Once the five year clock is met, all distributions are qualified.
- Regardless of your age, you won't incur the IRS 10% additional tax on early or pre-59½ distributions for any taxable amounts distributed from the IRA you inherited. This is because Inherited IRA distributions are coded as "death" on IRS Form 1099-R, and death is an exception to the 10% additional tax.

Beneficiary Categories

Your distribution rules depend on the below three beneficiary categories when the IRA owner died after 2019.

Non-Designated Beneficiary (NDB)	Designated Beneficiary (DB)	Eligible Designated Beneficiary (EDB)
• Charity • Estate • Non-qualified trust	• Child of the IRA owner who has surpassed age 21 • Individuals who are more than 10 years younger than the IRA owner (based on date of birth) • Individuals not chronically ill/disabled • Primary beneficiary of a qualified trust (QT) who is not the spouse or chronically ill/disabled	• Child of the IRA owner, or their QT, who has not surpassed age 21 • Individuals not more than 10 years younger, the same age, or older than the IRA owner • Individuals who are chronically ill/disabled • Primary beneficiary of a QT who is the surviving spouse or a chronically ill/disabled individual • Surviving spouse (S/S)

Distribution Options

The charts below outline the options for each beneficiary category. Some options depend on whether the IRA owner died before or on/after their required beginning date (RBD). The RBD is generally April 1 following the year the IRA owner reached their required minimum distribution (RMD) age:

- Age 75 (if born in 1960 or later)
- Age 73 (if born after 1950)
- Age 72 (if born after June 30, 1949)
- Age 70½ (if born before July 1, 1949)

If the IRA owner died before 2020, non-spouse or qualified trust beneficiary options are similar to those of an EDB. The exception is the 10-year rule, which applies to beneficiaries when the IRA owner died after 2019.

Beneficiary	Life Expectancy (LX)	5-Year Rule	10-Year Rule	10-Year Rule with RMDs	Lump-Sum	Disclaim
Eligible Designated Beneficiary						
Surviving Spouse						
Owner died **before** RBD	X		X		X	X
Owner died **on/after** RBD	X			X	X	X
Child of the IRA owner, or their qualified trust, who has not surpassed age 21. After age 21, RMDs are taken over a 10 year term.						
Owner died **before** RBD	X		X		X	X
Owner died **on/after** RBD	X			X	X	X
Chronically ill/disabled individuals						
Owner died **before** RBD	X		X		X	X
Owner died **on/after** RBD	X			X	X	X
Individuals not more than 10 years younger, the same age, or older than the IRA owner						
Owner died **before** RBD	X		X		X	X
Owner died **on/after** RBD	X			X	X	X

Beneficiary	Life Expectancy (LX)	5-Year Rule	10-Year Rule	10-Year Rule with RMDs	Lump-Sum	Disclaim
Eligible Designated Beneficiary						
QT[1] primary beneficiary is the spouse or chronically ill/disabled.						
Owner died **before** RBD	X		X		X	X[2]
Owner died **on/after** RBD	X			X	X	X[2]
QT[1] primary beneficiary is the child of the IRA owner who has not surpassed age 21. After age 21, RMDs are taken over a 10 year term.						
Owner died **before** RBD	X		X		X	X[2]
Owner died **on/after** RBD	X			X	X	X[2]
Designated Beneficiary						
Individual more than 10 years younger, not chronically ill/disabled, or a minor who is not the IRA owner's child.						
Owner died **before** RBD			X		X	X
Owner died **on/after** RBD				X	X	X
QT[1] primary beneficiary is not the spouse or chronically ill/disabled.						
Owner died **before** RBD			X		X	X
Owner died **on/after** RBD				X	X	X
Non-Designated Beneficiary						
Charity, estate, non-qualified trust						
Owner died **before** RBD		X			X	X[2]
Owner died **on/after** RBD	X[3]				X	X[2]

1. The duration an Inherited IRA can remain open depends on several factors, including the QT type (accumulation or conduit), the primary beneficiary, and the number of primary beneficiaries. It's essential for the trustee to consult with an attorney to understand the specific trust distribution options available.
2. In some instances an entity may be able to disclaim.
3. RMDs are based on the IRA owner's age as of their birthday in the year of death. The divisor is reduced by one in each subsequent year.

Distribution Rules

<u>10-Year Rule</u>

- An Inherited Traditional and/or Roth IRA must be emptied by the end of the 10th year following the year the IRA owner died. For example, if an IRA owner died in 2024, the beneficiary has until the end of 2034 to empty the Inherited IRA. An oversight a beneficiary may make is thinking 10 years ends on 2035 (2025 + 10). However, 2025 is year 1 and 2025 + 9 more years = 2034.
- An Inherited Traditional IRA will have RMDs if the IRA owner died on or after their RBD. These RMDs are calculated in the same manner as the life expectancy option. One difference is in year 10, the RMD is the account value.
- If the IRA owner died before their RBD, there are no RMDs during the 10 years. Roth IRA owners are always considered to have died before their RBD.
- A bigger concern than the need for RMDs is managing taxes. Even a modest account value has the potential to increase substantially over the 10 years. If the beneficiary doesn't take distributions, or only takes the RMD, that last amount could push them into a higher tax bracket. A better strategy would be to smooth distributions as illustrated in the hypothetical below for Natasha, a DB who inherits $100,000.
- **No distributions** - In this hypothetical example, Natasha takes no distributions, and the account grows at 8% for 10 years. In year 10, the Inherited IRA's value is $215,892. If she has no other income, she will be in the 32% tax bracket if filing single and 24% tax bracket if filing joint.

Year	Age	ROI	Earnings	LX	RMD	Account Balance
2025	50	8%	$8,000			$108,000
2026	51	8%	$8,640			$116,640
2027	52	8%	$9,331			$125,971
2028	53	8%	$10,078			$136,049
2029	54	8%	$10,884			$146,933
2030	55	8%	$11,755			$158,687
2031	56	8%	$12,695			$171,382
2032	57	8%	$13,711			$185,093
2033	58	8%	$14,807			$199,900
2034	59	8%	$15,992	1.0	$215,892	$0

10-Year Rule (continued)

- **Taking RMDs** - In this hypothetical example, Natasha takes RMDs, the account grows at 8%, and in year 10, the Inherited IRA's value is $165,736. If she has no other income, she will be in the 24% tax bracket if filing single and 22% tax bracket if filing joint.

Year	Age	ROI	Earnings	LX	RMD	Account Balance
2025	50	8%	$8,000	36.2	$2,763	$105,237
2026	51	8%	$8,419	35.2	$2,990	$110,666
2027	52	8%	$8,853	34.2	$3,236	$116,283
2028	53	8%	$9,303	33.2	$3,503	$122,082
2029	54	8%	$9,767	32.2	$3,792	$128,057
2030	55	8%	$10,245	31.2	$4,105	$134,197
2031	56	8%	$10,736	30.2	$4,444	$140,489
2032	57	8%	$11,239	29.2	$4,812	$146,916
2033	58	8%	$11,753	28.2	$5,210	$153,459
2034	59	8%	$12,277	1.0	$165,736	$0

- **Smoothing** ™,[4] - In this hypothetical example, Natasha smooths distributions, the account grows at 8%, and in year 10, the Inherited IRA's value is $26,512. If she has with no other income, she will be in the 12% tax bracket if filing either single or joint.

Year	Age	ROI	Earnings	LX	RMD	Account Balance
2025	50	8%	$8,000	10.0	$10,000	$98,000
2026	51	8%	$7,840	9.0	$10,889	$94,950
2027	52	8%	$7,596	8.0	$11,869	$90,677
2028	53	8%	$7,254	7.0	$12,954	$84,977
2029	54	8%	$6,798	6.0	$14,163	$77,612
2030	55	8%	$6,209	5.0	$15,523	$68,298
2031	56	8%	$5,464	4.0	$17,075	$56,687
2032	57	8%	$4,535	3.0	$18,896	$42,326
2033	58	8%	$3,386	2.0	$21,163	$24,548
2034	59	8%	$1,964	1.0	$26,512	$0

Life Expectancy

- This option is often referred to as the stretch IRA strategy[5]. To use this strategy, starting the year after the owner's death, the beneficiary takes annual RMDs from an Inherited Traditional and/or Roth IRA. The calculation uses a divisor from the Single Life Table, the IRA's prior year-end value, and the term certain calculation method. This method subtracts one from the original divisor in each subsequent year.
  - The divisor is based on the beneficiary's age, as of their birthday, in the year following the death of the owner.
  - A QT that inherited the IRA before 2020, uses a divisor based on the age of the oldest trust beneficiary.
    - However, if the IRA owner died on/after their RBD, is younger than the beneficiary, and their remaining Single Life Table divisor is longer than the beneficiary's, their divisor is used. The divisor is determined using the owner's age as of their birthday in the year of death, one is subtracted in each following year.
    - A minor child of the IRA owner takes RMDs up until age 21. The year after they turn 21, they will have 10 years, until age 31, to empty the Inherited IRA. RMDs continue during the 10 year term.

RMD Formulas

Non-spouse:		**Non-spouse older than IRA owner who died on/after RBD:**
$\dfrac{\text{Prior IRA Year-End Value}}{\text{(Beneficiary's Single Life Table divisor in year after owner's death – 1 in each following year)}}$	= RMD =	$\dfrac{\text{Prior IRA Year-End Value}}{\text{(Owner's Single Life Table divisor in year of death – 1 in each following year)}}$

- A surviving spouse uses the recalculation method, meaning a new divisor is used each year.
  - The S/S uses:
    - A Single Life Table divisor when their deceased spouse reached RMD Age before 2024
    - A Uniform Life Table divisor when their deceased spouse reached RMD Age on/after 2024

Life Expectancy (continued)

- When the IRA owner died on/after their RBD, is younger than the S/S, and the owner's divisor is longer than the S/S's, the deceased spouse's Single Life Table divisor is used with the term certain calculation method. The divisor is based on their age as of their birthday in the year of death, one is subtracted each following year.
- The S/S is required to start RMDs:
  - The year their deceased spouse would have reached RMD age or
  - The year after their deceased spouse died, if they died on/after reaching RMD age

RMD Formulas

Spouse:

$$\frac{\text{Prior IRA Year-End Value}}{\text{Spouse's Single Life or Uniform Table divisor}} = \text{RMD} = \frac{\text{Prior IRA Year-End Value}}{(\text{Owner's Single Life Table divisor in year of death} - 1 \text{ in each following year})}$$

S/S older than deceased spouse who died on/after RBD: (right-hand formula)

Rollover/Transfer to own IRA

- Only the spouse has this option. Once the assets are moved into the spouse's own IRA, the distribution rules as the IRA owner will apply.

5 Year Rule

- An Inherited Traditional and/or Roth IRA must be emptied by the end of the 5th year, following the year the IRA owner died. For example, if an IRA owner died in 2024, the beneficiary has until the end of 2029 to empty the Inherited IRA. An oversight a beneficiary may make is thinking 5 years ends on 2030 (2025 + 5). However, 2025 is year 1 and 2025 + 4 more years = 2029.

Lump-Sum

- A beneficiary can empty the IRA and will owe ordinary income tax on the taxable portion of the distribution. This may bump the beneficiary into a higher tax bracket.

Disclaim

- A beneficiary can refuse or disclaim all or some of the IRA they inherited, generally within nine months of the IRA owner's death. The beneficiary cannot determine who will inherit the amounts disclaimed. Instead, the IRA beneficiary form completed by the IRA owner will be followed. If there are no other named beneficiaries, the IRA custodial agreement defaults will be used.

Distribution Rules When Inheriting an Inherited IRA

A successor beneficiary is the individual or entity who inherits an already Inherited IRA. The Internal Revenue Code (IRC) no longer allows the successor to continue taking distributions over the original beneficiary's life expectancy. Instead, the distribution rules depend on if the original beneficiary was a DB or EDB.

DB Successor Beneficiary

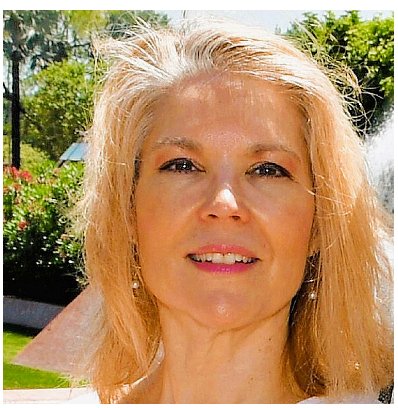
- A DB follows the 10 year rule. If they die before they end of the 10 years, the successor has the remainder of those years to empty the Inherited/Inherited IRA.
- RMDs are necessary if the IRA owner died on/after their RBD. RMDs are based on the original owner's date of death and the DB's Single Life Table divisor, obtained the year following the death of the owner, and the term certain calculation method. If the DB's divisor is less than 10 years: the account may be emptied sooner.

EDB Successor Beneficiary

- An EDB was able to use the stretch IRA strategy, but the successor cannot. Instead, their successor has 10 years to empty the Inherited/Inherited IRA. RMDs are taken during the 10 years. RMDs are calculated using the original IRA owner's date of death, the EDB's Single Life Table divisor, the IRA prior year-end value, and the term certain calculation method. The divisor was determined in the year after the death of the IRA owner. If the divisor is less than 10 years, the account may be emptied sooner.
- However, if the owner died on/after their RBD, is younger than the EDB and their remaining life expectancy is longer than the EDB's, their divisor is used. The divisor was determined in the year of the owner's death, and one is subtracted from it annually. If the divisor is less than 10 years, the account may be emptied sooner.

Break Analytics Can Help

Understandably, when you are inheriting an IRA, you are dealing with many issues. You have to make decisions that have tax and financial impacts, therefore it is important to learn the rules, so you make a choice that works for your situation. Be sure to speak with financial, tax, and legal professionals before completing any paperwork involved with claiming your inheritance and ask your advisor for a Break Analytics IRA Illustration.



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4. Smoothing ™ is an option available with Financial Cloud Works, LLC Break Analytics software.
5. The "stretch" IRA isn't a specific type of IRA, but a strategy to extend an IRA's benefits beyond the IRA owner's lifetime. This approach suits individuals who won't need these assets during retirement. When considering this strategy, evaluate potential changes in tax laws, inflation effects, and other risks. For detailed guidance, consult your tax advisor.