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Navigating Inherited IRA Rules as a Spouse

Inheriting your spouse's IRA involves many considerations and you may feel overwhelmed with the myriad of decisions you have to make in various aspects of your life. While this is a time of grief, it is crucial that you understand your options to make the best decision for your circumstances. Remember, once you take a distribution from the inherited IRA assets, you can roll it over to your own IRA within 60 days, provided you have not completed a 60 day rollover in the past 365 days. The laws regarding Inherited IRAs are complex. Understanding these rules can help you avoid common pitfalls and take full advantage of the available options.

Your Situation Determines Your Decision

When you inherit your spouse's IRA you will need to decide whether to open an Inherited IRA and move the assets to that account or transfer them to your own IRA. There are various reasons for either choice, but your age and need for distributions are two important deciding factors. You should also understand the tax consequences when taking a distribution. Navigating these decisions can be complex, but understanding your options and the associated tax implications can help you make the best choice for your circumstances.

Key Considerations

1. **Tax Consequences for Traditional IRAs**
   - Generally, distributions from a Traditional IRA are taxable. The amount is added to your other ordinary income and could put you in a higher tax bracket.
   - If there are after tax amounts, you will follow the pro-rata rule, meaning a portion of the distribution won't be taxable. Review your income tax forms to see if IRS Form 8606 was filed for your deceased spouse's IRA; 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 tax return to be certain.

2. Tax Consequences for Roth IRAs

- Roth IRAs are funded with after tax amounts, so only the earnings might be taxed if the Roth IRA was opened less than five years ago, and you take a distribution.
- If the Roth IRA you inherited was opened more than five years ago, the distributions from an Inherited Roth IRA are considered qualified and therefore are tax free.
- If you transfer the asset to your own Roth IRA, you can use longer of you or your spouse's five year holding term, but if you are not 59 ½ or older, the earnings will still be taxable.

3. Early or Pre-59 ½ Additional Tax

- 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 an Inherited IRA. 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.

Distribution Options

As an Eligible Designated Beneficiary (EDB), you have several distribution options. Making informed decisions during this challenging time can help you manage your financial future more effectively.

<u>Rollover/Transfer to Own IRA</u>

- Only a spouse has this option. This option continues the tax-advantaged growth potential and deferral of any taxes. Once the assets are moved into your own IRA, the distribution rules as the IRA owner will apply. This means you will not have required minimum distributions (RMDs) from a Traditional IRA until you reach RMD age. You have no RMDs from a Roth IRA as the owner.

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)

Establish an Inherited IRA

You might consider this option when you are under age 59 ½, because distributions from Inherited IRAs avoid the 10% additional tax. If you are younger than 59 ½ and move the assets into your own IRA, you would owe the 10% additional tax on a taxable distribution.

RMD Considerations

- If you are already RMD Age, and your spouse was not, you may use the Inherited IRA to avoid RMDs until your deceased spouse reached RMD Age.
- RMDs are not necessary from an Inherited IRA for a spouse until the year your spouse would attain RMD Age, had they lived.

You can move the assets from your Inherited IRA to your own IRA at any time and once you are 59 ½, you may be better off doing so.

Life Expectancy Option

- This option is often referred to as the stretch IRA strategy[1]. It allows the EDB to take RMDs using a life expectancy divisor, the IRA prior year-end value and a specific calculation method.
- Recalculation Method
    - Surviving Spouse (S/S) uses the recalculation method, meaning a new divisor is used each year.
        - A Single Life Table divisor is used when your deceased spouse reached RMD Age before 2024
        - A Uniform Life Table divisor is used when your deceased spouse reached RMD Age on/after 2024
- Term Certain Calculation Method
    - 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.

1. *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.*

- When RMDs Begin for the S/S:
  - The year your deceased spouse would have reached RMD age or
  - The year after your deceased spouse died, if they died on/after reaching RMD age

Spouse RMD:

$$\frac{\text{Prior IRA Year-End Value}}{\text{Single or Uniform Table Divisor}} = \text{RMD}$$

10-Year Rule

- 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, you will have until the end of 2034 to empty the Inherited IRA. An oversight you may make is thinking 10 years ends on 2035 (2025 + 10). However, 2025 is year 1 and 2025 + 9 more years = 2034.
- RMDs are necessary from an Inherited Traditional or Roth IRA if your spouse died on or after their RMD Age or beginning the year they would have reached RMD Age.

Lump-Sum

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

Disclaim

- You can refuse or disclaim all or some of the IRA inherited, generally within nine months of the IRA owner's death. You 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.

The chart below outlines the options for a surviving spouse. 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 RMD Age.

Spouse	Life Expectancy (LX)	10-Year Rule	10-Year Rule with RMDs	Lump-Sum	Disclaim
Owner died **before** RBD	X	X		X	X
Owner died **on/after** RBD	X		X	X	X

Common IRA Strategies

Roth IRA Conversion

You have the option to convert all or part of your spouse's Traditional IRA you inherit into a Roth IRA in your name. Once the assets are transferred, the standard Roth IRA rules will apply. Taxes on any taxable amount will be due in the year of the conversion, which may bump up your tax bracket. However, converting in the year of death, when you can still file jointly, might make this an attractive option. Be sure to speak with your tax advisor to ensure you have the means to cover these taxes, as the conversion cannot be undone or recharacterized once completed.

Updating Your Beneficiaries

Whether you choose to establish an Inherited IRA or transfer the assets into an IRA in your own name, it is crucial to name or update beneficiaries for these accounts as soon as possible. This ensures that your assets will be passed according to your wishes. Remember, beneficiary designations on IRAs take precedence over instructions made in a will or trust.

If your beneficiaries inherit your Inherited IRA, they are considered a "successor" beneficiary. It is important to note that the Internal Revenue Code (IRC) does not let your successor beneficiary use the stretch IRA strategy. Instead, they will follow the 10-Year Rule.

Completing a Qualified Disclaimer

You might consider disclaiming some or all the IRA to a younger beneficiary. For example, if you are a parent named as the primary beneficiary who does not need the money and your children are named as contingent beneficiaries, you might choose to disclaim all or a portion of the assets. This allows your children to inherit some assets upon your spouse's death, giving them an opportunity to better manage the distributions and taxes. If they inherit all the retirement assets after your death, the amount inherited could be larger, potentially resulting in higher taxes for them.

Essential Takeaways

When handling an IRA inherited from your spouse, remember these takeaways:

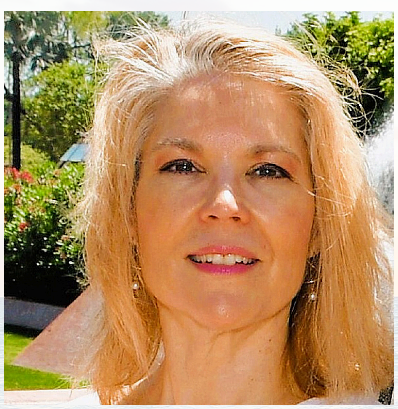
- Transferring Traditional or Roth IRA assets to your own Traditional or Roth IRA or to an Inherited Traditional or Roth IRA is not a taxable event.
- Converting Traditional IRA assets you inherit to your own Roth IRA is taxable event.
- You cannot convert an Inherited Traditional IRA to a Roth IRA or Inherited Roth IRA.

Essential Takeaways (continued)

- If your spouse had an RMD due that wasn't satisfied, you must take it by December 31 in the year of death.
  - You can satisfy the RMD from your own IRA or Inherited IRA.
  - If you are not 59 ½ or older, taking the distribution from your own IRA will trigger the 10% additional tax.
  - Taking the RMD from an Inherited IRA will not trigger the 10% additional tax.
- You may own a 25% excise tax for any RMD not satisfied in the year due. The excise tax may be reduced to 10% if satisfied timely.
- If you are not yet at RMD age, starting with an Inherited IRA gives you time to decide whether you will need distributions in the next few years or if you can wait until RMD age. Additionally, if your spouse was not at RMD age or would not reach RMD age while you hold the assets in an Inherited IRA, RMDs are not necessary.

Break Analytics Can Help

Inheriting an IRA from your spouse involves many considerations, including tax and financial impacts. It's crucial to understand the rules to make informed decisions that suit your situation. Be sure to consult with financial, tax, and legal professionals before completing any paperwork related to your inheritance and ask your advisor for a Break Analytics Inherited IRA Illustration.



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