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How to Manage an Inherited IRA

If you don't take inherited IRA distributions correctly, you could face large tax penalties.

By Brian O'Connell | Sept. 5, 2024

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The steps you must take after inheriting an IRA will vary depending on the account owner's age and the type of beneficiary you are.

Key Takeaways

- Beneficiaries must understand the IRS rules for inherited IRAs to avoid penalties and maximize tax efficiency.
- There are specific deadlines for taking required minimum distributions from inherited IRAs, and failure to comply can result in penalties.
- Beneficiaries may be subject to the 10-year rule, which requires that all assets in the inherited IRA be withdrawn within 10 years of the original owner's death.

Inheriting an individual retirement account can be a bittersweet experience. Although it's a loving gesture from the deceased to help fortify your retirement, the machinations of an inherited IRA tend to be more complicated than the average recipient may realize. Once you're able, sit down with a trusted financial professional who understands the rights and obligations that come with your new IRA.

It’s critical to thoroughly vet Internal Revenue Service rules on inherited IRAs, especially tax triggers and penalties. As you navigate the obligations of an inherited IRA, consider the following:

- What is an inherited IRA?
- Remember the first required minimum distribution.
- Understand the 10-year rule.
- Take action to minimize taxes.
- Label the account correctly.
- Consider separating accounts.

What Is an Inherited IRA?

An inherited IRA is an individual retirement account a beneficiary receives after the account owner's death. It's usually bequeathed to spouses, children, grandchildren or other family members.

“Retirement savers should know the specific distribution rules to avoid penalties and maximize tax efficiency,” said Stephen Kovach, chief executive officer at Global Advisors in Philadelphia, in an email.

Retirement savers should also know the beneficiary of the inherited IRA has to pay taxes on the IRA at the inheritor’s tax rate. “Typically, the inheritor's tax rate is much higher than the principal's,” said Kelsey Simasko, attorney at Simasko Law in Mount Clements, Michigan, in an email.

Remember the First Required Minimum Distribution

The first required minimum distribution must usually be taken by Dec. 31 of the year after the original owner’s death. “The amount depends on your life expectancy or the 10-year rule, which can be tricky, so double-check your calculations to avoid penalties,” said James Carlson, a financial planner at Carlson Planning Company in Mansfield, Massachusetts, in an email.

The steps you must take after inheriting an IRA will vary depending on the account owner's age and the type of beneficiary you are. “For instance, if the original account owner was in RMD status but hadn’t taken their annual withdrawal before death, then you could be at risk of a 25% penalty on the amount that should have been taken,” said Michael Unger, vice president of investment and planning at Coral Gables Trust in Miami, in an email. “However, there’s always the option of disclaiming or not accepting

the inherited retirement account. Disclaiming an IRA can be prudent if you are financially sound and would like to avoid the potential tax consequences of the additional income."

Understand the 10-Year Rule

Inherited IRA recipients should take time to understand the 10-year rule as it applies to account distributions.

"The 10-year rule for inherited IRAs requires that all assets in the account need to be withdrawn by the end of the 10th year after the original account owner's death," Unger said. "For example, if an IRA owner dies in September 2024, the beneficiary must deplete the account no later than Dec. 31, 2034."

The 10-year rule allows the beneficiary to take equal distributions to spread out the tax liability over 10 years. "Alternatively, you can take larger distributions in years when your income is lower to benefit from an overall lower tax," Unger added.

Some designated beneficiaries may be exempt from the 10-year rule. "This applies to surviving spouses or minor children, the chronically ill, disabled and people who are not more than 10 years younger than the deceased," Unger said. "This loophole permits these beneficiaries to extend the life of the tax-deferred benefit by spreading out distribution over their lifetime. As such, the assets continue their tax-deferred growth, and the beneficiary receives a lower total tax bill."

Take Action to Minimize Taxes

Annual required minimum distributions can leave inherited IRA investors with a hefty tax liability. But there can be a way out. Take these action steps to minimize taxes.

- **Think small**. If you inherit an IRA in 2024 and plan to retire in 2026, it's best to take smaller distributions until you are retired. "Once you retire and your tax rate drops due to the income loss, begin to take out more from the inherited IRA," Simasko said. "It may even be worth it to retire a few years earlier than you planned."
- **Consider qualified charitable distributions.** "Qualified charitable distributions can be utilized to reduce the tax liability of an RMD," Unger said. "QCDs allow individuals who are 70 1/2 years old or older to donate up to $105,000 total to one or more charities directly from a taxable IRA." For married couples, each spouse can make QCDs up to $210,000. "Since these donations are excluded from your taxable income, QCDs are an incredible strategy to lower your tax bill, avoid Medicare premium surcharges and prevent phaseouts of other tax deductions," Unger noted.
- **Aim for low-income years**. Cut your inherited IRA tax bill by withdrawing the bulk of the funds during a low-earning working year. "If you have some years of

> lower income, plan to take the distributions in those years," said Leah Coleman, a certified financial planner and founder of Orchard Financial Group in Austin, Texas, in an email. "For example, if you were going to retire in five years, wait to start distributing from the account until you are retired. This gives you five years to distribute the account at a potentially lower tax bracket."

Label the Account Correctly

Inherited IRA recipients should verify that their IRA paperwork is correct and easily understood. "Make sure the account is labeled as an inherited IRA with the deceased person's name and your name as the beneficiary," Carlson advises. "This ensures that you follow the correct rules for distributions."

It's also a good idea to list all beneficiaries on the account. "That ensures the account will avoid probate court if the owner passes away," Simasko said.

Additionally, you can move the money from an inherited IRA to a new financial institution without incurring taxes or penalties. If you make a trustee-to-trustee transfer into another IRA setup, it must be maintained in the name of the deceased IRA owner to benefit the beneficiary. Distributions from the new IRA must adhere to the same beneficiary distribution rules as under the old IRA.

Consider Separating Accounts

If multiple beneficiaries inherit an IRA, it's often a good idea to split it into separate accounts. "This way, each beneficiary can manage their own distributions according to their financial needs and the required rules," Carlson said.

Separate accounts can be especially beneficial if one or more beneficiaries qualify for an exception to the 10-year withdrawal rule.