

What are my options if I inherit an IRA or benefit from an employer-sponsored plan?

Answer:

If you don't want the money, you can always disclaim (refuse to accept) the inherited IRA or plan funds. But if you're like most people, you will want the money. Your first thought may be to take a lump-sum distribution, but that's usually not the best idea. Although a lump sum provides you with cash to meet expenses or invest elsewhere, it can also result in a huge income tax bill (in most cases, due all in one year). A lump-sum distribution also removes the funds from a tax-deferred environment. Fortunately, you probably have other alternatives.

If you are the designated beneficiary (i.e., you are named as beneficiary in the IRA or plan documents), you can take post-death distributions over your remaining life expectancy, spreading out distributions over a number of years. This life expectancy calculation will give you the minimum amount you must withdraw from the IRA or plan each year (you can always withdraw more than required in any year). Yearly distributions from the IRA or plan must begin by December 31 of the year following the year of the owner's or participant's death. If there are other designated beneficiaries and separate accounts have not been set up, the oldest beneficiary must be used for the life expectancy calculation.

You may have other options as well. If the IRA owner or plan participant died before he or she began taking required minimum distributions, you can generally elect to distribute the entire interest in the IRA or plan within five years of the owner's or participant's death. (In this case, you don't have to begin taking distributions the year after death.) If the IRA owner or plan participant died after beginning to take required minimum distributions, you may be able to spread distributions over the owner's or participant's remaining life expectancy (calculated in the year of death) if that period is longer than your own life expectancy. Be careful, though. An employer-sponsored retirement plan can specify the distribution method that beneficiaries must use. If your choices are limited by a plan, however, you may have the ability to transfer the plan funds to an IRA established in the deceased IRA owner's or plan participant's name--the rules that apply to inherited IRAs would apply to the transferred funds.

You may also have additional options if you are a surviving spouse and a designated beneficiary of the IRA or plan. You can roll over inherited traditional IRA or plan funds into your own traditional IRA or retirement plan. If you're the sole beneficiary you can also leave the funds in an inherited traditional IRA and treat it as your own traditional IRA. In either case you can then name beneficiaries of your choice and defer taking distributions until the required age (usually 70½). Certain restrictions apply, however. For example, you cannot roll over required minimum distribution amounts (i.e., distributions required in the year of death). Consult a tax advisor for more information.

Finally, Roth IRAs are subject to different rules. If you inherit a Roth IRA, you can take distributions over a five-year period (following the Roth IRA owner's death) or over your remaining life expectancy. If you are a surviving spouse beneficiary, you may be able roll the assets over to your own Roth IRA or, if you're the sole beneficiary, treat the Roth IRA as your own. This is significant because, as a Roth IRA owner, you do not have to take any distributions from the Roth IRA during your life. Distributions from an inherited Roth IRA are usually free from income tax if made at least five years after the first contribution to the Roth IRA.