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The IRA Digest

Retirement Account Strategies and Tips

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3 Tax Saving Moves for Spouse Beneficiaries of IRAs

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Spouse beneficiaries can save on taxes by electing the 'right' distribution option for IRAs they inherit.

The elections you make for IRAs that you inherit could determine the amount of income tax you owe on distributions and the extent to which you continue to benefit from tax-deferred growth. If the IRA was inherited from your spouse, your choices are more varied than those available to other beneficiaries, and your elections are even impactful. In some cases, elections are irrevocable, making it crucial to get it right the first time. Due to the highly technical nature of the applicable rules, careful research and partnering with an advisor who understands how IRAs work is often necessary for ensuring that the correct elections are made.

First Things First: Your Options as a Spouse Beneficiary
If you inherit an IRA from your spouse, you have two options for taking distributions from that IRA. You can move the inherited IRA to your own IRA and take distributions based on your status as an *owner*. Or, you can keep it in a Beneficiary IRA (Inherited IRA) and take distributions based on your status as a *beneficiary*.

1) ***If you move the assets to your own IRA***: In this case, the distribution rules would be the same as those that apply to IRAs that you fund yourself. Under these rules, the following would apply:
    a. Distributions are optional until you reach age 72.
    b. Distributions that you take before reaching ag 59-½ are subject to a 10% additional tax (early distribution penalty) unless you qualify for an exception. And,
    c. You must begin taking required minimum distributions (RMDs) the year you reach age 72. These RMDs would be calculated based on your joint life expectancy, which uses your age and a beneficiary who is assumed to be two years younger than you. If your spouse is the sole primary beneficiary and more than ten years younger than you, you would be eligible to use your spouse's actual age, which would produce a lower RMD.

2) If you keep the assets in an Inherited IRA: If the IRA owner died before the required beginning date (RBD)*, distributions may be taken over your single life expectancy. These life expectancy distributions must begin by the later of December 31 of the year that follows the year of the owner's death or December 31 of the year of the owner's 72^{nd} birthday. Your Inherited IRA could also be subject to the 5-year rule, but that option would be impractical for the purposes of minimizing income tax and maximizing tax-deferred growth.

**The RBD, which is April 1 of the year that follows the year of the IRA owner's 72nd birthday, is the date that the IRA owner is supposed to start taking RMDs if he or she lives to that date.*

If the IRA owner died on or after the RBD and has a longer life expectancy than yours, then his/her life expectancy would be used to calculate your distributions. Otherwise, your life expectancy would be used. In either case, these life expectancy distributions must begin by December 31 of the year that follows the year of the owner's death. This rule does not apply to Roth IRAs, as there is no RMD for Roth IRA owners and therefore no RBD.

The 10-year rule might also be an option in certain cases. Under the 10-year rule, distributions are optional until December 31 of the 10th year that follows the year in which the owner died, at which time the entire balance must be withdrawn.

If you have questions about your options, please contact us. In the meantime, the following are some guidelines that could help to reduce any income tax that might be owed.

1. **Avoiding the 10 Percent Early Distribution Penalty**

   Distributions taken from your IRA before you reach age 59 ½ are subject to a 10% additional tax (early distribution penalty) unless you qualify for an exception. One of the exceptions is a 'death' distribution. All distributions from Inherited IRAs are death distributions.

   An Inherited IRA must be registered in the names of you and your deceased spouse and under your social security number. In addition, it must be set up to ensure that all distributions from the account are reported to the IRS as 'death' distributions.

   If you want to benefit from the death distribution exception, you must let the custodian of the IRA know that the IRA you inherit must be kept in an Inherited IRA. Any amount moved to your own IRA instead of an Inherited IRA would no longer qualify for the death exception.

2. **Putting Off Distributions as Long as Possible When Owner Died Young**

   The primary reason to keep assets in an IRA is to benefit from tax-deferred growth of earnings. Beneficiaries may continue benefiting from this feature for IRAs that they inherit by taking only RMDs each year. If you keep an IRA that you inherit from your spouse in an Inherited IRA and he or she died before reaching age 72 (age 70-½ if inherited before 2020), you would not be required to start taking RMDs until the year he or she would have reached age 72. Keeping the assets in an Inherited IRA would allow the entire inherited balance to continue growing tax-deferred until then while still allowing you to take penalty-free distributions if needed (see **Number 1** above).

   Example 1: 57-year-old Nia inherited a traditional IRA from her husband Paul, who died in 2021 at age 64. The IRA balance is $500,000. Nia elects to keep the assets in an Inherited IRA. Because Paul died before reaching age 72, Nia has until 2029- which is when Paul would have reached age 72- before she must begin taking RMDs. She can take distributions before then if she wants to. If she does, the amount would not be subject to the 10 percent early distribution penalty. If Nia does not take distributions before she is required to, the entire $500,000 can continue to grow tax-deferred. Assuming a conservative rate of interest of 5%, Nia's inherited IRA would grow to over $700,000 in 2029.

3. **Switching from Inherited IRA to Own IRA to Reduce Distributions**

   Moving the inherited IRA to your own IRA can help to reduce the amount of distribution that you need to take. If you elected to keep the assets in an Inherited IRA, moving it to your own IRA should be done at the time you would be required to take beneficiary RMDs based on your single life expectancy. This could defer your RMDs longer as well as reduce them.

Example 2: Using the facts from **Example 1** above, NIA would be required to start taking beneficiary RMDs over her single life expectancy in 2029, when her RMD would be $32,259. But, if she moves the amount to her own IRA in 2029, she would not need to start taking RMDs until 2036, when she would be age 72.

Example 3: 63-year-old Tom inherited a Traditional IRA from his spouse Janet, who died in 2021 at age 63. The IRA balance is $500,000. If Tom keeps the assets in an Inherited IRA, he would need to begin RMDs in 2030, when Janet would have reached age 72. In this case, his 2030 RMD would be $45,097.

If Tom moves the assets to his own IRA in 2030, he would still need to start taking RMDs in 2030. However, in this case, his RMDs would be calculated based on him being the owner, which would reduce his RMD to $28,309.

Contact Us for a Beneficiary Options Analysis

Minimization of income tax and maximization of tax-deferred growth are the two efficient distribution planning strategies for inherited IRAs. For Roth IRAs, strategies must be applied to ensure that all distributions are tax-free. These rules might also apply to assets inherited under an employer-sponsored retirement plan, such as a 401(k) 403(b) or pension plan.

These are only a few of the factors that should be included in a beneficiary options analysis. If you inherited an IRA or other retirement account, please contact us for assistance with determining which option is most suitable for you. Making the wrong move might be an unfixable mistake. As such, we recommend that you contact us before making any elections or requesting any transactions from any retirement account that you inherit.