BENJAMIN F. EDWARDS®
INVESTMENTS for GENERATIONS®

Beneficiary Options After Inheriting a Retirement Account

Inheriting Retirement Accounts Can be Confusing

When a loved one dies, there seem to be a million decisions that must be made. Some of those are financial decisions that may require your attention. When a retirement account, such as an IRA or 401(k) are part of your deceased loved one's financial assets, you may have to act quickly to take care of what the IRS refers to as required minimum distributions (RMDs).

RMDs Apply to Many Types of Retirement Accounts

RMDs are annual withdrawals that are required from certain types of retirement accounts once the account owner reaches age 73, or in some cases, after you inherit them. RMDs are generally subject to income taxes and the Internal Revenue Service (IRS) imposes a 25% tax penalty if required amounts are not distributed[1]. RMDs apply to the following types of retirement accounts:

- Traditional IRAs, SEP IRAs, and SIMPLE IRAs
- Qualified employer-sponsored retirement plans – such as 401(k), profit sharing, money purchase pension, and defined benefit pension plans
- Certain other tax-deferred retirement accounts – such as 403(b) and governmental 457(b) plans
- Roth IRAs – after the death of the account owner

[1]The 25% tax penalty can be reduced to 10% if the shortfall is corrected within two years.

When Must Distributions Begin?

If you are a beneficiary that inherited a retirement account, you may be required to take a RMD in the year the account owner died. If the owner of the account died after his or her required beginning date, and the amount required for the year was not distributed to the owner prior to his or her death, then the beneficiary or beneficiaries that inherit the retirement account must receive any remaining RMD before the end of the year of death.

Otherwise, when you are required to take your first distribution will depend on your relationship to the account owner, their required beginning date, and whether an exception to the 10-year rule applies to your situation.

Required Beginning Date

Required beginning date is generally April 1st of the year following the year in which the account owner turned age 73.

In some cases, if the account owner was still working, the required beginning date can be delayed from their employer's retirement plan until after retirement (but not for IRAs or retirement plans with former employers). The employer's plan administrator can confirm for you if the decedent was required to take distributions or if they had not yet reached their required beginning date at the time of death.

Non-Spouse Beneficiaries and the 10-Year Rule

If you are not the surviving spouse, distributions will generally have to be made from the inherited retirement account over 10 years.

Exception for Eligible Non-Spouse Beneficiaries

"Eligible" non-spouse beneficiaries may instead choose to begin taking required minimum distributions over their own life expectancy beginning no later than December 31st of the year following the year of death. Eligible non-spouse beneficiaries include:

- a minor child of the retirement account owner,
- a chronically ill individual,
- a disabled individual, or
- an individual who is not more than 10 years younger than the retirement account owner.

If the life expectancy option is elected, then annual distributions would be required to avoid the IRS 25% penalty. Also, keep in mind that once a child is age 21, they must switch to the "10-year rule".

Surviving Spouse

A surviving spouse may also elect to take life expectancy distributions from an inherited retirement account, however, RMDs are not required until the decedent would have been required to begin distributions. In addition, a surviving spouse can roll over or treat the retirement account as his or her own and delay the start of RMDs until the surviving spouse's own required beginning date.

Charities, Estates and Non-Qualified Trust Beneficiaries

If the beneficiary is a charity, estate, or non-qualified trust, a 5-year rule applies.

Special Rules for Non-Spouse Beneficiaries Who Inherited Retirement Accounts Prior to 2020

Non-spouse beneficiaries that inherited retirement accounts from account owners that died prior to 2020, were generally able to distribute inherited retirement accounts over their own single life expectancy and were not limited to the 10-year rule. Sometimes referred to as "stretch IRAs" for their ability to stretch-out distributions over the beneficiary's life expectancy, they continue to be available to beneficiaries if the account owner died in 2019 or a prior year. However, in the future when the current beneficiary dies, successor beneficiaries will generally need to distribute over the 10-year rule.

How Much Must Be Distributed Each Year?

10-Year Rule

When using the 10-year rule, the primary requirement is that the account balance be zero by the end of the 10th year. Treasury regulations proposed in early 2022 require annual distributions following the account owner's death in some circumstances, but not in others. Keep in mind that because distributions are generally included in your taxable income for the year and penalties can apply if required distributions are not taken, you should discuss your situation and strategy with your tax professional.

5-Year Rule

Similar to the 10-year rule, the 5-year rule requires certain entities that are named as beneficiaries of a retirement account, such as a charity, estate, or non-qualified trust, to distribute the entire retirement account balance by the end of the 5th year following the year of death.

Life Expectancy Distributions (RMDs)

The annual amount of an RMD is determined by dividing the prior year-end account balance by the appropriate life expectancy factor.

The IRS Single Life Expectancy Table is generally used to calculate RMD amounts for eligible designated beneficiaries of inherited retirement accounts. Unlike lifetime RMDs for the account owner, a beneficiary's life expectancy is generally determined once, beginning in the year following the year of death.[2]

In subsequent years, you reduce the beneficiary's original life expectancy by one for each year that passes. This is referred to as the "term-certain" or "declining years" method. For example, if a beneficiary will be age 50 by the end of the calendar year following the year of the account owner's death, the first RMD would be based on the single life expectancy of a 50-year-old (36.2 years) even if the beneficiary is currently 49 years old. The next year, the beneficiary's RMD would be determined using a life expectancy factor of 35.2 years (36.2 - 1). The following year 34.2 (35.2-1), and so on.

The chart below is the IRS single life expectancy table used for eligible designated beneficiaries of inherited retirement accounts:

[2] A surviving spouse also has the option to recalculate his or her life expectancy each year. The life expectancy of a deceased account owner can also be used if the account owner died after required beginning date and the beneficiary is older than the decedent.

Single Life Expectancy Table – For Use by Eligible Designated Beneficiaries							
Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy
0	84.6	30	55.3	60	27.1	90	**5.7**
1	83.7	31	54.4	61	26.2	91	**5.3**
2	82.8	32	53.4	62	25.4	92	**4.9**
3	81.8	33	52.5	63	24.5	93	**4.6**
4	80.8	34	51.5	64	23.7	94	**4.3**
5	79.8	35	50.5	65	22.9	95	**4.0**
6	78.8	36	49.6	66	22.0	96	**3.7**
7	77.9	37	48.6	67	21.2	97	**3.4**
8	76.9	38	47.7	68	20.4	98	**3.2**
9	75.9	39	46.7	69	19.6	99	**3.0**
10	74.9	40	45.7	70	18.8	100	**2.8**
11	73.9	41	44.8	71	18.0	101	**2.6**
12	72.9	42	43.8	72	17.2	102	**2.5**
13	71.9	43	42.9	73	16.4	103	**2.3**
14	70.9	44	41.9	74	15.6	104	**2.2**
15	69.9	45	41.0	75	14.8	105	**2.1**
16	69.0	46	40.0	76	14.1	106	**2.1**
17	68.0	47	39.0	77	13.3	107	**2.1**
18	67.0	48	38.1	78	12.6	108	**2.0**
19	66.0	49	37.1	79	11.9	109	**2.0**
20	65.0	50	36.2	80	11.2	110	**2.0**
21	64.1	51	35.3	81	10.5	111	**2.0**
22	63.1	52	34.3	82	9.9	112	**2.0**
23	62.1	53	33.4	83	9.3	113	**1.9**
24	61.1	54	32.5	84	8.7	114	**1.9**
25	60.2	55	31.6	85	8.1	115	**1.8**
26	59.2	56	30.6	86	7.6	116	**1.8**
27	58.2	57	29.8	87	7.1	117	**1.6**
28	57.3	58	28.9	88	6.6	118	**1.4**
29	56.3	59	28.0	89	6.1	119	**1.1**
						120+	**1.0**

Planning Tip

Regulations permit certain trusts that are "qualified trusts" to be treated as though the beneficiary of the trust is the designated beneficiary of the IRA. For a trust to be a qualified trust it must be valid under state law, irrevocable or become irrevocable upon death, the beneficiaries of the trust must be identifiable, and documentation identifying the designated beneficiary must be provided to the IRA trustee or custodian by October 31 of the year following the year of death. Consult with your legal advisor to ensure your trust meets all the requirements before naming a trust as the beneficiary of your retirement account.

For a Surviving Spouse – Rollover or Inherited IRA?

Since a surviving spouse has more than one way to keep retirement account assets tax-deferred after the account owner dies, it's important to understand the difference between choosing to treat the retirement account as your own (by rolling over into an IRA in your own name) and choosing to establish an inherited IRA (moving the assets into an account in both the deceased account owner's name and your own name as beneficiary).

Spouse Rolls to Own IRA

When a surviving spouse rolls over the retirement account assets into an IRA of their own:

- RMDs don't begin until the surviving spouse reaches age 73.
- Withdrawals may begin at any time, but distributions prior to age 59 ½ may be subject to a 10% early withdrawal penalty unless certain exceptions apply.
- RMDs are made using the Uniform Lifetime Table, which is a joint life expectancy factor, so RMDs may be less than if you received them from an inherited IRA.
- Additional contributions can be made to the account if the surviving spouse has earned income.
- It allows consolidation into one IRA if the surviving spouse is inheriting multiple retirement accounts from the decedent or has other IRAs of their own.

Surviving Spouse Establishes Inherited IRA

When a surviving spouse opens an inherited IRA:

- RMDs must begin if the deceased spouse was taking RMDs at the time of death or when the deceased spouse would have been required to begin RMDs at age 73 – whether income is needed or not.
- RMDs use the surviving spouse's single life expectancy, which will generally require larger distributions than if rolled over to their own IRA.
- The 10% early withdrawal penalty does NOT apply regardless of the age of the surviving spouse.
- No contributions or rollovers may be made to the inherited IRA.

Which Approach Should a Surviving Spouse Use?

An inherited IRA may be more appropriate than a rollover IRA if the surviving spouse if younger than age 59 ½ and income is needed from the inherited retirement account to meet expenses. It may also be appropriate if the surviving spouse is considerably older than the decedent and the decedent died before his or her required beginning date. In that situation, RMDs can be delayed until the deceased spouse's required beginning date.

Are Beneficiary Distributions Taxable?

Distributions to a beneficiary from an inherited retirement account may be taxable depending on the type of retirement account they inherit and the nature or source of the contributions that were made to the account. Distributions are reported on IRS Form 1099-R each January for distributions made in the prior tax year.

Traditional IRAs and Employer-Sponsored Retirement Plans

Distributions paid from inherited retirement accounts are generally taxed as ordinary income. Special rules apply to determine the taxation of after-tax contributions distributed, if any were made to the account.

Roth IRAs and Designated Roth Accounts

Distributions paid from inherited Roth IRAs and designated Roth accounts in a 401(k), 403(b) or governmental 457(b) plans are generally income tax free to the beneficiaries that inherit them. Special rules apply to Roth IRAs if the deceased account owner did not have the account for at least five years at the time of their death, which can make a portion of the payments taxable to beneficiaries.

Keep in mind that retirement accounts may also be included in the estate of the decedent and payments from them may be treated as "income in respect of a decedent" (IRD). The tax rules for estates and IRD are complex and you should consult with your tax or legal advisor to see how these rules will apply to you.

IRS Penalties and Successor Beneficiaries

IRS Penalties

With an inherited IRA, beneficiaries receiving distributions avoid the 10% early withdrawal penalty even if they are younger than age 59 ½. In addition, for those eligible designated beneficiaries receiving life expectancy payments, keep in mind there may be a 25% IRS penalty for failure to take the annual amount required.

Successor Beneficiaries

You also may designate beneficiaries on an inherited retirement account. Any balance remaining after your death may continue to be paid out to your successor beneficiaries. Successor beneficiaries generally must distribute over the shorter of your remaining life expectancy or 10 years.

Does Each Retirement Account Require a Separate Distribution?

Distributions required for inherited retirement accounts cannot be taken from non-inherited retirement accounts and vice versa. For example, if you inherited an IRA from your brother and have your own IRA, you cannot take the distribution from one account to satisfy the required distribution from the other. You must take a separate distribution from each account.

However, if you have more than one inherited IRA from the same decedent at multiple financial institutions, you can aggregate and take the total required from one or more of the inherited accounts. The inherited IRAs must be from the same decedent and for the same beneficiary. For example, if you inherited two IRA accounts from your brother and you have a $5,000 RMD from one account and a $7,000 RMD from the other, you can aggregate and take the $12,000 required from either account. But if you have one inherited IRA from your brother and one from your sister, you cannot take a distribution from one to satisfy the other.

Need Help?

To avoid costly mistakes with the retirement account you inherit, talk with your tax and financial advisors to discuss a plan for how and when to distribute them. Your financial advisor can help you understand your alternatives and work with your tax advisor to create a strategy that works best for you and your individual situation. ■

IMPORTANT DISCLOSURES The information provided is based on internal and external sources that are considered reliable; however, the accuracy of this information is not guaranteed. This piece is intended to provide accurate information regarding the subject matter discussed. It is made available with the understanding that Benjamin F. Edwards is not engaged in rendering legal, accounting or tax preparation services. Specific questions on taxes or legal matters as they relate to your individual situation should be directed to your tax or legal professional. In providing this information to you, neither Benjamin F. Edwards nor our financial advisor, is acting as a "fiduciary" under the Employee Retirement Income Security Act of 1974 (ERISA) and it should not be considered individualized investment advice or an investment recommendation.