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The Hazards of Inheriting an IRA

Retirement accounts require their own beneficiary forms. Here's what you need to know.

Families are increasingly getting large chunks of their inheritances in individual retirement accounts. Some of them are finding themselves mired in messes caused by missing beneficiary forms.

Retirement accounts generally require their owners to fill out specific forms naming beneficiaries, separate from wills. When the owner dies, the designated beneficiary—if there is one—can choose to stretch those distributions across his life expectancy, giving the remaining assets more time to grow. No taxes are due until withdrawals are made.

How do you figure out how much you are supposed to take out? The calculation is different from the way retirees figure out how much they have to take from their own accounts.

If you are a nonspouse beneficiary, look up your life expectancy on the single-life table in IRS Publication 590. Subtract one year from your initial life expectancy to figure out how much to withdraw each year.

So, for example, if your life expectancy the first year is 20 and you inherit an IRA worth $100,000, you would withdraw $5,000. The next year, you would divide the balance by 19, and so forth. Most IRA custodians will calculate that withdrawal amount for you. But you need to make sure they are using the table and math for an inherited account.

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Since Traditional IRAs can have both pre-tax and post-tax contributions keep good records. If necessary, file Form 8606 to account for post-tax contributions. The useful information on Form 8606 could prevent you and your beneficiaries from unnecessarily paying taxes on withdrawals.

Once assets reside in a Roth IRA, either through contributions or conversions, they are exempt from federal and state income taxes. The original Roth IRA owner and their spouse beneficiary are exempt from required minimum distributions (RMDs). Non-spouse beneficiaries of the Inherited Roth IRA are subject to RMDs. Fortunately, withdrawals from both Roth IRAs and Inherited Roth IRAs are exempt from federal and state income taxes.

Investors seeking a stream of tax free retirement income should consider:
1. Contributing to a Roth IRA
2. Contributing to a Roth 401(k), 403(b) and/or Roth 457(b)
3. Converting a: 401(k) to a Roth 401(k), 403(b) to a Roth 403(b) and/or 457(b) to a Roth 457(b)

Congress has loosened in-plan conversion rules for Roth 401(k), Roth 403(b) and Roth 457(b) accounts. Roth retirement plan assets can be converted to Roth IRAs.

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