Avoiding the IRA-Mageddon of Inheriting a Retirement Account

Last month we discussed the importance of proper beneficiary designation on a retirement plan or Individual Retirement Account (IRA). In many cases, a retirement plan may represent the largest single form of inherited assets a person may receive, short of life insurance proceeds or a home. Financial planning with regards to inheriting retirement account assets is important because it involves income planning as well as taxes.

A person inheriting a retirement plan from a non-spouse must take care to properly handle these assets. The failure to do so could result in significant taxes, and perhaps some penalties. What dictates these are certain crucial dates.

For example, if the original IRA owner was over the age of 70 ½ at the time of their death, they likely had begun receiving required minimum distributions (RMDs). An RMD must be taken by April 1st of the year after the IRA owner turns 70 ½. This is known as the Required Beginning Date.

If a deceased IRA owner had begun receiving his or her Required Minimum Distributions, the non-spouse beneficiary must receive distributions at least as rapidly as the original account owner had prior to their death. This limits the options available because the non-spouse beneficiary in this case cannot lengthen the distribution schedule.

If the original account owner died before the Required Beginning Date, the non-spouse beneficiary has several more options to choose from. The beneficiary must choose one of two methods to receive their distributions. The first is to withdraw the entire balance no later than December 31st of the fifth year after the IRA owner's death. This is known as the Five-Year Rule.

There is one exception to the Five-Year Rule for the Non-spouse beneficiary, and it is a good option for a person who does not need the income or the tax consequence of liquidating the entire account balance within a short time period. The beneficiary may elect to receive distributions over a period not exceeding their individual life expectancy, as calculated by IRS tables. If this method of receiving distributions is elected, it is imperative that the individual receive the initial distribution by December 31 of the year following the original account owner's death. Otherwise, the Five-Year Rule automatically triggers and the account must be liquidated before the end of the fifth year, as described above. There is no grace period or forgiveness by the IRS on this subject. In other words, if you snooze, you lose. This life expectancy option may be important if there is a sizable retirement account in question.

Regardless which method is chosen, the non-spouse beneficiary must roll the inherited IRA over to a special IRA account known as a Beneficiary IRA or Inherited IRA. These funds may not be co-mingled with the beneficiary's own IRA or retirement funds, and the beneficiary is not allowed to make any retirement contributions to this Beneficiary IRA.

Keep in mind that any funds withdrawn from an inherited IRA are taxable to the beneficiary at their own tax rate, however there are no penalties for withdrawing prior to age 59 ½ as there would be for an individual IRA or retirement plan.

If you know that you are the beneficiary of a non-spouse's retirement account, or if you learn that you are after the death of a non-spouse family member or friend, you owe it to yourself to seek professional advice immediately. There are many costly considerations to evaluate and the clock starts running immediately after the death of the original account owner.

Gary W. Beard, CLU, ChFC, is the owner of Beard Financial Group, and is a local, independent financial advisor and planner and has over 37 years experience in the financial community. Mailing address 370 N. East Camano Dr. #149, Camano Island, WA 98282. (360) 387-2372 (866) 217-3350. Securities offered through KMS Financial Services, Inc., Seattle WA