IRA Rules for Spouses

Understand the IRA inheritance rules to avoid paying higher taxes or forfeiting growth

If you are the spouse of an IRA owner who has named you as his or her beneficiary, it's critical that you—and the owner of the IRA—understand the rules that govern IRA inheritances.

"While the rationale behind the creation of IRAs was quite simple, the rules for inheriting and distributing assets upon the death of an IRA owner have become anything but," says Ken Hevert, vice president of retirement products at Fidelity. "If IRA owners and their beneficiaries are not careful, they could end up paying higher taxes or penalties and forfeiting the opportunity for future tax-advantaged growth."

Here is what you need to know about inheriting IRA assets as a spouse.

There are two important ages to keep in mind as you consider your options: 70½ and 59½. The IRS requires IRA owners to start taking minimum required distributions (MRDs) starting the year in which they turn 70½.[1] This rule also applies to withdrawals from an IRA you inherited from your spouse, depending on the withdrawal method a spouse chooses to employ. In addition, distributions taken prior to age 59½ (either by the IRA owner or the inheritor) could be subject to a 10% early withdrawal penalty, depending on where the assets are being withdrawn from—your own IRA or an inherited IRA.

Your ultimate course of action will be determined by your age, the age of your spouse, your income needs, the timing of your need for income from your inherited IRA assets, and the type of IRA you inherit. If you are the spouse of an IRA owner, you generally have four options from which to choose:

1. Roll over the assets into a new or existing IRA in your own name.

As a surviving spouse, you have one option that nobody else has: rolling over inherited IRA assets into your own IRA and treating these assets as if they were your own. This may be a good choice if you don't have an immediate need for your spouse's IRA assets and you are looking to keep the money in a tax-advantaged account for as long as possible. If you have not reached age 70½ but your spouse had, this option enables you to delay taking distributions until you reach age 70½, rather than continuing your spouse's MRDs.

If you are under age 59½ and you do need to access some or all of the assets you inherit from a traditional IRA, you will be subject to a 10% early withdrawal penalty if you roll those assets into your own IRA and then take a distribution. If you find yourself in this situation, you can take withdrawals penalty free, even if you're under 59½, if you instead transfer the assets to an inherited IRA, also known as an IRA beneficiary distribution account (see option 2, below).

No matter which option you choose, the rules for MRDs will still apply. This means you must withdraw a certain amount of money from your IRA, including inherited assets, each year once you reach age 70½.

Keep in mind that if your spouse was age 70½ or older at the time of death, you will need to determine whether he or she met the MRD for the year in which he or she passed away. If your spouse did not meet the MRD, you must take an MRD for that calendar year by December 31. However, this distribution must be reported under your Social Security number, not your spouse's. The year of death MRD will be calculated using your spouse's age and life expectancy. If you fail to meet the December 31 deadline, you may be subject to an IRS penalty equal to 50% of the amount not withdrawn. For deaths that occur late in the year, consider filing IRS Form 5329 with a letter of explanation to request a waiver of the penalty.

Distributions from a traditional IRA will be taxed as ordinary income. However, if the original account was a Roth IRA and the assets were in the account for five years or more, distributions may be tax free. In either case, the registration type of both IRAs must match in order to transfer the assets from one account to another (e.g., traditional IRA to traditional IRA or Roth IRA to Roth IRA). If the assets were not in a deceased spouse's Roth IRA for more than five years, it would be best to consult a tax adviser regarding how withdrawals may be taxed, and whether or not it's best to roll them into your own Roth IRA or keep them separate in an inherited Roth IRA.

2. Transfer the assets to an inherited IRA.

Transferring assets to an inherited IRA may make the most sense if you are under age 59½ and need to access some or all of your spouse's IRA assets now, or before you attain the age of 59½. Why? Because you won't be subject to a 10% penalty when you take withdrawals from an inherited IRA prior to age 59½ as you would be if you were withdrawing assets from a non-inherited IRA you may own.

The timing of your first MRD will be based on the age your spouse attained, not on your age. If your spouse was older than 70½, you must begin MRDs by December 31 of the year following your spouse's death. The MRD amounts will be based on the IRS's Single Life Expectancy table (Appendix C, IRS Publication 590), based on your age.

If your spouse was under age 70½, you can delay commencing MRDs until the year your spouse would have turned 70½, even if you are older than 70½.

Another option is to invoke the five-year rule. So long as your spouse was under age 70½ when he or she died, you have five years during which you can withdraw inherited assets from an inherited IRA at any time, in any amount, as long as all the assets are withdrawn by December 31 of the fifth year following your spouse's death. However, keep in mind that these larger distributions could push you into a higher tax bracket.

If you inherit a Roth IRA and transfer the assets to an inherited Roth IRA, your MRDs will always be treated as if your spouse were under age 70½. Therefore, you must begin MRDs by December 31 of the year following your spouse's death. These MRDs will be based on the Single Life Expectancy table. You may also elect to take distributions under the five-year rule. Withdrawals from inherited Roth IRAs are normally tax free so long as the funds were in the original Roth IRA for five years or more.

If you decide to establish an inherited IRA, be sure your IRA custodian registers the account properly. The account registration should include the name of the person who died, an indication that the account is an IRA beneficiary distribution account, and the inheritor's name. Note that different IRA custodians may have varying interpretations of the IRS's rules regarding account registrations.

3. Roll over the IRA assets into a new or existing IRA and convert the assets to a Roth IRA.

If you don't anticipate needing to rely on MRDs from your spouse's IRA to pay your living expenses, you may want to consider rolling over the assets into an IRA in your name (option 1, above) and then converting the assets into a Roth

IRA. This assumes that the IRA you inherited is a traditional IRA and not already a Roth IRA.

With a Roth IRA, contributions are not tax deductible, but you pay no tax when you withdraw assets, provided certain conditions are met.[2] However, you will have to pay taxes on the amount of money you convert from your traditional IRA into a Roth IRA. Therefore, converting to a Roth IRA may make sense for people who anticipate being in a higher tax bracket in the future and who have assets in a nonretirement account to pay the income tax associated with the amount converted to a Roth IRA.

4. Disclaim (decline to inherit) all or part of the assets.

If you choose this option, the IRA assets will pass to your spouse's contingent beneficiaries. This could be your children or grandchildren, another relative, a trust, or a charity.

When assets pass directly to the IRA owner's children or grandchildren, the potential for tax-deferred (or tax-free) growth will be stretched out over a much longer period. Though the children or grandchildren will need to begin taking MRDs in the year after the IRA owner's death, MRD calculations will be based on the longer life expectancies of these younger inheritors.

In some cases, disclaiming IRA assets can be a smart estate-planning move, especially if your spouse's estate was not structured properly. While assets you inherit from your spouse are generally not subject to estate taxes, they do become part of your estate when you die.

If you think that the inclusion of inherited IRA assets will cause the total amount of your estate to exceed the estate tax exemption limit for married couples, disclaiming all or a portion of your spouse's IRA could make sense. Note that a decision to disclaim assets must be made within nine months of your spouse's death and before you take possession of the assets. This is an irrevocable decision. Therefore, as with any tax-related matter, it's critical that you consult a tax adviser or attorney before disclaiming IRA assets.

Other key points to remember

Pay close attention to your first withdrawal

A separate MRD will be required if the original IRA owner was 70½ or older at the time of his or her death and he or she didn't take the first MRD before passing away. If that's the case, this money must be distributed to you after transferring the rest of the assets to an inherited IRA in your name. Also, the money must be distributed by December 31 of the year in which the IRA owner died. The amount of that MRD will be based on the IRA owner's age, but the assets will be distributed to you under your Social Security number. You should consult a tax adviser to ensure that this "year of death" MRD is properly reported to the IRS. Contact your financial provider to inquire about how it handles "year of death" distributions, as one firms may differ in the way they provide this service.

Confirm your spouse's beneficiaries are up to date. As life events such as marriage, divorce, and deaths occur, it's in your best interest (and your spouse's) to confirm that your beneficiary designations are up to date. Remember that IRA beneficiary designations supersede a will.

Request a trustee-to-trustee transfer. No matter which option you choose, make sure that any assets transfer directly from one account to another or from one IRA custodian to another. There is no option for a 60-day rollover when inheriting IRA assets. If you receive a check, the money will be taxed as ordinary income, and will be ineligible to be deposited into an inherited IRA you may own at another firm or back into the inherited IRA that it was withdrawn from to begin with.

Commingling of inherited IRAs is not permitted. If you inherit different types of IRAs from your spouse (Roth, traditional, SEP, etc.) or from other IRA owners, you cannot combine them into a single inherited IRA. As for commingling IRAs of the same account type, the answer differs based on whether they were inherited from the same original owner or different owners. Consult a consult a tax adviser regarding this situation. Distribution rules will vary for entities such as trusts, estates, or charities. If the assets were not in a deceased spouse's Roth IRA for more than five years, it would be best to consult a tax adviser regarding how withdrawals may be taxed, and whether or not it's best to roll them into your own Roth IRA or keep them separate in an inherited Roth IRA.

Also, note that the Supreme Court recently ruled that an inherited IRA held by a nonspouse beneficiary is not exempt from attachment by creditors under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. While some states have laws that still may protect inherited IRAs, for a nonspouse beneficiary living in a state without such laws, the inherited IRA is effectively now treated as any other account owned by the beneficiary for bankruptcy purposes, and may not be protected under bankruptcy from claims by creditors. It is not clear whether and how this decision affects an inherited IRA held by a spousal beneficiary. Beneficiaries should be reminded to speak to their lawyer or tax adviser before taking any distribution from a retirement account or if they have specific questions regarding protection from creditors.