3 things you should know if you inherit an IRA

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Inheriting an IRA often comes with mixed emotions. There's happiness that someone cared enough to leave you a portion of his or her savings. There's sadness that someone you cared about has passed away. And, quite possibly, there's confusion about what exactly you just inherited and how you should handle it.

Knowing these 3 things about inherited IRAs may clear up the confusion and help you handle the situation more comfortably.

Different tax rules for surviving spouses vs. all other beneficiaries

IRAs were created to encourage people to save for retirement. Because they have tax advantages, they're regulated by the IRS. (You can find details in IRS Publication 590-A.)

When you inherit an IRA, certain tax benefits may come along with it—but which ones apply to you depend on whether you're a surviving spouse or what's called a "non-spouse."

If you're a spouse and the sole beneficiary of the account, you can "assume" the IRA. That means you can transfer the assets into an IRA in your name and the IRS treats the IRA as if it had always been yours. You get the same tax advantages (and will be subject to the same required distribution rules) as the original account owner.

There are several distribution options that apply to both spouses and non-spouses. Each option has its own tax implications. Regardless of your relationship, you can:

- **Inherit the IRA.** You can transfer the proceeds into an inherited IRA for your benefit so that the assets can grow tax-deferred. You can then take distributions over your lifetime and enjoy the benefit of tax-deferred growth on the assets remaining in the inherited IRA.
- **Take a lump-sum distribution of the assets.** Once you've inherited the IRA, you can take a lump-sum cash distribution. However, you'll lose the benefit of tax-deferred investing and, because the money counts as ordinary income for the year in which you receive it, you may end up with a sizable tax bill.
- **Refuse to take ownership of the assets.** You have the right not to take the inheritance. This refusal is called "disclaiming" or "renouncing" the inheritance. If you do, the surviving primary beneficiaries, or secondary beneficiaries if there are no other primaries, are entitled to the undistributed amounts. If you're considering this option, be sure to consult with your attorney first to be sure you're meeting legal requirements.

Required minimum distributions still apply

If you inherit an IRA, whether it's a traditional or Roth, the IRS requires you to take at least some of the account balance out each year. It's called a required minimum distribution (RMD). (Depending on your situation, you may be able to wait until you reach age 70½ to take your first RMD.)

The amount of your first RMD and when you need to take it to avoid tax penalties are based on a few factors:

- Your status as a surviving spouse, a spouse who's also one of several beneficiaries, or a non-spouse beneficiary.
- The date of the original owner's passing and whether the owner was older or younger than age 70½ at the time of death. In most cases, you'll need to take your RMD by December 31 of the following year. However, if the owner passed after reaching age 70½, you may also be responsible for satisfying the owner's remaining final RMD by December 31 of the year of death.

- If other beneficiaries were named. The life expectancy used in the RMD calculation depends on whether each beneficiary has established his or her own inherited IRA by December 31 of the year following the original owner's death. If so, you can use your own life expectancy. However, if the account isn't split into separate IRAs by the deadline, the oldest beneficiary's age is the one used to determine the RMD amounts for all the beneficiaries.

The assets are no longer protected if you declare bankruptcy

On June 12, 2014, the Supreme Court ruled that inherited IRAs aren't protected by federal law from creditors if you declare bankruptcy. (Any assets you have in your own IRA or employer-sponsored retirement savings plans still have that protection, and spouses still have the ability to assume the IRA, which extends the protection.)

The ruling is a change from the previous assumption that these account balances were considered retirement savings. If you find yourself in financial straits and end up having to declare bankruptcy, you may not be able to count on your inherited IRA balance to rebuild your finances. Some states, including Alaska, Florida, Missouri, North Carolina, Ohio, and Texas, do offer some protection for these assets during bankruptcy. So, it might be worth checking your state tax laws.

Notes:

- All investing is subject to risk, including the possible loss of the money you invest.
- Distributions received before you're age 59½ may not be subject to the 10% federal penalty tax if the distribution is due to your disability or death; is distributed by a reservist who was ordered or called to active duty after September 11, 2001, for more than 179 days; or is for a first-time home purchase (lifetime maximum: $10,000), postsecondary education expenses, substantially equal periodic payments taken under IRS guidelines, certain unreimbursed medical expenses, an IRS levy on the IRA, or health insurance premiums (after you've received at least 12 consecutive weeks of unemployment compensation).
- You may wish to consult a tax advisor about your situation.