4 Must-Know Rules for Inherited Roth IRAs

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Careful planning and execution can allow a Roth IRA beneficiary to benefit from tax-deferred growth for as long as allowed under the tax code. How long this can be is primarily determined by “beneficiary status”—and in some cases, whether there are multiple primary beneficiaries.

Earnings accrue in a Roth IRA on a tax-deferred basis, and beneficiaries who inherit Roth IRAs continue benefiting from this tax-deferred treatment—so long as the assets remain in the Roth IRAs. However, the period over which tax deferral can continue is limited, and that limit is generally determined by whether the beneficiary is a spouse, non-spouse, or nonperson. And in some cases, an IRA agreement can limit the options that are available under the tax code. Tax deferral is only one of the many points of consideration for Roth IRA beneficiaries. Following, we unpack four of the important rules that Roth IRA beneficiaries should consider.

1. No post-RBD rule

When determining the distribution options that are available to the beneficiary of a traditional IRA, the first step is to determine whether the traditional IRA owner died before his required beginning date (RBD). The RBD is the deadline by which the traditional IRA owner must start to take required minimum distributions (RMD). This determines the distribution options available to the beneficiary of a traditional IRA. But for a Roth IRA, the owner is not subject to RMDs, therefore there is no RBD.

As such, the distribution options available to the beneficiary of a Roth IRA are the same regardless of the age at which the Roth IRA owner dies.

2. Type of beneficiary determines distribution options

There are three primary types or categories of beneficiaries:

i. Spouse
ii. Non-spouse
iii. Nonperson

The distribution options available to a beneficiary is determined by the category into which the beneficiary falls. The following is an introductory explanation of the options that are available to each type of beneficiary.

Spouse beneficiary

Beneficiaries who inherit a Roth IRA from a spouse may transfer or rollover the account to their own Roth IRA. By doing so, the spouse beneficiary will never be required to take distributions, because, as noted earlier, Roth IRA owners are not subject to the RMD rules. This allows the assets to continue to grow tax-deferred for as long as the spouse lives.

A spouse beneficiary may also transfer the amount to an inherited Roth IRA. Under this option, distributions must be taken under one of the following options:

1. **The five-year rule.** Under this option, distributions for the first four years are optional. But by December 31 of the fifth year following the year of the Roth IRA owner's death, the entire inherited Roth IRA balance must be distributed.
2. **The spousal life-expectancy option.** In this case, distributions would be taken over the beneficiary's single life expectancy. These life expectancy distributions must begin by the later of:

a. December 31 of the year following the year in which the Roth IRA owner died, or
b. December 31 of the year in which the Roth IRA owner would have reached age 70 ½

Planning tip: Unless the distribution includes earnings that would be taxable, moving the assets to the spouse's own Roth IRA is the better option. First, this means distributions would be optional (no RMDs). But in addition, it allows any of the spouse's successor beneficiaries who are younger than the spouse to take distributions over *their own* life expectancy rather than the spouse's life expectancy.

Non-spouse beneficiary

Any individual who is a beneficiary and is not the surviving spouse of the Roth IRA owner is considered a non-spouse beneficiary. The distribution options for a non-spouse beneficiary are the five-year rule, as outlined above, and the *non-spousal* life expectancy option.

Under the *non-spousal* life expectancy option, distributions must be taken over the beneficiary's single life expectancy, beginning by December 31 of the year following the year in which the Roth IRA owner died.

Nonperson beneficiary

Nonperson beneficiaries include estates, charities, and some trusts. The only option available to a nonperson beneficiary is the five-year rule, as outlined above.

Note: Special rule for trust beneficiaries

If a trust meets certain specific requirements that allow it to be classified as a 'qualified trust,' it is eligible for the distribution options that are available to a non-spouse beneficiary. If the spouse is the sole beneficiary of such a trust, the distribution options that apply to a spouse beneficiary might also be available to the trust.

If a trust is the beneficiary of a Roth IRA, an estate planning attorney with expertise in the area of IRA distribution planning should be consulted to determine whether the trust is eligible to be exempted from the distribution limitations that apply to a nonperson beneficiary.

Roth IRA agreements can include a default option for a spouse or non-spouse beneficiary. For example, the IRS model document Form 5305-RA, Roth Individual Retirement Custodial Account, provides that the spouse by default is the owner of the Roth IRA, instead of allowing the spouse to choose between moving it to the spouse's own Roth IRA or the inherited Roth IRA option.

Similarly, an IRA custodian's prototype document can provide that the five-year rule is the default option for a nonspouse beneficiary, unless the non-spouse beneficiary elects otherwise on a timely basis.

It is important therefore, to check the terms of an IRA agreement for two reasons. First, to determine whether the agreement follows the provisions of the tax code that makes the life expectancy the default option. And second, to determine whether or not the beneficiary is subject to any deadline by which a default provision could be overridden. In cases where such restrictions apply, the beneficiary might need to transfer the Roth IRA to a different custodian to be able to choose options which are not available under the current custodian's IRA agreement.

3. Separate accounting rules apply

If there is more than one beneficiary of a Roth IRA, the distribution options might be limited unless certain steps are taken. For instance, the five-year rule is the only option that applies if any one of the multiple beneficiaries is a nonperson, unless the nonperson beneficiary takes a full distribution of its share by September 30 of the year following the year in which the Roth IRA owner dies.

If the nonperson beneficiary distributes its share by the September 30 deadline, individuals who remain beneficiaries are required to take distributions over the life expectancy of the oldest beneficiary (see the article "IRA Beneficiary Audit: Help Clients' Beneficiaries Maximize Their Benefits"). An exception applies if the assets are split into separate accounts by December 31 of the year that follows the year in which the Roth IRA owner dies. Under this exception, each beneficiary would be eligible to take distributions over his or her own life expectancy.

The ability to take distributions over one's own life expectancy is favorable to younger beneficiaries, as they would have a longer period (than an older beneficiary) over which to take distributions.

4. Death is a 'qualified' status for tax-free distributions

Similar to distributions from an individual's own Roth IRA, whether any portion of a distribution from an inherited Roth IRA is subject to income tax is determined by whether the distribution is qualified, and if not, whether it includes amounts attributable to earnings.

A distribution from an inherited Roth IRA is qualified if it is made at least five years following the first day of the year for which the Roth IRA owner first contributed to the Roth IRA.

If the distribution is qualified, it is tax-free.

If the distribution is nonqualified, the ordering rules must be used to determining if any portion of the distribution is subject to income tax.

Under the ordering rules, regular contributions are distributed first and are always tax-free.

Roth conversion amounts are distributed second, and those too are tax-free distributions.

Earnings are distributed only after all regular contributions and conversion amounts have been distributed. Distributions of these amounts before the five-year period are subject to income tax.

Distributions from an inherited Roth IRA are never subject to the 10% early distribution penalty regardless of the age at which the distribution occurs, because they automatically qualify for the 'death exception.'

This is a high-level explanation of the distribution options that are available to the beneficiary of a Roth IRA, and beneficiaries should be encouraged to work with professionals who understand the complexities of inherited Roth IRAs.

Guiding beneficiary clients

Mistakes made with inherited IRAs and other retirement accounts often cannot be fixed, and many of these are made when paperwork is completed to claim the accounts. As such, your clients with inherited retirement accounts should be encouraged to contact you before completing any paperwork. Providing them with a checklist and holding their hands throughout the process can help to ensure that costly mistakes are avoided.

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