FLORIDA TODAY MONDAY, MAY 31, 2020

What are the payout options for an inherited Traditional IRA?

Q: My father passed away last month and left his Traditional IRA to me and my brother. I work full time and plan to retire in five years. My brother retired last year. What are the payout options for this money?

A: When an IRA is left to anyone other than a spouse, these inherited IRA accounts, called Beneficiary IRA Accounts, have very different rules.

Each named beneficiary is required to open a new separate account with the name, relationship, dates of birth and death of the decedent.

The IRS will not permit rollovers into an existing IRA nor can you make contributions to the new Beneficiary IRA account.

If the inheritor/beneficiary is a minor, the account must have a named custodian and will follow the state UGMA/UTMA statutes. Certain states permit the age of termination to extend beyond the statutory age of termination. Complete this document carefully.

This new Beneficiary IRA Account requires the designation of new beneficiaries by percentage and has the per stirpes (offspring) option.

Non-spouse beneficiaries (like you and your brother) are permitted to take distributions without a penalty even if you're under the age of 59 ½.

When spouses are under 59 ½ they may choose an inherited Beneficiary IRA Account instead of rolling the account in to their own. An important decision based on surviving spouse's age and the availability of other resources.

The SECURE Act requires most IRA beneficiaries to deplete the account in ten years following the year of the account owner's death. This new rule took effect January 1, 2020.

Prior to January 1, 2020 rules required minimum annual distributions using a life expectancy table. Failure to take these required distributions resulted in a tax penalty of 50 percent of the amount that was required to be distributed. The rules for these accounts have not changed.

Traditional Beneficiary IRAs have a ten-year payout requirement and these payouts are taxed as ordinary income. This ten-year window is a huge tax planning opportunity.

ROTH Beneficiary IRAs have the same ten-year distribution requirement and payouts are not taxed.

Since you are working full time and plan to retire in five years, consider current versus future marginal tax rates. The IRS allows discretionary distributions providing the account is depleted after ten years. Decide if waiting until the year following retirement is better to start taking distributions and know that distributions don't have to be evenly spread. It's often better to take a taxable windfall when income and tax rates are lower.

It's all about taxes. In retirement, consider requesting the custodian of the account to send federal tax payments to the IRS when distributions are taken. This may avoid a surprise tax bill.

Estimate taxes on Social Security. Depending on other income, 15% or 50% of the benefits may be taxed, and high wage earners will have 85% of the SS benefit taxed as ordinary income. It depends on "combined income" that include adjusted gross income plus nontaxable interest plus half of the SS benefit. Estimate life expectancy and do the math to determine if waiting until age 70 to take this benefit makes sense.

At age 65 workers (or spouses of workers) become Medicare eligible. The Medicare Part A hospital coverage is usually free because it was paid with payroll taxes while working. Not so with Medicare Part B. The cost increases with income, starting at $144.60 and may be as high as $491.60 per month.

Rules are different for spouse and non-spouse beneficiaries and non-individual beneficiaries like a trust or charity.

Inherited IRA's are not protected from creditors in bankruptcy under federal law.

These inherited accounts should be transferred only as trustee-to-trustee transfers to the new beneficiary IRA account. There is no option for a 60-day rollover. Any distribution payable to a beneficiary directly will be taxable and will not be eligible to go into any IRA account.

The rules and regulations for inherited IRA's have all changed recently. Since the process can be complicated, review the new SECURE Act and CARES Act to understand the rules and options that apply. It's about taxes, IRS penalties and careful income planning.

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