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PERSONAL FINANCE

Here's how to get the most out of an inherited IRA or Roth IRA account

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Special to The Star

Many of us have inherited an IRA or Roth IRA account at some point. What to do next? Nothing's simple anymore — especially since the SECURE Act. I work for a client who inherited both an IRA and a Roth IRA from a non-spouse in 2021. His friend died in late 2020 after the Secure Act's effective date of January 1, 2020.

When a non-spouse inherits an IRA and a Roth, we need to distribute all funds in the accounts by the end of the 10th year after the decedent's passing. There's no stretch-out distribution anymore except for a few exemptions.

Assessing what's most advantageous to do with the inherited Roth IRA is the easiest. Since the client doesn't need funds for spending, we'll let it ride and keep it invested. The funds will grow tax-free in that account. We'll distribute everything in year 10. Best of all there's no tax on the distribution.

My client doesn't need funds in the inherited IRA for spending either, but that's more challenging. Here's why:

- We pay taxes on every dollar we distribute.
- We have to distribute it all by the end of year 10.
- We want to keep it inside the account because it grows tax-deferred in there, without the headwind of taxes on the growth.
- We want to avoid distributing so much in a given year that we trigger the higher marginal tax brackets on the client's tax return. Paying 10% or 12% tax on these distributions is a better deal than paying 22% or 24%. Paying 24% is a better deal than 32% or 35% or 37%. When we jump up any of those two levels, we pay about 10% more tax.

You'll want to ask three questions for your own situation.

First, find your taxable income on page 1 of your Form 1040 tax return and look up your marginal tax rate. Refer to the IRS's tax rate tables at https://taxfoundation.org/2022-tax-brackets/. What are you now paying on the last dollar of income? Is it a 12% rate; a 22% to 24% rate; or a 32% or higher rate?

Second, review your income sources (wages, capital gains, social security, pensions, etc.) on page 1 of Form 1040. Check the last three years of tax returns. Are those sources pretty steady, or can they vary significantly year-to-year? Are upcoming increases expected?

Finally, find out how large this inherited IRA is. If it's $25,000, you can easily distribute in the last two or three years of your 10-year timeframe, and likely not spike your tax rate. If it's $1 million, you'll want to plan better. To get a rough estimate, divide your inherited IRA by 10, add that to your tax return's taxable income, and check the IRS's tax rate tables to see if you'll stay in the same marginal tax bracket.

Those with smaller inherited IRAs are likely to stay in the same tax bracket and can distribute in the latter portion of the 10-year window. Those with large inherited accounts will likely benefit most if they distribute somewhat ratably over the 10-year period. That avoids most of the higher jumps in tax brackets.

Those with smaller or moderate incomes and marginal tax brackets, even up to a 24% bracket, may best distribute ratably when facing a large IRA, such as a $500,000 inheritance. Those with high income, already in the higher marginal tax brackets before inheriting, may find that deferring to year 10, to get the most tax-deferred growth, may be best.

For my client's situation we are distributing ratably over the 10-year period and think we can avoid large increases in tax rates.

Here are some tips. My client has opted to make a charitable contribution this year. We have two smart choices: giving straight from his regular IRA, or from his inherited IRA. Both beat writing a check from bank checking. We're gifting from his inherited IRA since we need to empty that account in 10 years anyway.

If you've inherited a large IRA, and still have earned income and a pension or IRA, you might consider tax-shifting: distributing from the IRA (taxable dollars), spending that, and increasing your contributions commensurately to a pension or IRA. The distribution increases tax; the contribution decreases tax; try to offset. Contributions to a pension sidestep income taxes. Contributions to an IRA are usually deductible.

Even though nothing's simple anymore, a step-by-step analysis can save you significant tax dollars.

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