WEALTH MANAGEMENT

Has Your Client Recently Inherited an IRA or Roth?

By Sandi Weaver, CPA, CFP, CFA

Many clients have inherited an IRA or Roth IRA account recently. Because of the SECURE Act, there are decisions to be made. Consider a client who inherited both an IRA and a Roth IRA from a non-spouse in 2021. The friend died in late 2020 after the Secure Act's effective date of Jan 1, 2020.

When a non-spouse inherits an IRA and a Roth, all funds in the accounts need to be distributed 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 easiest. Because this client doesn't need funds for spending, it's best to let it ride and keep it invested. The funds will grow tax-free in that account. They can distribute everything in year 10. Best of all, there's no tax on the distribution.

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

- Taxes are due on every dollar distributed, assuming $0 cost basis.
- All funds have to be distributed by the end of year 10.
- Funds should be kept inside the account because it grows tax-deferred there.
- It's important to avoid distributing so much in a given year that it triggers the higher marginal tax brackets on the client's tax return. Paying 10 or 12 percent tax on these distributions is a better deal than paying 22 or 24 percent. Paying 24 percent is a better deal than 32 or 35 or 37 percent. When you jump up any of those two levels, you pay about 10 percent more tax.

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

- What's their marginal tax rate based on taxable income? Is it a 12 percent rate; a 22 to 24 percent rate; or a 32 percent or higher rate?
- Review the client's income sources (e.g., wages, capital gains, social security, pensions) on page 1 of Form 1040. Check the last three tax returns. Are those sources steady? Or can they vary significantly? Are upcoming increases expected?
- How large is this inherited IRA? If it's $25,000, you can easily distribute in the last two or three years of the 10-year timeframe, and likely not spike the marginal tax rate. If it's $1,000,000, you'll want to plan better. To get a rough estimate, divide the inherited IRA by 10, add that to taxable income, and check the IRS' tax rate tables to see if the client can stay in the same marginal tax bracket.

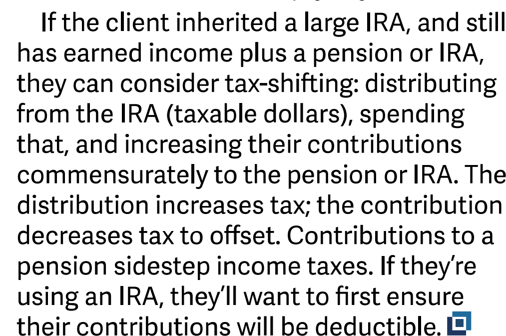
Clients with smaller inherited IRAs are likely to stay in the same tax bracket and can distribute in the latter portion of the 10-year window. Those with large inherited accounts will likely benefit most if they distribute somewhat ratably over the 10-year period. That avoids most of the higher jumps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

Those with small or moderate incomes, and lower marginal tax brackets even up to a 24 percent 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, is best. That assumes tax conditions don't become more onerous than now. You can review a detailed analysis by Luke Delorme, using several scenarios, at *mocpa.org/inherited-IRAs*.

For this client's situation, they are distributing ratably over 10 years to potentially avoid large increases in marginal tax rates. Here are some tips. The client has opted to make a charitable contribution this year. There are two solid choices: giving straight from his regular IRA or from his inherited IRA. (Both options beat writing a check from bank checking.) He could gift from his inherited IRA because that account needs to be empty in year 10.

If the client inherited a large IRA, and still has earned income plus a pension or IRA, they can consider tax-shifting: distributing from the IRA (taxable dollars), spending that, and increasing their contributions commensurately to the pension or IRA. The distribution increases tax; the contribution decreases tax to offset. Contributions to a pension sidestep income taxes. If they're using an IRA, they'll want to first ensure their contributions will be deductible.



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