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Inheriting an IRA comes with complexities and potential dangers

An unintended benefit of Individual Retirement Accounts is that they often survive their owner and can provide continuing income to the owner's heirs. But if you should inherit an IRA from a deceased relative, you need to be very careful not to get caught in one of several very expensive "gotchas."

Surviving spouses are protected from most of these problems; this article concerns issues faced by non-spouse IRA beneficiaries.

Several of the potential problems with inherited IRAs stem from what's called the "required minimum distribution," or RMD. You may be familiar with this provision if you own an IRA of your own: you must start taking these RMDs no later than the year after the year in which you turn 70 ½.

Why is this required? The idea is to spread out your IRA distributions over your expected lifespan. That, in turn, is intended to prevent us from accumulating more tax-deferred money than we need for retirement and passing that extra money to our heirs. But, inevitable as both death and taxes are, nobody can be certain how long they will live. And so, the reality is that IRA balances are, in fact, frequently passed down to heirs.

RMD rules affect heirs, but in a different way from the IRA's original owner. The heir or beneficiary of someone else's IRA has to start taking those distributions the year after the owner dies. This is true even for Roth IRAs; unlike "traditional" IRAs, their original owners don't have to take RMDs, but inheriting beneficiaries do.

This is important. The potential consequences of getting it wrong include a very steep penalty: 50 percent of what should have been taken out for the year. There is a footnote, however. If the owner hadn't gotten to that age 70 ½ when the RMDs had to start, the heir who failed to take an RMD when required might be able to dodge that 50 percent bullet. Doing that requires emptying the entire IRA within five years.

Whether that's the best idea, though, isn't a simple question. It may well be better to take your medicine and pay the penalty rather than forego the potential earnings you'd get if you keep the IRA open indefinitely.

A related wrinkle is that if the owner died before taking the RMD for that year, the heir or heirs must do so — and do so the same year, not the year after.

Head spinning yet? Just wait. There are some additional RMD "gotchas" involved if the IRA is shared among multiple heirs. The simple advice on this score is this: divide the inherited IRA so all the heirs have accounts of their own. The inherited assets can't be rolled into the heirs' own IRAs, by the way. A new, separate account needs to be set up, with a title based on the owner's name as well as the beneficiary's name. So, it might be something like "[Dad's name], deceased Oct. 1, 2018, IRA for the benefit of [your name]." When that new account is set up, be sure to designate your own beneficiaries.

Why it's important to split up the IRA gets us back to those pesky RMDs. If the inherited account stays intact, the rules on RMDs will be applied to the oldest of the beneficiaries. The tax law requires that RMDs are calculated based on life expectancy. That can create serious problems if there's a big age difference among beneficiaries. The younger ones may well find that their money runs out far more quickly than if the RMD had been figured on their own ages and life expectancies.

Another important reason to split up that inherited IRA is to give each beneficiary the right to determine how to invest their own assets.

A final matter to be aware of is what happens if an IRA's beneficiaries include institutions like charities or trusts. A charity's share of the account must be paid out, in full, at the end of the third quarter of the year after the owner's death. Trusts have their own complex requirements. The consequences if these rules aren't followed correctly are complex, with a lot of tricky "ifs" and deadlines, but they all boil down to sharply restricting what the human beneficiaries can do.

So how in the world can a normal person keep up with all of this? It's neither easy nor simple, frankly. To avoid serious, and irrevocable, consequences — which can range from loss of money to loss of control over how you draw on your assets — it's wise to consult a professional who has expertise in these convoluted rules. If you should inherit all or part of a relative's IRA, the experienced financial planners at Old North State Trust can help you navigate these troubled waters.