**3644.01 What rules does an individual need to be aware of when inheriting an inherited IRA??**

An inherited, inherited IRA will first have to be re-registered in the name of the deceased beneficiary’s beneficiary (the “successor beneficiary”) in order for the successor beneficiary to take required minimum distributions (RMDs) from the account.

A spousal successor beneficiary is not entitled to use the special rules that typically apply to allow the surviving spouse to treat the IRA as his or her own account (see Q 3641)—based upon the logic that the surviving spouse-successor beneficiary was not the spouse of the original account owner. Instead, that successor beneficiary (whether a surviving spouse or non-spousal beneficiary) is required to take RMDs from the account based upon whatever method the original beneficiary had been using upon his or her death.

As a result, in many cases, the inherited, inherited IRA will be distributed to the successor beneficiary based upon the life expectancy of the deceased original beneficiary. The options that the original beneficiary could have chosen are summarized in the paragraphs below.

The rules governing inherited IRAs generally allow individuals to “stretch” the tax-deferral associated with these accounts by providing for distribution of the account value over a period of years following the original account owner’s death. However, there are several options that the beneficiary can choose from in taking RMDs from the inherited IRA.

If the original account owner died after taking RMDs, a non-spousal account beneficiary must either take distributions based upon his or her own life expectancy or based upon the original account owner’s life expectancy—whichever is longer.[[1]](#footnote-1) If the owner died before taking RMDs, a non-spousal account beneficiary must either take distributions based upon his or her life expectancy or exhaust the account funds within five years of the original owner’s death.[[2]](#footnote-2) (See Q 3639 and Q 3640 for a detailed discussion of these rules.)

An original spousal beneficiary has the additional option of rolling the inherited IRA funds into his or her own IRA and treating them as if they were traditional, non-inherited IRA funds.

The option chosen by the original beneficiary of an inherited IRA is the option that the successor beneficiary to that inherited IRA will be required to use in order to exhaust the account funds—the successor beneficiary’s own life expectancy is not a factor.

**8582.01 Can conversions from a traditional IRA to a Roth IRA cause an individual to indirectly become subject to the net investment income tax?**

Officially, distributions from traditional retirement accounts (IRAs, 401(k)s) are excluded from the net investment income tax (NIIT). Similarly, amounts that are rolled over into Roth accounts from these traditional accounts are technically excluded.[[3]](#footnote-3) While retirement account distributions (and Roth conversions)[[4]](#footnote-4) are excluded from the definition of *net investment income* (see Q 8579), these amounts still count in determining an individual’s AGI—and can cause the individual to exceed the applicable threshold and become subject to the NIIT (see Q 8577).

As a result, for some individuals, Roth conversions are best exercised in small steps over time—converting only a small portion of traditional retirement funds each year to avoid crossing the AGI threshold. For others, Roth conversions may no longer be the best option for generating tax-free income during retirement—especially if the individual cannot balance the added income by contributing additional pre-tax dollars to traditional accounts because he or she has already maxed out the annual contributions.

**3634.01 What can be done before the IRA required beginning date in order to minimize his or her required minimum distributions?**

The required minimum distribution (RMD) rules essentially require taxpayers to begin withdrawing funds from IRAs when they reach age 70½. The minimum amounts that must be withdrawn are calculated based on the account value and the taxpayer’s life expectancy, determined using IRS actuarial data.[[5]](#footnote-5) Despite this, there are ways that individuals can minimize their RMDs in the year prior to 70 ½ if they will have no immediate need for the funds at that time.

Many individuals are able to reduce their RMDs by converting a portion of their traditional IRA funds into Roth funds. Roth IRAs have no minimum distribution requirements, so converting traditional IRA funds to Roth accounts will reduce the owner’s RMDs. Unfortunately, if the taxpayer is still working, he or she may still be in a high enough income tax bracket that the taxes generated by the rollover can be substantial (all amounts rolled over from a traditional IRA to a Roth IRA are taxed at the owner’s ordinary income tax rate).

If the individual is still working, the taxpayer can also consider rolling the funds into a qualified plan (such as a profit-sharing or 401(k) plan) where distributions are not required until the later of the year the taxpayer turns 70 ½ *or* the year the taxpayer retires. . In this case, it’s important that the taxpayer learn the rules of the qualified plan before making the rollover. Some plans don’t accept rollovers, and others require that distributions begin at 70 ½ regardless of the option to postpone until retirement.

Importantly, both of these rollover moves must be made before the RMD requirements kick in—otherwise the individual will have to pay both the taxes associated with the RMD (which cannot be rolled over) and those generated by the rollover itself.[[6]](#footnote-6)

A taxpayer can also reduce RMDs by purchasing a qualified longevity annuity contract (QLAC, see Q 483)—which is a relatively new annuity product that is purchased within the IRA, deferring annuity payouts until the taxpaye reaches old age. The value of the QLAC is excluded from the account value when calculating the RMDs, though the taxpayer is limited to purchasing a QLAC with an annuity premium value equal to the lesser of 25 percent of the account value or $125,000.[[7]](#footnote-7)

**3617.01 What should an individual consider when choosing whether to convert retirement funds to a Roth IRA or to a Roth 401(k)?**

One important characteristic of a Roth IRA conversion is the taxpayer’s ability to undo the transaction through a recharacterization transaction that moves the funds back into the traditional account, eliminating the tax liability that the initial conversion created.[[8]](#footnote-8) This option is unavailable if the individual chooses to convert to a Roth 401(k).

If the taxpayer’s account performs poorly in the months after the conversion takes place, or if the taxpayer otherwise finds that he or she can’t pay the tax bill that results from a Roth conversion, the taxpayer has until October 15 of the year following the conversion to recharacterize the funds. Once a Roth 401(k) conversion takes place, however, the taxpayer is required to pay the associated taxes regardless of any events that occur post-conversion.

Further, a taxpayer who converts to a Roth IRA is able to escape the IRS’ required minimum distribution (RMD) rules so that the funds in the account are permitted to grow tax-free over a longer period of time. Taxpayers who use Roth 401(k)s are often required to comply with the RMD rules when they turn 70 ½, possibly reducing the account’s growth potential if the taxpayer doesn’t need to access the funds.[[9]](#footnote-9) A taxpayer who plans to use a Roth account as a wealth transfer vehicle may also prefer the Roth IRA because the entire account value can be passed to heirs upon his or her death.

Taxpayers who anticipate that they will need access to the funds before retirement should also consider how the application of the “five year rule” could impact the tax-free availability of these funds. To access the funds, a qualifying event must have occurred *and* the Roth must be at least five years old before a qualified distribution is permitted. However, if the taxpayer has multiple Roth IRAs, only *one* of the taxpayer’s IRAs must be five years old before a tax-free withdrawal is permitted.[[10]](#footnote-10) With a Roth 401(k), the particular account must be five years old or a penalty tax will apply.[[11]](#footnote-11)

Importantly, for high-income taxpayers, post-conversion contributions may be limited or blocked entirely because of the income limits that apply to Roth IRA contributions (but not to Roth 401(k) contributions). In 2015, the ability to make contributions to a Roth IRA begins to phase out for married taxpayers with income over $183,000 ($116,000 for single filers). Roth IRA contributions are completely blocked for married taxpayers who earn over $193,000 and single filers who earn over $131,000.[[12]](#footnote-12)

Stronger creditor protection rules also apply to Roth 401(k) accounts. While Roth IRAs are protected under state law, the rules that apply in some states offer much less in the way of creditor protection than can be found in others. Roth 401(k)s are always protected by ERISA-mandated federal creditor protection rules regardless of where the taxpayer lives.

**3603.01 What are some of the potential benefits and consequences of holding a fixed income annuity within an IRA?**

The primary benefit of holding fixed income annuities within an IRA is the simplification of the required minimum distribution process. Fixed income annuities held inside a taxpayer’s IRA usually comply with the RMD rules automatically because their payments are determined in the same way that the RMD itself is calculated—using a formula based on the life expectancy of the individual and the amount invested.

While a cash RMD is required each year after the taxpayer turns 70 ½ regardless of general market conditions, it is important to remember that IRA assets may be invested in a variety of holdings, including securities and funds that will fluctuate with the equity markets. Unfortunately, the RMD requirements may, depending on market performance, cause taxpayers to miss out on market upswings by requiring that the taxpayer liquidate securities held within the IRA in order to satisfy his or her RMDs. Using a fixed income annuity can help eliminate this risk because the payments are fixed in advance.

In other words, there is no investment decision required each year because the taxpayer has already determined the value of the payout (whether it is made monthly, quarterly or annually). While the RMD for any non-annuitized portion of the IRA will still have to be calculated, the value of the annuity is excluded from this calculation, thereby reducing the risk that the taxpayer will be forced to make an unfavorable investment decision simply to comply with the RMD rules.

Further, the fixed income annuity actually allows the taxpayer to set an income level in advance—RMDs will fluctuate with the IRA value in any given year, but the annuity payments will remain constant regardless of the performance of the remaining underlying IRA assets. Taxpayers also have the option of adding a cost of living increase to the annuity payouts to ensure sufficient income during retirement.

As with any planning strategy, however, there are potential objections. Most commonly, advisors may feel that it makes little sense for some taxpayers (especially younger individuals) to hold an annuity within the IRA because both types of investments are tax-deferred, so the annuity could be held separately from IRA assets with similar consequences. As a result, some might feel that the strategy is simply redundant.

Additionally, amounts held in an annuity are more difficult to access than other IRA funds without incurring significant penalty charges—if the taxpayer has a financial emergency after age 70 ½, he or she could access non-annuitized IRA funds without penalty. Taxpayers should, therefore, only consider purchasing the annuity with IRA funds if they have sufficient assets held outside of the annuity to cover any unforeseen expenses.

Further, while holding an annuity within an IRA can allow the taxpayer to avoid selling IRA assets during unfavorable market swings, it can also mean that the taxpayer has no reason to liquidate those holdings when their value is high, potentially avoiding a loss if the value eventually falls.

**3642.01 How can an IRA be used to stretch the tax benefits of funds held within an inherited 401(k) over a beneficiary's lifetime?**

Inherited IRAs generally allow an individual to “stretch” the tax-deferral associated with these accounts by providing for distribution of the account value over a period of years following the original account owner’s death. Typically, the account beneficiary will take distributions over his or her lifetime or exhaust the account funds within five years of the original owner’s death, which allows the account value to continue to grow and stretches the tax liability that accompanies the distributions over a period of years.[[13]](#footnote-13) See Q 3638 to Q 3640 for a discussion of the distribution rules that apply following the original account owner’s death.

Qualified plans (such as 401(k)s and profit sharing plans), however, are subject to a different set of rules that do not allow the funds to be distributed over time. As a result, when a 401(k) is inherited, the funds will usually be distributed immediately in a single lump sum payment, resulting in an immediate tax liability for the beneficiary.

If the designated beneficiary of an inherited 401(k) is an individual, however, he or she has the option of rolling the inherited account funds into an IRA that will be treated as an inherited IRA, thus allowing the individual to stretch distributions over his or her life expectancy (or over a five-year period). The rollover must be accomplished through a trustee-to-trustee transfer whereby the 401(k) plan administrator transfers the funds directly into a new IRA account that only holds the inherited 401(k) funds.

If the original account owner has failed to name a beneficiary, the IRA will likely be paid out to his or her estate upon death—which will cause a loss of the tax-deferral benefits that can otherwise be realized with an inherited IRA. This is because the favorable rules that allow the account value to be distributed over time only apply if the account’s designated beneficiary is an individual (or a trust, the beneficiary of which is an individual) that actually has a life expectancy.[[14]](#footnote-14)

Further, if the estate is the eventual beneficiary of an inherited qualified plan (401(k)), the taxpayer loses the option of rolling the funds into an inherited IRA in order to maximize the tax-deferral potential.

**3606.01 What is sequence of return risk?  How can sequence of return risk impact a taxpayer’s retirement income strategy?**

Sequence of return risk is a market volatility issue surrounding the order in which returns on a taxpayer’s investments occur. Essentially, if a greater proportion of low or negative returns occur during the early years of retirement, the taxpayer’s overall returns are going to be lower than if those negative or low returns occurred at a later point in the taxpayer’s (and the investment’s) lifetime.

Logically, this is because the investment has had less time to grow during the early years of ownership, so there is a danger that negative returns could even cause a portion of the principal investment to be lost. Even if the return is simply lower than average in the early years, the investment will generate an overall lower return because the investment will gain less value early on, meaning there will be a lower account value to generate growth even in later, higher return periods.

When the taxpayer is making withdrawals from his or her investment accounts, this risk of outliving the retirement assets is magnified when negative returns occur in early years.

**3720.01 What should a taxpayer consider when deciding whether to roll funds from an employer-sponsored 401(k) into an IRA?**

For a taxpayer who has reached age 55, but has not yet reached age 59 ½, the tax advantages of allowing the funds to remain in the 401(k) are clear. If the taxpayer were to roll the funds into his or her IRA, a 10 percent penalty tax would apply to any withdrawals made before the taxpayer reaches age 59 ½ (in addition to the otherwise applicable ordinary income tax rate). A taxpayer who leaves employment once he or she has reached age 55 can withdraw funds from the 401(k) without incurring the 10 percent penalty for early withdrawals.[[15]](#footnote-15)

If a taxpayer plans to work past the age when distributions become mandatory (age 70 ½), he or she can avoid the required distributions by leaving the funds in the employer-sponsored 401(k). As long as the taxpayer continues to work and does not own 5 percent or more of the company, he or she can avoid taking distributions from a 401(k), thereby avoiding the associated income tax liability that those distributions generate. Distributions from an IRA are required to begin when the taxpayer turns 70 ½, regardless of whether he or she has actually retired.[[16]](#footnote-16)

Further, if a taxpayer holds stock in his employer within the 401(k) plan, he or she may qualify for favorable tax treatment if the stock is left in the 401(k). Upon distribution from the 401(k), the sale may qualify for taxation at the taxpayer’s long-term capital gains tax rate, rather than the ordinary income tax rate that would apply to the appreciation on the stock if it was rolled into the IRA and later sold.

Taxpayers may wish to keep funds in an employer-sponsored 401(k) after leaving employment because it’s possible to borrow against those funds, though these loans are limited and must be repaid relatively quickly. Despite this, a loan against an IRA balance is not an option (penalties and taxes would apply to the IRA as though it were a distribution).

If the 401(k) offers attractive investment options, the taxpayer may wish to keep the funds invested in the 401(k). Further, if the 401(k) has lower than average fees, the taxpayer may be better off leaving the funds in the 401(k). Because recently enacted disclosure rules require 401(k) plan sponsors to disclose administrative expenses and fees to participants, there is evidence to suggest that 401(k) fees may be decreasing.

1. IRC Sec. 401(a)(9)(B)(i). [↑](#footnote-ref-1)
2. Treas. Reg. §1.401(a)(9)-3, A-1(a). [↑](#footnote-ref-2)
3. IRC Sec. 1411(c)(5), Treas. Reg. §1.1411-8(a). [↑](#footnote-ref-3)
4. Treas. Reg. §1.1411-8(b)(2). [↑](#footnote-ref-4)
5. Treas. Reg. §1.408-8. [↑](#footnote-ref-5)
6. Treas. Reg. §1.408-8. [↑](#footnote-ref-6)
7. IRC Sec. 401(a)(9); Treas. Reg. §1.401(a)(9)-6. [↑](#footnote-ref-7)
8. IRC Sec. 408A(d)(6). [↑](#footnote-ref-8)
9. Treas. Reg. §1.401(k)-1(f)(3). [↑](#footnote-ref-9)
10. IRC Secs. 408A(d). [↑](#footnote-ref-10)
11. Treas. Reg. §1.402A-1, A-4. [↑](#footnote-ref-11)
12. IRC Sec. 408A(c)(3); IR-2014-99 (Oct. 23, 2014). [↑](#footnote-ref-12)
13. See Treas. Reg. §1.401(a)(9)-6; Treas. Reg. §1.408-8. [↑](#footnote-ref-13)
14. See Treas. Reg. §1.401(a)(9)-4. [↑](#footnote-ref-14)
15. IRC Sec. 72(t). [↑](#footnote-ref-15)
16. Treas. Reg. §1.408-8, A-3. [↑](#footnote-ref-16)