

WHAT HAPPENS WHEN AN ADULT CHILD INHERITS AN IRA FROM A PARENT?

By Robert E. Whitney, Jr., CFP®

Sometimes, even the simplest, seemingly most straightforward financial transaction can be fumbled in a hurry without having the right expertise at your disposal.

One of the easiest financial transactions to mishandle is an inherited Individual Retirement Account (IRA).

Inherited IRAs involve the transfer of wealth from parents to spouses, siblings, charities, endowments, etc. For illustrative purposes, we are going to concentrate on one of the most common types of transfer, which is from a parent to an adult child.

If you are inheriting an IRA from a parent who has recently passed away, consider these rules in your approach to processing the required documentation:

Rule No. 1 – Do not do anything abruptly. Be deliberate in every step.

- Do not sign anything, do not cash anything, and do not transfer anything until you have talked to a qualified advisor or knowledgeable family member or friend. Advisors report that inherited IRA recipients too often cash in their IRA prematurely, losing tax benefits that could have been theirs if they had only waited a little longer to reflect carefully. The tax benefits disappear forever once you distribute cash from an inherited IRA, with the distribution amount being characterized as taxable income.

Rule No. 2 – If your parent was past age 70½, find out if he or she made the required minimum distribution (RMD) that year.

- If yes, great. You won't have to make one for them.
- If no, consult an advisor and withdraw the remaining RMD by Dec. 31 of the year of your parent's passing.

Rule No. 3 – Time your distribution of the proceeds to your particular needs so you can capture maximum tax benefits and avoid penalties.

- If it is your first time undergoing this experience, it is terribly difficult to know all the intricacies of this important decision. Ask your advisor the best way to capture the full tax benefits and avoid penalties – the answer is largely determined by when you need the proceeds.
- One commonly used option is to stretch out your tax liability on your RMDs over your entire lifetime to minimize distributions, taxable income and therefore taxes.

An example of stretching out your tax liability over a lifetime might look like this: Assume you inherited your parent's IRA after he or she passed away in 2018 and had already satisfied the RMD for that year. In 2019, you will



turn 50 years old. Based upon IRS Publication 590-B, Appendix B (“Life Expectancy Tables,” page 45, <https://www.irs.gov/pub/irs-pdf/p590b.pdf>), you have a life expectancy factor of 34.2. To arrive at your RMD, you would divide the balance at the end of the prior year by the life expectancy factor. For example, assuming the inherited IRA was valued at \$100,000 as of 1/1/2019, your RMD would be \$2,924.

Now this is the part of the process where most financial fumbles occur. If you fail to take your RMD, you will be subject to a 50% IRS penalty on the amount you failed to withdraw. Sounds harsh, but it is the law. While you can distribute more than your RMD, be aware you lose out on the tax-deferred benefit in addition to recognizing additional taxable income.

Be sure to document your life expectancy factor in the first year, because the factor is reduced by one for subsequent years when calculating inherited IRA RMDs. Therefore, in 2020 you would use a life expectancy factor of 33.2.

An advisor can help you avoid the pitfalls so you don’t accidentally wreck your tax advantages by acting impulsively or without being fully informed. There are also ways to pass the inherited IRA to grandchildren, too, which effectively extends the tax breaks for decades.

If you are a parent reading this commentary, you may want to huddle with your children and get your beneficiaries updated, especially if the IRA has high value. If you are an adult child, do not be misinformed and subject yourself to IRS penalties or waste an opportunity to capture tax-deferred growth with the inherited IRA.

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Rob is a senior financial planner for Commerce Trust Company. He is a member of the financial advisory services team — a dedicated financial planning practice within Commerce Trust that provides objective financial advice to clients. Following a thorough assessment of a client’s unique situation and thoughts regarding wealth, Rob develops holistic and coordinated plans to help clients meet their short-term and long-term goals as well as take full advantage of various planning, tax, and investment strategies along the way. With more than 16 years of experience, he specializes in building relationships with clients and providing comprehensive financial planning services to business owners and individual investors to help them achieve their goals. Rob holds the CERTIFIED FINANCIAL PLANNER™ designation. He received his bachelor of administration degree in business finance from Loyola University in Maryland and his master of business administration degree from the University of Delaware. Rob serves on the Allocation Panel for the United Way of Greater St. Louis. Additionally, he is an Eagle Scout.



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