SUZIE ALLEN: Hi, David. Thanks for joining me.

DAVID PETERSON: Hi, Suzie. It's great to be with you.

SUZIE ALLEN: Well, as you know, we get a lot of questions from clients who have IRAs that they might pass on to their beneficiaries or think they might inherit IRAs themselves. What are the tax implications of inheriting an IRA?

DAVID PETERSON: Yes, well, it's understandable that we get so many questions on this topic since it can be quite complicated. For starters, it's important to understand that when a beneficiary withdraws from a traditional IRA, funded with pre-tax dollars, those withdrawals are generally taxed at the beneficiary's ordinary income tax rate. So what it means from an income tax perspective depends on whether the beneficiary has to take withdrawals from the IRA and when.

Now, recent changes in the law have accelerated the time frame during which many IRA beneficiaries, who inherited after 2020, need to take distributions. The rules are different depending on the beneficiary's relationship to the IRA owner, the beneficiary's age and health, and whether the IRA owner dies before or after the required beginning date for RMDs.

Now, the IRS breaks down individual beneficiaries into 2 main categories. One is Eligible Designated Beneficiaries, or EDBs, and these individuals are spouses, minor children of the account owner, beneficiaries who are disabled or chronically ill, and those beneficiaries who are no more than 10 years younger than the IRA owner. All other individuals are non-eligible designated beneficiaries, including, for instance, healthy children and grandchildren.

Generally speaking, eligible designated beneficiaries get a better tax treatment than other individual beneficiaries. Spouses, in particular, are entitled to options unavailable to other beneficiaries.

SUZIE ALLEN: All right, we're going to break this all down. So let's start with leaving an IRA to your spouse. What are their options?

DAVID PETERSON: OK, so as I just mentioned, spouses get extra preferential tax treatment when it comes to inheriting IRAs. The surviving spouse can elect to treat the decedent's IRA as their own or roll it into one of their existing IRAs. With the election or rollover, the surviving spouse then doesn't need to take any required minimum distributions from the account until their own required beginning date, which is now April 1 of the year after they turn 73. This is true even if the decedent had begun taking RMDs during life.

In some cases, the surviving spouse will not choose to do an election or rollover, in which case different rules apply. But for many, possibly a majority of spouses, an election or rollover will make sense.

SUZIE ALLEN: Well, now let's talk about what happens if you leave a traditional IRA to a non-spouse individual, say your child. What are the rules around that?

DAVID PETERSON: OK, here's where it gets complicated. Legislation effective in 2020 changed the rules for children who are not eligible designated beneficiaries. First is the 10-year rule. If you name your adult child as beneficiary, your child has to take the entire inherited IRA within 10 years of your death. This limits the time during which the IRA could potentially grow tax deferred, and forces your child to pay income tax on traditional IRA assets fairly quickly as they take distributions.

Second are the rules around required minimum distributions. Before the legislative change, an adult child could stretch RMDs over their lifespan. That's no longer the case. Now, if you die after your required beginning date, your adult child will have to take RMDs based on their life expectancy during each of years one through nine, before emptying the account completely in year 10. If you die before your required beginning date, however, the child just has to empty the account by the end of the 10th year.

Now, the rules I just described apply to all individual beneficiaries who are not eligible designated beneficiaries, not just children. Different rules apply for beneficiaries who are minors, disabled or chronically ill, or no more than 10 years younger than the account owner.

SUZIE ALLEN: Very helpful, David. Now, those are the rules for traditional IRAs. What about Roth IRAs?

DAVID PETERSON: Well, the same rules around distributions apply to the beneficiary of a Roth IRA as apply to the beneficiary of a traditional IRA. The effect of these rules is different, however, because Roth IRAs don't require the original owner to take required minimum distributions and because contributions to Roth IRAs are made with after-tax dollars.

So to use the same example of your healthy adult child as your Roth beneficiary, your child must empty the Roth IRA 10 years from your death. However, they don't have to take RMDs during that time.

Similarly, a surviving spouse inheriting your Roth can choose to treat it as the spouse's own, or roll it into their existing Roth account. And because the account is a Roth, like you, your spouse won't need to take RMDs during life.

Regardless of when a beneficiary has to take distributions from a Roth, however, the potential tax consequences are different from those for a traditional IRA. Since Roth contributions were made with after-tax dollars, the beneficiary does not pay income tax on qualified Roth contribution withdrawals. As long as the Roth account was opened 5 years prior to the original owner's death, the earnings or appreciation would generally not be subject to income tax upon distribution.

SUZIE ALLEN: All right, David. Finally, many of our clients may have an estate plan that includes a trust. Now, what are the considerations around leaving an IRA to a trust?

DAVID PETERSON: This question gets at a different category of beneficiary-- non-individuals. When an IRA owner names a beneficiary that is not an individual, such as a charity, the owner's estate or a trust not designed for designated beneficiary treatment, different rules apply from the ones we just discussed.

Naming a charity as beneficiary of an IRA can be very advantageous from a tax perspective, as a charity won't pay income tax on traditional IRA distributions received. In contrast, naming an IRA owner's estate as beneficiary or naming a trust not specifically designed to receive retirement benefits could potentially have unfortunate tax consequences.

Now, the rules can be complex, but in general, please know that, first, for tax reasons, you want to avoid naming your estate as IRA beneficiary, as this can potentially accelerate the distributions. And second, if you want to name a trust as IRA beneficiary, know that you'll want to work with an estate planning attorney familiar with drafting trusts for retirement benefits to make sure that tax considerations are properly handled.

SUZIE ALLEN: David, as always, thank you so much for taking the time to help us understand these questions. We appreciate it.

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DAVID PETERSON: Always a pleasure.

SUZIE ALLEN: If you have questions about managing an inheritance, reach out to your Fidelity representative. If you don't have a Fidelity representative, visit Fidelity.com/FindAnAdvisor. And for more timely news and thinking from Fidelity's top thought leaders, subscribe to *Insights from Fidelity Wealth Management*℠. I'm Suzie Allen. Join me again soon.

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