What You Should Know about Inherited IRAs

The rules governing inherited IRAs can be complicated. Here are the major issues.

Transferring inherited IRA assets

If you inherit an IRA from someone who isn't your spouse, your options are fairly limited. You can't roll the proceeds over to your own IRA, treat the IRA as your own, or make any additional contributions to the IRA. What you can do is transfer the assets to a different IRA provider, as long as the registration of the account continues to reflect that the IRA is an inherited IRA and not your own.

If you inherit an IRA from your spouse, you have many more options. You can roll all or part of the IRA proceeds over to your own IRA. You become the owner of the IRA assets, and the rules that apply to IRA owners, not beneficiaries, apply from that point on. If you're the sole beneficiary of the IRA, you can also generally treat the inherited IRA as your own by retitling the IRA in your name. But you aren't required to assume ownership of an inherited IRA. You can instead continue to maintain the inherited IRA as a beneficiary. You might want to do this if you inherit a traditional IRA and you'll need to use the funds before you turn 59½ (distributions from inherited IRAs aren't subject to the 10% penalty that typically applies to early distributions from IRAs you own).

Required minimum distributions (RMDs)

Non-spouse beneficiary: Federal law requires that you begin taking distributions (called required minimum distributions, or RMDs) from the inherited IRA after the IRA owner dies. If the IRA owner died after turning 70½ and didn't take a required distribution for the year of death, you'll need to make sure to take that distribution by December 31 of the year of death in order to avoid a 50% penalty.

Spouse beneficiary: If you roll the inherited IRA over to your own IRA, or treat it as your own, then the RMD rules apply to you the same way they apply to any IRA owner--you'll generally need to begin taking RMDs from a traditional IRA after you turn 70½; no lifetime RMDs are required at all from a Roth IRA. If you don't roll the IRA assets over or treat the IRA as your own, then the same rules described above for non-spouse beneficiaries generally apply to you, except that you can defer receiving distributions until your spouse would have turned 70½.

Special rules--inherited Roth IRAs

Qualified distributions to a beneficiary from an inherited Roth IRA are free from federal income taxes. To be qualified, the distribution must be made after a five-year holding period. The five-year period begins on January 1 of the year the deceased IRA owner first established any Roth IRA, and ends after five full calendar years. If you take a distribution from an inherited Roth IRA before this five-year period ends, any earnings you receive will be subject to federal income taxes (earnings generally come out last). If you're a spouse beneficiary, and you roll the inherited Roth IRA over to your own Roth IRA or treat the inherited IRA as your own, then you'll be eligible to take tax-free distributions only after *you* reach age 59½, become disabled, or have qualifying first-time homebuyer expenses. You'll also need to satisfy the five-year holding period, but a special rule applies--the five-year period for *all of your Roth IRAs* will be deemed to have started on January 1 of the year you or your spouse first established any Roth IRA, whichever is earlier.

And speak to a financial professional if...

- You're sharing the inherited IRA with other beneficiaries. This can impact when and how you must begin receiving RMDs from the IRA.
- You don't want or need the IRA funds. You may be able to disclaim the IRA and have it pass to another beneficiary. This must be done in accordance with strict IRA rules.
- Any estate taxes were paid that are attributable to the inherited IRA. You may be entitled to an income tax deduction equal to the estate taxes paid.

Ask the Experts: How have stocks performed after a recession?

Mark Twain said it best: "History doesn't repeat itself; at best it sometimes rhymes." Past performance is no guarantee of future results, and history can be an uncertain guide in terms of what might happen with stocks this time around as the economy begins to stagger out of a recession.

That said, it's fascinating to look at how various sub-segments of the stock market have behaved relative to one another. Particularly interesting is the comparison between the performance of small-cap stocks and that of large caps after each of the last six recessions. In each case, small caps led the way out of those downturns. During the 12 months after the recession came to an end, as declared by the National Bureau of Economic Research (NBER), small caps beat large caps every time.

The average difference over the six recovery periods was 14.5%. In some cases, the difference was dramatic; in others, small caps were barely ahead. Here are the percentages by which small caps beat the S&P 500*:

- December 1970-November 1971: 1.3%
- April 1975-March 1976: 23.2%
- August 1980-July 1981: 28.4%
- December 1982-November 1983: 14.4%
- April 1991-March 1992: 14.8%
- December 2002-November 2003: 5.2%

Will history rhyme this time? It's hard to say. Many economists feel the current recession ended sometime in summer 2009. Small-cap stocks have certainly done well since then, but some experts feel large caps are best equipped to navigate a credit crisis. However, until the NBER retroactively declares an official end to this recession, there's no way to know for sure. And don't forget that small caps historically have involved greater risk from market fluctuation, so a double-dip downturn could hit them hardest.

*Percentages calculated based on data from Ibbotson SBBI *Market Results for Stocks, Bonds, Bills, and Inflation* for small company stocks and the S&P 500 Composite Index.

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