WHEN THE FIVE-YEAR RULE APPLIES

Wednesday, June 15, 2022

By Sarah Brenner
Director of Retirement Education
Follow Us on Twitter: @theslottreport

If you inherit an IRA, especially if it is a larger one, you may be afraid of being stuck with the five-year distribution rule. If this rule applies, your IRA must be entirely emptied in five years, which can be a serious tax hit.

Under the tax rules, if you are named as the beneficiary on the IRA beneficiary designation form, you will not be subject to the five-year rule. Instead, you will most likely be looking at a 10-year payout under the SECURE Act. If you qualify as an eligible designated beneficiary, you can even still stretch payments from the inherited IRA over your life expectancy. Eligible designated beneficiaries include spouses, disabled and chronically ill individuals, minor children of the IRA owner who are under age 21, and individuals who are not more than 10 years younger than the deceased IRA owner.

So, what are those rare times when the five-year rule does apply? Well, this can happen if you inherit IRA funds through an estate (as opposed to if you were named directly on the beneficiary designation form). If an estate is the beneficiary, there is no designated beneficiary. If the IRA owner dies before the required beginning date with his estate as beneficiary, that is the time under the tax rules when you will be stuck with the five-year rule. If the IRA owner dies on or after their required beginning date, you escape the five-year rule and can take distributions over the remaining life expectancy of the deceased IRA owner. Here is where the rules can be tricky. All Roth IRA owners are considered to have died before their required beginning date because required minimum distributions do not apply to Roth IRAs during the original owner’s lifetime. That means whenever you inherit a Roth IRA through an estate you will be hit with the five-year rule.

Example: Joseph, age 82, dies in 2022. His Roth IRA beneficiary is his estate. His daughter Missy is a beneficiary of the estate. Because the estate was the named beneficiary and not Missy, the inherited Roth IRA must be distributed in five years. If Missy had been named on the beneficiary form, she could have had 10 years to empty the inherited IRA.

It is important to keep in mind that while most IRA documents do not limit the options to a beneficiary that are otherwise available under tax law, a few do. It is possible that your inherited IRA might include language that would limit you to the five-year rule. In these cases, it is your IRA document and not the tax rules that is leaving you stuck with the five-year rule.

Professional Advice

The rules can be complex. When you inherit an IRA, be sure that everything is done the right way. To minimize the risk of unnecessary taxes and penalties, your best bet is to seek advice from a knowledgeable tax advisor.