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Heirs Finally Get an Answer From IRS About Money in Inherited Retirement Accounts

Investors have been waiting for clarity from the IRS for years after a 2019 law changed the rules

By *Ashlea Ebeling* [Follow](#)

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People who inherit retirement accounts have 10 years to take out the money, and most of them must take out a minimum amount each year, under rules the Internal Revenue Service finalized Thursday.

It used to be that most heirs could stretch out inherited retirement account withdrawals over their lifetimes, meaning decades of smaller payouts and more growth potential. In 2019, a new retirement law said many people who inherited individual retirement accounts or 401(k)s had to take the money out within 10 years.

The law didn't specify whether people had to take out money each year, or could wait until the final year to take out all of the funds.

Investors asked the IRS to do away with minimum annual withdrawals to take advantage of tax savings and allow their money to grow. The IRS's final rules say money must come out each year for many heirs. The agency said that is what it determined Congress intended.

The rules affect most heirs, but not spouses. The new guidance applies to both future inheritors and the many people who inherited accounts since 2020, who have been in limbo waiting for the rules.

Congress, in an effort to raise revenue and keep the wealthy from shielding money, has been changing laws governing the trillions of dollars in 401(k)s and other retirement accounts. It is also likely to keep doing so. This means individual investors will have to readjust how they plan for retirement and continue to work through a maze of ever-changing new rules.

Roberton Williams, a 76-year-old retired economist in Alexandria, Va., inherited an IRA from his 101-year-old mother in 2020. He thought the rules meant he had to take out a 10th of the account each year, a common misconception.

“It’s complicated. It’s not obvious how much you have to take out, when, over the 10 years,” he said. “I figured as long as I got it out in 10 years I’d be OK.”

He took some money out last year and is considering taking the rest out before the Trump-era tax cuts are set to expire after 2025. Under the final rules, he does have to take a minimum withdrawal next year.

New rules

The new rules don’t apply to spouses who inherit an IRA—that is a whole different set of rules. It also doesn’t apply if the person with the IRA died before required distributions kicked in—today, that is anyone under age 73.

But, if the person who died was required to take withdrawals, the person who inherits the account must take annual payouts starting the year after death. The law mostly affects children and other inheritors, like grandchildren, siblings and friends.

Because there has been confusion about the new rules, many people didn’t take distributions in the past several years. The IRS has essentially excused them, saying it won’t penalize people in this situation for failing to take required payouts for the years 2021 through 2024.

The penalty for missed withdrawals is 25% of the amount that should have been withdrawn. In a separate 2022 retirement law, Congress cut the penalty from 50% effective 2023.

Some who inherited IRAs in the years 2020 to 2023 and held off on taking withdrawals had hoped the IRS would give them a few extra years to empty the account. But the final rules don’t extend the 10-year period, said Denise Appleby, an IRA

consultant in Grayson, Ga.

You have to start taking annual withdrawals in 2025, with the calculation of how much based on your life expectancy. If you were worried about having to make a big payout in 2025 because you skipped withdrawals from 2021 through 2024, that won't be the case.

If someone died and left you an IRA before they had to take withdrawals, you are allowed to take the money out any time during the 10-year period, even waiting until year 10, according to the final rules.

Congress has been moving up the age at which payouts must start. The required beginning date for IRA owners is currently April 1 of the year after you turn 73.

Tax balloon

Withdrawals from traditional retirement accounts are taxable.

Following the updated IRS guidance, tax professionals said heirs should be careful if they take out only the required distributions each year. Doing so would mean a balloon distribution in the final year and potentially a big tax bill.

For example, if a taxpayer who inherited a \$100,000 IRA in 2020 at age 50 didn't take distributions for 2021 through 2024, and the IRA had a 5% rate of return, the market value would be about \$121,550. In 2025, the required distribution would be just under \$4,000.

If the taxpayer continued taking out only the minimum amount by default, by 2030, the year the account would have to be depleted, there would be \$151,000 to distribute. That could tip you into a higher income bracket for that year and leave you with a bigger tax bill. The one caveat to taking out larger distributions is if you're expecting your income to drop in the future. If so, you might want to wait to take a bigger distribution in the final year, said Appleby, the IRA consultant.

Multiple IRAs and caveats

The final rules don't end the confusion. Congress layered the new law on top of older IRA rules, so heirs can be left juggling multiple IRAs with different payout rules.

For example, Williams is taking required payouts from his own IRA, calculating the payouts using one set of life expectancy rules. The IRA inherited from his mother entails different calculations.

The best type of IRA to inherit is a Roth IRA. You don't have to take the money out until the 10th year, and withdrawals are generally tax-free.

There are people who must take a required minimum distribution, or RMD, this year. Spouses and certain other beneficiaries, including the chronically ill, generally take annual RMDs over their expected lifetimes. And heirs who inherited accounts before 2020 are still subject to the old rules, which require annual withdrawals over their expected lifetimes.

Write to Ashlea Ebeling at ashlea.ebeling@wsj.com

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