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Inherited IRA Q&A

Q: When I inherited several traditional Individual Retirement Accounts (IRAs) from my spouse, I chose to place them into inherited IRAs. My spouse and I were both born in the same year. I'm currently under 59½. Is there a penalty or are there rules against transferring these inherited IRA accounts into IRAs under my name now or a few years down the line? What about an Inherited Roth IRA?

A: There is no rule prohibiting a surviving spouse from rolling their deceased spouse's IRA into the survivor's IRA or into an inherited IRA and then into the survivor's personal IRA. The same can be said for Roth IRAs. Only spouses have this ability. Everyone else, either takes the funds as an inherited account or must cash out within five years and pay any applicable taxes.

You were smart to keep his IRA in an inherited IRA instead of automatically rolling it into your own because once it is in your IRA, the funds are treated as if they were always yours. Since you are under 59½, that would mean being subject to the 10% penalty for early distributions should you need cash.

By leaving the money in an inherited IRA, withdrawals will be taxed but the exception for death will avoid the 10% penalty. Once you reach 59 ½ or get close enough to that age that you don't think you will need a withdrawal, you can then roll it into your own IRA.

Another good reason to roll the inherited IRA into your own IRA is that if desired, you can convert funds in your own IRA to a Roth IRA but conversions from an inherited IRA are not permitted.

With an inherited Roth IRA, most spouses roll those into their own Roth IRA because there are no Required Minimum Distributions (RMDs) from an individual's Roth IRA but inherited Roth IRAs are subject to RMDs, even if it is a spouse inheriting.

In addition, if you roll the inherited Roth IRA into your Roth IRA, you can access some money tax free due to the ordering rules that apply to Roth accounts. All contributions your spouse made to a Roth IRA and any amounts that were converted from a traditional IRA to Roth more than five years ago are available without any tax even if you are under 59½.

Once you hit 59½, the only funds in a Roth that could be taxed are earnings, but if it has been five years or more since you opened your first Roth IRA, that stops being an issue and all distributions from your Roth IRA are tax-free. Earnings come out last so, if owning a Roth IRA is new for you, you would have to take out all contributions and converted amounts before you got to the earnings and owed any tax.

Q&A Extra: An additional item to check when dealing with an inherited IRA is whether the deceased still had any basis left in their traditional IRA which would be available to come to the beneficiary tax free over time as distributions are made. A check of the deceased's last tax return should reveal any remaining basis.