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Tax planning: Minimizing taxes on inherited IRA distributions

Key takeaways:

- Proposed IRS regulations requiring certain inherited IRA beneficiaries to continue taking required minimum distributions (RMDs)[1] would result in lower overall taxes for most beneficiaries.
- Inherited IRA distributions that are spread equally across 10 years would improve the tax outcomes even further for most beneficiaries.
- Income spread over multiple tax years lowers an individual's taxes over time by enabling them to take advantage of lower tax brackets.

The IRS issued proposed regulations in 2021 to clarify the inherited IRA distribution requirements that were first laid out in the 2019 SECURE Act. The proposed regulations state that IRA beneficiaries who inherit after the original owner began taking RMDs, are subject to both continued RMDs and the 10-year rule.[2] Although this requirement may be perceived unfavorably by investors because of the taxes they'll incur, the new regulations may benefit investors by enabling them to spread income over multiple years. This paper examines the tax consequences of different withdrawal strategies. While tax impacts are relatively straightforward, wealth impacts are complex and require detailed analysis of the investor's individual circumstances.

Opportunity for threshold planning

IRAs are valued for their tax-deferred growth opportunity—the more tax-deferred growth, the better—but that may not be the end of the analysis. The flip side is to consider the tax treatment of inherited IRA distributions within the context of threshold planning.

Looking for ways to spread income across multiple years to take advantage of lower tax brackets is a fundamental way to manage income taxes. This opportunity applies any time a decision is made between taking taxable income in a lump sum or in installments over time. Inherited IRA distributions can be viewed in the same manner.

By spreading distributions over the full 10 years, the beneficiary can take advantage of lower tax brackets each year and avoid creeping into higher brackets. The overall difference in taxes can be meaningful while also allowing for some continued tax-deferred growth.

To learn more about threshold planning, refer to the Vanguard research paper, *Fundamentals of tax planning: Beyond the basics*.

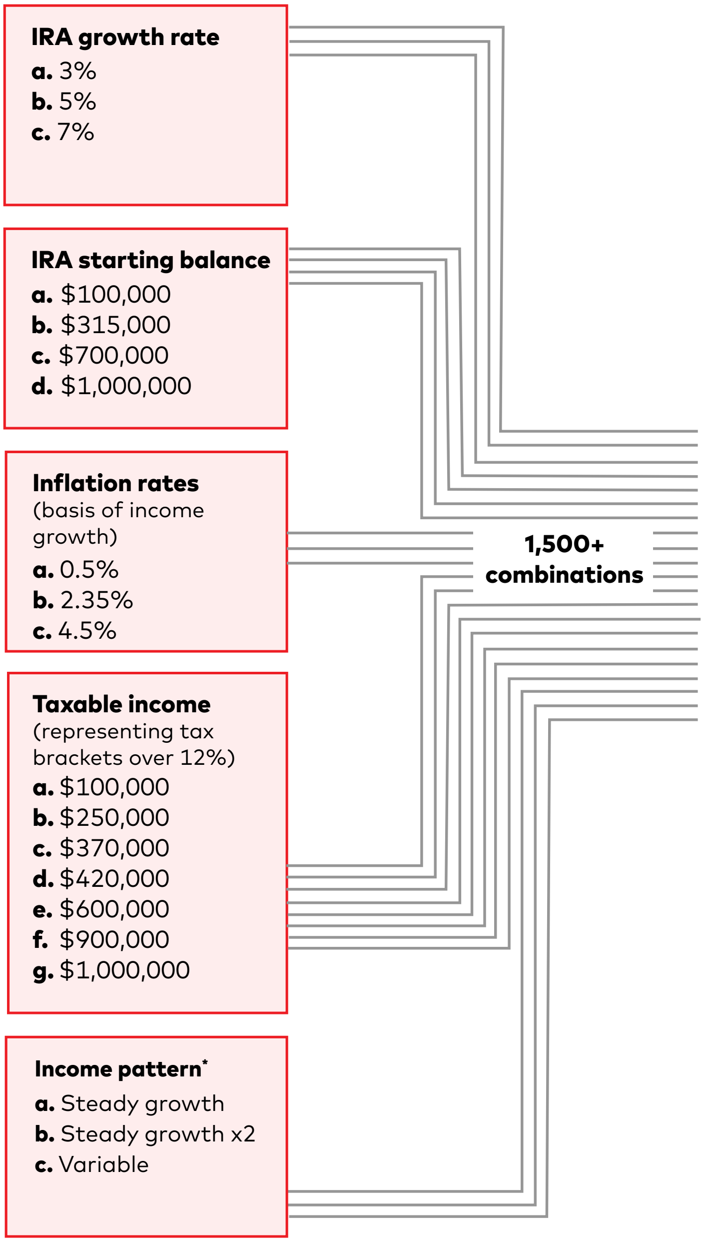
1 The IRS requires that most owners of IRAs withdraw part of their tax-deferred income each year. Due to changes to federal law that took effect on January 1, 2023, the age at which you must begin taking RMDs differs depending on when you were born. If you reached age 72 on or before December 31, 2022, you were already required to take your RMD and must continue satisfying that requirement. However, if you hadn't yet reached age 72 by December 31, 2022, you must take your first RMD from your traditional IRA by April 1 of the year after you reached age 73.

2 If you inherited an IRA on or after January 1, 2020, you may need to withdraw the balance of the account no later than the 10th anniversary following the calendar year of the IRA owner's death. In some cases, annual RMDs must also be taken.

Testing distribution strategies

To confirm this conclusion, members of Vanguard's Enterprise Advice Methodology team took a matrixed approach and tested three distribution strategies across a variety of inputs. The variables were selected as a representative sample of all possible scenarios. The visual below represents the variables used as inputs and the combinations of those variables that were tested:

Inputs



Distribution strategies

1. All out in Y10 = Complete distribution in year 10.
2. RMD with balance out in Y10 = RMDs taken in years 1-9, with remaining balance distributed in year 10.
3. Equal annual distributions = Multiplying the inherited IRA balance each year by 1/N in which N is the number of remaining years for distribution. Keep in mind that the balance continues to grow over the 10 years, so the yearly distributions won't be exactly equal.

The results were consistent across the tested representative combinations. Equal annual distributions led to the lowest total taxes paid on nearly all inherited IRA distributions.**

***** Patterns of income represented include steady growth which increases income annually at the inflation rate. Steady growth x 2 increases income annually at 2x the assumed income inflation rate and other income fluctuations that were randomly generated to represent a wide range of potential fluctuations.

****** Out of more than 1,500 combinations, 12 had the lowest taxes with distribution strategy 2.

Note: These hypothetical examples do not represent the return on any particular investment and the rate is not guaranteed.

Case study: Henry and Willow Joyner

Let's see what testing these strategies looks like with hypothetical investors. Henry and Willow are a married couple with $420,000 in taxable annual income (32% tax bracket), who file jointly. Willow's mother passed recently leaving them an inherited IRA with a $1M balance. They want to understand their distribution options to decide which strategy makes the most sense for them.

Distribution strategies	Annual distributions	10-year tax increase from distributions
All out in Y10	Years 1-9 = $0	$563,840
	Year 10 = $1,551,328	
RMD with balance out in Y10	Year 1 = $19,418	$532,045
	2 = $20,388	
	3 = $21,408	
	4 = $22,478	
	5 = $23,602	
	6 = $24,782	
	7 = $26,021	
	8 = $27,322	
	9 = $28,689	
	10 = $1,280,222	
Equal annual distributions	Year 1 = $100,000	$417,743
	2 = $105,000	
	3 = $110,250	
	4 = $115,763	
	5 = $121,551	
	6 = $127,628	
	7 = $134,010	
	8 = $140,710	
	9 = $147,746	
	10 = $155,133	

Note: The tax increase represents the amount in taxes paid above what they would have paid on income that didn't include the distributions. These figures only apply to income from the distributions; other income isn't included in these numbers. The income growth is calculated with an inflation rate of 2.35% and the inherited IRA rate of return is 5%.

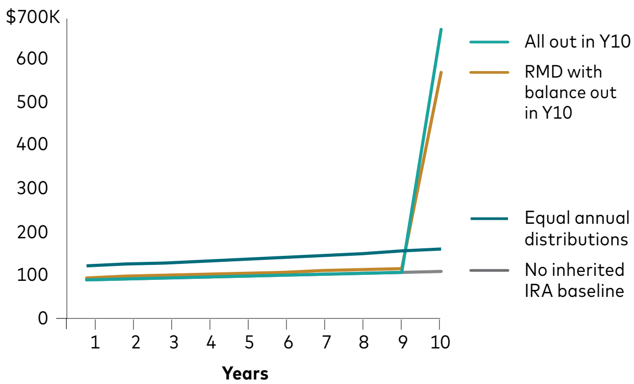
This hypothetical example does not represent the return on any particular investment and the rate is not guaranteed.

As we can see from the table above, the equal annual distributions strategy results in the Joyners paying less in taxes over the 10 years compared to the other two strategies.

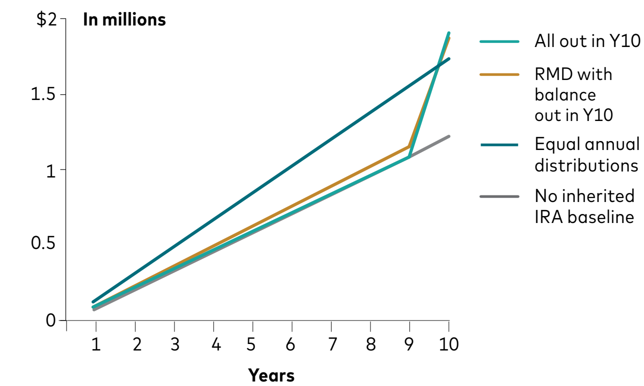
The following graphs further illustrate the differences in the taxes the Joyners would incur using the three different strategies.

Comparing taxes paid

Taxes paid each year



Cumulative total annual taxes paid



Note: To simplify the information being presented, the graphs show total taxes paid, inclusive of the amounts the Joyners would owe for their normal income taxes.

Source: Vanguard.

Special circumstances

While the Joyner case study shows how spreading distributions over the full 10 years can be beneficial to most inherited IRA beneficiaries, there are some circumstances when it might make sense to go a step further:

Taxpayers in the highest tax bracket. Individuals in the top tax bracket and likely to stay there have a limited opportunity to manage the taxes on inherited IRA distributions. Consider opportunities to broadly adjust and defer income when possible.

Taxpayers with inconsistent income. Individuals who experience meaningful income fluctuations from year to year will likely want to adjust distributions annually based on each year's taxable income. Combining an understanding of potential fluctuations with threshold planning may provide additional tax savings.

Taxpayers with isolated income fluctuations. Some individuals may experience a limited year income increase or decrease. Adjusting distributions in these years may provide additional tax savings.

Unique circumstances. There are several exceptional circumstances which might indicate the need for a more customized approach. These include taxpayers who:

- Have impacts to their Medicare costs brought about by their income-related monthly adjustment amount (IRMAA).
- Want to qualify for specific deductions or tax credits.
- Seek to qualify for student loans.

Next steps

Investors who've inherited an IRA and want to minimize the tax impacts of their distributions may want to consider taking the following actions:

1. Compare distribution strategies.
2. Discuss options and outcomes.
3. Evaluate the ability to shift distributions to other tax-deferred accounts.
4. Reinvest distributions in tax-efficient ETFs or index funds.

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