IRA Post-Mortem Considerations

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When an individual retirement account (IRA) owner passes away, those handling the estate assets and making IRA elections and other decisions have to take many things into consideration. An incorrect decision can lead to immediate taxation of the entire IRA; a prudent decision can result in a significantly larger tax deferral for the beneficiaries. Below are just some of the matters a fiduciary should keep in mind when handling an inherited IRA.

Required Minimum Distributions
A designated beneficiary of an IRA is entitled to receive post-death required distributions over his or her lifetime. The key is making sure the named beneficiary qualifies as a designated beneficiary. Only individuals may qualify as designated beneficiaries. Entities such as the IRA owner's estate cannot be a designated beneficiary (however there are special rules that apply to trusts).

If the IRA owner doesn't have a designated beneficiary and dies before the required beginning date, the five-year provision goes into effect. This provision calls for the entire IRA to be distributed within five years of death. The life-expectancy rule is applicable, however, where death occurs after an IRA owner's required beginning date and there is no designated beneficiary.

If an IRA owner dies on or after the required beginning date, the beneficiary must take a required minimum distribution (RMD) for the year of death if the decedent has not already taken the RMD. This year-of-death RMD is calculated the same way regardless of whether the IRA owner is alive or deceased. Subsequent RMDs for non-spouse beneficiaries who wish to utilize a life expectancy payout must begin by December 31 of the year following the year of the IRA owner's death. A spouse beneficiary can defer taking RMDs until the year the deceased IRA owner would have attained age 70½. If the IRA owner died on or after the required beginning date, the spouse beneficiary must begin taking RMDs by December 31 of the year following the year of the IRA owner's death. If, however, the spouse beneficiary rolls over the account into an IRA in the spouse's own name, the spouse can defer RMDs until the spouse's required beginning date (i.e., April 1 of the year following the year the beneficiary spouse turns age 70½).

Title of Account
While non-spouse beneficiaries generally are allowed to transfer an inherited IRA to another account or custodian, the receiving account must be titled in the name of the decedent. If the IRA is not titled correctly, it will cause a deemed distribution and trigger income tax on the entire account. It is critical that the beneficiary maintains the IRA in the name of the decedent and does not unwittingly cause the benefit to be immediately subject to income tax. In this regard the beneficiary should maintain title to the IRA in the name of the decedent, held for the benefit of the beneficiary. Sample language is “John Smith, Deceased IRA held fb/o Jane Smith.”

Disclaimers
Perhaps the most beneficial rule of the regulations is the one that requires that a beneficiary isn't “finalized” (i.e., determined) until September 30 of the year following the year of death. In the case of a qualified disclaimer—where a beneficiary refuses to accept an interest in the property—the disclaimant is treated as if he or she died before the interest in the property was created. In the case of IRAs, a qualified disclaimer will allow for the interest to pass to a contingent beneficiary and also for such contingent beneficiary’s life expectancy to be used to calculate RMDs.

Given the opportunity to finalize a designated beneficiary as of September 30 of the year following the year of death, as well as proactively anticipating potential spousal needs and estate tax, disclaimer-based planning often will be the mechanism of choice. An important element in planning will be to envision the possibility of a disclaimer and embrace the potential for post-mortem planning. The key to this opportunity is to name a series of beneficiaries. If no contingent beneficiary is named, disclaimer assets will pass according to the plan document (custodial agreement). Typically, custodial agreements will make the IRA payable to an estate, which cannot be a designated beneficiary. Beneficiaries cannot be added but they can be removed. Thus, it is critical that the planner grasp the requirements of a qualified disclaimer and potential pitfalls, especially the default provisions of the custodial agreement and where assets pass to in the event of a disclaimer.

Recall that when the IRA owner dies after reaching his required beginning date, the RMD for the year of death must be made (or have been made) to either the participant or the designated beneficiary. In Revenue Ruling 2005-36, the beneficiary’s disclaimer of his beneficial interest (i.e., the interest he
would receive as beneficiary) in the decedent’s IRA was ruled a qualified disclaimer under Code Sec. 2518 even though the beneficiary received the RMD for the year of the decedent’s death before making the disclaimer. The ruling held that the beneficiary may make a qualified disclaimer with respect to all or a portion of the balance of the IRA, other than the income attributable to the RMD that the beneficiary received, provided that at the time the disclaimer is made, the disclaimed amount and the income attributable to the disclaimed amount are paid to the beneficiary entitled to receive the disclaimed amount, or are segregated in a separate account.

Example: Keith’s spouse, Lydia, is the designated sole beneficiary of Keith’s IRA after his death. Their son Nick is the designated contingent beneficiary in the event Lydia predeceases Keith. Three months after Keith’s death, the IRA custodian pays Lydia $100, the RMD for the year of Keith’s death. No other amounts have been paid from the IRA since Keith’s death. Seven months after Keith’s death, Lydia disclaims $600 of the IRA account balance plus the income attributable to the $600 after the date of death. The disclaimer is valid and effective under applicable state law. As a result, Lydia is treated as predeceasing Keith with respect to the disclaimed property and Nick, the contingent beneficiary, is paid the disclaimed $600 plus its income earned between the date of death and the date of the disclaimer. Under Revenue Ruling 2005-36, Lydia has made a qualified disclaimer of the $600 plus its income earned.

Separate Shares
Where multiple beneficiaries exist, segregating the account into separate shares will allow each beneficiary to utilize his or her own life expectancy to calculate RMDs. If separate shares are established before December 31 of the year following the year of the IRA owner’s death, the 401(a)(9) Regulations allow the distribution from each share to be determined based on the age of the share beneficiary. For example, if dad names his three children as IRA beneficiaries, and if a separate share is set up for each child within the required time frame, the required distribution from each share is based solely on the child’s age. The significance of separate shares is two-fold:
1. Each separate share allows the beneficiary to calculate RMDs based on the beneficiary’s own life expectancy.
2. Where multiple beneficiaries exist, one of which is not a qualified beneficiary, separate shares allow for life expectancy distributions for the qualified shares.

When naming a trust as designated beneficiary, the shares must be created under the plan or beneficiary designation rather than merely within the trust. In Private Letter Ruling (PLR) 200537044, however, the Internal Revenue Service (IRS) allowed individual beneficiaries to use their own life expectancies to calculate RMD for their shares of the IRA. Upon the IRA owner’s death, the “IRA Trust” created a separate sub-trust for each beneficiary and the IRA was divided into separate IRAs, one for each sub-trust. The IRA owner expressly named each separate sub-trust as a beneficiary of his IRA, each with a different percentage interest. In prior PLRs, however, the taxpayer named the master trust as IRA beneficiary, with instructions that it then be divided into equal shares and payable to the separate sub-trusts. This situation is analogous to an individual naming two completely independently executed trusts as equal beneficiaries of an IRA.

Pay out of Estate/Trust
If an IRA is payable to an estate or to a trust that pays the beneficiaries, there is no need to keep the estate or trust open simply to receive IRA distributions. The fiduciary can instead make an in-kind distribution of the IRA to the beneficiaries by retitling the IRA as an inherited IRA for the benefit of the estate/trust beneficiaries. This allows the estate/trust to close. Some custodians refuse to do this, saying they can only title the IRA for the benefit of the named beneficiary (i.e., the estate or trust) or make distributions to the named beneficiary. The IRS, however, has allowed this in-kind distribution in at least one PLR. In PLR 200647030, the deceased IRA owner named his estate as the beneficiary of his IRA. Under the IRA owner’s last will and testament, his children were the equal beneficiaries of the estate. The children, as co-executors of the estate, proposed to transfer, by means of trustee-to-trustee transfers, in equal shares, the IRA into two newly created inherited IRAs. The IRS ruled the IRA created by means of a trustee-to-trustee transfer, which will be titled “Decedent A (Deceased) f/b/o Child [1 or 2], beneficiary thereof,” constituted an inherited IRA. Of course, PLRs cannot be relied on for precedent and are binding on the IRS for only the taxpayer who requested the ruling. If the custodian simply refuses to make such a transfer, the alternative is to perform a trustee-to-trustee transfer of the IRA to a custodian who will agree to make an in-kind distribution of the IRA to the estate/trust beneficiaries.

Pay out Undesirable Beneficiaries
Because a designated beneficiary can be finalized up until September 30 of the year following the year of death, it is possible to eliminate non-individual or individual beneficiaries through cash out. This can help save the designated beneficiary status of the individual beneficiaries and allow such beneficiaries to take RMDs over a life expectancy payout, as explained in the following example.

Assume that an IRA is payable 50 percent to charity and 50 percent to children. Because a charity is not an individual, it does not qualify as a designated beneficiary. If the interest payable to charity is paid out before
September 30 of the year following the year of death, the charity need not be taken into consideration in determining whether a designated beneficiary exists. If the charity is not paid out by that date, the children will not be able to utilize their life expectancies to calculate RMDs.²

**Roth IRA Recharacterization**

When a taxpayer converts a traditional IRA to a Roth IRA, the entire tax liability associated with the Roth IRA conversion can be eliminated by recharacterizing the entire Roth IRA back to a traditional IRA. This recharacterization election generally must occur on or before the date prescribed by law, including extensions, for filing the taxpayer’s federal income tax return for the year of the Roth conversion. The election to recharacterize a Roth conversion may be made on behalf of a deceased IRA owner by the executor, administrator, or other person responsible for filing the decedent’s final federal income tax return. If the Roth IRA owner dies before the deadline for recharacterizing the Roth IRA back to a traditional IRA, the person responsible for filing the decedent’s final federal income tax return should explore whether a recharacterization would be prudent. This is particularly true if the IRA value has fallen since it was converted to a Roth IRA.

**Conclusion**

When dealing with an inherited IRA, an incorrect decision can lead to immediate taxation of the entire IRA and a prudent decision can result in a significant increase in tax deferral for the beneficiaries. It is therefore important that an advisor fully understand the choices available and the ramifications of such choices before making decisions regarding an inherited IRA. An understanding of the areas discussed in this article should give an advisor a good start on spotting potential issues and solutions involved with inherited IRAs.

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**Endnotes**

1  Treas. Reg. § 1.401(a)(9)-4, A-5(c). See PLRs 200317041, 200317043, and 200317044 in which the taxpayers were forced to take RMDs over the life expectancy of the oldest trust beneficiary.

2  In this case, the opportunity for separate shares exists. If the shares are not segregated by September 30th, however, the nonqualifying beneficiary may infect the entire designation.