

Traps: Inheriting an IRA Through an Estate

Take-Away: Naming an estate as the beneficiary of an IRA is probably a mistake, because there are potentially two different distribution periods that might apply, which in turn can cause confusion that then leads to a 25% excise tax for the failure to take a required minimum distribution (RMD.)

Background: Many IRA custodians use the decedent's estate as the default beneficiary. When the default beneficiary is the deceased IRA owner's probate estate, problems can arise, usually due to the different required minimum distribution (RMD) rules that apply to a non-designated beneficiary.

Estate as Default Beneficiary: A non-designated beneficiary is an entity that does not qualify as a designated beneficiary (admittedly this is not a helpful definition.) Examples of non-designated beneficiaries includes the decedent's estate, charities, and corporations, i.e., those that are not individuals. For this summary, the non-designated beneficiary will be limited to the deceased IRA owner's estate.

Key Point: If an individual inherits an IRA *through* the deceased IRA owner's probate estate, that individual is *not a designated beneficiary*. That means that the individual cannot follow the distribution rules had he/she been directly named as the designated beneficiary of the decedent's IRA, even when the inherited IRA is later retitled in the individual's name.

Distribution Rules for Non-Designated Beneficiaries: This is when the 5-year distribution rule for non-beneficiaries comes into play.

RBD: The distribution rules for a non-designated beneficiary, e.g., an estate, depend on whether the IRA owner died *before* his/her required beginning date (RBD). Currently the RBD for the IRA owner is April 1 of the year that follows the year that the IRA owner attains his/her 73rd birthday. [The date of birth- 73 years is for those individuals who were born on or after January 1, 1951, but before January 1, 1960. The RBD for those who were born on or after January 1, 1960, is age 75.] Roth IRA owners are always treated as if they died before their RBD, since Roth IRA owners are not subject to required minimum distributions (RMDs)

so a Roth IRA that is paid to the IRA owner's probate estate must be distributed within 5 years!

Distribution Period: If the IRA owner died *before* his/her RBD, the IRA must be fully distributed no later than the fifth (5th) year after the year of the IRA owner's death. Distributions during that period are optional, i.e., not required.

If the IRA owner died on or *after* his/her RBD, distributions must be made over (not at the end) the remaining single life expectancy of the IRA owner. It is the IRA owner's life expectancy, not the individual who might ultimately inherit the IRA, that governs this distribution period. Note that more than the annual RMD amount for a year can be taken at any time by the inheritor.

Distribution Traps: Since it is the IRA owner's RBD and his/her life expectancy that controls the distribution period to a non-designated beneficiary, some erroneous assumptions can be made that lead to excise tax traps. A couple of examples describe those potential traps.

Example: Ted died in 2022 at age 75 (after his RBD.) Ted left \$1.0 million in a traditional IRA. Ted's estate was the default beneficiary of his IRA. The sole beneficiary of Ted's estate is his niece, Nancy, who is age 55. Since Ted died after his RBD, his estate may take *annual* distributions based on Ted's remaining life expectancy of 13.8 years. Form 1099-R will be issued to Ted's estate reporting those distributions from the IRA.

However, Nancy does not want to keep Ted's probate estate open for 13.8 years. Nancy asks the custodian of Ted's IRA to transfer the IRA to an inherited IRA held in Ted's name in 2023. As a result, 1099-R's will then be issued to Nancy using her own Social Security number. However, the distribution option for Ted's IRA is still based on Ted's estate being the non-beneficiary of the IRA, not Nancy. (Nancy was never a designated beneficiary.) [Aside: Some IRA custodians may not accommodate Nancy's request, and they will not honor the request without an expensive Private Letter Ruling before they will follow Nancy's request.]

Example: Same facts as above, except Ted dies in 2022 at age 70, before Ted's RBD. In this case the five-year distribution rule applies, which means that Ted's IRA must be fully distributed by December 31, 2027. Any remaining balance after that December 31, 2027, date would be considered an RMD shortfall and be subject to a 25% excise tax for the failure to take an RMD. Because this inherited IRA is now in Nancy's name and it uses her Social Security number, there is a risk that Nancy's IRA new custodian (or her CPA) will assume that Nancy was the designated beneficiary of this inherited IRA, which is not the case.

Mistake: If it is a new IRA custodian, or a new CPA, and Nancy inherited the IRA *before* Ted's RBD, they might assume that since the IRA is registered in Nancy's name and it uses Nancy's Social Security number, that she inherited the IRA directly from Ted and thus they calculate the RMD based on Nancy's life expectancy. In other words, Nancy's CPA thinks that Nancy had 10 years to distribute the IRA, instead of 5 years, thus causing Nancy to have an RMD shortfall after the 5th year.

Mistake: Or, if Ted died on or *after* his RBD, Nancy's CPA might think that Nancy had 10 years to distribute the IRA instead of 13.8 years, causing Nancy's annual RMD to be incorrectly calculated.

Dealing with the Traps: Following the examples which can lead to the imposition of an excise tax, Nancy is responsible to pay the excise tax to the IRS. Yet there are two steps to consider: (i) if Nancy corrects the RMD shortfall during the correction window period [described on Form 5329], the excise tax will be reduced from 25% to 10%; and (ii) Nancy can always request a waiver of the excise tax based on some unique circumstances which the IRS might consider *reasonable cause*, e.g., Nancy relied on her IRA custodian's erroneous calculation of her RMD for the year. There is no guarantee that the IRS will grant the waiver of the excise tax, though.

Practical Observation: Should an IRA owner name his/her estate as the beneficiary of their IRA? No.

Before RBD: If the IRA owner dies before his/her RBD, the 5-year distribution rule will apply. In contrast, if an individual person is named as the IRA beneficiary, he/she will have 10 years to distribute the IRA, which will allow for more efficient tax-planning. If the decedent owned a Roth IRA, that account could grow tax-free for 10 years if an individual is named as the beneficiary, and if the individual was an *eligible designated beneficiary*, he/she would have the option of taking annual distributions from the inherited IRA over their full life expectancy (except in the case of minor children, where their distribution period can only be extended until they attained age 31 years.)

After RBD: If the IRA owner dies after his/her RBD, distributions can be stretched over the deceased IRA owner's ghost life expectancy, if they name their estate as the beneficiary, or the estate becomes the default beneficiary of the IRA. In contrast, if the IRA owner names an individual person as the beneficiary of the IRA, they would have 10 years to distribute the inherited IRA, but they must take annual RMDs over that 10-year period. If the individual beneficiary is an *eligible designated beneficiary*, he/she must take annual distributions over their full life expectancy, again with the age 31 limit for a child of the deceased IRA owner.

Conclusion: It is a simple take-away. If an IRA is inherited through an estate, the distribution rules for the estate apply, even if the IRA is later transferred to an individual. That individual who ultimately inherits the IRA is stuck following the non-designated beneficiary distribution rules, not their own as a designated beneficiary, the only exception being a surviving spouse who may (not always) be able to rollover the deceased spouse's IRA to their own IRA if the survivor controls the decedent's estate and he/she is the sole beneficiary of deceased spouse's estate.

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