Your Questions Answered

By Gil Charney, CPA, CFP®

BABY BOOMERS ARE EXPECTED TO INHERIT TRILLIONS OF DOLLARS, and IRAs will be among those assets inherited in this intergenerational transfer of wealth. Receiving an inherited IRA can be a good thing, but the tax effects can be a headache. Many tax professionals have questions on the rules on required minimum distributions (RMDs), multiple designated beneficiaries, the relationship of the beneficiary to the decedent, and other aspects of inherited IRAs when preparing a client's return. Below is a collection of questions many tax preparers have been asking.

INHERITING IRAs

Q: My client received an inherited IRA in which the decedent had basis. How is the basis transferred to the beneficiary?

A: Taxpayers who inherit IRAs also inherit the decedent's basis in those IRAs, regardless of the beneficiary's relationship to the decedent (e.g., spouse or non-spouse). Ideally, the decedent will have filed Form 8606 (Nondeductible IRAs), showing the amount of basis in the IRA. Any remaining basis in the IRA shown on Form 8606 then becomes the beneficiary's basis. However, if the decedent did not file Form 8606, the taxpayer has the same challenges as any IRA owner in demonstrating that he or she has basis in the IRA. If the decedent had no basis in the IRA at the date of death, the beneficiary is taxed fully on distributions from the inherited IRA (which must equal or exceed the RMD requirement). If the decedent did have basis in the IRA, the beneficiary must file Form 8606. The 1099-R issued by the payer should identify whether there is basis in the IRA.

Q: My client's husband was seventy-two when he died in May. He had been taking distributions, but he did not take one in 2011 before he died. Is a spouse younger than age 70½ required to take minimum distributions from her husband's IRA after inheriting it?

A: Generally, your client has three options for how to handle the inherited IRA, and the RMD rules differ for each option:

1. Treat the account as her own IRA by designating herself as the account owner;
2. Roll the IRA into her own existing IRA (or into a qualified plan); or
3. Treat herself as the beneficiary of the IRA instead of the owner.

Option 1: If she chooses to treat the IRA as her own, she will have to take RMDs. However, she may use her own life expectancy (which is longer than her husband's), so less will be withdrawn from the account with each distribution. However, the distribution taken in 2011 will be based on her husband's life expectancy because he had not taken a distribution for 2011. Her own life expectancy may be used to calculate the RMD starting with the 2012 distribution.

Option 2: If she rolls the inherited IRA into an existing IRA that she owns (Option 2), she need not take RMDs from the IRA until she turns age 70½. This strategy maximizes the tax deferral of the IRA.

Option 3: If she treats herself as the beneficiary of the IRA, she must begin taking distributions over her life expectancy. The same rules that applied to Option 1 will also apply under Option 3.

Q: My client has two IRAs. IRA 1 is an inherited traditional IRA, and the client is taking distributions over his lifetime. IRA 2 is a traditional IRA, but the client has made nondeductible contributions to this IRA. If he were to convert some of his own traditional IRA (from IRA 2) to a Roth IRA, is the value of both IRAs used to calculate the non-tax portion of his distribution or only the value of his own IRA?

A: The basis and FMV of the inherited IRA are kept separate from the taxpayer's basis and FMV in his own IRA. If the client is the spouse of the decedent who elected to treat the inherited IRA as his own, the inherited IRA would be treated as his own and aggregated with his other IRAs on Form 8606.

Q: My client, a U.S. taxpayer, died and left several foreign beneficiaries on her IRA. What needs to be done?

A: The IRA trustee or custodian should notify the beneficiaries of their status as IRA beneficiaries. The beneficiaries must begin to take required distributions from the account by December 31 following the year of death. If the beneficiaries are nonresident aliens for U.S. tax purposes, the IRA trustee may need to withhold U.S. tax on the distributions.

Q: My client's daughters (ages eighteen and twenty-three) inherited equal shares of a traditional IRA from their father after he died at age fifty-three in June 2009. In late 2009, the IRA was divided into separate accounts. No distributions have been made. Are they both required to take distributions, and if so, should they have started in 2009, 2010, or 2011? How are these determined?

A: The daughters are required to take RMDs, but they may base the distributions on their own life expectancies because the IRA was separated into individual accounts for each beneficiary before December 31 of the year following the decedent's death. (The divided IRA must remain titled in the decedent's name, but "for the benefit of" the designated beneficiaries).

Because the owner died before reaching the required beginning date for RMDs, each beneficiary can take required minimum distributions based on her own life expectancy, or take a distribution of the entire account balance by December 31 of the calendar year that includes the fifth anniversary of the decedent's death.

The trustee of the IRA is responsible for reporting RMDs to account owners (or beneficiaries of inherited IRAs). Thus, you, your client, and her daughters are not responsible for determining the RMD amount. However, to determine the RMD, the balance of the account at the end of the previous year is divided by the beneficiary's life expectancy from Appendix C, Table I (Single Life Expectancy), available in IRS Pub. 590 (Individual Retirement Arrangements (IRAs)). Non-spouse beneficiaries, such as your client's daughters, must begin taking RMDs by December 31 of the year after the year the IRA owner died, which in this case would have been December 31, 2010.

Unfortunately, if an RMD is not taken, a hefty fifty-percent excise tax may be assessed (IRC Sec. 4974). Penalties are reported on Form 5329 (Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts). However, the IRS may waive the fifty-percent penalty if there was a reasonable cause for failing to take the distribution (such as erroneous advice given to the daughters or to your client), and steps to correct the error have been taken.

If there was a reasonable cause for failure to take the RMD, the taxpayers need not pay the fifty-percent excise tax when they file their tax returns. Form 5329 instructions direct the taxpayer to complete lines 50 and 51 and enter "RC" and the amount of waiver requested on the dotted line next to line 52. This amount should be subtracted from the total, with the tax paid on the remaining amount (line 53).

About the Author:

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REFERENCES

IRC Sec. 401(a)(9)
IRC Sec. 402(c)(11)(A)
IRC Sec. 408(a), 408(b), 408(d)(3)(C)
Reg. Sec. 1.401(a)(9)-8, A-2(a)(2)
Reg. Sec. 1.408-8, Q&A 10
IRS Pub. 590, Individual Retirement Arrangements (IRAs)
Form 5329 instructions