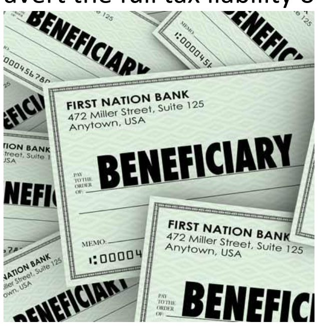
Case Study: Unintended Tax Consequences from Mishandling an Inherited IRA

As primary beneficiaries, some clients may share traditional IRA distributions with others, but have to pay income tax on the full IRA amount if they do not follow the applicable IRA rules. An examination of a case study illustrating this exact issue, along with a few preemptive strategies, can help your clients avert the full tax liability of sharing distributions.



If a client inherits a traditional IRA and wants to share it with a sibling, then the client can take steps to ensure the sibling is responsible for any income tax due on the amount he or she receives. But if proper procedures are not followed, then your client will bear the tax burden solely, despite sharing the IRA amount with others.

Such was the case in Morris v. Commissioner, TC Memo 2015-82, where the Tax Court found that the individual who inherited an IRA was responsible for paying income tax on a lump sum distribution of over $95,000, despite having given a portion of the amount to his siblings.

In this instance, the IRS determined a federal tax deficiency of $27,037 and an accuracy-related penalty on underpayments of $5,387 because the beneficiary did not include the amount in his income for the year.

Generally, an individual who inherits a traditional IRA will owe ordinary income tax on distributions of any pretax amounts from the account. The income tax is owed for the year in which the distribution occurs.

Sharing Inherited IRAs

An individual who inherits an IRA might be able to share that IRA with another party, if that party is a named beneficiary on the IRA as of the IRA owner's death, or becomes a beneficiary under the default provisions of the IRA agreement. Referred to as a disclaimer, this sharing process must meet certain specific requirements, and is a recommended strategy only if the result is consistent with the objective of the beneficiary on record at the time of the IRA owner's death.

Morris v. Commissioner, TC Memo 2015-82

Elroy Morris inherited an IRA from his father, who died on June 4, 2011. He was the sole primary beneficiary of the IRA. Morris withdrew the entire balance of more than $95,000 in 2011, and as is required by the IRS, the IRA custodian reported the amount as a taxable death distribution on Form

1099-R, "Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc."

Morris served as the personal representative of his father's estate. Based on what he believed to be his father's wishes, he issued checks for $37,000 to each of his two siblings in 2011 after he received the distribution from the inherited IRA.

In his role as personal representative for his father's estate, Morris engaged the services of a local law firm. A paralegal who worked for the law firm informed him that "there would be no tax due on the IRA distribution." According to the Tax Court memo, "By this she evidently meant that there would be no federal estate tax or Michigan inheritance tax due." However, Morris's understanding was that no tax of any kind would be due. As a result, he did not report the IRA distribution as income on his tax return.

Observation: This is a classic case of IRA rules getting lost in translation and underscores the importance of using the proper terminology when discussing IRAs.

When it comes to tax matters, a distinction must be made for the different types of taxes, such as income tax, the additional 10% tax (early distribution penalty), federal estate tax, and state inheritance tax. It would be unreasonable to expect consumers to understand and/or be aware of the different types of taxes that apply, so the assistance of a professional is necessary. However, professional assistance is worthwhile only if the professional fully understands the matter, and is able to translate that understanding into plain English for the taxpayer.

On September 30, 2013, the IRS sent Morris a notice of deficiency in which they determined that the IRA distribution constituted taxable income. Morris petitioned the Tax Court on the basis that he did not "…solely owe this debt and should not be held solely responsible for it."

Traditional IRA distributions are taxable

Generally, IRA distributions should be reported in the recipient's ordinary income for the year in which the distribution occurs, including distributions from inherited IRAs. Exceptions apply to amounts representing basis, amounts that are properly rolled over, and qualified distributions for charity.

Morris did not dispute the fact that the amount was taxable. It is possible that by the time he filed the petition, he understood that the amount should be treated as ordinary income.

Morris claims no fair!

In his petition, Morris contended that it would be inequitable to hold him solely liable for the income tax owed on the distribution because he voluntarily shared the amount with his siblings, and he would probably not recover anything from them.

Since Morris had given a total of $74,000 to his two siblings, his position may seem fair and logical to him. But the issue is that while he did share the amount with his siblings, the method he used did not result in a sharing of the tax burden with them.

As such, the Tax Court determined that despite his "honorable" intentions, he was still required to include the entire IRA distribution amount in his 2011 income.

Morris contended that the law firm gave him bad advice, which put him at a disadvantage. The Tax Court responded that the advice from the law firm does not change the fact that the distribution is taxable.

What Morris should have done!

If Morris wanted his siblings to pay the income tax on the amount that they received, he could have used either the disclaimer method or the "net of taxes" method.

Disclaimer method

The disclaimer method works only if his two siblings become beneficiaries on the disclaimed amount. The disclaimer includes the following steps:

1. Check the IRA beneficiary designation form to determine if there are contingent beneficiaries named. If Morris's siblings are the only contingent beneficiaries, they would become the beneficiaries for any amount that he properly disclaims. If another party is the contingent beneficiary, the disclaimer method would not work for Morris as it would result in that other party being the beneficiary of the disclaimed amount.
2. If there is no contingent beneficiary, check the default provisions of the IRA Agreement & Disclosure Statement (IRA Agreement). Some IRA Agreements state that if no beneficiary is named or survives the IRA owner, the beneficiary would, by default, be the IRA owner's surviving spouse. And if there is no surviving spouse, then the surviving children of the IRA owner would be the beneficiaries. If such were the case with the IRA in question, the surviving spouse would need to disclaim the amount, if she were alive, so that it would go to his siblings.

   If the IRA does not include such a provision and the siblings are not contingent beneficiaries, the disclaimer option would not be a solution for Morris.

3. If the siblings were to become beneficiaries under the disclaimer method, Morris would need to ensure that the disclaimer is valid. The requirements for a valid disclaimer include:

- It must be a written irrevocable and unqualified refusal to accept the disclaimed amount.
- The IRA custodian must receive the disclaimer no later than nine months after the later of:
- the day on which the IRA owner died
- the day on which the beneficiary attains age 21

4. None of the IRA should be "accepted" before the disclaimer.
5. The disclaimed amount must pass without any direction from the person making the disclaimer.
6. Ideally, an estate-planning attorney should be consulted to determine if a disclaimer satisfies regulatory and other requirements. The IRA custodian should also be consulted to ensure that it satisfies their operational requirements.

‘Net of taxes’ method

The inherited IRA can also be shared outside of a disclaimer. Under this option, the beneficiary would take a distribution and give the siblings the amount. However, unlike a disclaimer where the sibling would owe income tax on any amount received through a disclaimer, the beneficiary would owe income tax on any taxable portion of the distribution. In such cases, the named beneficiary could deduct the amount of taxes that would be owed on the amount and give the balance to his siblings.

The bottom line…

Ultimately, retirement-account owners will be responsible for paying any income tax due on distributions that they take from their retirement accounts, whether or not those distributions are shared with others. This may come as a surprise to clients who are not knowledgeable about how retirement accounts work.

For clients who request distributions, ensure they understand any possible tax consequences to help prevent such surprises. For those who want to share inherited accounts with others, strategies can be implemented so that any tax burden is also shared.

In some cases, putting measures in place before the death of the retirement account owner is optimum. For instance, if the intent is to have three siblings share an inherited IRA, it might be more practical to name all three as primary beneficiaries of the IRA, instead of naming one and expecting him (or her) to share distributions with the other siblings.

Need More Information:

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