Avoiding Penalties for Not Taking Distributions From Inherited IRAs

By Bruce J. Rogers

September 2, 2008

The Legal Intelligencer

As we are all painfully aware, the stock market has experienced a significant downturn in the last year, and that decline has negatively impacted many individual retirement accounts, whether invested in mutual funds or otherwise. While the shrinking values of IRAs are disconcerting enough, when they are compounded with penalties for failure to take minimum required distributions, or MRDs, a more dire situation emerges, particularly in the case of inherited IRAs, where beneficiaries are often not properly advised regarding IRA distribution options and requirements. While an article cannot cure the current stock market woes, it can provide guidance for avoiding penalties for failure to take MRDs from inherited IRAs.

Minimum Required Distribution Rules for IRAs

Internal Revenue Code Sec. 401(a)(9) mandates that owners of traditional IRAs must begin taking annual MRDs no later than April 1 of the year following the year the account owner is 70 years and six months old. This is referred to as the required beginning date, or RBD. The IRS imposes a 50 percent penalty for each annual failure to comply with the MRD rules, and the penalty is assessed on the difference between the MRD amount for the year and the amount actually withdrawn during that year.

When the owner of a traditional IRA dies, different MRD rules apply depending upon whether the death occurred before or after the RBD. As these rules are complex, it is wise to consult with a qualified tax professional who can assist in determining the options that will best suit the taxpayer.

The designated nonspousal beneficiary must take MRDs based upon his or her life expectancy, to avoid the 50 percent penalty. If the beneficiary does not comply with the MRD rules, the 50 percent penalty can be assessed for each annual failure.

A nonspousal beneficiary may always withdraw more than the MRD amount each year, or he or she may opt to completely liquidate the inherited IRA by the end of the fifth year following the year of the deceased IRA owner's death. IRAs are not required to offer the five-year distribution rule as an option, but many do. In some cases, the five-year rule is required because the IRA trust document so specifies or because the deceased IRA owner so specified before he or she died.

While both of these distribution alternatives (higher annual distributions or five-year rule) will prevent the imposition of the 50 percent penalty for failure to comply with the MRD rules, they will also reduce or eliminate the tax-deferral feature (compounded tax-deferred earnings within the IRA, on which no current federal income taxes are due until distributions are made) that is probably its greatest tax advantage. Therefore, if the inherited IRA funds are not needed immediately, neither of these alternatives is recommended.

The Life-Expectancy Method

For a nonspousal beneficiary who wants to maximize the tax-deferral opportunity that an inherited IRA provides, the optimum strategy is to withdraw the funds over the beneficiary's life expectancy. This strategy is known as the life-expectancy method. Following this method stretches out the inherited IRA's tax advantages for as long as possible while avoiding the 50 percent penalty for failure to comply with the MRD rules. To implement the life-expectancy method, a nonspousal beneficiary must withdraw the initial MRD no later than Dec. 31 of the year following the year of the deceased IRA owner's death. Additionally, the nonspousal beneficiary must also withdraw MRDs by Dec. 31 of each subsequent year to avoid the 50 percent penalty for failure to comply with the MRD rules.

What if A Beneficiary doesn't Comply With MRD Rules?

It is a common predicament for a nonspousal beneficiary to neglect to withdraw an initial MRD by Dec. 31 of the year following the year of the account owner's death, when the IRA owner died before the RBD and the IRA allows the life-expectancy method to be used. In some cases the beneficiary also fails to take the second MRD by the end of the subsequent year. The question that arises is whether or not it is too late for the beneficiary to remedy these missteps and remain eligible for the preferred life-expectancy method discussed above.

In a March 18 IRS private letter ruling (Ltr. Rul. 200811028), the IRS allowed a nonspousal beneficiary to use the life-expectancy method after she withdrew three years' worth of MRDs in the third year following the year of the account owner's death, even after she paid the 50 percent penalty for failing to withdraw the year-one and year-two MRDs in those years. In this case, as in many others, the tax-deferral advantages of using the life-expectancy method exceeded the penalties incurred for the failure to withdraw in years one and two.

The Government's Logic

In this particular case, the provisions of the inherited IRA required the nonspousal beneficiary to use the life-expectancy method unless the five-year method was elected. The beneficiary did not specifically elect to use the five-year method, so the question then became: Did her failure to take MRDs for years one and two under the life-expectancy method result in a deemed five-year election?

Fortunately, the IRS concluded that this was not the case. They reasoned that under the MRD rules, the life-expectancy method is the default method unless the IRA document says otherwise (which this particular IRA did not do). Therefore, the five-year rule was not required unless the beneficiary specifically elected to follow it or the account owner stipulated it before he or she died.

It is important to note that private letter rulings are not binding on the IRS for subsequent cases, so despite the favorable ruling in this case it is not regarded as precedent. However, private letter rulings do provide guidance as to what direction or position the IRS is taking with regard to the issues ruled upon. Consequently, as noted above, it is important to consult a qualified tax professional when treading in the murky waters of these complex rules.

Conclusion

A remedy may be available to a nonspousal beneficiary who fails to follow the rules of the life-expectancy method. However, and it cannot be stressed enough, the most prudent measure an IRA beneficiary can take is to engage an experienced tax professional to review the terms of an IRA soon after it is inherited. This will help avoid unintended tax consequences and reduce or eliminate any MRD violation penalties that may otherwise arise.

Bruce J. Rogers is a manager in the tax accounting group of Duane Morris, where he devotes his practice to federal, state and local income taxation and litigation consulting services. He is a published author of articles on tax matters and a speaker at seminars

regarding tax and litigation consulting topics. He is a member of both the Greater Philadelphia Chapter of the Pennsylvania Institute of Certified Public Accountants and the American Institute of Certified Public Accountants.

This article originally appeared in The Legal Intelligencer and is republished here with permission from law.com.