MORGAN AND DiSALVO, P.C.
attorneys at law

RICHARD M. MORGAN, Esq.
rmm@morgandisalvo.com

LORAINE M. DiSALVO, Esq.
ldisalvo@morgandisalvo.com

OF COUNSEL
DIANE B. WEINBERG, Esq.
dweinberg@morgandisalvo.com

Non-Spouse Beneficiaries of Inherited IRAs & The 50% Penalty: Timing is Everything!

By Richard M. Morgan & Loraine M. DiSalvo

The IRS recently published IRS Information Letter 2016-0071. This Information Letter discusses rules that apply to anyone who has inherited an IRA account or other tax-deferred retirement savings account (which we will collectively refer to as "IRA accounts" for convenience in this post), and who is not the surviving spouse of the original IRA account owner (a "non-spouse beneficiary"). These rules are the Required Minimum Distribution ("RMD") rules, and they are critically important because, if the beneficiary of an inherited IRA fails to take an RMD for a given year, the IRS imposes a penalty equal to 50% of the amount that was not timely withdrawn. A penalty waiver may be available, but it has to be properly requested from the IRS, and the IRS does not have to grant the waiver. In other words, failing to know how these rules apply to an inherited IRA account can create a very big problem!

I. Background.

Many people are familiar with the application of the RMD rules to the original owner of an IRA account: once the owner reaches age 70 1/2, he must begin to withdraw at least a certain minimum amount from his IRA accounts each year, or the 50% penalty will apply. Many people are also familiar with the way these rules apply after the IRA account owner dies where his spouse is the listed beneficiary: either the spouse rolls the IRA account over into her own IRA, at which point it is treated as if she were the original account owner, or she begins to take the RMDs based on her own life expectancy. However, not as many people are familiar with the way the RMD rules apply if a non-spouse is the beneficiary of a deceased account owner's IRA.

In IRS Information Letter 2016-0071(the "IRS Letter"), an individual non-spouse beneficiary failed to start taking RMDs on a timely basis from an inherited IRA account. Because the IRA account's listed beneficiary was an individual who was not the original owner's surviving spouse, the first RMD had to be withdrawn from the IRA account no later than December 31st of the year after the year in which the original account owner died. The RMD had to be calculated based on the non-spouse beneficiary's life expectancy, using the applicable IRS table and that beneficiary's age at the account owner's death. (This same rule would also have applied if the designated beneficiary of the IRA account had been a trust that qualified as a "look-through" trust under other IRS rules, but in that case the life expectancy used would have been the life expectancy of the trust's oldest counted beneficiary.)

If the listed beneficiary on a traditional IRA account is an unqualified beneficiary, such as a non-qualifying trust or the deceased owner's estate, the RMDs are not calculated based on any beneficiary's life expectancy. Instead, the RMD calculation for that account depends on the IRA account owner's age at his death. If the IRA account owner is younger than 70 1/2 years old at his

RICHARD M. MORGAN, Esq.
rmm@morgandisalvo.com

LORAINE M. DiSALVO, Esq.
ldisalvo@morgandisalvo.com

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DIANE B. WEINBERG, Esq.
dweinberg@morgandisalvo.com

death, all of the assets in the IRA account will have to be distributed to the beneficiary within 5 years of the IRA owner's death, under the "5 year rule." Note: The 5 year rule does not require any set minimum distribution to be taken in any of those five years, as long as all of the assets are withdrawn from the account by the end of the 5 year period. If the IRA account owner is at least 70 1/2 years old at death, however, then the unqualified beneficiary must withdraw RMDs from the account over the owner's remaining life expectancy, based on the owner's actual age on his date of death but as if he were still living.

With a Roth IRA, the RMD rules are somewhat modified. First, there are no RMD requirements during the lifetime of the original IRA owner, and the 5 year rule is the only applicable RMD rule if the beneficiary is an unqualified beneficiary, such as a non-qualifying trust or the decedent's estate. This means that for any Roth IRA account that does not name one or more individuals or qualifying trusts as beneficiaries, all of the assets will have to be completely withdrawn within 5 years after the deceased owner's death without regard to the owner's age at his date of death. In the IRS Letter, the account at issue was a Roth IRA.

II. The IRS Information Letter.

In the IRS Letter, the question presented to the IRS was whether the failure to timely withdraw the first RMD from the inherited IRA prevented the individual non-spouse beneficiary (the "taxpayer") from using an RMD period based on his life expectancy and required the beneficiary to follow the 5 year rule and withdraw all of the assets from the account within 5 years after the original owner's death. The flip side of this question would be whether the beneficiary would be subject to the 50% penalty for failing to withdraw the first RMD in a timely manner. The IRS came back with a logical answer, but one that may surprise many non-experts: The beneficiary did not have the option to use the 5 year rule, and, because he failed to withdraw the first RMD on a timely basis, the 50% penalty applied for that year.

Unless the contract under which the IRA account was established either (1) requires the use of the 5 year rule or (2) permits the beneficiary to make an election between taking RMDs over his life expectancy or using the 5 year rule, the beneficiary does not get a choice. That means, if an individual or a qualifying trust is the properly designated non-spouse beneficiary of the IRA account, the beneficiary must take RMDs based on the beneficiary's life expectancy, and **cannot** decide to use the 5 year rule instead. In the case discussed in the IRS Letter, the taxpayer was a properly designated individual non-spouse beneficiary and qualified for the use of his life expectancy as the RMD period. The IRA account contract did not permit him to elect to use the 5 year rule. This meant that the taxpayer had to calculate the RMDs based on his life expectancy, and that he was required to withdraw the first RMD no later than December 31 of the calendar year following the year of the original account owner's death.

RICHARD M. MORGAN, Esq.
rmm@morgandisalvo.com

LORAINE M. DiSALVO, Esq.
ldisalvo@morgandisalvo.com

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dweinberg@morgandisalvo.com

Because the taxpayer in the IRS Letter failed to withdraw his first RMD in a timely manner, the 50% penalty applied for that year. To avoid the penalty, the taxpayer would have to request and be granted a penalty waiver by the IRS. (For information on how to request a waiver of this 50% penalty, see *IRS Publication 590-B* and IRS Form 5329.)

This IRS Letter really highlights the need to review a decedent's IRA accounts and their beneficiary designations as soon as possible after death, so that the rules that apply to each account can be determined, and so that new accounts can be established and RMDs withdrawn in a timely manner in order to avoid the onerous 50% penalty. If a beneficiary qualifies for RMDs based on his life expectancy but fails to withdraw the first RMD in a timely manner, he may not have the option to simply rely on the 5 year rule and may have to pay the 50% penalty on the late RMD. If a beneficiary makes an honest mistake and fixes the RMD issue going forward, then he may be able to request a penalty waiver from the IRS, and it may be granted. However, the extra expense and hassle of requesting a penalty waiver would be best avoided, especially because the IRS is not required to grant the waiver even if it is properly requested.

Here is the IRS Information Letter: https://www.irs.gov/pub/irs-wd/16-0071.pdf