How to wipe out an IRA: Run afoul of IRS distribution rules

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Advisors should encourage trustees to not distribute IRA funds without first getting professional advice.

In a 2014 IRS private letter ruling, an entire IRA was lost to a fatal distribution error after death. This is a textbook case of what not to do after death, when a trust is named as the IRA beneficiary.

Trusts are set up to protect assets, like IRAs, after death, but if the rules are not followed precisely, an IRA can mistakenly be distributed and taxed soon after death.

Rollover gone awry

In private letter ruling (PLR) 201425023, released by IRS on June 20, 2014, the IRS ruled that a surviving spouse who received IRA proceeds through a trust, which was the beneficiary of her deceased husband's IRA, could not roll over the IRA funds she received because more than 60 days had passed since the trust received the funds. The IRS denied her request for more time to do the rollover because she didn't provide sufficient proof of financial institution error.

The Supreme Court issued a ruling removing bankruptcy protections from IRAs, meaning those assets are now fair game for creditors.

The deceased husband, "Ben," had an IRA and named a trust as his beneficiary. The trustees of the trust were his two children; Ben's wife, "Ann," was a partial trust beneficiary. Part of the trust called for Ann to receive 25 percent of the value of Ben's IRA as a distribution from the trust.

After Ben died, instead of setting up a properly-titled inherited IRA for the trust and distributing out the applicable 25 percent to Ann, the *entire* proceeds of the IRA were distributed to the trust and deposited into the trust's non-IRA checking account. That triggered taxes on the distribution, an error that cannot be corrected because the trust is a non-spouse beneficiary. A non-spouse beneficiary can never do a rollover, which is the only way to correct this mistaken distribution (other than the spousal rollover for her share, which was denied in this case).

Since the IRS denied Ann's spousal rollover request, the money she received from the trust and then deposited into her own IRA was not eligible for rollover. This also meant that Ann's portion of the inherited IRA distribution was taxable and could not be treated as a rollover. The fact that she had already rolled the funds over resulted in the deposit being treated as a regular tax-year contribution for 2009.

Assuming the deposit was more than $6,000 (the IRA contribution limit for 2009 for someone age 50+) and that Ann was not 70 ½ or older that year, then any amount above $6,000 is automatically treated as an excess IRA contribution. If an excess contribution is not timely removed by October 15th of the year after the deposit, it is subject to a 6 percent penalty each year until it's corrected.

The 6 percent excess contribution penalty is reported on IRS Form 5329. When Form 5329 is not filed, the statute of limitations (normally 3 years) never begins to run, potentially adding more penalties and interest to an already costly situation.

While there are many good reasons to name a trust as the beneficiary of an IRA, the main reason is for post-death control and protection. If the IRA owner wants to control how the funds are paid out after he dies, a trust can do that. The IRA owner tried to do that here, but bad advice and a misunderstanding of the IRA tax rules while implementing the plan after death, negated the intent of his estate plan.

Trusts are also often named as an IRA beneficiary for creditor protection purposes. In light of the June 2014 U.S. Supreme Court's ruling in the *Clark* case where the Court ruled that inherited IRAs are not protected in bankruptcy under federal law, more IRA owners may consider naming a trust as the beneficiary of their IRA to protect the money from a beneficiary's creditors.

Trusts, by themselves, are complicated. The IRA required minimum distribution rules are complicated too. When you mix the two by naming a trust as an IRA beneficiary, problems often occur.

How to handle the IRA

After the IRA owner dies, paying out the entire inherited IRA to the trust should *not* be done, unless the trust says so. And if, in fact, the trust says so, it's generally a useless and unnecessary trust.

Under the tax rules, only the required minimum distribution (RMD) needs to be paid to the trust, not the balance. Additional funds can be paid out, depending on the trust terms. But anything paid will generally be taxable and cannot be returned to the inherited IRA, even if the entire IRA is paid out to the trust in error.

This was the case in a 2005 ruling (PLR 200513032), where the entire inherited IRA was mistakenly paid out to the trust, triggering taxation and ending the inherited IRA. IRS denied 60-day rollover relief here as well.

Once inherited IRA funds are distributed to a non-spouse beneficiary, the tax shelter is terminated and the distribution is taxable. This mistake cannot be corrected. Advisors can help avoid these problems by encouraging trustees of a trust to not distribute *any* IRA funds without first getting professional advice. Mistakes here are costly and generally irrevocable.