



Whose IRA Was It? The Issues of Surviving Spouses and IRAs
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Surviving Spouses and IRAs

This week the Tax Court dealt for the first time with an issue that many of us may have felt was already resolved—whether a surviving spouse who has rolled her deceased husband's IRA into her own IRA may later take distributions from that account prior to attaining age 59 ½ and claim the death benefit exception from the premature distribution tax for such distributions. The Tax Court, in the case of *Gee v. Commissioner*, (127 T.C. No. 1), decided the answer was no—but that since the court decided this was a case of first impression, no negligence penalty was imposed.

Spouses and IRAs

A surviving spouse has a choice to make when considering his/her spouse's IRA account. The spouse may be treated as the beneficiary of the account and take distributions, subject to the required distributions under §409(a)(9) and the related regulations being treated as

the beneficiary of the account, or may treat the IRA as his/her own pursuant to Regulation §1.408-8 Q5, in which case the IRA will now be treated as the surviving spouse. That provision provides:

Q-5. May an individual's surviving spouse elect to treat such spouse's entire interest as a beneficiary in an individual's IRA upon the death of the individual (or the remaining part of such interest if distribution to the spouse has commenced) as the spouse's own account?

A-5. (a) The surviving spouse of an individual may elect, in the manner described in paragraph (b) of this A-5, to treat the spouse's entire interest as a beneficiary in an individual's IRA (or the remaining part of such interest if distribution thereof has commenced to the spouse) as the spouse's own IRA. This election is permitted to be made at any time after the individual's date of death. In order to make this election, the spouse must be the sole beneficiary of the IRA and have an unlimited right to withdraw amounts from the IRA. If a trust is named as beneficiary of the IRA, this requirement is not satisfied even if the spouse is the sole beneficiary of the trust. If the surviving spouse makes the election, the required minimum distribution for the calendar year of the election and each subsequent calendar year is determined under section 401(a)(9)(A) with the spouse as IRA owner and not section 401(a)(9)(B) with the surviving spouse as the deceased IRA owner's beneficiary. However, if the election is made in the calendar year containing the IRA owner's death, the spouse is not required to take a required minimum distribution as the IRA owner for that calendar year. Instead, the spouse is required to take a required minimum distribution for that year, determined with respect to the deceased IRA owner under the rules of A-4(a) of §1.401(a)(9)-5, to the extent such a distribution was not made to the IRA owner before death.

(b) The election described in paragraph (a) of this A-5 is made by the surviving spouse redesignating the account as an account in the name of the surviving spouse as IRA owner rather than as beneficiary. Alternatively, a surviving spouse eligible to make the election is deemed to have made the election if, at any time, either of the following occurs --

(1) Any amount in the IRA that would be required to be distributed to the surviving spouse as beneficiary under section 401(a)(9)(B) is not distributed within the time period required under section 401(a)(9)(B); or

(2) Any additional amount is contributed to the IRA which is subject, or deemed to be subject, to the lifetime distribution requirements of section 401(a)(9)(A).

(c) The result of an election described in paragraph (b) of this A-5 is that the surviving spouse shall then be considered the IRA owner for whose benefit the trust is maintained for all purposes under the Internal Revenue Code (e.g., section

72(t)).

Generally the second option allows for more flexibility due to reduced minimum distribution requirements imposed on the owner of an IRA and the simple flexibility of being able to access the IRA as owner (for instance, a beneficiary of an inherited IRA cannot take a cash distribution and then roll it into a new IRA within 60 days, unlike the owner), based on the “all purposes” provision found in A5(c) above.

Indirectly, question 7 of the Regulation §1.408-8 seems to “bless” making this election by rolling the funds into the taxpayer's own IRA. That question provides:

Q-7. What rules apply in the case of a rollover to an IRA of an amount distributed by a qualified plan or another IRA?

A-7. If the surviving spouse of an employee rolls over a distribution from a qualified plan, such surviving spouse may elect to treat the IRA as the spouse's own IRA in accordance with the provisions in A-5 of this section. In the event of any other rollover to an IRA of an amount distributed by a qualified plan or another IRA, the rules in §1.401(a)(9)-7 will apply for purposes of determining the account balance for the receiving IRA and the required minimum distribution from the receiving IRA. However, because the value of the account balance is determined as of December 31 of the year preceding the year for which the required minimum distribution is being determined and not as of a valuation date in the preceding year, the account balance of the receiving IRA is only adjusted if the amount is not received in the calendar year in which the amount rolled over is distributed. In that case, for purposes of determining the required minimum distribution for the calendar year in which such amount is actually received, the account balance of the receiving IRA as of December 31 of the preceding year must be adjusted by the amount received in accordance with A-2 of §1.401(a)(9)-7.

However, one disadvantage that exists with getting the funds from your own IRA vs. that of the decedent occurs if the surviving spouse has not attained age 59 ½ distributions from the spouse's IRA would generally be subject to the 10% premature distribution tax. A beneficiary doesn't face that problems due to §72(t)(2)(A)(ii) which provides an exception for distributions:

(ii) made to a beneficiary (or to the estate of the employee) on or after the death of the employee

If the spouse receives the payment from the decedent's IRA, this clause is satisfied. However, if the spouse has elected to treat the IRA as his/her own, the question becomes whether the payment may still be traced back to that IRA.

The Gee Case

In the Gee case we have an individual whose spouse passed away in 1998, at the age of 73 (so he was at the point of required minimum distributions from the account). Charlotte instructed the brokerage firm holding her deceased husband's IRA account to transfer the balance of his IRA (\$1,010,988.38) to an IRA account in her name held at the same brokerage. At the time of the transfer Charlotte was age 51. She later transferred those funds to a new IRA custodian (SEI) in 2000.

In 2002 Charlotte took a distribution from the IRA of \$977,887.79. SEI issued a 1099 to Charlotte showing the entire amount of the 2002 distribution as a premature distribution with no known exception. Charlotte did not compute the 10% early distribution tax on her 2002 return, and instead included a disclosure with her return that SEI had entered the wrong distribution code and that it should have been coded as "a distribution of IRA for her deceased husband."

The IRS disagreed with Charlotte's treatment and takes the position that the distribution is subject to the 10% penalty since it claims she had converted the IRA to her own and that only distributions from an "unconverted" IRA would be subject to the exception found at §72(t)(2)(A)(ii) noted above.

Court Ruling

The key issue is noted by the court in the following sentence:

We note that this Court has not previously decided whether an IRA distribution retains its character as a distribution to a beneficiary "on or after the death of an employee" if the distribution is of funds that were rolled over to the IRA upon the employee's death.

In reality, there appears to be two issues—first, can the spouse continue to "trace" the funds after conversion. Second, if tracing doesn't work after conversion, can the spouse argue that unless she specifically redesignates an account that it was never converted to her own.

The court summarizes the positions of the parties in the following paragraph:

Respondent argues that once petitioner as surviving spouse decided to maintain the funds in an account in her own name as owner of the IRA, she became the owner of the IRA "for all purposes of the Code," relying upon section 1.408-8, Q&A-5 and 7, Income Tax Regs. Petitioner counters that the funds from her deceased husband's IRA did not lose their character as funds from her deceased husband's IRA. Even though petitioner rolled over the funds from her deceased husband's IRA into her separate IRA, petitioner did not make any additional contributions after her husband died and also did not "redesignate" the account as

her own. See sec. 1.408-8, A-5(b), Income Tax Regs.

The Court ends up siding with the IRS in this case, holding both that the penalty applies to rolled over funds and that Charlotte did not need to formally “re designate” the account in order to convert it to her own account for the purpose of determining if this was a distribution of her IRA or as a beneficiary of her deceased spouse's IRA.

The Court holds:

We find that petitioner received the distribution from her own IRA, not from an IRA of which she was a beneficiary on or after the death of an employee. We further find that the source of the amount received, whether originating from her deceased husband's IRA or petitioner's own contributions, is irrelevant. We recognize that petitioner may not have technically redesignated the IRA as her own. She did not need to "re designate" the IRA. The IRA was her previously existing account. We therefore find no merit to petitioner's argument that the rolled over funds retain their character because she did not redesignate her IRA.

It's important to remember that she placed these funds into her own IRA. Generally an IRA owner can only place funds into an IRA that are either a contribution or a rollover. There's no provision in the IRC for a “joint” IRA of some sort. The court indirectly notes this issue by pointing out:

Petitioner cannot have it both ways. She cannot choose to roll the funds over into her own IRA and then later withdraw funds from her IRA without additional tax liability because the funds were originally from her deceased husband's IRA. Accordingly, once petitioner chose to roll the funds over into her own IRA, she lost the ability to qualify for the exception from the 10-percent additional tax on early distributions. The funds became petitioner's own and were no longer from her deceased husband's IRA once petitioner rolled them over into her own IRA. The funds therefore no longer qualify for the exception.

The Court holds the rollover itself was effect in “re designating” her deceased spouse's IRA as her own. The mere fact that no additional contributions were made and that you could perform a tracing isn't relevant—reality is that nothing would allow a combining of a decedent's IRA with a taxpayer's own. Rather, only a taxpayer's own IRA funds can be placed in the taxpayer's IRA.

If Charlotte was correct that this was still her husband's IRA then, arguably, she had a taxable distribution back in 1999 along with an excess contribution to her own IRA. Since Charlotte did not take that position back in 1999, it would appear the view of the law she is advancing now is at odds with the position she took on her 1999 return.

Comments and Actions

A couple of issues not mentioned in the case are interesting. First, as noted above, Charlotte's deceased spouse was age 73 at his death, and so would have been receiving required minimum distributions—so the account was in “pay” status at the time. The case doesn't say what Charlotte's had done in 2000 and 2001 with regard to those minimum distributions, nor whether a penalty tax had been applied. That's of interest because according to Answer 5(b)(1) of Regulation 1.408-8, a failure to take the required distribution counts as an alternative method of converting the IRA to the spouse's own.

While it's possible the court simply didn't deal with this issue since it didn't have to, it would seem to have created a real problem with Charlotte's position if she hadn't been taking minimum distribution. However, it is of interest that she might have been doing so—note that the amount she withdrew was less than the amount rolled over. That may have been due to market changes, but it may also have been the remaining balance. That raises the possibility that, in prior years, SEI had coded the distributions as from the deceased spouse and only in the year of the large distribution did someone in the firm's tax department balk at that treatment.

As well, the court isn't totally clear, but it appears that Charlotte may not have attached a 5329 and filled in Part I to indicate the exception she was claiming. Thus, that may have generated an automatic CP2000 (the computer doesn't read statements attached to the return) and begun this entire process. As irrelevant as that should be (the law is the law), reality is that tax preparers need to be aware that information returns do cause automatic CP2000s to go out if certain items aren't found on the return—and a 1099R with a “no known exception” code will do so unless the taxpayer provides an explanation on the 5329.

But moving on to the real underlying issue—it's important to have spouses, especially those under age 59 ½, the pros and cons of the IRA treatment. Note that while you can decide to treat it as the spouse's own at any time, a failure to take a required distribution causes the account to be “deemed converted” to the spouse's own. While that's “good news” in that you don't face the penalty for failure to take a required distribution, that may not be good news if the spouse draws out the entire, much larger, balance the following year and faces the 10% tax. In any event, the taxpayer facing the 10% premature distribution tax would have been able to avoid that by simply taking what may have been a relatively small distribution in the earlier year.

This needs to be an issue that is discussed in a timely fashion following the death of the spouse, with special urgency for spouses who are not age 59 ½ at the time. As well, since the IRA would be the surviving spouses, if that spouse is over 70 ½, then we have someone's required minimum distribution to deal with as well in that following year.