

IRA trustees wipe out an inherited IRA — their own

A lifetime of accumulation and growth goes up in smoke because the beneficiaries don't know the IRA trust tax rules. Advisers can help their clients avoid such colossal blunders.

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Imagine spending a lifetime building a retirement account only to have your beneficiaries lose it in one fell swoop: They mishandle the account, triggering tax on the entire inherited individual retirement account.

This is a real-life horror story described in a recent [private letter ruling](#) released by the IRS on June 25.

Advisers can learn from this and help clients and their beneficiaries preserve their retirement savings by avoiding what happened here. It comes down to this basic tax rule for inherited retirement accounts: A non-spouse beneficiary cannot do a rollover; only a spouse beneficiary can do that. A trust is a non-spouse beneficiary, so the same rule applies when a trust becomes the IRA beneficiary, which was the situation in this case.

HERE'S WHAT HAPPENED

The husband had an IRA. He died and left his IRA to his wife, who rolled it over to her own IRA. She then named a trust as her IRA beneficiary and named her children as both trustees and beneficiaries of the trust.

Naming a trust as the IRA beneficiary is often done when there are large IRA balances at stake, and the IRA owner wants to create some level of post-death control.

Then the wife died, and the trust inherited the IRA funds. As trustees, the children had total control over the trust funds, and it didn't take long for things to unravel. A few months later, the children decided that they didn't like the investments in the IRA. Instead, they wanted to trade stocks with their inherited IRA funds, but the custodian informed them that the existing account could not accommodate stock trades.

So the children decided to move "substantially all" of the inherited IRA assets to a nonqualified (non-IRA) brokerage account, owned by the trust.

This was a fatal error resulting in a distribution of the inherited IRA assets! The inherited IRA became fully taxable.

Once funds are withdrawn from an inherited IRA by a non-spouse beneficiary such as a trust, they cannot be put back in. This mistake cannot be fixed, but these beneficiaries tried anyway with a desperate Hail Mary attempt that ended up costing them even more money.

The children requested this private letter ruling from the IRS to reverse the transaction by moving the assets back into a trust-owned inherited IRA and eliminating any tax owed on the distribution. Spoiler alert: Denied. They lost it all.

THE IRS RULING

Based on the tax code rules, the decision by the IRS was easy. The requests to relieve the trust of taxes and “repatriate” the dollars back into an inherited IRA were both denied since a non-spouse beneficiary can never do a rollover where funds are withdrawn from the inherited account.

“Once the assets have been distributed from an inherited IRA, there is no permitted method of transferring them back into an IRA,” the IRS said in its ruling.

Proper movement of money is paramount. The only way to move money from one inherited IRA to another is via a direct trustee-to-trustee transfer. There is no other option. A 60-day rollover is not allowed because a non-spouse beneficiary cannot do a rollover. Once inherited IRA assets are distributed, there is no method to return those dollars to an inherited IRA. The dollars must remain distributed, and taxes will be due.

The adult children were entirely within their rights to move the inherited IRA dollars to another inherited IRA in order to purchase stocks. However, they chose (or were incorrectly advised about) the wrong mechanism for the move, and the results were disastrous.

Depositing those dollars into the non-IRA account, regardless of how they got there, was the death knell for their qualified status.

Trust tax rates. Compounding this IRA trust horror story is the fact that high trust tax rates most likely applied to the distribution. We can assume the balance in the inherited IRA was significant given that a trust was created and named as beneficiary and the inherited IRA was emptied in one year.

Understand the rules. This PLR demonstrates what not to do. Ultimately, the children have only themselves to blame for either failing to seek proper guidance or for employing an adviser who didn’t understand the clear rules about transferring inherited IRA assets.

Additionally, if you are going to name a trust as your IRA beneficiary, you should be sure to have a legitimate reason for doing so. What was the point of this trust? The

children had complete control over the funds, and they could pay the inherited IRA out to themselves at any time (which they erroneously did).

Private letter rulings are expensive. Adding to the misery, the children paid for a private letter ruling. PLR costs and corresponding professional fees can easily climb into the tens of thousands of dollars, and there's no guarantee of success. As demonstrated here, the IRS can rule against you.