



“TRUSTWORTHY”

A Free Estate Planner's Email Newsletter by Lawrence J. Robertson, P.C.
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AVOID PROBATE AND SAVE TAXES WITH LIVING TRUSTS

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A Note on This Topic – Spousal Rollover of IRA – Take Care!

When a spouse inherits an IRA, it is “generally desirable” to perform a spousal rollover. This allows the spouse to defer required minimum distributions until he/she reaches his/her required beginning date and also allows for further deferral to after the surviving spouse’s death if the spouse does proper beneficiary planning.

However, as this case highlights, if a spouse is younger than age 59 ½, a spousal rollover should not be automatic. If there is a possibility that the spouse will need to access the IRA funds before age 59 ½, a rollover should not be performed.

Larry Robertson

Case Illustrates That One Rule Does Not Fit All Situations

In *Peggy A. Sears v. Commissioner*, the taxpayer was found to be liable for the **10% early distribution penalty** from an IRA she inherited from her husband because she performed a spousal rollover of an inherited IRA before taking the distribution.

FACTS:

Mrs. Sears’ husband died in 1998. Before his death he maintained an IRA at Morgan Stanley with account number ended in 7189. Mrs. Sears was the primary beneficiary of

this IRA.

Mrs. Sears also had an IRA rollover account at Morgan Stanley with an account number ending in 9853. As of the end of February 1999, account No. 9853 had a zero balance. On March 24, 1999, Morgan Stanley transferred securities valued at \$442,863.87 from account No. 7189 (the IRA Mrs. Sears inherited from her husband) to account No. 9853.

As of 2005 Mrs. Sears also maintained a non-IRA account at Morgan Stanley ending with 9860. On May 24, 2005, she signed two distribution request forms directing on-demand distributions from account No. 7189 to her non-IRA account in variable amounts.

On June 13, 2005, petitioner signed another distribution request form directing monthly distributions of \$1,370 from account No. 9853. In September 2005 petitioner made her last withdrawal from account No. 7189, thereby depleting the funds in that account. On May 31, 2006, petitioner signed a distribution request form with respect to account No. 9853 requesting distributions in amounts to be determined by her for each payment and directing Morgan Stanley to deposit the amounts in her non-IRA account.

On her 2006 Form 1040, Mrs. Sears reported \$60,937 in distributions from her IRAs but did not report the 10-percent additional tax pursuant to section 72(t) for an early withdrawal from an IRA. The IRS adjusted her tax by adding 10 percent of the total distributions on the ground that petitioner had not reached age 59½ in 2006 and no other exception to the additional tax under section 72(t) applied.

Mrs. Sears argued that the distributions should not be subject to the additional tax under section 72(t) because the exception under section 72(t)(2)(A)(ii) (distributions made to a beneficiary on or after the death of the employee) applies. She apparently argued that, in effect, the assets in account No. 9853 were transferred from her deceased husband's IRA account No. 7189 to account No. 9853 in 1999 without her authorization and that the 2006 distributions from account No. 9853 should have been treated as distributions to her as the beneficiary of her deceased husband's IRA.

The IRS was able to show that the distributions were not from the IRA inherited from Mrs. Sears' husband (i.e. account No. 7189). Consequently, Mrs. Sears has both the burden of producing evidence to show that the 2006 distributions from account No. 9853 are not subject to the additional tax under section 72(t) and the burden of proving that respondent's determination is incorrect. Mrs. Sears failed to meet this burden.

The court had previously held that the beneficiary loses the ability to claim the exception under section 72(t)(2)(A)(ii) if the beneficiary rolls over the funds from the deceased spouse's IRA into his or her IRA and thereafter withdraws funds from the IRA. See *Gee v. Commissioner*, 127 T.C. 1, 4-5 (2006). In *Gee v. Commissioner*, the court held that when a beneficiary rolls over funds from the deceased spouse's IRA, the funds become the beneficiary's own and any subsequent distributions are no longer occasioned by the death of the spouse. Thus, such distributions do not qualify for the section 72(t)(2)(A)(ii) exception. The court found that this is the case even if custodian error can be found.

The court stated that it did not need to decide whether the exception from the 10-percent additional tax under section 72(t)(2)(A)(ii) applies when the transfer from the deceased employee's IRA account to the beneficiary's IRA resulted from a trustee's advice or from a lack thereof or from a mere bookkeeping error. The court was unable to conclude that the transfers were the result of a trustee or custodial mistake.

CONCLUSION:

When a spouse inherits an IRA, it is generally desirable to perform a spousal rollover. This allows the spouse to defer required minimum distributions until he/she reaches his/her required beginning date and also allows for further deferral to after the surviving spouse's death if the spouse does proper beneficiary planning.

However, as this case highlights, if a spouse is younger than age 59 ½, a spousal rollover should not be automatic. If there is a possibility that the spouse will need to access the IRA funds before age 59 ½, a rollover should *not* be performed.

Instead, the IRA should remain titled in the name of the deceased spouse for the benefit of the surviving spouse. Distributions can then be taken from this inherited IRA without imposition of the 10% early distribution penalty because of the IRC Sec. 72(t)(2)(A)(ii) exception.

Once the surviving spouse reaches age 59 ½, a rollover can be performed as there is no time limit imposed on a spousal rollover.

As always, I stand ready to assist your clients in explaining all of their Estate Planning alternatives at a **FREE consultation.**

And, as always, **I very much appreciate your continued kind referrals.**

Sincerely,

Larry Robertson