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## Tax Practice and Accounting News

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### IRS Resolves IRA Disclaimer Dilemma

By Michael J. Jones

Michael J. Jones, CPA, is a partner in Thompson Jones LLP, Monterey, Calif. He serves as a consultant on estate-planning strategy for attorneys, CPAs, and other professionals. He is a frequent lecturer on estate-planning topics.

Disclaimers can be a valuable postmortem planning tool. By making a disclaimer, a gift, bequest, or inheritance can be diverted to accomplish family goals, including tax savings. For an IRA, a disclaimer qualifying under section 2518 can decrease required minimum distributions by eliminating an "undesirable" beneficiary. Disclaimer planning nearly always includes taking steps to ensure that there will be a qualified disclaimer under section 2518, to avoid treatment as a taxable gift.

The IRS has made it clear in Rev. Rul. 2005-36<sup>1</sup> that the potential to make qualified disclaimers of IRAs is not negated merely because a required minimum distribution has been made after the date of the decedent's death but before the disclaimer is made. However, any disclaimer made after the required minimum distribution has been made must exclude income related to that distribution, and any income related to the portion of the IRA that is disclaimed must be disclaimed. The ruling provides the method for determining the income related to the required minimum distribution and the disclaimed property in three situations.

For any disclaimed portion of the IRA, the ruling confirms that the beneficiary who makes a qualified disclaimer as described in the ruling is disregarded in determining the identity of the designated beneficiary over whose life expectancy distributions may be made, under the required minimum distributions rules.<sup>2</sup> No new ground is broken here. The last sentence of Treas. reg. section 1.401(a)(9)-4, Q&A 4(a) already says that for all disclaimers that qualify under section 2518.

This article will discuss the rationale and practical application of Rev. Rul. 2005-36, based on the three situations presented in the ruling. First, the underlying problem of the relationship between

required minimum distributions and disclaimers will be discussed. Second, examples using facts similar to those in the ruling will be given and will include solutions. The rationale behind the ruling follows that. Finally, a practice question is raised about the definition of income earned by an IRA for purposes of partial disclaimers.

For purposes of this article, the individual who accumulates the IRA based on that individual's earnings will be referred to as the initial IRA owner. The person who is entitled to the IRA by reason of the IRA owner's having designated that person as the IRA death beneficiary will be referred to as the IRA beneficiary. Required minimum distributions for the year of the IRA owner's death but unpaid at the time of death will be referred to as the decedent's unpaid distribution. If the IRA beneficiary disclaims IRA benefits, the disclaimed IRA benefits will pass to some other person, who will be referred to as the alternate beneficiary.

### **Required Minimum Distribution in Year of Death**

Initial IRA owners (other than Roth IRA owners) must begin taking required minimum distributions during their lifetime. The distributions must begin on or before the required beginning date of the initial IRA owner. The required beginning date is April 1 of the year following the year when the initial IRA owner reaches age 70- 1/2.

If the initial IRA owner's death occurs on or after the required beginning date, there is always a required minimum distribution for that year when the initial IRA owner dies. The initial IRA owner might not have taken steps to withdraw the required minimum distribution for the year when death occurred, creating a decedent's unpaid distribution.

Because the decedent's unpaid distribution was not withdrawn before death occurred, it must be withdrawn by the IRA beneficiary by December 31 of the year of the decedent's death. The decedent's unpaid distribution must be paid to the IRA beneficiary because that distribution is the property of the beneficiary under the terms of the IRA. For example, if the IRA beneficiary is the decedent's spouse, it is the decedent's spouse and not the estate of the decedent that is entitled to all IRA distributions made after the death of the initial IRA owner, including the decedent's unpaid distribution.

### **Question Raised in the Ruling**

Now, suppose that some time after the IRA beneficiary receives the decedent's unpaid distribution, the IRA beneficiary wishes to make a disclaimer of all or a portion of the IRA. Can it be done? Rev. Rul. 2005-36 answers that question in the affirmative.

The question arises because of the requirements for disclaimers under section 2518. A disclaimer of IRA benefits will cause benefits to pass from the IRA beneficiary who disclaims to the alternate beneficiary. Without the protection granted by section 2518, that disclaimer would constitute a transfer subject to gift tax. For an IRA, qualification under section 2518 also potentially affects future required minimum distributions. For those reasons, it can be of paramount importance that the disclaimer qualify under section 2518.

### **General Requirements of Disclaimers**

To be a qualified disclaimer under section 2518, the disclaimant -- in that case, the IRA beneficiary -- must refuse to accept an interest in property. The refusal must be unqualified and it must be irrevocable. Also, four requirements must be met:

It must be in writing;

It must be made on time;

The disclaimant must not have already accepted the interest or any benefits in interest; and

As a result of the refusal, all rights in the disclaimed property (or interest in property) must pass without any direction on the part of the disclaimant. Either the spouse of the decedent or some person other than the disclaimant must succeed to the disclaimed property (or interest in property).

To be on time, the refusal generally must be made on or before the lapse of nine months from the day when the transfer creating the interest in the disclaimant is made. However, if the disclaimant was under age 21 when the transfer was made, the disclaimer may be made on or before the lapse of nine months from the day when the disclaimant attains age 21, if that date is later than nine months after date of the decedent's death.

### **Distribution Precludes Qualified Disclaimer?**

The uncertainty that Rev. Rul. 2005-36 addressed was this: No qualified disclaimer may be made by an IRA beneficiary if, before making the disclaimer, payment of the decedent's unpaid distribution to that beneficiary occurs and that payment constitutes an acceptance of benefits. For reasons discussed following the examples below, the ruling concludes that payment does not constitute an acceptance of benefits. Accordingly, it is still possible to make a qualified disclaimer after receiving that distribution. However, once the IRA beneficiary has accepted that distribution, income from the decedent's unpaid distribution may not be disclaimed.

### **Examples**

The following facts relate to each of the three examples below.

Jackie, an initial IRA owner, died on July 12, 2005, several years after reaching her required beginning date for commencing required minimum distributions. Jackie was survived by her husband, Brad, and their daughter, Audrey, who was over age 21 at the time of Jackie's death. The fair market value of Jackie's IRA account at her death was \$200,000. A valid IRA beneficiary form provides that the IRA will pass to an individual on Jackie's death. The identity of the beneficiary varies in the examples.

Jackie died not having withdrawn her required distribution of \$10,000 for 2005.<sup>3</sup> If the IRA beneficiary wishes to disclaim her interest in Jackie's IRA and also avoid gift tax consequences, a qualified disclaimer must be executed by April 12, 2006. However, Jackie's unpaid distribution of \$10,000 is required to be made on or before December 31, 2005. The IRA beneficiary did not make a disclaimer before Jackie's unpaid distribution was due. Accordingly, the IRA beneficiary received Jackie's unpaid distribution, which was distributed on December 29, 2005. The IRA beneficiary makes a disclaimer on April 3, 2006. The IRA earned \$4,000 of income between July 12, 2005, and April 3, 2006. It will be assumed that the income also represents the change in value of the IRA between Jackie's date of death and the date of the disclaimer.

The income from the distribution is \$200 (\$4,000 of income, divided by \$200,000 of value at date of death, times the \$10,000 distribution). See the discussion below for further details on how to make that computation.

*Note:* The outcomes of the examples below cover some issues not discussed in Rev. Rul. 2005-36, such as IRA transfers by beneficiaries, the election by a surviving spouse who is a beneficiary of an IRA to treat the IRA as an IRA of the surviving spouse, the permissible period for making required minimum distributions after death of the IRA owner, and the 10 percent tax on IRA withdrawals before reaching age 59-1/2.

### **Example 1: Pecuniary Disclaimer**

Under the terms of Jackie's IRA, Brad is the primary IRA beneficiary. But if Brad does not survive Jackie, Audrey is the alternate IRA beneficiary. Brad disclaims \$60,000 of Jackie's IRA. Brad may make a qualified disclaimer of that amount of Jackie's IRA, but he must also disclaim the related income of \$1,200 (\$4,000 of income, divided by \$200,000 of principal, times the \$60,000 disclaimer). Therefore, the total amount of Jackie's IRA disclaimed by Brad is \$61,200.

For the disclaimed portion of the IRA, Brad is treated as though he did not survive Jackie. Therefore, Audrey, as the alternate beneficiary, becomes entitled to the disclaimed portion of Jackie's IRA.

The \$61,200 may be distributed to Audrey immediately following the disclaimer. Alternatively, that amount may be segregated within Jackie's IRA to be held for the benefit of Audrey. In that case, Audrey's share of Jackie's IRA may be distributed to Audrey over her life expectancy, beginning in the year 2006. Also, as discussed later, Audrey may transfer \$61,200 to a separate IRA held in the name of Jackie, for the benefit of Audrey.

For the portion of the IRA that Brad did not disclaim, Brad continues to be treated as the beneficiary. He is not required to immediately withdraw the \$200 of income attributed to Jackie's unpaid distribution. Brad is only required to withdraw required minimum distributions. Also, Brad may elect to treat his portion of Jackie's IRA as his own.<sup>4</sup> One way of making that election is to make a transfer or a rollover to an IRA held in Brad's name.<sup>5</sup> Whether Brad makes the election will affect his future required minimum distributions.<sup>6</sup> If Jack rolls over or transfers Jackie's IRA to an IRA of his own, or elects to treat his segregated share of Jackie's IRA as his own IRA, then, depending on Brad's age, he could be subject to the 10 percent tax on withdrawals before age 59-1/2.<sup>7</sup> Some surviving spouses avoid the election to qualify for an exception to the 10 percent excise tax on withdrawals before reaching age 59-1/2.<sup>8</sup> If Brad wishes to avoid the election, he may transfer his share of Jackie's IRA to a separate IRA held in the name of Jackie, for his benefit, as discussed later.

### **Example 2: Fractional Disclaimer**

Under the terms of Jackie's IRA, Brad is the primary IRA beneficiary. But if Brad does not survive Jackie, Audrey is the alternate IRA beneficiary. Brad disclaims 30 percent of his principal and income interest in Jackie's IRA remaining after reduction for \$10,200, the amount of Jackie's unpaid distribution and related income. Brad may make a qualified disclaimer in that manner.

As in Example 1, for the disclaimed portion of the IRA, Brad is treated as though he did not survive Jackie. Therefore, Audrey, as the alternate beneficiary, becomes entitled to the disclaimed portion of Jackie's IRA.

On the date of Brad's disclaimer, Jackie's IRA is worth \$194,000 (\$200,000 date-of-death value, plus \$4,000 of income, minus \$10,000 distribution to Brad). After reducing that balance for \$200

of income allocated to Jackie's unpaid distribution, Brad has disclaimed 30 percent of \$193,800, a value of \$58,140.

The \$58,140 may be distributed to Audrey immediately following the disclaimer. Alternatively, that amount may be segregated within Jackie's IRA to be held for the benefit of Audrey. In that case, beginning in the year 2006, Audrey's share of Jackie's IRA may be distributed to Audrey over her life expectancy. Alternatively, as discussed later, Audrey may transfer \$58,140 to a separate IRA held in the name of Jackie for the benefit of Audrey.

For the portion of the IRA that Brad did not disclaim, Brad continues to be treated as the beneficiary. Brad's choices and the effects of those various choices are the same as discussed in Example 1.

*Comment:* If Brad wished Audrey to receive exactly \$60,000, neither disclaimer in the foregoing examples accomplished it. If that is Brad's wish, he could employ a fractional formula disclaimer. For example, the disclaimer could be the adjusted value of the IRA times a fraction, the numerator of which is \$60,000 and the denominator of which is the adjusted value of the IRA. The adjusted value of the IRA could then be defined as the value of the IRA as of the date of the disclaimer, less Jackie's unpaid distribution, if any, less income allocable to Jackie's unpaid distribution.

### **Example 3: Entire Balance Disclaimed**

Under the terms of Jackie's IRA, Audrey is the primary IRA beneficiary but if Audrey does not survive Jackie, Brad is the alternate IRA beneficiary. Audrey disclaims the entire balance of Jackie's IRA that remains after distribution of Jackie's unpaid distribution and after reduction for \$200 of income allocated to Jackie's unpaid distribution.

For the disclaimed portion of the IRA, Audrey is treated as though she did not survive Jackie. Therefore, Brad, as the alternate beneficiary, becomes entitled to the disclaimed portion of Jackie's IRA.

The value disclaimed is \$193,800 (\$200,000 date-of-death value, plus \$4,000 of income, minus \$10,000 distribution to Audrey, minus \$200 of income that Audrey must not disclaim).

The \$193,800 may be distributed to Brad immediately following the disclaimer. Within 60 days of receiving that distribution, Brad may roll over up to \$193,800 to an IRA held in his own name because he is the surviving spouse of Jackie, the initial IRA owner.<sup>9</sup> Alternatively, that amount may be segregated within Jackie's IRA to be held for the benefit of Brad. In that case, Brad may elect to treat his share of Jackie's IRA as an IRA of his own.<sup>10</sup> The effects of Brad's various choices are the same as discussed in Example 1.

### **Required Distribution Payment Is Corpus**

The holding that disclaimers may be made by an IRA beneficiary who has received the decedent's unpaid distribution turns on finding that the distribution of the decedent's unpaid distribution is a distribution made out of the corpus -- that is, the principal -- and not out of income. The significance of the distinction between corpus and income is that acceptance of income from property precludes making a qualified disclaimer of that property or any part of it.<sup>11</sup> Said another way, nonacceptance of income from disclaimed property is a condition precedent to characterization as a qualified disclaimer. Characterization of the decedent's unpaid distribution as corpus, rather than as income, avoids the problem caused by the acceptance of income.

The ruling cites Treas. reg. section 25.2518-3(c), which provides that an amount distributed to the disclaimant from property transferred by bequest or gift before the disclaimer is treated as a distribution of corpus from the bequest or gift. The ruling found that the decedent's unpaid distribution is such an amount. The regulation also provides that the acceptance of that distribution from property is considered to be an acceptance of a proportionate amount of income earned by the bequest or gift.

Furthermore, that finding makes it possible to apply the rule of partial disclaimers described in Treas. reg. section 25.2518-3, which permits an individual to disclaim less than that individual's entire interest in property, and, at the same time, accept the rest. Thus, the ruling concludes that, once the decedent's unpaid distribution has been paid to the IRA beneficiary, that beneficiary may nevertheless disclaim all or any part of the IRA other than the decedent's unpaid distribution and related income.

*Comment:* What if, in the examples above, Jackie had left several IRAs, and then the beneficiary aggregates required distributions from all IRAs and withdraws the total from only one of the IRAs?<sup>12</sup> Because the amount withdrawn relates to a required minimum distribution from each of the IRAs, and because the ruling characterizes each required minimum distribution as a distribution of corpus, it seems that the amount withdrawn should also be characterized as corpus. However, the income of the account from which the withdrawal is made, and not the income from the other IRA accounts, should form the basis for the income from the distribution or corpus that cannot be disclaimed. If all that is true, it should be possible to make a partial disclaimer of any of the IRAs, or a full disclaimer of any of the IRAs from which no distribution was made, but not a full disclaimer of the IRA from which the distribution was made.

### **Determination of Income**

Income of the IRA must be determined because the amount of income allocated to the decedent's unpaid distribution cannot be disclaimed. The ruling provides the method for making that determination.

Before discussing the method for apportioning income to the portion of the IRA disclaimed, it must be noted that the ruling avoids the question of how to determine income in total. Inspection of regulations under section 2518 sheds no light, either. Without further guidance, one might be left to assume that because an IRA is a trust or a custodial account, the usual concepts of fiduciary accounting income should apply.<sup>13</sup> Moreover, the distinction of property -- a share of which may be accepted while making a partial disclaimer -- versus income -- the acceptance of which precludes disclaimer of the property that produced the income -- implies an income determination consistent with traditional concepts of fiduciary accounting income. In general, income includes items of receipts like dividends, rents, and royalties while capital gains and losses are allocated to principal. However, there is a provision defining income of a Roth IRA in Treas. reg. section 1.408A-5, Q&A 2(c), regarding recharacterization of contributions to a Roth IRA when less than the entire Roth IRA is recharacterized. There, the net income (or loss) is defined as the difference between the fair market value of the Roth IRA, measured on two dates: that of contribution and that of recharacterization. Thus, income in the universe of IRAs might be a case aside from the general definition found in the law of trusts. Clarification on that point from the IRS would be welcome.

Once determined, income is apportioned to the decedent's unpaid distribution under the formula provided in Treas. reg. section 25.2518-3(c). Under that formula, the income for the period

beginning on the date of death and ending on the date of distribution to the beneficiary is divided by the value of the IRA account at the date of death. That result is then multiplied by the amount of the decedent's unpaid distribution made to the beneficiary.

Applying that formula to the examples above, the income from Jackie's unpaid distribution is \$200 (\$4,000 income, divided by \$200,000 date of death IRA value, times the \$10,000 unpaid distribution).

### **Required Minimum Distributions**

In addition to its holding regarding disclaimers, Rev. Rul. 2005-36 holds that, for the disclaimed portion of the IRA, the IRA beneficiary who made the disclaimer is disregarded for purposes of determining the identity of the designated beneficiary for determining required minimum distributions after the death of the IRA owner. Moreover, the alternate beneficiary is recognized as a beneficiary as of the date of the IRA owner's death. Thus, the alternate will be considered in determining the identity of the designated beneficiary, and the alternate will meet the requirement of Treas. reg. section 1.401(a)(9)-4, Q&A 4 that: "In order to be a designated beneficiary, an individual must be a beneficiary as of the date of death."

Now assume that the alternate beneficiary is one individual. Rev. Rul. 2005-36 essentially leads to the result that required minimum distributions beginning the year after the death of the IRA owner may be stretched out over the life expectancy of the alternate beneficiary.

### **IRA-to-IRA Transfer by Beneficiary**

The examples above indicate that an IRA beneficiary may transfer that beneficiary's interest in the IRA to a new IRA held in the decedent's name for the benefit of that IRA beneficiary. Aside from tax considerations, a significant attraction of transfers is beneficiary control over investment decisions.

Transfers are described and distinguished from rollovers in Rev. Rul. 78-406. If a transfer to a new IRA is accomplished in accordance with Rev. Rul. 78-406, it is of no concern that section 408(d)(3)(C) generally prohibits rollovers of inherited IRAs. A transfer to a separate account is authorized under Rev. Rul. 78-406 as long as the account is titled in the name of the deceased IRA owner. A direct transfer is distinguishable from an IRA rollover. In a transfer, no funds ever pass through the hands of the IRA owner or beneficiary on its way to the destination IRA, whereas in an IRA rollover, there is a distribution to the IRA owner or beneficiary followed by a rollover contribution to another IRA within 60 days of receipt.

### **Conclusion**

Because of Rev. Rul. 2005-36, IRA beneficiaries considering making a disclaimer should now be comfortable accepting a required minimum distribution that the deceased IRA owner was scheduled to withdraw in the year of death but did not withdraw. There is no longer any reason to hurry up a disclaimer decision because of the need to make a timely required minimum distribution. However, once that distribution is accepted, any disclaimer made later must exclude income from the distribution and must include income from the disclaimed portion of the IRA. Further, the disclaiming beneficiary will not be considered in determining the designated beneficiary for purposes of required minimum distributions for the disclaimed portion of the IRA.

## FOOTNOTES

<sup>1</sup> 2005-26 IRB 1368, *Doc 2005-13783* [[PDF](#)], 2005 TNT 122-6.

<sup>2</sup> *See generally* sections 408(a)(6), 408(b)(3), 401(a)(9), and related regulations.

<sup>3</sup> That number is based on the facts of Rev. Rul. 2005- 36. It cannot be reconstructed using the required minimum distribution tables found in Treas. reg. section 1.401(a)(9)-9.

<sup>4</sup> *See* Treas. reg. section 1.408-8, Q&A 5.

<sup>5</sup> *See* section 408(d).

<sup>6</sup> If Brad does not make the election, see Treas. reg. section 1.401(a)(9)-5, Q&A 5; but if Brad does make the election, see Treas. reg. section 1.401(a)(9)-5, Q&A 4.

<sup>7</sup> *See* section 72(t), which imposes a 10 percent tax on withdrawals from IRAs and other retirement accounts before reaching age 59-1/2. Exceptions to that tax are provided. Potential imposition of the tax in the case of an election by the surviving spouse to treat an IRA of a deceased spouse as an IRA of the surviving spouse is highlighted in Treas. reg. section 1.408-8, Q&A 5(c).

<sup>8</sup> *See* section 72(t)(2)(A)(ii).

<sup>9</sup> *See* note 5 *supra*.

<sup>10</sup> *See* Treas. reg. section 1.408-8, Q&A 5.

<sup>11</sup> Treas. reg. section 25.2518-2(d)(1).

<sup>12</sup> That is permitted under Treas. reg. section 1.408-8, Q&A 9.

<sup>13</sup> *See* Treas. reg. section 1.643(b)-1.

## END OF FOOTNOTES

### Relevant Code Sections

Section 408 -- IRAs

Section 2518 -- Disclaimers