Dealing with RMD Shortfalls

This penalty can be waived if the taxpayer establishes, to the satisfaction of the IRS, that the shortfall in the amount of distributions was due to reasonable error, and that reasonable steps are being taken to remedy the insufficient RMDs. Reasonable steps include taking the RMDs from prior years and thus accepting the resulting tax obligation. However, as you will read below, in some cases the person with personal liability for the unpaid taxes (an IRA owner’s executor) may lack access to the IRA money. This can result in a conundrum that’s not easily resolved!

When the Client is Alive

In one scenario, suppose John is in his early 80s, with a six-figure IRA. He has never taken any distributions from that IRA, accumulating a huge income tax obligation, plus possible penalties.

Assume that John has hired a new tax professional who reviews John’s prior tax returns and discovers the lack of RMDs. According to Treasury Department Circular 230, a publication that establishes ethics rules for tax professionals, a practitioner who discovers insufficient RMDs with respect to a client must inform the client and urge steps to clear the slate.

In the real world, though, our hypothetical John may not want to take all the back RMDs and pay the tax. John could be tempted to ignore the tax pro’s advice, believing that the shortfall won’t be discovered.

If so, John should be advised that there is no statute of limitations on RMD shortfalls, unless Form 5329 is filed for the relevant year. John must rectify the insufficient RMD to avoid the 50% penalty.

If John still refuses to comply, Circular 230 states that the tax professional must resign the account with John. Ethically, a tax professional cannot file a tax return with an RMD calculation known to be incorrect.

Advisors other than tax professionals are not covered by such federal rules. Nevertheless, it probably is a good policy to notify clients who have not met their RMD obligations.

If clients prefer to continue gambling on not getting caught, advisors may want to consider if they should maintain the relationship, in order to avoid possible problems in the future. Even advisors who are not tax pros might have some liability if they continue to work with clients who flagrantly disregard the rules.

IRA Has Been Left Outright

In another example, Mary has died and left her IRA to her son Josh. Here, a tax professional who notices any prior RMD shortfalls that occurred while Mary was alive
DEALING WITH RMD SHORTFALLS

(this applies to the calendar years before her year of death) would be obligated to inform her executor. The executor, in turn, would be personally liable for any penalties that result from noncompliance.

However, if Josh refuses to take the delinquent RMDs, the executor’s liability would remain, perhaps placing the executor’s personal assets at risk, and the executor would lack access to the IRA money. Form 5329 requires reasonable steps, to support a request to waive the 50% penalty, but the executor can’t take the reasonable step of rectifying past RMD shortfalls.

If no Form 5329 has been filed, there will be no statute of limitations to eventually protect the executor or the IRA beneficiary or (if different) the estate heirs. To collect the tax due, the IRS might pursue the person or people who can be reached easily, with ample assets.

Moreover, the executor can’t force a reluctant IRA beneficiary to pay the taxes that are due. This is a potential problem without an easy solution!

IRA Has Been Left to a Trust

Many IRA owners name a trust as beneficiary, for asset protection and estate planning. RMD rules apply during the IRA owner’s lifetime and after the IRA passes to the trust.

One outcome that should be desired is to have the trust be considered a qualifying trust. Then RMDs may be based on the life expectancy of the oldest trust beneficiary, as determined by IRS rules. If the oldest beneficiary is, say, age 58, with a 27-year life expectancy on the IRS table, RMDs may be stretched over 27 years, providing a big tax deferral.

With that background, consider this relatively common situation.

The IRA owner has died, the IRA was left to a trust, and the trustee has been taking RMDs based on an improper payout period. Years later, it is discovered that the trust was non-qualifying and the subsequent RMDs from the IRA to the trust have not been calculated correctly.

Suppose that Sarah died in August 2012, before her required beginning date, leaving her IRA to a trust. The required documents were not filed with the IRA custodian by October 31, 2013, so the trust is non-qualifying.

On December 31, 2017 (five years after the year of death), the IRA still contained $300,000. Under the five-year rule, which applies to a non-qualifying trust, if the IRA owner died before the required beginning date, the amount in the IRA as of December 31, 2017 should have been zero.

Therefore, tax rules require the entire IRA amount to be distributed, subject to income tax. In addition, a $150,000 penalty (50% of the $300,000 IRA balance) may be imposed if the distribution is not timely taken.

In this scenario, the $150,000 penalty would be the trustee’s responsibility. A tax professional who discovers this obligation is required to inform the trustee immediately.

Once informed, the trustee should immediately distribute the IRA balance. The amount to be distributed probably would be taxable, to the trust or the trust beneficiary or some combination of the two.

As explained, the trustee should file IRS Form 5329 for 2017, the year the IRA should have been emptied. On this form, the trustee can ask for the penalty ($150,000 in this example) to be waived. IRS can waive the penalty for good cause. If the trustee does not want to empty this large IRA, the tax pro can tell the trustee that the Tax Court has ruled there is no statute of limitations on an IRA penalty unless Form 5329 has been filed for the year of the shortfall. (Paschall v. Commissioner, July 5, 2011).

As a result, the IRS can assert the 50% penalty at any time if a timely Form 5329 is not filed. The trustee’s period of personal liability could be significant, if the evidence shows that the trustee knew about the insufficient RMD. A trust beneficiary who received IRA money also might be liable for the penalty if the trustee doesn’t pay it.


Goldberg is the senior partner in the law firm of Goldberg & Goldberg, P.C., Long Island, New York and is Professor Emeritus of Accounting, Law and Taxation at Long Island University. He has taught many CLE and CPE programs at the state and national level as well as CLE courses for the American Bar Association, New York State Bar Association, City Bar Center for Continuing Legal Education, NJICLE, local bar associations and law schools. Mr. Goldberg has been quoted in major publications including the New York Times, Forbes and The Wall Street Journal. He was formerly associated with the Internal Revenue Service, serving in the Fraud Group, and has been involved in conducting continuing education outreach programs with the IRS. He has authored guides for the American Bar Association and the American Institute of Certified Public Accountants on IRA compliance issues. Mr. Goldberg is the recipient of Outstanding Discussion Leader Awards from both the AICPA and the Foundation for Accounting Education. His IRA guides can be found in well over 100 law school libraries. Mr. Goldberg can be reached by phone at 516-222-0422 or via email at info.goldbergira@gmail.com.
End Note

Advisor Action Plan

- Inform all clients who owe RMDs about their annual obligation. Keep records of your correspondence, including those notifications.
- If you learn of past RMD shortfalls, urge clients to withdraw amounts in question and file Form 5329, requesting a waiver of the 50% penalty.

If you discover that clients are not remedying insufficient RMDs from past years, despite several communications from you, consider whether it is in your best interests to maintain the relationships.