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Avoiding Roth IRA Taxing Tax Traps

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Roth IRAs and other Roth plans offer tax-free cash flow to account owners and beneficiaries, once the age (59½) and holding period (five years) requirements have been met. However, tax code technicalities could lead to the taxation of all distributions of inherited Roth assets. Fortunately, certain steps can reduce that risk.

Creating Consistency

IRS Form 8971, including Schedule A, must be filed whenever IRS Form 706, the federal estate tax return, is required for an estate over the threshold amount. Therefore, these forms are used for estates larger than $11.4 million in 2019. Looking back, this requirement also applies to estate tax returns filed after July 2015, if the estate exceeded the relevant threshold amount.

On Schedule A of Form 8971, the decedent's assets that contain basis items (in whole or in part, with limited exceptions) must be listed. The object is to promote consistent basis reporting between assets reported on federal estate tax returns and the basis reported by people who have acquired property from the decedent. Moreover, the IRS Proposed Regulations and Instructions for Form 8971 and Schedule A have no exception for bifurcated assets.

Consistent basis reporting is important because some estate personal representatives may have erroneously reported a low valuation on an estate tax return, reducing estate tax. In addition, some estate beneficiaries may have erroneously reported a higher valuation than the amount on the estate tax return, on a subsequent sale, thereby decreasing their personal tax liability.

Preventing such inconsistency is the purpose behind Form 8971 and the attached Schedule A, which locks in the reported value of the property that's listed, based on the Form 706 filed for the estate. From that report, a consistent basis can be used to calculate the tax resulting from subsequent transactions entered into by estate beneficiaries.

Zero Tax Shelter

What does all this have to do with Roth IRAs? Assets not listed on Schedule A of Form 8971, with certain exceptions, will have a zero basis. Then, any money received from such unlisted assets will trigger tax liabilities.

Following this reasoning, suppose John Smith had a Roth IRA when he died, worth $500,000. (Assume that the Roth IRA satisfies the five-year requirement prior to John's year of death.) Further, suppose that John's executor fails to see that the Roth IRA is listed on Schedule A of Form 8971.

Under the IRS' Proposed Regulations, John's Roth IRA would have a zero basis, and all subsequent distributions to the Roth IRA beneficiary would be fully taxed as ordinary income. Accounts in Roth versions of employer plans also would get a zero basis if not listed properly.

Any money received from such unlisted assets will trigger tax liabilities.

The same could be true for traditional IRAs holding after-tax dollars from non-deductible contributions as well as nonqualified annuities.

Data reported to the IRS on Form 706 may not flow easily into Schedule A of Form 8971. That's especially true for bifurcated assets (those containing partial basis and deferred income), such as those previously mentioned.

Limited Exceptions

The Proposed Regulations for Form 8971 and Schedule A include some exceptions, which would not have a zero basis, even if omitted from the listing. Of those exceptions, the item most meaningful to retirement plans is income in respect of a decedent (IRD) assets.

The IRD rules are meant to prevent double taxation of inherited assets: exposure to both estate and income tax. Beneficiaries can take a tax deduction in years they withdraw money from an inherited IRA, if that IRA has triggered some estate tax obligation.

Wouldn't a Roth IRA be included in the IRD exception to requirements for listing on Schedule A of Form 8971? No, because IRS Letter Rulings and Revenue Rulings indicate that an investment in a contract is not IRD.

Roth IRAs, for example, have basis (or partial basis, depending on whether the five-year holding period requirement has been met) and therefore would not qualify for the IRD exemption, in the absence of subsequent relief and guidance by the IRS.

Although the treatment of Roth IRAs in this context has been questioned by practitioners' organizations, the IRS has not provided any guidance to date.

Consequently, if an item contains basis (including an investment in a contract such as an annuity), it currently lacks an exemption and must be reported on Schedule A of Form 8971. Therefore, omitting a Roth IRA (or other retirement assets with basis from after-tax dollars) will result in zero basis, making all payouts subject to income tax. Listing retirement assets with basis on Schedule A of Form 8971 may prevent this surprisingly harsh future tax treatment for beneficiaries.

Practical Points

Filling out Schedule A of Form 8971 may be especially challenging when listing Roth IRAs that are not fully qualified for tax-free distributions, under the five-year rule. Schedule A of Form 8971 provides no way to list a bifurcated asset, which is a problem for estate tax practitioners once the five-year rule has been satisfied.

Listing retirement assets with basis on Schedule A of Form 8971 may prevent this surprisingly harsh future tax treatment for beneficiaries.

If the five-year test has been satisfied prior to the decedent's year of death, the current value of a Roth account can be listed on Schedule A, with no footnote. If that test has not been passed, more information is needed.

One suggested approach is to list the decedent's date-of-death Roth IRA balance on Schedule A of Form 8971. Then indicate in a detailed footnote that the five-year rule was not satisfied prior to the decedent's year of death, and the Roth IRA's basis is "X" dollars and will be adjusted once that milepost is past.

Listing nonqualified annuities also can pose problems. Again, one possible solution is to list the annuity at its current value on Schedule A of Form 8971. On the next line, after an indentation, the decedent's basis in that annuity must be entered.

Yet another puzzle relates to deaths that are still subject to the statute of limitations for estate tax purposes, which is three years after Form 706 was filed or after the due date for that form, including extensions, whichever is later. That could include large estates which did not list, say, a Roth IRA or a nonqualified annuity on Schedule A of Form 8971.

For such estates, advisors should urge that a Supplemental Form 8971 be filed with the IRS, including a Supplemental Schedule A with a date-of-death listing of all required assets and basis amounts; copies should be sent to affected beneficiaries. Doing so as soon as possible may avoid adverse tax effects.

Caution: *The IRS' Proposed Regulations and Instructions do not provide for filing a Supplemental Form 8971 and a Supplemental Schedule A to include items initially listed on an estate tax return, Form 706, but erroneously omitted from Schedule A.*

Representatives of estates that exceed the estate tax threshold should act to immediately remedy the issues described in this article, assuming no relief from the IRS. These representatives should work with professionals who are experienced in addressing complex estate tax and related issues. ■

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