

A Traditional IRA Beneficiary Is Ineligible to Convert an Inherited/Beneficiary IRA to a Roth IRA

Slowly but surely some individuals with funds in traditional IRAs are making the decision to convert their traditional IRA funds to a Roth IRA. These individuals are pursuing the goal of tax-free income.

Individuals who have inherited a traditional IRA are starting to ask their IRA custodians if they can convert their inherited traditional IRA funds to an inherited Roth IRA.

The answer is, “no.” The current conversion rules are primarily based on the standard rollover rules found in Code section 408(d) (3). The law requires that the individual include the taxable amount in his or her income regardless if the conversion is done by rollover, an internal transfer conversion, or an external transfer conversion.

Code section 408(d)(3)(C) expressly denies rollover treatment (i.e. conversion) for inherited IRAs.

Code section 402 also denies rollover treatment of employer funds into inherited IRAs for non-spouse beneficiaries. That is, if a distribution is made to a non-spouse beneficiary, he or she must include the taxable portion in his or her income as the law does not authorize a rollover contribution. However, the law creating and defining direct rollovers mandates that a non-spouse beneficiary have the same rights as participants to do a direct rollover. In a direct rollover, the plan trustee issues the check to the IRA custodian for benefit of John Doe's inherited traditional IRA and/or John Doe's inherited Roth IRA. A non-spouse beneficiary must be given the right to have a direct rollover of inherited funds into an inherited traditional IRA and/or an inherited Roth IRA.

Admittedly, allowing a non-spouse beneficiary to directly rollover inherited funds into an inherited IRA is logical in the sense that a participant has the direct rollover right. But it is somewhat illogical that a non-spouse beneficiary of a pension plan may convert non-Roth funds within the pension plan to a Roth IRA when he or she is unable to do this for funds within a traditional IRA.

Since different Congresses and different Presidents enact tax laws over many years there will be inconsistencies. An IRA custodian will need to be ready to inform a beneficiary that the current law does not authorize an individual who has an inherited traditional IRA to convert it to being an inherited Roth IRA.