# The Pension Digest

May 2013
Published Since 1984





**Collin W. Fritz and Associates, Inc.,**
***"The Pension Specialists"***




## A Personal Guarantee of an IRA Investment Must be Avoided

Banks and security firms almost always seek a personal guaranty for loans and many investments. This may be what is best for the bank or the securities firm, but it will cause major problems when an IRA is involved. The individual and possibly the bank or securities firms will learn a tax lesson the hard way.

Example. John Doe has $300,000 in his IRA. He instructs his IRA trustee to purchase a parcel of real estate for $350,000 on a contract for deed and his initial payment is $200,000 with the remaining $150,000 to be paid within 18 months. The IRA is purchasing the real estate from another bank which acquired the property by foreclosure. The bank selling the property wants a personal guaranty because that is its standard practice. If with respect to the IRA's purchase John Doe gives his personal guaranty, that act will constitute a prohibited transaction and whatever balance was in his IRA as of January 1 is considered distributed. No one likes to pay income tax on $300,000.

In summary, a cardinal rule for a self-directed IRA or trust IRA is that the individual must never personally guaranty an investment within his or her IRA, be it traditional, Roth, SIMPLE or SEP. Furnishing a personal guarantee is always a prohibited transaction unless the DOL would grant a special exemption.

See the following newsletter article discussing the special relief the DOL is making available to individuals who furnished guarantees when they signed the "standard" forms of many security firms. The DOL has chosen to grant relief to both the individuals and the securities firms. Without such relief the securities firms would be facing unhappy customers and their lawsuits. ◆

## DOL Proposes Class Exemption to Resolve PT Problems With IRAs for Securities Firms and Others

Securities and brokerage firms have written many of their account opening documents so that an individual opening a new investment account agrees that if he or she owes money with respect to any one of his or her accounts that the security company has the right to withdraw the amount owed from a different account. This is generally called a cross-collateralization agreement. In order for a person (or an IRA) to be able to engage in short sales, margin transactions, options and futures the securities firm wants to be assured of getting paid and so imposes a cross-collateralization agreement or an indemnification agreement.

The securities and brokerage firms have rightfully concluded that there needs to be a prohibited transaction class exemption granted by the DOL/EBSA or many firms will suffer adverse tax and financial consequences because of their account


**Continued on page 2**

**DOL,**
**Continued from page 1**

agreements. One does wonder why the securities firms have been so stubborn and so stubborn for so long in requiring individuals setting up an IRA to furnish a cross-collateralization.

As discussed in the previous article, this is a prohibited transaction. The securities industry has been brazen to think it is not a prohibited transaction or try to argue it is not. IRA custodians have known since the 1970's and 1980's that they could not have a person's IRA serve as collateral for any personal loan or investment. Nevertheless, it is 2013 and the securities industry wants to keep doing what they have been doing. The securities industry has requested of the DOL/EBSA that prohibited class exemption (PTE) 80-26 be amended on a prospective basis to allow an individual in the future to be able to use his or her IRA to cover debts of other non-IRA accounts.

In general, the DOL/EBSA is not granting the request on a prospective basis, but is granting limited relief on a retroactive basis if certain conditions are met. The securities industry should be ecstatic as they have ignored a basic tax rule for over 30 years.

In October of 2009, the DOL/EBSA in Advisory Opinion 2009-03A made clear that the grant by an IRA owner to a broker of a security interest in the IRA owner's non-IRA accounts in order to cover indebtedness of, or arising from, the IRA would be an impermissible extension of credit under Code section 4975. In October of 2011, the DOL issued Advisory Opinion 2011-09A and made clear the exemption provided by PTE 80-26 granting class PTE exemption for certain interest free credit would not apply to the cross-collateralization situations.

Independent auditors are apparently discussing this cross-collaterization topic in their public audit reports. In some situations the financial consequences could be so adverse as to materially impact the securities firm's financial condition.

Remember when a prohibited transaction (PT) occurs as a result of an individual with respect to an IRA, that the IRA is either considered totally taxable since a deemed distribution takes place on the first day of the tax year, or if the PT occurs as a result of the IRA custodian, then the financial institution will need to pay a tax equal to 15% times the total value of the involved IRAs. The possible adverse tax consequences are very large.

The DOL/EBSA has concluded that its proposed regulatory action of amending PTE 80-26 is not so "significant" that the Office of Budget and Management (OBM) must first review the proposal before it was submitted to the general public. The OBM is supposed to review a regulatory proposal if on an annual basis the proposal will have an impact on the economy of $100 million or more. Considering that IRAs have a value of 4.7 trillion and that over 75% of IRAs are with Securities firms, it is almost a certainty that taxing such IRAs would amount to more than $100 million. And there certainly would be lawsuits by individuals against the security and brokerage firms.

Consequently, the Securities Industry and Financial Markets Association (SIFMA) has requested the DOL/EBSA issue the proposed amendment to PTE 80-26 and code section 4975. The proposed amendment, if adopted, would give temporary and retroactive exemptive relief for certain guarantees of the payment of debts to plan investment accounts (including IRAs) by parties in interest to such plans as well as certain loans and loan repayments made pursuant to such guarantees. If adopted, the proposed amendment will be effective from January 1, 1975, until the date that is 6 months after the date on which an adopted amendment is published in the Federal Register.

That is, the prohibited transaction exemption (PTE) is to be retroactive. It may be that a person who has had to pay the income tax penalties associated with a PT will be able to seek a refund. It will certainly mean that large tax amounts currently owed will not need to be paid. This is a nice "settlement" for the securities industry. The DOL/EBSA does not discuss whether it has considered or could consider having the security industry pay a monetary penalty.

At the present time, the DOL/EBSA proposal is to forgive any tax amount owing as long as the conditions set forth in the proposed exemption are satisfied.

Even though SIMFA did not request any relief where a business and its 401(k) plan might have executed a cross-collateralization agreement, the DOL/EBSA on its own has pointed that such agreements may also need

**Continued on page 5**

The Pension Digest

## Correcting Certain Rollover Mistakes–Sometimes not so Easy

Set forth below is discussion of a situation where a person withdrew funds from both a traditional IRA and a Roth IRA with IRA custodian #1 and then the person went to IRA custodian #2 and prepared all of the proper paper work to roll over such distributions into a traditional IRA and a Roth IRA. The problem – at IRA custodian #2 the funds were combined and invested in a traditional IRA CD. The purported rollover took place on November 6, 2010. It is now April of 2013 and IRA custodian #2 has just discovered its error.

For the reasons set forth below, this error is not easily correctable. Unlike with pension plans, SEPs and SIMPLEs, the IRS does not have a voluntary correction program for traditional IRAs and Roth IRAs. As in the current situation, there are times when funds are invested in one type of IRA (traditional IRA) in error when the person actually wanted the funds invested in the other type of IRA (Roth IRA) or vice versa.

On October 6, 2010, Mr. Davis completed various IRA forms to make two rollovers. He directed to rollover $35,207.54 into a traditional IRA (from another traditional IRA) and he directed to rollover $17,105.10 into a Roth (from another Roth IRA). For whatever reason, human error or computer glitch, bank personnel combined the two deposit amounts into a traditional IRA deposit account. I understand that the bank prepared just one 2010 Form 5498 for Mr. Davis and one 2011 Form 5498 for him. Mr. Davis did everything he was supposed to do to make the two rollover contributions.

The legal/tax question – Was a rollover into a Roth IRA accomplished or was there no such rollover since the funds were deposited into a traditional IRA CD?

The bank may consider the approach of considering the error to be just a reporting error and that the bank will now prepare the forms needed to correct for the reporting error(s).

The bank would prepare for the Roth IRA an original 5498 form for 2010 and an original 5498 for 2011. The 2010 Form 5498 would report the rollover contribution of $17,105.10 and the fair market value. The 2011 Form 5498 would report the fair market value.

The bank would prepare for the traditional IRA a corrected 5498 for 2010 and a corrected 5498 for 2011. The amount rolled over would be shown as $35,207.54 and not the combined amount.

The bank has some contingent liability in this situation. The individual understood he had made a rollover contribution into a Roth IRA. He expected the funds within the Roth IRA to earn tax-free income. This expectation will be met only if the IRS allows him to now complete the rollover.

Although the bank may adopt the approach of correcting the reporting forms, the bank's argument of being able to correct its error without following the IRS procedure discussed below is not very strong.

The more conservative approach would be to submit a request to the IRS to waive the 60-day rollover rule. If the bank admits fault, I expect the IRS would issue the waiver, but there is no guaranty.

Since this error was not discovered and corrected by the IRA custodian within the one-year time period, a filing with the IRS is needed. The filing fee is $500 as the amount involved is $17,105. The positive with this approach is that there would be tax certainty for Mr. Davis and the bank. Without getting an express letter from the IRS authorizing him to move the funds into a Roth IRA, Mr. Davis would have to be concerned that the IRS might argue that he was not authorized to move the funds into his Roth IRA and therefore such a movement would be an excess contribution. The IRS might also argue that the $17,105 within the traditional IRA is an excess contribution.

Mr. Davis should certainly consult with his tax advisor. In this situation, it appears that both the IRA custodian and Mr. Davis will benefit by seeking an extended rollover time period from the IRS. The current IRS procedures do not expressly address whether the IRA custodian could make the IRS filing on its own. ◆

## Serious Missed RMDs Situation

Under current rules and procedures, a taxpayer who has a missed RMD will need to pay the 50% tax unless the taxpayer requests the waiver of the 50% tax and the IRS grants the request.

The discussion set forth below deals with a situation where the RMD calculation for an inheriting nonspouse beneficiary has been incorrect since 2000. This discussion was furnished to an IRA manager with the IRA custodian.

You are working to correct a situation where the annual RMDs for a beneficiary have been calculated incorrectly. The wrong divisors in the RMD formula were used for 2001-2012. It is not clear for some years how/why a certain divisor was used. It appears that for 2002-2008 the divisors came from the Uniform Lifetime Table using the age of the decedent. The rule to be used – determine the age of the beneficiary in the year after the year of the accountholder's death and then refer to the Single Life Table. The beneficiary was 69 in 2000. The initial divisor was 17.8. For subsequent years, 1.0 is to be subtracted each year to determine the divisor.

Since the incorrect divisor was used for each year, the beneficiary was not distributed the total amount of her annual RMD for 2001-2012. That is, for each year the amount she withdrew was less than her RMD amount. Unless the IRS will waive the 50% tax, she owes the 50% tax on her missed RMDs.

Your spreadsheet shows the determination of the under-distribution amount as being $45,842.13. CWF has calculated this amount to be $68,072.35. The missed RMD amount should be withdrawn as soon as possible once it is confirmed what the total shortage is.

IRS rules do not require or permit each year's RMD calculation to be adjusted for any earnings or losses or to adjust the balance for the distributions which should have been taken, but were not. Such a rule does apply for purposes of withdrawing a current year/excess contribution but that rule is totally independent of the RMD rules.

CWF has not seen the IRS discuss in writing the situation where a person has missed multiple year RMDs. One knows it has happened. The 50% tax is due for each year the missed RMD remains in the IRA. It is not due for just one year. The IRS takes the position that the statute of limitations does not begin to run until the Form 5329 has been filed showing the tax is owing.

The parties may wish to consider submitting an amended tax return for 2012. Or, if the 2012 return has not yet been filed, the request to the IRS for a waiver could be made with the filing.

The IRS does have the authority to waive the 50% tax if equity would warrant such waiver. See the instructions for Form 5329. The amended 2012 tax return would contain a request to waive the 50% tax for tax years 2000-2012. The argument would be: the beneficiary should not have to pay the 50% tax since the errors were caused by the IRA trustee (its software??). There is no guaranty the IRS would waive the tax. CWF has not seen anything from the IRS indicating it would be willing to settle for a lesser amount. The current IRS approach appears to be – the IRS will waive all of the 50% taxes for all years or require it all to be paid.

The IRS might argue that the individual would need to pay the tax as the IRS has furnished guidance that the IRA custodian is not required to furnish an RMD notice to a beneficiary.

The Form 5329 instructions indicate, it is important that there is no excess accumulation of missed RMDs at the time the IRS request for a waiver is made. So, the letter/filing to the IRS should state that once the errors were discovered the under-distributions of $68,072.35 were distributed.

Note that the 2013 RMD is $29,825.34. This is in addition to the $68,072.35. The actual balance as of the preceding December 31 is used in each year's RMD calculation.

The IRA Custodian will need to make the business decision as to what degree it will accept fault. There may well be some liability concerns if the IRA Custodian admits fault and the IRS rules it will not waive the 50% taxes. An IRA Custodian/Trustee is able under existing IRS guidance to argue that it is not required to furnish RMD notices or do the RMD calculation.

In summary, the tax consequences can be extremely harsh when mistakes are made with respect to failing to comply with the RMD rules for IRAs. Under current IRS rules there is no special voluntary compliance program for correcting IRA mistakes as there is for pension plans.

The Pension Digest

The individual must seek relief under the standard rules for filing and amending the individual's tax return(s). Hopefully, the IRS will give consideration to adopting an IRA correction program. ◆

## SEP Plan FAQs – Terminating a SEP plan

**Do I need to amend my SEP for the new law before I terminate it?**

Generally, the IRS has not required employers to amend their SEPs for new law prior to termination. Check with your plan professional.

**Do I have to fund my SEP in the year of termination?**

SEPS can be terminated at any time. You can stop funding your plan once it is terminated.

**What are the notification requirements when a SEP terminates?**

When you terminate your SEP plan, it is a good idea to notify the employees that you are discontinuing the plan. You may need to notify the financial institution that you chose to handle the plan that there will be no more contributions and that you will terminate the contract or agreement with it. DO not notify the IRS of the plan's termination.

**If I go out of business or my employee terminates service, can the amount in a SEP-IRA be left untouched?**

Yes ◆

## 2011 IRS Tax Returns – Basic Info

| Type of Return | Number of Returns | Gross Collections (Millions of $1) |
|---|---|---|
| Individual income tax | 143,607,800 | 1,331,160 |
| Corporation income tax | 2,312,909 | 242,848 |
| Employment taxes | 29,445,812 | 767,505 |
| Excise taxes | 522,165 | 49,338 |
| Gift tax | 207,858 | 6,572 |
| Estate tax | 11,128 | 2,507 |
| **Total** | **176,107,672** | **$2,339,930 or 2.34 trillion** |

DOL, Continued from page 2

to be revised and that retroactive relief is also available by the same deadline.

The DOL/EBSA has proposed a 6 month time period during which the securities and brokerage firms must replace all of the existing account opening agreements. Any cross-collateralization or indemnification provisions must be removed from the account opening form. In some cases there may need to be refunds of various fees.

The DOL/EBSA did not adopt a 12 month correction period as requested by SIFMA. The DOL/EBSA said that 12 months was unreasonable considering the DOL/EBSA had put the industry on notice in 2009 that such provisions result in a prohibited transaction.

And the DOL/EBSA is unwilling to grant the UNLIMITED exemption requested by SIFMA on a prospective basis. However, if the new conditions of the revised exemption are satisfied, then there will be exemptive relief.

The DOL/EBSA has set July 23, 2013, as the deadline to submit a request for a public hearing and to submit written comments. The DOL/EBSA must receive such on or before July 23, 2013 (i.e. 60 days after the proposal on May 23, 2013).

To read sections IV-VI of the propose class exemption, go to www.pension-specialists/dolebsa.pdf. Once the 6 month period has expired (sometime in 2014) the general exemption will apply if the general prospective requirements are met.

Consulting Guidance, Continued from page 7

and if applicable on any amended tax return(s). The tax preparer can also explain the tax consequences of withdrawing the earnings.

It appears the mother was frustrated that there would be the assessment of an early withdrawal interest penalty for the surrender of the Roth IRA CD prior to maturity. The bank is not being unreasonable. She is. Interest penalties are normally charged by the bank when either a traditional IRA or Roth IRA CD is surrendered prior to maturity by a person under age 59½.

If any earnings are withdrawn by the son, in addition to having to include this amount in his income, he will also have pay the 10% additional tax unless he would meet an exception. ◆

## Email Consulting Guidance

**Q-1 Which Distribution Code?**

A Roth IRA accountholder died on 3/13/13. The Roth IRA was opened in 2002 and the accountholder designated her three daughters as beneficiaries. We opened 3 Inherited Roth IRAs for the daughters.

One of the daughters chose to withdraw all funds from her Inherited Roth IRA. From what I read, the distribution is a "Qualified" distribution (opened 5 years and beneficiary). My question is: do we code it with a death distribution tran code? Or, is it just a plain Roth distribution?

**A-4**

This distribution is a "Q" because a distribution was made to the daughter of a Roth IRA owner who has died and it is known that the 5-year rule was met. On CWF's form the box/circle would be checked that the Roth owner had died.

There is no specific death distribution code for a Roth IRA distribution paid to a beneficiary as there is for a traditional IRA (reason code 4). Either the reporting code "Q" or "T" will be used. The IRS is not expressly told the recipient is a beneficiary.

**Q-2 Which Reporting Code?**

Can you please tell me what IRS reporting code to use when a customer is over 59$^1/_2$ years of age but the customer has NOT met the 5-year rule?

**A-2**

A code "T" would be used. Since the 5-year rule has not been met at your bank, the bank will report it as a nonqualified distribution. Two codes need to be considered. Code "J" is used when the bank is unaware of an exception to the 10% additional tax. Code "T" is used when the bank is aware of an exception. Since you know he is age 59$^1/_2$ and that this is an exception, Code "T" is to be used.

**Q-3 Question regarding SEP-IRAs**

I received a call from our local CPA who advised their client to set up a SEP-IRA with our institution. It is a one-person business and this individual has two employees both over the age of 70 working for him. I understand how to set the SEP up for the employer, however can you give me a little clarification?

So I prepare the SEP form for this individual but per the CPA I also then would need to setup IRAs for each of the two employees. Do I use the traditional form from CWF for these individuals but then make sure our operating system codes them as SEP contributions?

**A-3**

The owner will complete the Form 5305-SEP and the traditional IRA form, CWF Form #40-T.

The two employees will complete the CWF Form 40-T unless they would have an existing IRA and then it would not be mandatory as the SEP-IRA contribution could be made to the existing IRA. The owner would give them a copy of the completed Form 5305-SEP. As you state, you will want to double check your 2013 Form 5498 to make sure the employer contribution is reported in box 8 and not in box 1.

**Q-4 Direct Rollover**

I received a check today made payable to the bank as "Custodian of the IRA of Mary Smith as beneficiary of John Smith" from Public School Retirement System of Missouri. The check stub description calls it a "Death Benefit Rollover" and further describes it as a "Rollover transfer from a 401(a) governmental defined benefit plan for Mary Smith". Mary Smith is John Smith's spouse and John died earlier this year. Mary's age is 62 and her husband would have been 68 in Oct.

It looks like it should be deposited in an Inherited IRA but Mary only has a Traditional IRA. Can we deposit the funds directly to her Traditional IRA and treat it as her own or do we have to open an Inherited IRA, deposit the funds in that account, and then transfer from Inherited to Traditional?

**A-4**

The law clearly authorizes a surviving spouse to rollover or directly rollover a deceased spouse's plan funds into her own IRA. Since the payee of the check is the IRA custodian, this is a direct rollover contribution. There is no law authorizing a nonreportable transfer from a pension plan to an IRA or an Inherited

**Continued on page 7**

The Pension Digest

**Consulting Guidance,**
**Continued from page 6**

IRA. Since she is over age 59½, I am unaware of any reason she would want to maintain the IRA as an Inherited IRA. The most conservative approach is that the check would be added to her existing IRA as a direct rollover contribution. The law is unclear if she could put it into an Inherited IRA.

### Q-5 Form 5498

I have a customer that wants to know why a 5498 is sent after taxes are filed.

### A-5

Your customer has an excellent question.

The primary purpose of furnishing the Form 5498 is that it serves as an IRS audit tool. The IRA custodian sends the same information to the individual and the IRS. The IRS uses this information to make the determination that the individual has made the contribution(s) indicated on his or her federal income tax return. The contribution could be an annual, rollover, recharacterization, postponed contribution, etc.

The primary purpose of the 5498 is <u>not</u> to help the individual complete his or her tax return although the IRS in recent years has suggested that an IRA custodian may wish to furnish the Form 5498 in January and then correct it by May 31 if a person makes a prior year contribution during the period of January 1 to April 15. This would allow the individual to have the Form 5498 available when his or her tax return is prepared. The IRS has also suggested that an IRA custodian may use the Form 5498 to meet the requirements to furnish a fair market value statement and the RMD notice by January 31.

Since a person can still make a 2012 prior year contribution by April 15, 2013, the IRS has set May 31 (i.e. end of the following month) as the deadline to submit the 5498 to both the IRS and the individual.

### Q-6 Nonqualified Distribution

I have a customer who came in and established a Roth IRA for her son, already a strike. It was done at a branch in 2010, and I'm just finding out about it today.

She withdrew $5,000 from her Savings Account to fund it and did a Prior Year Contribution for 2009. My first question, has the 5-year period been met?

Today I receive a phone call from the branch at which the Roth was opened at, mom is there, she wants the IRA closed. She's yelling at the manager because the 33 year old son shouldn't have to pay penalties. To make a long story really short, mom called a CPA.

The son will be back in May when the IRA CD matures and we'll withdraw the basis of $5,000, (not sure which IRS code to use, "Q"? Then I will withdraw the earnings with IRS code "J" and close the CD) the CPA is having us treat it as an excess contribution, the contribution was made in 2010. I want to treat it as a non-qualified distribution, however, if the contribution was made for 2009, this year is the fifth year, does it become qualified as of December 31, 2013?

### A-6

The 5-year requirement has not been met. 2009 was the first year of the 5-year period, so the 5-year rule will be met on and after January 1, 2014.

The bank should not treat this as the withdrawal of an excess contribution. You are correct; it is to be reported as a nonqualified distribution. A nonqualified distribution may have two portions – one portion is non-taxable as it is the return of the contributions and the other portion may be earnings, such earnings are taxable as the 5-year rule has not been met.

The bank is to report this Roth IRA distribution or distributions as you would any other. You will report the gross distribution amount in box 1 and you will leave box 2a blank. Box 7 will be completed with "J" as the 5-year rules has not been met. Another reason for the "J" is that he is not yet age 59½.

The bank is not concerned about whether the individual is withdrawing his previous contribution or the earnings which the account has earned. You report the gross distribution. Because a person must aggregate all of his Roth IRAs wherever located, the tax rules do not require or allow the bank to report the withdrawal of earnings any different than the withdrawal of contributions. The individual or tax preparer has the responsibility to do this on the Form 8606.

If the original contribution was an excess, then the tax preparer will need to explain on the current year return

**Continued on page 5**

## IRS Issues 2014 HSA Indexed Amounts

The Treasury Department and Internal Revenue Service issued new guidance on the maximum contribution levels for Health Savings Accounts (HSAs) and out-of-pocket spending and deductible limits for High Deductible Health Plans (HDHPs) that must be used in conjunction with HSAs. The HSA contribution limits for 2014 have increased by a small amount and a small percentage over the 2013 limits. The 2014 limits are set forth in Revenue Procedure 2013-25. The catch-up contribution amount of $1,000 is not subject to being adjusted by the COLA adjustment of Code section 223(g) and so it remains at $1,000 for 2014.

The maximum annual out-of-pocket expense limits for 2014 have also increased. The minimum annual deductible limits for 2014 did not change.

### HSA Maximum Contribution Limits Under Age 55

| | 2013 | 2014 | Change | % Change |
|---|---|---|---|---|
| Single HDHP | $3,250 | $3,300 | + $50 | 1.54% |
| Family HDHP | $6,450 | $6,550 | + $100 | 1.55% |

### HSA Catch-Up Contributions

| | 2013 | 2014 | Change |
|---|---|---|---|
| Age 55 and Older | $1,000 | $1,000 | $0 |

### HSA Maximum Contribution Limits Age 55 & Older

| | 2013 | 2014 | Change | % Change |
|---|---|---|---|---|
| Single HDHP | $4,250 | $4,300 | + $50 | 1.18% |
| Family HDHP | $7,450 | $7,550 | + $100 | 1.34% |

### High Deductible Health Plans

| | Minimum Annual Deductible | | | Maximum Annual Out-of-Pocket Expenses | | |
|---|---|---|---|---|---|---|
| | 2013 | 2014 | Change | 2013 | 2014 | Change |
| Single Coverage | $1,250 | $1,250 | $0 | $6,250 | $6,350 | + $100 |
| Family Coverage | $2,500 | $2,500 | $0 | $12,500 | $12,700 | + $200 |

The IRS announces these changes in May each year so that employers and individuals will have sufficient time to plan for HDHP insurance coverage and HSA contributions for 2014 and so that insurance companies may revise their HDHP policies.

CWF will be updating our HSA brochures and our HSA Amendments. ◆