The Pension Digest

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ALSO IN THIS ISSUE – -

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

Election Day November 8th, 2016 and the Politics of IRAs.

You and other voters will go the voting booth on November 8th, 2016.

IRAs are political because they are a created by the federal income tax laws. IRA owners receive tax preferences for making various types of IRA contributions or because the IRA has received a direct rollover or rollover contribution from a 401(k) plan or another employer sponsored retirement plan.

The federal deficit is a political issue waiting to be addressed. More and more politicians are starting to seriously look at IRAs and 401(k) plans as sources of tax revenues. Money in traditional, SEP and SIMPLE IRAs is tax deferred, it is not tax-free. When distributed or withdrawn, the distribution amount must be included in the recipient's income and tax paid at the person's applicable marginal income tax rate.

There is approximately 7.2 trillion dollars in traditional IRAs. Assuming an average marginal tax rate of 20% the federal government is looking to collect 1.4 trillion dollars from future IRA distributions. There is approximately 6.8 trillion dollars in 401(k) and other defined contribution plans. Assuming an average marginal tax rate of 20% the federal government is looking to collect 1.3 trillion dollars from future 401(k) distributions.

The federal debt is estimated to be 19.5 trillion dollars as of September 30, 2016. IRAs and 401(k) plans cover 13.8% of the federal debt.

The question is, when will these tax revenues be collected?

Some politicians are starting to suggest the IRA rules need to be changed so the federal government starts to collect tax revenues sooner than under existing law.

Senator Ron Wyden represents the State of Oregon. He is a Democrat. There is a 50% chance he will become the chairman of the Senate Finance Committee in 2017 after the November 8th elections. He recently communicated that he and other Democrats will be pursuing the following IRA law changes.

1. With respect to inherited IRAs, the 5-year rule would apply once an IRA owner dies. This would be a monumental change.

A traditional IRA beneficiary would have 5-6 years to take distributions, include such amounts in income and pay tax. The ability to stretch out distributions over the beneficiary's life expectancy would be repealed.

A Roth IRA beneficiary would lose the right to have the Roth IRA earn tax-free income for a period equal to his or her life expectancy. The beneficiary would be given only 5-6 years of tax-free income.

2. It is unclear if everyone would lose the right to make Roth IRA conversion contributions or if a person with traditional IRA funds could make a conversion contribution but only to the extent the IRA funds are taxable. That is, a person with basis in his/her IRA or pension

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plan could not convert any basis. The Obama administration has previously proposed not allowing basis within an IRA to be converted. A total repeal of the right to make a Roth IRA conversion contribution would be radical.

At least on a short term basis, the federal government likes it when individuals make Roth IRA conversion contributions as tax revenues are collected.

3. There would be a new tax rule stipulating that the maximum value of a person's Roth IRAs would be limited to $5,000,000 and if this limit was exceeded then the excess would have to be withdrawn. This also would be a radical change.

4. A non-IRA change would be to change the law governing 401(k) plans. Somehow a person making student loan payments would be given credit under their 401(k) plan so that the loan payments would be treated as an elective deferral contributions so that an employer would have to make a matching contribution.

In summary, IRAs are political. As with other political subjects, each person will need to make their own voting decisions. Taking away IRA tax preferences is in essence a tax increase and individuals will need to decide the degree it will influence how they will vote. We at CWF believe switching to the 5-year rule for an inherited IRA beneficiary should be unacceptable.

Financial Institution Must Notify DOL It Will Use BICE And Must Comply With Record Keeping Requirements

In order to use the BICE. a financial institution must notify the DOL by providing an email to *e-bice@dol.gov*.that it will to use the BICE. The notice can be generic. That is, it need not mention any specific IRA or any specific plan. If the notice requirement has been met, then the financial may receive compensation. The notice remains in effect until it would be revoked by the financial institution.

The financial institution must maintain for six years the records necessary for certain persons to determine whether the conditions of the BICE have been met with respect to each specific transaction. Upon request the following individuals must have the right to exam these records during normal business hours:

1. Any authorized employee or representative of the IRS;
2. Any plan fiduciary which has participated in an investment transaction pursuant to the BICE;
3. Any authorized employee or representative of a plan fiduciary which has participated in an investment transaction pursuant to the BICE;
4. Any contributing employer and any employee organization whose employees or members are covered by the plan;
5. Any authorized employee or representative of a contributing employer and any employee organization which has participated in an investment transaction pursuant to the BICE;
6. Any IRA owner or plan participant or inheriting beneficiary or an authorized representative of such persons.

None of the non-IRS individuals are authorized to examine records regarding a recommended transaction of another retirement investor, privileged trade secrets or privileged commercial or financial information of the financial institution or information identifying other information.

When a financial institution refuses to furnish requested information for a reason state above, it has 30 days in which to inform the requester of the reasons for denying the request and that the DOL if requested could request such information.

If the required records are not maintained, there is a loss of the exemption only for that transaction or transactions for which the records are missing or have not been maintained. Other transactions will still qualify for the BICE if those records are maintained. If the records are lost or destroyed, due to circumstances beyond the control of the financial institutions, then no prohibited transaction will be considered to have occurred solely on the basis of the unavailability of those records.

The financial institution is the party who is responsible to pay the ERISA civil penalty under section 502 or the taxes under section 4975 if the required records are not maintained.

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Financial Institution Must Maintain Website Under BICE

In order to meet BICE requirements, the financial institution is required to maintain a Web Site, freely accessible by the public which must be set forth the following:

1. A discussion of its IRA business model(s) along with a discussion of the inherent material conflicts of interest, if any.
2. A schedule of typical fees and service charges.
3. A copy of a model contract along with required disclosures. Such must be reviewed quarterly and if applicable, updated within 30 days. It is also possible to set forth a notice describing the contractual terms rather than the contract.
4. A written description of the financial institution's policies and procedures relating to conflict mitigation and incentive practices so an IRA owner is able to determine how seriously the financial institution is to guard against conflicts of interest.
5. A list of third parties with whom the financial institution has business arrangements that result in third party payments being made to the financial institution or its advisers for recommending investments to the IRA owner. In addition, the financial institution must furnish a statement setting forth what it furnishes the third party in exchange for the third party payments.
6. An explanation of the financial institutions policies for paying compensation and other incentive arrangements to its advisers for: (i) recommending the investments being sold by a specific third parry, (ii) recommending specific investments of a specific third party or for an Adviser to move from another financial institution to the financial institution or for an Adviser to stay with the financial institution and full and fair description of any payout of compensation grids. There is no requirement to set forth information for any individual adviser.

Understanding the New DOL BICE Rules When A Financial Institution Has Sales of Proprietary and Other Nondeposit Investment Products

The FDIC has issued a pocket guide for financial institutions covering uninsured investment products. This may be found at the FDIC's website.

The Interagency Statement addresses: (1) how the location of uninsured nondeposit products sales activities should be distinguished from other retail banking services within a financial institution; (2) training of nondeposit investment products sales representatives; (3) how sales representatives should assess the suitability of uninsured investment products for your customers; (4) compensation arrangements for bank employees for direct or indirect sales activities; (5) use of depositor information in nondeposit investment product sales programs; (6) what must be disclosed about the uninsured investment products you are selling; and (7) when the required disclosures must be made.

If a financial institution serving as an IRA custodian is receiving compensation which to any degree is on account of "IRA business going to a third party vendor, then the financial institution is going to want comply with Best Interest Contract Exemption rules.

The DOL in the final regulation has made clear that the Best Interest Contract Exemption may be used by a financial institution even if it imposes restrictions requiring use of products or investments that generate third party fees or proprietary products/investments as long as all exemption requirements are met.

The Financial institution and an advisor must ensure that its recommendation is prudent, compensation and fees being earned are reasonable, all conflicts are disclosed and the conflicts are managed in such a way that the Adviser's focus is on the customer's best interest.

Proprietary products of the financial institution for purposes of the BICE are defined to be products that are managed, issued, or sponsored by the financial institution or any affiliate.

Third party payments exist when a financial institu-

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BICE Rules,
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tion is being paid by someone other than the IRA owner or the IRA. For example, the financial institution is paid by a third party the following types of compensation as a result of an IRA transaction: revenue sharing payments, gross dealer concessions, sales charges that are not paid directly by the IRA, 12b-1 fees, distribution, referral or solicitation fees, volume based fees, fees for seminars, training or educational and any other compensation or consideration.

Both the financial institution and an adviser are deemed to satisfy the Best Interest Standard of Section VIII(d) of BICE if:

1. The IRA owner is informed in writing that the Adviser is limited regarding the investments he or she may recommend. Such limitations must be defined and explained. Such writing must be furnished prior to or at the same time as the transaction occurs. Such written explanation must be clear and prominent that the Institution offers proprietary products and/or receives third party payments on account of its recommendations or assistance with respect to buying, selling, or holding the investments being made available.

   There must be an explanation that the limiting of the investments is a Material Conflict of Interest.
2. The Financial Institution must disclose in writing what it will do in exchange for the third party payments and also disclose the services or consideration it will furnish to any other party for such payments. The Financial institution must determine its will receive only reasonable compensation from all third parties and the investment limitations will not result in imprudent investment recommendations for the IRA owner. It must state it rationale for its decisions and positions.
3. The Adviser must make his or her "limited" investment recommendation to the IRA owner using the prudent person rule. That is, his or her recommendation must reflect the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the IRA owner.
4. The Financial institution must define the compensation program applying to its Advisers in such a way that it does not or reasonably would not be expected to cause an Adviser to recommend to an IRA owner investments which are imprudent for that person, or more in favor of the Adviser's interests rather than the IRA owner or the Adviser makes such recommendation to primarily benefit a third party rather than the IRA owner after considering the IRA owner's investment objectives, risk tolerance, financial circumstances and other needs.
5. The Financial Institution must must comply with the Web Disclosure Rules and also disclose the fees charged and compensation earned with respect to transaction.

   The financial institution must maintain a Web site freely accessible to the public.

   It must set forth its Ibusiness model for IRAs and describe the material conflicts of interest of this business model.

Exemption for Purchases and Sales Transactions, Including Insurance and Annuity Sales and Purchases

This exemption permits a financial institution that is a service provider and an IRA (or other plan) or the IRA owner (or other retirement investor) to engage in a transaction to purchase or sell an investment or other property. This exemption is necessary since the financial institution is now receiving compensation from a third party. The following requirements must be met to qualify to use this exemption:

1. The transaction is effected by the financial institution in the ordinary course of its business;
2. The direct and indirect compensation received by the financial institution for services rendered must not exceed what is reasonable compensation;
3. The terms of the transaction must be as favorable to the IRA or IRA owner (or plan or plan participants) as terms generally available to an unrelated party when there is an arm's length transaction.

This exemption is inapplicable in the following situa-

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tions:

1. The compensation is received as a result of a principal transaction;
2. The adviser has or exercises any discretionary authority or discretionary control with respect to the recommended transaction.
3. robo advice

In order to meet the BICE requirements, the financial institution is required to maintain a Web site, freely accessible by the public which must set forth the following:

1. A discussion of its IRA business model(s) along with a discussion of the inherent material conflicts of interest;
2. A schedule of typical fees and service charges;
3. A copy of a model contract along with required disclosures, Such must be reviewed quarterly, and if applicable, updated within 30 days. It is also possible to set forth a notice describing the contractual terms rather than the contract.
4. A written description of the financial institution's policies and procedures relating to conflict mitigation and incentive practices so an IRA owner is able to determine how seriously the financial institution is to guard against conflicts of interest;
5. A list of third parties with whom the financial institution has business arrangements that result in third party payments being made to the financial institution or its advisers for recommending investments to the IRA owner. In addition, the financial institution must furnish a statement setting forth what it furnishes the third party in exchange for the third party payments.
6. An explanation of the financial institution's policies for paying compensation and other incentive arrangements to its advisers for: (i) recommending the investments being sold by a specific third party; (ii) recommending specific investments of a specific third party or for an Adviser to move from another financial institution to this financial; institution; or for an Adviser to stay with the financial institution and a full and fair description of any payout or compensation grids. There is no requirement to set forth information for any individual adviser.

A New Exemption For Certain Principal Transactions

The new exemption applies to a riskless principal transaction, but it does not apply to a principal transaction.

A riskless principal transaction occurs when there is a transaction in which the financial institution, after having received an order from the IRA owner or other retirement investor to but or sell an investment product, purchases or sells, the same investment product for the financial institutions own account to offset the contemporaneous transaction with the IRA owner or other retirement investor.

A principal transaction occurs when there is the purchase or sale of an investment Product if a financial institution and/or its adviser and an IRA and/or the IRA owner is purchasing from or selling to an IRA or a plan on behalf the financial institutions own account. A principal transaction will also occur if the sale or purchase involves another party controlling, controlled by, or under common control with the financial institution.

The DOL sees the possibility of acute conflicts of interest in a principal transaction as the financial institution is on one side of the transaction (buying or selling an asset) and the IRA and IRA owner are on the other side (selling or buying of an asset. Even so, an exemption will be granted under the BICE if certain protective requirements are met.

The DOL has created a new exemption for principal transactions. It permits investment advice fiduciaries of an IRA and a Plan to sell and/or purchase certain debt securities and other investments in principal transactions and riskless principal transactions. The DOL expanded this new exemption to include all riskless principal transactions. That is, it covers all investments and not just debt instruments.

However, for purposes of BICE, sales of insurance,annuity contracts or mutual fund shares are not treated as principal transactions. That is, the DOL has concluded that mutual fund transactions may occur on a <u>riskless</u> principal basis.

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New Exemption,
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BICE Never Applies to the Following Transactions.

1. With respect to the recommended investment transaction where the Adviser has any discretionary authority or control or exercises any discretionary authority or control.
2. When compensation is received as a result of a principal transaction.
3. When compensation is received as a result of investment advice furnished to an IRA owner or other retirement investor solely by an interactive Web site. The individual furnishes personal information and the advice is provided without the participation of an individual adviser. Exception, compensation may be received by a robo-advice provider as long as the financial institution is a level fee fiduciary that complies with requirements applying to a Level Fee Fiduciary.
4. The Plan is covered by Title I of ERISA and the financial institution, any affiliate or any adviser is the employer of the employees covered by the plan. Obviously, this inapplicable for IRAs.
5. The Plan is covered by Title I of ERISA and the financial institution or adviser (or any affiliate) is a named fiduciary or plan administrator of such plan that was selected to provide advice to the Plan by a fiduciary who is not independent. Obviously, this is inapplicable for IRAs.

Email Consulting Guidance

Titling an Inherited IRA arising From an Employer Plan

Q-1. Could you clarify for us the proper titling of an inherited retirement plan that rolled from a TSP to an IRA? It is being debated amongst our officer group - do we need to reflect "IRA" in the titling?

This is our account name: Jane Smith as Beneficiary of John Smith TSP

A-1. The IRS has not given clear guidance on this situation. I believe your client has established an inherited traditional IRA because she instructed to have the funds directly rolled over from her inherited TSP account originating from John Smith.

I suggest using the titling, Jane Smith as inheriting IRA beneficiary of John Smith. I would not use TSP. Or, use Jane Smith as IRA beneficiary of John Smith.

The important information is that there is an inherited IRA for Jane Smith. It is not that important for titling purposes to know if the funds arose because the decedent was a TSP participant or had a traditional IRA. Having TSP in the title confuses things as the account is now an inherited IRA. Once the funds are in the inherited IRA, IRA tax rules apply and not the TSP tax rules.

One knows that an inherited traditional IRA comes into existence for one of two reasons - there was a deceased IRA accountholder or funds have been directly rolled over on account of an employer plan participant dying. The file should indicate the situation, but the tittle need not.

Special Procedures Needed by IRA Owner for IRA Rollovers at Year-End

Q-2. An IRA client has come into the bank asking the bank to correct his 2014 Form 1099-R to show he made a rollover contribution in 2014.

Here is his situation. He separated from service in December of 2014 and he received a pension distribution. He came into our financial institution in January of 2015 and he made a rollover contribution equal to the amount distributed.

He has received a letter from the IRS stating that he needs to demonstrate that he in fact did rollover such funds. He and his CPA apparently believe the bank should revise the 2014 Form 5498 to show a 2014 rollover contribution was made.

Concerning this indirect rollover. I just spoke with the individual and he stated that his CPA told him because he was within the 60 days of doing the rollover, that he was eligible to make the contribution for the previous year 2014. He also stated that he and his CPA read the "law" and it said that this could be done. Am I missing something here? Can it really be done?

A-2. You are not missing anything. The CPA is not doing a good job of explaining the situation to the client/individual. You may furnish this email to the individual and

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the CPA.

He received the pension distribution in 2014 and he made the rollover contribution in 2015 within the 60 day limit. To the extent he made a rollover contribution he is not required to include that amount on his 2014 tax return. However there should have been a note of explanation attached to his 2014 tax return. I am guessing the CPA did not attach this note.

I assume he has received a letter from the IRS assessing additional taxes owing for 2014. I don't know if he gave you a copy of this IRS letter or not. I don't know if he has given you a copy of his 2014 tax return.

I am going to give a hypothetical situation for discussion purposes so that I can illustrate some points.

John Doe separates from service. On 12-10-2014 he has a balance of $30,000 in his 401(k) account. He instructs the 401(k) plan administrator he is not doing a direct rollover and he elects to be paid cash. He is paid $24,000 as the plan must withhold $6,000 or 20% as his federal withholding. On January 28, 2015 he makes a rollover contribution of $30,000. He will show on his 2014 tax return that 0.00 of the $30,000 is to be included in his income as he made a rollover.

The 401(k) plan administrator prepares a 2014 Form 1099-R informing him and the IRS that he was paid $30,000 from the 401(k) plan. The 2014 Form 1099-R shows the taxable amount as $30,000 in box 2a. The "taxable amount not determined" box is left blank.

ABC Bank as the IRA custodian will report on the 2015 Form 5498 that a $30,000 rollover contribution was received during the period of January 1 to December 31, 2015. There is no indication whether this rollover relates to a 2014 distribution or a 2015 distribution. See attached IRS instructions. A rollover contribution made in January or February of 2015 does NOT get reported on the 2014 Form 5498 even if the "related distribution" happened in 2014. If the CPA can cite some tax authority he or she should do so. There is no such authority.

There is no IRS authority to show/report this rollover on the 2014 Form 5498 rather than the 201 5 Form 5498. I assume the CPA knows this, but if not, he or she should know it.

Continue example discussion.

In March or early April 2015 he files his 2014 tax return. On line 16a (pension distribution) of his 2014 return he should have shown the gross distribution amount as $30,000 and then on line 16B where the taxable amount is shown there should have been a 0.00 inserted along with "RO" to inform the IRS that he did a rollover. However, more info should have been furnished the IRS by attaching a note saying - "I took a distribution in December of 2014 and I rolled it over with 60 days in January of 2015; I am attaching this note since I understand since I made the rollover contribution in February of 201 5 that you (the IRS) will not see the 2015 FORM 5498 from my IRA custodian reporting my rollover contribution until June of 2016 or later since the IRA custodian reports this 2015 rollover contribution on the 2015 Form 5498. See the attached form showing I made a rollover contribution."

ABC Bank is not the party who has not serviced the individual well. It is either the CPA or the IRS who needs to communicate more clearly. **The note of explanation needs to be attached to the 2014 tax return because the IRS runs its audit program for 2014 tax returns before the 2015 5498 forms have been filed/processed.** That is, if a person indicates he doesn't owe tax on a distribution he received in 2014 since he rolled it over, but the IRS does not see such a rollover on the 2014 Form 5498, the IRS will send its collection letter even though the IRS knows there %. ^ will be a certain number of taxpayers (such as your client) who took a distribution in late 2014 and rolled it over in 2015. The IRS doesn't care. The customer can explain once he gets the assessment letter. Admittedly, the IRS approach is not very tax-payer friendly and is inefficient. That should not surprise anyone.

The individual still needs to furnish his explanation to the IRS that he did a rollover in 2015 of the amount he received in 2014. He should now have his 2015 Form 5498 showing the rollover. He needs to furnish it to the IRS. He cannot furnish the IRS with a 2014 Form 5498 showing a rollover as IRS procedures do not permit it. He made the rollover in 2015 and not 2014. If I can write this letter (for the bank and client), so could have the accountant.

IRS Reporting When HSA Closed Due to Failing USA Patriot Act Requirements

Both the contribution and the distribution must be reported on the Forms 1099-SA and 5498-SA when an HSA custodian closes a person's HSA because the person has failed to satisfy the Customer Identification Program Requirements of the USA Patriot Act.

The IRS reporting depends on the type of the initial contribution.

If the contribution being returned is an annual contribution then it is to be reported in box 2 or box 3 of the Form 5498-SA as applicable. The distribution of this contribution (similar to an excess) is to be reported on the Form 1099-SA as follows: enter the gross distribution in box 1; enter 0.00 in box 2 if there are no earnings distributed, but enter the amount of earnings in box 2 if there are earnings distributed; and enter code "2" (Excess) in box 3.

If the contribution being returned is a rollover contribution then it is to be reported in box 4. The distribution of this rollover contribution is to be reported on the Form 1099-SA as a normal HSA distribution with the gross distribution amount in box 1; box 2 left blank and code "1" (Normal) in box 3.

If the contribution being returned is a Qualified HSA Funding contribution then it is to be reported in box 2. The distribution of this rollover contribution is to be reported on the Form 1099-SA as a "normal" HSA distribution with the gross distribution amount in box 1; box 2 left blank and code "1" (Normal) in box 3.

The IRS needs to furnish additional guidance if the contribution being returned is a transfer contribution. The IRS instructions do not discuss in as much detail as desired the closure of a transferred HSA for failing the Patriot Act requirements. The general rule is - no reporting of an HSA transfer contribution.

As in the case of a rollover contribution, if the HSA funds would be distributed to the individual it appears the IRS reporting rule should be the same as a distribution of a rollover contribution. It would be reported as a normal HSA distribution. However, if the HSA funds would be returned to the remitting HSA custodian (i.e. transfer reversed), then it appears there would be no reporting for an HSA transfer-in HSA contribution.

As discussed above, there is to be special IRS reporting of an HSA contribution which is distributed to the person because he or she failed to furnish the required customer information as required by the USA Patriot Act.

IRS Guidance on the Need to Terminate a One Person Profit Sharing Plan

The IRS has adopted the tax position that a qualified plan is able to exist only if there is a "current" plan sponsor. A plan sponsor without a sponsor is called an orphan plan and the IRS may/will argue that the plan fails to meet the Internal Revenue Code qualification requirements. Such a plan is not entitled to its tax favored status which means the funds are taxable and cannot be rolled over into either a traditional IRA or a Roth IRA.

The IRS position is - an orphan plan comes into existence because there no longer is a plan sponsor. In the case of a one person plan, this will occur if the individual "retires", if the individual dies without a successor being appointed or if the individual abandons the plan before properly terminating it.

The IRS believes a person must properly terminate the qualified plan prior to retiring, closing the business or selling the business. The IRS does not define what it means for a person to retire. A plan must be amended and restated so that it is qualified at the time of termination.

A person who files a Schedule C or Schedule F should terminate his or her profit sharing plan prior to time he or she person ceases the business activity of filing the final tax return for such business. The conservative approach is for a one person plan sponsor who is no longer working to directly rollover his/her plan funds into an IRA.