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Purchasing A Financial Institution Having Inherited IRAs-Caution Is Warranted

Most everyone tends to believe what the IRS says is correct and must be followed. That is not always the case. The IRS must follow the statutory law and its regulations, and the U.S. Tax Court has no problem ruling that the IRS is wrong in its tax position. Courts give some deference to the IRS, but it is not absolute. For example, in the Bobrow rollover case the tax court ruled the IRS did not have the authority to expand the once per year rollover rule to permit a person to make rollovers on a per plan agreement basis.

Sometimes a taxpayer should be more conservative and adopt a position more conservative than the IRS' position. This is the case with inherited IRAs. In IRS Notice 2002-27 and the instructions for Forms 1099-R and 5498 the IRS had stated an IRA beneficiary is responsible to calculate and withdraw the applicable required distribution. The IRA custodian is not required to send a beneficiary a required distribution notice as it must for someone age 70 1/2 or older.

An IRA custodian must remember that its relationship with its IRA clients is primarily governed by the IRA plan agreement and not by what IRS guidance provides. The IRA plan agreement requires that certain distributions be made to IRA owners who are age 70 1/2 and older and to an IRA beneficiary after the IRA owner dies. A strong argument exists that the IRA custodian has a duty to make sure such distributions are taken.

The law imposes a 50% excise tax when a person fails to take their RMD by the applicable deadline. This 50% tax is an annual tax. For example, if a beneficiary had an RMD of $400 for 2013 and fails to withdraw it for 2013-2016 but withdraws it in 2017, the beneficiary owes $800 plus interest and applicable penalties (i.e. $200 for 2013, 2014, 2015 and 2016).

A financial institution wants to protect itself against the following situation. Bank A had purchased Bank B in 2013. Bank B had a long time IRA client, Jane Smith, who had died in February of 2012 at age 73. She had designated her daughter Mary (age 48) to be her IRA beneficiary. It is now May of 2017. Mary's IRA CD has just matured and she is in the process of deciding if she will reinvest it with Bank A or have it transferred to another IRA custodian. Mary understands her IRA is an inherited IRA. The problem is - Mary's IRA is not listed on the computer system at Bank A as an inherited IRA. It is listed only as her own IRA. She has not taken any required distributions for 2012-2016.

What's to be done? What are the possible adverse tax consequences and the possible adverse non-tax consequences? Jane is required to pay the 50% on her missed RMDs unless she can convince the IRS she should not have to pay the tax on account of the IRA custodian's failure to perform its duty of distributing the RMD for each year. The IRS may well rule she owes the taxes on account of Notice 2002-47. Jane may well commence legal action to include the IRA custodian

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(Bank A) in her tax dispute with the IRS. Litigation is expensive and it is to be avoided.

When a financial institution buys another financial institution (and its IRAs) the buyer wants to determine that there are no inherited IRA problems within the seller's IRA portfolio. There should be a thorough review conducted before the closing and possibly the inclusion of a contract provision where the seller remains liable if any unknown problems arise after the sale/purchase.

State IRA Programs - They Are Sure To Fail and They Should Fail.

Since January 1, 1975, federal tax law has allowed individuals to make IRA contributions. The individual receives various tax benefits for making a contribution. There are now 4 types of IRAs - traditional IRAs, SEP-IRAs, SIMPLE-IRAs and Roth IRAs. An IRA in essence is a person's own one person retirement plan. No employer is needed. An individual decides on a voluntary basis whether he or she will make an IRA contribution. There is no federal law requiring a person to contribute to his or her IRA.

In order to achieve having more individuals increase their saving for retirement, some states have concluded that they should pass laws requiring an employer to automatically deduct certain sums from each employee's payroll and contribute it to such person's IRA. The key is "automatic." The employer must make the deduction (mandated savings) unless an employee instructs that he or she does not want the deduction.

Since the inception of the United States there has been an going conflict between what laws apply at the federal level (i.e. such laws apply to all persons uniformly regardless of where a person is located in the United States) versus those state laws which apply only to the residents of a certain state or individuals who are located in such state.

In 1974 ERISA was enacted. ERISA is the acronym for, Employee Retirement Security Income Act of 1974. A primary purpose of ERISA was to create federal law for pension plans so that employers and employees did not have to comply with the laws of 50 different states.

ERISA does not require an employer to establish a retirement plan or a health plan for its employees. But if an employer does choose to establish a retirement plan and/or a health plan it must comply with ERISA. There are participation and coverage rules, investment rules, vesting rules, distribution rules, etc.

ERISA section 514 provides that its laws shall supercede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan. There are limited exceptions for State laws regulating banking, insurance or securities as long as such laws do not include any employee benefit issues. ERISA was effective on January 1, 1975.

Several states have enacted legislation within the last two years requiring an employer to offer various types of IRA retirement programs to their employees if they do not sponsor a retirement plan.

Oregon is one of the states. It has adopted a State Retirement Savings Plan. Illinois has adopted its own program. The Oregon plan requires businesses that don't sponsor a retirement program to participate in a state payroll IRA deduction program. The law would require an employer to automatically withdraw a certain percentage/amount from an employee's paycheck. However, an employee does have the right to elect out of this automatic deduction arrangement. The employer is not required to contribute any of its funds.

The DOL under the Obama administration had issued special guidance as to how a State could set up its own retirement program requiring small employers to participate without violating the ERISA preemption rules. The law was "stretched" to reach the result they wanted to reach.

The special Obama rules have been repealed by legislation signed by President Trump. States will be violating ERISA by requiring small employers to participate in their state required retirement programs.

We at CWF are of the opinion that these state mandated IRA payroll retirement plans are not a good idea and are not needed.

Why?

Since the 1970's the IRS and the DOL have allowed employers on a voluntary basis to set up a payroll deduction program for its employees and as long as certain rules are met, such a program in not an employee benefit program for ERISA compliance purposes.

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In this internet age, it is very simple for any employee to set up their own IRA with their own IRA custodian if that is what they wish to do. An employee can have his/her paycheck deposited to his/her checking account and then set-up an automatic transfer from his/her checking account to his/her IRA. For example, a person may instruct - on the 3rd and 18th of every month withdraw $150 from my checking account and transfer/contribute it to my IRA with account number 1234. There is no need to require employers be involved.

Requiring employers to be involved makes a simple situation more complicated.

We at CWF believe there should be changes at the federal level which would lead to more employers offering retirement plans. The goal should be more simplification, not more complexity. State mandated IRA deduction programs add unneeded complexity and they are illegal.

The Five Year Rule Applies Differently to Inherited Traditional IRAs versus Inherited Roth IRAs

There are times the 5 year rule may be elected by the IRA beneficiary and there are times when the 5 year rule applies automatically. As a general tax rule, the designation of a beneficiary who is not a person results in the five year rule applying. There will be times the tax consequences will be harsh when the five year rule automatically applies. There should be planning to eliminate the possibility of the five year rule applying.

The 5 year rule may apply to an inherited traditional IRA and also to an inherited Roth IRA, but there is a difference.

With respect to a traditional IRA, the five year rule may only apply if the IRA owner dies before their required beginning date (e.g. 25, 39, 45, 57, 69). The five year does not apply if the IRA owner dies after their required beginning date (e.g. age 71, 75, 80, 92, etc.). In some situations use of the five year rule is mandated and the tax consequences may well be undesired.

Example. In 2016 Jane, age 62, directly rolled over $260,000 from her 401(k) into her traditional IRA. She established a new traditional IRA. She designated her husband, Mark, as the primary beneficiary of her IRA and her estate to be her contingent beneficiary. They have two children, Sue (age 30) and Amy (age 34). Mark dies in a car accident in March of 2017. Jane dies in June of 2017. She did not complete a new beneficiary designation after Mark's death. The five year rule applies to her estate because it is the beneficiary of her IRA. The tax bill to be paid by the estate will be larger and taxes will need to be paid much sooner than would have been the case had the daughters been the beneficiaries. The daughters don't have the option to take distributions over their life expectancy.

With respect to a Roth IRA, the five year rule is an option regardless of the age of the Roth IRA owner when he/she dies. That is, it may apply even though the Roth IRA owner is age 77 when he/she dies. In some situations use of the five year rule is mandated and the tax consequences would be undesired.

Example. In 2016 Jane, age 62, directly rolled over $150,000 from her 401(k) into her Roth IRA. She established a new Roth IRA. She designated her husband, Mark, as the primary beneficiary of her Roth IRA and her estate to be her contingent beneficiary. They have two children, Sue (age 30) and Amy (age 33). Mark dies in a car accident in March of 2017. Jane dies in June of 2017. She did not complete a new beneficiary designation after Mark's death. The five year rule applies to her estate because it is the beneficiary of her Roth IRA.

Almost always, no one wants to close a Roth IRA using the 5 year rule. Because Jane's estate is the beneficiary of her Roth IRA, the Roth IRA must be closed within the 5 year time period.

Her two daughters don't have the right to maintain an inherited Roth IRA for 50 plus years. They could have had tax free income for 50 plus years had they been the designated beneficiary. This very valuable tax/investment right has been lost.

CWF Has Suggested to the IRS It Needs to Improve Guidance Regarding Prohibited Transactions For IRAs

There should be a better discussion of how the Form 1099-R is to be prepared by an IRA trustee when there is a prohibited transaction. IRS guidance is minimal and should be improved. Taxpayers and IRA custodians deserve more help from the IRS than is being provided.

On page 2 of the 2017 Instructions for Forms 1099-R and 5498 the IRS gives the following 80 words of guidance. There is no way a subject as complex as prohibited transactions can be summarized in 80 words.

Prohibited transactions. If an IRA owner engages in a prohibited transaction with respect to an IRA, the assets of the IRA are treated as distributed on the first day of the tax year in which the prohibited transaction occurs. IRAs that hold non-marketable securities and/or closely held investments, in which the IRA owner effectively controls the underlying assets of such securities or investments have a greater potential for resulting in a prohibited transaction. Enter Code 5 in box 7.

Note the phasing of the first sentence, "If an IRA owner engages in a PT ... " This means if the IRA custodian has caused the PT then it is not to be reported by the IRA custodian on the Form 1099-R. It will need to be reported on the Form 5330 by the IRA custodian. The IRS should be helpful and add a sentence discussing the need of the IRA custodian to report the PT on the Form 5330.

On page 15 of the 2017 Instructions for Forms 1099-R and 5498 the IRS sets forth its Guide to Distribution Codes. An excerpt showing Codes 3-6 is set forth.

3-Disability. For these purposes, see section 72(m)(7).	D
4-Death. Use Code 4 regardless of the age of the participant to indicate payment to a decedent's beneficiary, including an estate or trust. Also use it for death benefit payments made by an employer but not made as part of a pension, profit-sharing, or retirement plan.	8,A,B,D,G,H,K,L,or P
5-Prohibited transaction. Use Code 5 if there was a prohibited transaction involving the IRA account. Code 5 means the account is no longer an IRA.	None
6-Section 1035 exchange. Use Code 6 to indicate the tax-free exchange of life insurance, annuity, long-term care insurance, or endowment contracts under section 1035.	W

Note that Code 5 is used to report an IRA PT. There is no mention here that it is to be used only if the PT occurred on account of the IRA owner. Also note that code 5 is not to be used if there has been a PT related to a qualified plan.

Regardless of when during the year a PT occurs with respect to an IRA during a calendar year, the IRA ceases to exist as of January 1st of such year.

The IRS does a poor job of explaining how an IRA custodian is to report or nor report other distributions which occurred prior to the PT or contributions which were made prior to the PT. We at CWF understand that each and every IRA distribution occurring after January 1st is not a reportable distribution and such distributions are not to be reported on the Form 1099-R and that any contribution made after January 1st would not be reported as a contribution.

The IRS does not make clear that a Form 1099-R is to be prepared with a reason code 5 and with the FMV as of the first day of the year as the gross distribution amount to be reported in box 1 and also in box 2a.

In summary, PTs are extremely complex. By now Congress and the IRS be should have determined that the law needs to be changed and made more simple. Why keep something which is not working as well as it should. Until a law change occurs, the IRS needs to furnish better guidance so that IRA owners and IRA custodians may more easily comply.

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CWF Has Suggested to the IRS It Needs to Improve Guidance Regarding Prohibited Transactions For HSAs

The IRS should improve its discussion of how the Form 1099-SA is to be prepared by an IRA trustee when there is a prohibited transaction. IRS guidance is minimal. HSA custodians and taxpayers deserve more help from the IRS than is being provided.

There is no mention in the IRS instructions for how a prohibited transaction with respect to an HSA is to be reported except for the listing of the various Distribution Codes for box 3 as set forth below:

Box 3. Distribution Code
Enter the appropriate distribution code from the following list that shows the type of distribution.

1-Normal distributions
Use this code for normal distributions to the account holder and any direct payments to a medical service provider. Use this code if no other code applies. Also, see Distribution after year of death, earlier.

2-Excess contributions
Use this code for distributions of excess HSA or Archer MSA contributions to the account holder.

3--Disability
Use this code if you made distributions after the account holder was disabled (see section 72(m)(7)).

4-Death distribution other than code 6
Use this code for payments to a decendent's estate in the year of death. Also use this code for payments to an estate after the year of death. Do not use code 6. See Death of Account Holder, earlier.

5-Prohibited transaction
See sections 220(e)(2) and 223(e)(2).

6-Death distribution after year of death to a nonspouse beneficiary
Use this code for payments to a decedent's nonspouse beneficiary, other than an estate, after the year of death. Do not use with code 4.

Note that Code 5 is used to report an HSA PT. There is no mention here that it is to be used only if the PT occurred on account of the HSA owner.

The instructions for Form 5330 discuss that an IRA custodian must complete and file Form 5330 (and pay the tax amount owing) if it caused the PTs. The IRS has not changed the instructions for Form 5330 to discuss an HSA custodian being required to file Form 5330. We at CWF believe the HSA custodian has the duty regardless if the IRS has not revised the Form 5330.

Regardless of when during the year a PT occurs with respect to an HSA during a calendar year, the HSA ceases to exist as of January 1st of such year. See Code sections 220(e)(2) and 223(3)(2).

The IRS does a poor job of explaining how an HSA custodian is to report or not report other distributions which occurred prior to the PT or contributions which were made prior to the PT. We at CWF understand that each and every HSA distribution occurring after January 1st is not to be reported on the Form 1099-R and that any contribution would not be reported as a contribution.

In summary, PTs are extremely complex. By now Congress and the IRS be should have determined that the law needs to be changed and made more simple. Why keep something which is not working as well as it should. Until a law change occurs, the IRS needs to furnish better guidance so that HSA owners and HSA custodians may more easily comply.

Reporting "Postponed" Required Distributions on the Form 1099-R

Sometimes a person who attained age 70 1/2 during 2016 will wait and take her RMD for 2016 by April 1, 2017. Does she include this distribution for 2016 on her 2016 federal income tax return or her 2017 federal income tax return? Does the IRA custodian report this distribution as being for 2016?

Email question/situation:

I have a customer who is 72 and on 2/27/2017 she made a distribution for $5,612.11.

That amount satisfied her required for both 2016 and 2017

2016 the required was $1,156.00

2017 the required was $1,201.00

Our customer never received a 1099R because the distribution was done after 2016 and the transaction was not coded as TYLY.

Is that how the RMD should be coded? Should she receive a 1099-R for 2016?

We want to make sure that we have this distribution broken down correctly so it shows she satisfied both RMDs.

How would you have the transactions done so that it shows that both 2016 and 2017's RMDs were satisfied, with the customer taking her 2016 RMD before April 1? Note that initially we did not understand that IRA client who is age 72 in 2017 was also age 70 1/2 in 2016. We originally thought her RMD deadline for 2016 was 12/31/16, but it actually was 4/1/17 as she attained age 70 1/2 during 2016. For example, Sara Willis who was born on 7-15-1945 attained aged 70 1/2 on 1-15-2016 and will attain age 72 on 7-15-17

CWF's Guidance:

An IRA owner includes an IRA distribution in his/her income for the year the distribution is received. This is the rule even when a person has missed taking his/her RMD for 2016 by December 31, 2016, but takes it soon thereafter in 2017.

Your customer's RMDs for 2016 and 2017 total $2,357. Your client took a distribution in February of 2017 of $5,612.11 and this amount exceeds her RMDs for 2016 and 2017. She will include the $5612.11 on her 2017 federal income tax return.

The bank will be preparing a 2017 Form 1099-R for your IRA customer. This will be prepared and furnished in January of 2018. The 2017 Form 1099-R form does not indicate how many distributions, if any, were aggregated, to comprise the distribution of $5,612.11.

A 2016 Form 1099-R is not to be prepared as there was no 2016 distribution.

This customer was late in being distributed the 2016 RMD. This means the customer owes the 50% tax ($1,156 x 50%= $578) unless the IRS agrees to waive the tax. The customer on his/her 2016 tax return can request on Form 5329 that the IRS waive the 50% tax. The taxpayer or the tax accountant can attach a note of explanation that the IRS should waive the tax as the 2016 missed RMD and the 2017 RMD were taken in February of 2017. Hopefully, the taxpayer has a good reason why the distribution was not taken by December 31st other than he or she forgot.

A person (and the tax accountant) may not want to tell the IRS that he or she was late in taking his/her RMD, but IRS procedures require it.

Some HSA Contribution Errors Cannot Be Corrected

Many times the tax rules do not authorize a simple method to correct a tax mistake. This is certainly the case for "mistaken" HSA contributions.

HSA Email Question/Situations

I am not sure what to do in this situation.

We have an employer that deposited $10 into the wrong employee HSA account back in November 2016.

It was supposed to be deposited into a different employee's account.

He has just discovered the error and made us aware. He would like the transaction to be corrected.

How would I go about doing this?

Can I do this?

CWF's Response

The employer may not like our answer, but the HSA laws do not allow for this type of mistake/error to be corrected 5-6 months after the error occurred or at any time Two different tax years are involved and complicate the situation. W-2 forms for 2016 have been submitted. Various tax forms have been filed.

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IRS rules do not allow/authorize the HSA custodian to take the action being requested by the employer.

The employer may confirm the following with his/her/its tax advisor.

Once an employer's HSA contribution is added to an employee's HSA those funds are owned by that person's HSA. An employer always wants to double check its HSA contributions.

Neither the employer nor the bank has any legal right to make any type of correcting withdrawal. To do so would be a prohibited transaction. There would be adverse tax consequences for an employer or the bank.

When an employer for a certain payroll contributes $10 too much to one employee's HSA and possibly $10 too little to another employee's HSA, the best way to correct the mistake is on a following payroll to short by $10 the HSA contribution for the employee who got too much and give an additional $10 to the person who was shorted. The error and the correction both should occur during the same calendar year.

The employer should discuss with its tax advisor whether it may take this correcting action in 2017. This is an employer's tax question. It is not the HSA custodian's concern.

It may be the law should be changed so this type of mistake could be corrected in the manner suggested by the employer. I personally don't think so.

HSAs are a tax subject. Tax subjects are rarely simple. The tax law has been written - an employer must understand that once the HSA contribution is made, then the funds are owned by the person's HSA. The IRS has not written rules regarding how an employer would explain and prove to the HSA custodian that a mistake occurred so that the HSA custodian could withdraw funds from a person's HSA. A complicated subject.

An employer should understand that it is unreasonable to ask the employee to return 100% of the erroneous contribution. Why? This contribution is not an excess contribution. If an employee is willing to withdraw the funds and return the funds to the employer, he or she will have to include the distribution in his or her 1 of 3 income and most likely will owe the 20% additional tax as the funds were not used to pay a qualified medical expense.

In summary, an employer must have procedures to prevent this type of contribution mistake because it must bear the consequence. The IRS has issued guidance that there are two situations when an employer may ask the HSA custodian to return funds from an employee's HSA. First, an employee informs his/her employer that he/she is HSA eligible, but is not. Since the person was HSA ineligible, it is fair and right to return the funds to the employer. Secondly, an employer contributes for a given year for an employee more than that person's maximum contribution for such year. For example, Jane age 45 had single HDHP coverage for 2016 and the employer contributed $4,350 and not $3,350 which is her maximum HSA contribution for 2017. The $1,000 (amount in excess of the $3,350) could be returned to the employer to the extent the funds are still within the HSA.

Under IRS procedures, an HSA custodian is not required to know whether a person has single HDHP coverage or family HDHP coverage. The HSA custodian only needs to monitor the HDHP contribution limit and need not monitor the single HDHP contribution limit.

Some IRA Contribution Errors Including Prior Tax Years Cannot Be Corrected - Too Late

A person who makes a tax mistake is generally hopeful that the tax rules will allow the person to correct the mistake. Many times it is too late to correct the mistake. Such is the case in the following question/answer regarding a contribution which went into a Roth IRA. The tax accountant and the IRA Custodian believe a correction can be made by moving the Roth funds to a traditional IRA.

For the 2015 tax year a tax accountant prepared a married couple's tax return showing a deduction for their two traditional IRA contributions. The problem is, this accountant had previously informed them to make two Roth IRA contributions for 2015 and they did so. The accountant did not realize there was a problem until he was working on their "transfer" the amounts in their Roth IRAs to their traditional IRAs.

For the reasons discussed below. It is too late to correct this mistake using standard procedures. The deadline to correct this mistake was October 15, 2016. It cannot be corrected in March of 2017 by doing a sim-

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ple transfer. It might be possible to correct this mistake by making a special submission to the IRS and paying a special fee.

The general rule is a recharacterization must be completed by the application deadline. For example a 2015 contribution had to be recharacterized by October 15, 2016.

DOL Requests Public to Provide Additional Comments About the Fiduciary Rule and Related Prohibited Transaction Exemptions

EBSA/DOL Guidance on July 6, 2017

EBSA News Release

On June 29, 2017, the DOL issued Request for Information (RFI) related to the fiduciary rule and certain PT exemptions. The public again may submit information and data that may be used to revise these new rules. The DOL poses 18 questions for the public to address.

The RFI "specifically seeks public input that could form the bases of new exemptions or changes to the fiduciary rule and the various applicability dates should be extended. Question 1 ask if there should be a delay in the January 1, 2018 Applicability Date. If so, reasons for the delay should be presented. The public has 15 days to submit their response. The response should be made by July 21, 2017 as the RFI was published in the Federal Register on July 6, 2017.

The DOL has questions for the following topics. The public has 30 days to submit their response. The response should be made by August 7, 2017 as the RFI was published in the Federal Register on July 6, 2017.

Questions 2-4 cover general questions.

Questions 5-6 ask whether the contract requirement should be eliminated or changed for the BIC Exemption and the Principal Transaction Exemption.

Question 7-11 asks if is now possible to have a simpler exemption approach or approaches because of various industry changes?

Question 12 asks if the Principal Transaction Exemption should be modified by expanding it to cover more investments.

Question 13 asks if the BIC disclosure requirements should be modified to allow an initial simple disclosure and the investor may request to be furnished a more comprehensive disclosure.

Question 14 raises the question whether recommendations to make or increase contributions to a plan or IRA should be expressly excluded from the definition of investment advice. Rollovers are expressly discussed under the new rule but regular contributions are not.

Question 15 asks if the new rules need to be changed for bank deposits and similar investments. That is there would be a streamlined exemption for such investments.

Question 16 discussed the various grandfathering rules.

Question 17 asks if the scope of PT 84-24 (annuities) should be expanded.

Question 18 asks if the exemption for communications with independent fiduciaries with financial expertise should be made available to more parties. Under the new rule it applies only when a party manages or controls at least $50 million of assets. Should the $50 million be changed to $20 million or $10 million.

EBSA/DOL Guidance on July 18, 2017

The DOL by way of a website notice has responded to public requests that the July 21st and the August 7, 2017 deadlines are too short and should to be extended.

The DOL states that it continues to encourage interested persons to submit comments as soon as reasonably possible and that it will consider comments submitted after August 7, 2017. However, commenters must understand that there will be a point in time when the DOL will not be able to consider such comments. The DOL does not give idea an of what the actual deadline is.