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ALSO IN THIS ISSUE –

Collin W. Fritz and Associates, Inc.,
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Making IRA Contributions <u>and</u> 401(k) Contributions Make the IRA Contributions by Payroll Deduction

A person is generally eligible to make both an IRA contribution and a 401(k) plan contribution. Each type of plan has its own maximum contribution limit. The amount a person contributes to their 401(k) Plan has no impact on what they are eligible to contribute to their traditional IRA or Roth IRA or vice versa. In order to maximize a person's contributions, a person must make both types of contributions.

A person should be able to instruct their employer so that he or she can elective deferral 401(k) contributions and also make IRA contributions. The IRA contributions may be made via a payroll deduction program.

Payroll-Deduction IRA Programs have lost favor with businesses and with IRA Custodians. The concept of these programs is so simple—an employer decides to help its employees save for their retirement by forwarding funds withdrawn from an employee's paycheck to an IRA custodian. Although one normally thinks of a payroll-deduction program as dealing with traditional IRAs, there is no reason there are not payroll-deduction programs for Roth IRAs. Note that the word "program" is used and not the word "plan." There is generally no plan document for an IRA payroll-deduction program. The employer must be willing to transmit the IRA funds to the IRA custodian as selected by each employee. In general, a business should be willing to offer this special service to all employees. And the IRA custodian should assist the employer.

What Are Payroll Deduction Contributions?

A payroll deduction IRA is a regular IRA that is funded by the accountholder who allows the money to be automatically deducted from his paycheck and deposited directly into his IRA account. Do not confuse the Payroll Deduction IRA with a Salary Reduction SEP or a SIMPLE-IRA plan. The accountholder/employee can elect to set up the deduction from his or her payroll on their own, or the employer can initiate the process. The employer, however, is not required to provide the payroll deduction service.

What is needed to have a payroll deduction IRA program?

An employee needs to have established a traditional IRA and/or Roth IRA with an IRA custodian. The employee then needs to authorize the employer to deduct the IRA contribution amount from his paycheck. The employer then must transmit the employee's authorized deduction contribution amount to the IRA custodian on a timely basis.

What contribution limits apply to payroll-deduction programs?

The standard IRA contribution limits

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Email Guidance – Inherited IRA

Q1. Could you confirm something for me? I am working with a client on opening up an inherited IRA stemming from a deceased parent's traditional IRA. On the form, they would like to name their children and not spouse as beneficiaries. I know a spouse has to sign-off when they are not named for retirement . (ERISA) plans but am I correct that in the case of an IRA/Inherited IRA we do not need the spouse's signature consent? Also, Michigan is not a community property state.

A1. I agree. A married person who has inherited an IRA from a parent is not required to designate their spouse as their IRA beneficiary with respect to the inherited IRA.

I understand most states have laws which provide in general that inherited property is owned by the inheritor and is not subject to being transferred to the other spouse pursuant to a divorce action or an estate action. This is true for community property law states and non-community property law states.

For example, under Minnesota my wife is entitled to receive 50% of my property and she will have an enforceable claim if I give her less than 50% of my property. My IRA is part of my property/estate for purposes of this rule. Inherited property is not part of my property for purposes of the 50% rule.

Q2. Husband and wife both died on the same day. They were each other's beneficiary. We received instructions from both their succession to equally divided IRA balance between their surviving children. Can one IRA be open for each child that combines the amount inherited?

A2. In general, a beneficiary is not allowed to have one combined inherited IRA when two IRA owners have died.

For the reasons discussed below the tax rules do not authorize a person who has inherited two IRAs from two different deceased IRA owners to combine the two inherited IRAs into one inherited IRA. There are tax reasons this is not authorized. It does not matter if the deceased IRA owners were the beneficiary's parents. There must be two distinct inherited IRAs. For example, the son as beneficiary of dad's IRA and the son as beneficiary of mom's IRA. The son must take an RMD with respect to both inherited IRAs.

I presume in your current situation there are two children beneficiaries. What amount must each withdraw as their RMD from each inherited IRA? If a person withdraws less than their applicable RMD, the 50% tax is owed.

In order to determine the tax rules and tax consequences applying to an inheriting IRA beneficiary the specific facts of the dying IRA owner or owners must be known. I did not review their I RA beneficiary designation forms. Did each die before their required beginning date or after?

In your current situation it must be determined, who is/are the IRA beneficiary(ies) of the husband's IRA and who is/are the IRA beneficiary(ies) of the wife's IRA?

Is it known which spouse died first? Or, were the death's simultaneous?

What are the provisions of the husband's IRA beneficiary designation? Were the children the contingent beneficiaries?

What are the provisions of the wife's IRA beneficiary designation? Were the children the contingent beneficiaries?

I am going to furnish the following hypothetical situation to illustrate various tax rules.

Mark and Ellen are married. Mark was born 7/10/1952 and Ellen was born 8/15/1957. Both died on June 5, 2019. Mark died before Ellen. They had two children, Paul, age 40 and Kim,age 38. Each had designated the other as their primary beneficiary and Paul and Kim as their contingent beneficiaries each to receive 50%.

Mark's IRA. It was inherited by Ellen. You must review the IRA plan agreement. The CWF document provides that upon the subsequent death of an inheriting beneficiary Ellen's beneficiary will be the person or persons she has designated to be the beneficiary(ies) of this inherited IRA, if any. It is assumed she had not designated a beneficiary with respect to this inherited IRA. It does not matter that with respect to her own IRA that she had designated her children to be her beneficiaries

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Inherited IRAs,
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if Mark predeceased her. Consequently, Ellen's estate is the default beneficiary. Because Mark died before his required beginning date, the 5-year rule will apply to the estate and such inherited IRA must be closed by 12/31/2024. Paul and Kim are not the direct beneficiaries of these IRA funds. There is no ability to stretch out distributions over the life expectancies of Paul and Kim.

Ellen's IRA. It was inherited 50/50 by Paul and Kim. Each may have set up a separate inherited IRA and distributions can be stretched out over their respective life expectancies.

The discussion would change if Mark dies on or after his required beginning date (i.e. the April 1 of the year following the year one attains age 70 1/2) and then Ellen dies with her estate as the beneficiary. The distribution period applying to the estate (or the children) would be based on Ellen's age and not the age of the two children.

In summary, the above information provides a general discussion. If you provide additional information, I will assist.

Q2A. As Custodian of the two IRA's for the deceased husband and wife we spoke about this morning, we do not want to assume which one died first. Since there is nothing that tells us otherwise, we have to go with that they both died at the same time which means neither one had named beneficiaries to their IRAs In that case, what do we do if the Judgement of Possession from IRA owners' successions state that IRA's of the decedents go to the 3 surviving children equally? Would the bank as custodian, pay each kid their share from each IRA as Death Distribution of entire balance immediately and withhold taxes if beneficiaries want tax withheld? Does the wording in the Judgement of Possession to pay each child equally, eliminate the options discussed this morning to pay out over 5 years or over life expectancy reduced by 1 for the parent who was in RMD?

A2A. You are asking IRA and tax questions for which the bank should have input, but so should the three children after talking with their respective tax and legal advisers.

Is the IRA plan agreement in effect that of CWF, Wolters Kluwer or another entity? What does it provide regarding the issues?

I understand you are suggesting, since there is no way to determine which spouse died before the other that each spouse is then considered to have designated their estate to be their IRA beneficiary. ·

Under your proposed approach, because his estate is his IRA beneficiary and he died after his required beginning date, then his estate is able to stretch out distributions based on his life expectancy as we discussed.

Under your proposed approach, because her estate is her IRA beneficiary and she died before her required beginning date, then her estate has the limited rig ht to stretch out distributions under the 5-year rule.

I don't believe either his estate or her estate is required to take a lump sum distribution. Everyone's life might be simpler if each estate would take a lump sum distribution or each child would take their 1/3 share of each estate, but a lump sum distribution is not required.

Your proposed approach will require the use of the 5-year rule with respect to her IRA. In our phone call we discussed that the 5-year rule would not apply if the husband had predeceased his wife. We had also discussed that if the if the husband had predeceased his wife that each child would be entitled to take distributions over their life expectancy. A much longer distribution period.

Your questions regarding the Judgement of Possession are state law questions and should be reviewed by the bank's attorney. I believe it would be rare if a state court would rule when an inheriting IRA beneficiary must take a distribution.

I believe the bank as the IRA trustee could set up two inherited IRAs for each child if an attorney will furnish a legal opinion that the respective estates have the right to pass through to separate inherited IRAs established for each child the right to take the future inherited IRA distributions that the estate was to take. For example, one inherited IRA could be established for child #1 as beneficiary of dad's IRA and a second inherited could be established for child #1 as beneficiary of mom's IRA. Similar inherited IRAs would be established for the other two beneficiaries. The distribution period apply-

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ing to each inherited IRA either life distribution rule based on his age in the year he died or the five year with respect to her IRA. Such periods would not be based on the age of each child.

Q3. I have a client who's Mom passed away and she received money from her Mom's IRA. She is asking me about a "stretch IRA", is that the same?

A3. A non-spouse beneficiary of an inherited IRA is not required to take a lump sum distribution. In general, the beneficiary is allowed to withdraw the funds over their life expectancy by using the life distribution rule. This inherited IRA is commonly called a stretch IRA. The beneficiary is required to withdraw their RMD each year or the beneficiary owes a 50% excise tax.

The beneficiary receives the tax benefit of continued tax deferred income until withdrawn from the inherited IRA have or use the 5 year IRA rather than a stretch IRA. In some situations a beneficiary will have or use the 5-year IRA rather than a stretch IRA.

Except for one rare situation, non-spouse beneficiary has no rollover rights. A beneficiary must include in their income any amount distribution to him or her. The rare situation is, a person who has an inherited IRA is eligible to rollover any distribution related to an IRS levy on such inherited IRA which the IRS repaid to the individual.

Q4. We have an IRA customer who is now deceased. He has two beneficiaries (his children) who want his RMD to be taken before they transfer his IRA into an Inherited IRA. Can we do that or would they have to take the RMD after they do the transfer?

A4. They need to take their share of the 2019 RMD after the inherited funds are transferred to the two beneficiaries.

I am unaware of any legal authority for making any distribution (RMD or otherwise) to the deceased person or his or her estate. The beneficiaries became inheriting IRA beneficiaries when the IRA owner died. The IRA owner did not designate their estate to be the beneficiary. In effect they want the estate to be the beneficiary to the extent of the RMD. Apparently the goal is to have the distribution reported as income on the final tax return of the decedent. The IRS most likely would consider this to be tax fraud.

If the beneficiaries or their advisers will provide a written explanation why they believe the tax rules permit them to do what they are proposing, then FNBA and CWF can review it.

NOTE. A beneficiary has the right to disclaim some or all their inherited IRA balance. Possibly, they can retain an attorney who will write an opinion letter stating that the RMD amount is it go to the estate as a result of both beneficiaries executing a disclaimer of their 1/2 share of the RMD.

Email Guidance – A Roth IRA Conversion

Q1. We have a client that currently has a self-direct traditional IRA and is considering converting part of it to a Roth IRA. Is there a$ limit he can convert? He holds stocks and mutual funds in the tradition IRA. How does it work or how is it calculated to convert an asset rather than selling an asset and converting cash? I hope you understand what I am asking in that last question.

A1. Here are the conversion basics. See the attached brochure discussing conversions.

An individual must aggregate all of their IRAs (traditional, SEP and SIMPLE) in order to determine what portion of the amount being converted will be included in income (and taxes paid) and what portion, if any, will be non-taxable as it is basis.

A person is able to convert a specific asset. There is no need to liquidate the investment. The titling of the asset would be changed to show the asset is now owned by the bank as the Roth IRA custodian fbo the person's Roth made in 2018 rather than by the bank as the traditional IRA custodian fbo the person's IRA.

The distribution and conversion instruction forms should be completed to indicate a specific asset is being converted. There must be a determination of the asset's value at the time of the conversion. There should be lit-

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Roth IRA Conversion,
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tle difficulty if the asset is publicly traded, but this will be more difficult if the asset is a hard to value asset.

When there is a conversion the IRA custodian reports on the Form 1099-R the distribution as it reports other distributions. If the IRA account holder is over age 59 1/2, the reason code will be a 7 for Form 1099-R purposes. If the IRA account holder is under age 59 1/2, the reason code will be a 2 for Form 1099-R purposes.

With the law change in 2017/2018, a conversion made in 2018 or any later year is irrevocable. Prior to 2018 a person could change their mind and undo the conversion by recharacterizing it. Not now.

There is no maximum amount for a conversion. The minimum amount is one cent.

Email Guidance – SEP-IRA Contribution

Q1. I know I should know this but.. Is it okay to do a transfer from a SEP to an IRA or should it be a rollover? I am thinking transfer is fine?

A1. It is okay to transfer from a SEP IRA to a Traditional IRA or vice versa.

Almost always it will be better for the IRA account holder to have their IRA funds transferred rather than taking a distribution and then·making a rollover contribution.

Q2. Help! The computer system won't allow me to add certain SEP-IRA contributions for our customer. Why?

A2. You called yesterday to discuss whether a person's SEP-IRA contributions were permissible as your computer software/system would not allow you to post or add the contributions as current year SEP-IRA contributions.

You sent me information showing 11 checks written from March 30, 2018 to May 10, 2019 totaling $98.095.15 to be deposited into the client's SEP-IRA The 11th check has an issuance date of May 10, 2019, and is for $79,402.50.

You should discuss the various SEP-IRA contributions with your client. He should furnish you with additional information.

What type of contributions are being made? Is an annual contribution being made for 2017, 2018 or 2019? Is a rollover contribution being made for 2018 or 2019? If a rollover contribution is being made, has the person determined he is eligible to make the rollover contribution? There are adverse tax consequences if a person makes an ineligible rollover.

The tax laws impose a maximum annual limit on SEP-IRA contributions. For tax year 2018 the limit is the lesser of $55,000 or 25% of a person's compensation. There is a special calculation to determine the compensation of a person who is self-employed. See attached excerpt from Publication 560. For tax year 2019 the limit is, the lesser of $56,000 or 25% of a person's compensation. The maximum limit for 2017 was $54,000.

There is no maximum limit applying to qualifying rollover contribution(s).

$79,402.50 was to be contributed. Was a portion to be designated for tax year 2018 and a portion for tax year 2019? Was this contribution a rollover? That is, a distribution from another SEP-IRA or the same SEP-IRA and now it is being rolled over?

The bank's duties as the SEP-IRA custodian and as an IRS reporting entity are limited. SEP-IRA contributions must be reported in box 8 on Form 5498. The IRS does not require the bank to inform the IRS (or the individual) on the Form 5498 the tax year or years for which the individual designated the contributions. The individual has this duty or responsibility and does so on his tax return. It is preferable that the individual designate on the check or a contribution form the year for which the contribution is being designated.

For example, John Doe made a contribution of $54,000 on 7/15/18 for tax year 2017 because he had a tax extension and he also contributed $55,000 on 12/31/18 for tax year 2018. This is permissible. The amount of $109,000 would be reported in box 8 on the 2018 Form 5498 since both contributions were received by the SEP-IRA custodian in 2018.

SEP-IRA software should allow both of these contributions to be processed or added.

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SEP-IRAs,
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SEP-IRA software may not be as current as it should be. Due to the relatively!ly small number of SEP-IRA transaction, some software vendors have not updated their software for many years. If the software is written to only consider the limit for one year, there will be error messages when there is no error. You may need to discuss with the software vendor.

We suggest a SEP-IRA custodian be furnished a copy of the person's Form 5305-SEP and then the person also established their own SEP-IRA

Email Guidance – Any PT Concerns if a Brother's IRA Makes a Loan to a Brother

Q1. Have you had time to research my inquiry if an IRA owner could put a NOTE in his IRA for his brother's business (IRA owner is 10% owner of Brother's business) and if that could be considered a disqualifying and prohibited transaction? You mentioned that the IRS recently expanded the immediate family interpretation to include siblings in recent prohibited transaction rulings but you were going look in to that for me.

A1. I did conduct some additional research.

The IRS and DOL in the 1980's, 1990's and 2000's had furnished written guidance that Code section 267 would be used to modify the definition of a family member as set forth in Code section 4975(e)(6) to include a person's siblings and spouses of siblings. It appears both the IRS and the DOL no longer argue that this modification is to be made. Current IRS guidance is that family member is defined to be a person's spouse, any ancestor, lineal descendant or any spouse of a lineal descendant.

Your prospective client's proposed IRA transaction does present prohibited transaction concerns. It is proposed that the IRA lend $800,000 to a business owned by the person's brother. And the individual is also a 10% owner of this business.

In 2004 the United States Tax Court in Joseph R. Rollins vs. Commissioner of the IRS (T.C. Memo. 2004-260) ruled that certain loans made by a one person 401(k) plan to business endeavors in which this person had a minority interest were prohibited transactions within the meaning of Code section 4975(c)(1)(D) and that Mr. Rollins was liable for the tax penalty.

The court ruled that Mr. Rollins benefited even though the loans were made to entities of which he was only a minority owner and that these other entities were not disqualified persons. It did not matter that no loan was made directly to him. The court adopted the IRS' position. "The individual benefited from the loans in that the loans enabled the borrowers, all entities in which the person owned interests to operate without having to borrow funds at arm's length from other sources. A prohibited transaction occurs if a disqualified person receives an indirect benefit (or a direct benefit) from an IRA transaction.

Any person who is considering this type of transaction must seek and rely on their attorney's guidance. The law is complex. The institution wants to have the individual accept responsibility should it be determined that a prohibited transaction occurs. There are real and substantial tax risks. An IRA is deemed distributed when a prohibited transaction occurs. $800,000 x 37% is $296,000. Presumably, tax litigation costs would be substantial.

The DOL does have the authority to grant an individual exemption if it decides an exemption is warranted. The individual must submit a formal request to the DOL. Additional research would need to done to determine what conditions most likely would need to be met in order for the DOL to grant an exemption for the proposed loan.

Email Guidance – Servicing an Investment of Designated Roth Funds Versus a Direct Rollover of Designated Roth Funds to a Roth IRA

Q-1. We have a new client wanting to move Roth funds within his 401(k) plan to our financial institution. Can we accept these funds?

A-1. Yes, but the client must make clear what transaction he wants to occur.

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Roth IRA,
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I understand the facts to be, your client is a participant in a one person 401(k) plan. He is also the trustee of this plan. He has a Designated Roth account within his 401(k) plan. Your client wishes to reinvest some of all of his Roth funds with United Southern Bank.

We discussed two possible scenarios.

Situation #1. He directly rolls over funds from the 401(k) plan into a Roth IRA for which United Southern Bank will be the IRA trustee. He as the 401 (k) trustee will furnish himself with a 401 (k) distribution form which he will complete. He must be eligible for a plan distribution under the terms of the plan document.

A Form 1099-R must be prepared him reporting the direct rollover. Reason code His to be used. USB as the Roth IRA trustee will report the rollover on the person's Form 5498. He will report the direct rollover/ rollover on his tax return as not being taxable.

Situation #2. As the trustee of the 401 (k) plan he has the authority to decide how and with whom the plan funds are invested. The enclosed article discusses when the investments will be a bank's time deposits. The discussion would change only slightly if the investments would be stocks, bonds, mutual funds, etc.

There must be paperwork showing he owns the assets as the plan trustee and that USB is assisting him.

Understanding the Two Special HSA Testing Period Rules

Roth IRAs have two distinct 5-year time period rules. HSAs have something similar as there are two special HSA testing period rules.

The concept of a testing period rule is, if a person does not satisfy the testing period requirement then the individual will need to include a certain amount in income and also a 10% additional tax.

Testing period #1 relates to the use of the last month rule.

An eligible individual as of December 1st who uses the last-month rule is for contribution purposes considered to be an eligible individual for the entire year. For example, a 35 year old person who was eligible as of November 1, 2018 and December 1, 2018 as she had single HDHP coverage may choose to contribute $3,300 and not $550 (1/6 of $3,300). That is, she may choose to contribute more than $550 up to the maximum of $3,300. It is assumed she contributed $3,300 and she claimed a $3,300 tax deduction on her 2018 tax return.

However, by contributing more than the $550, she becomes subject to the rules applying to testing period #1 . Her testing period begins with the last month of her tax period and ends on the last day of the twelfth month following that month. Since most individuals have a tax year of January 1 to December 31 (i.e. a calendar year tax year) the first day of the testing period is December 1, 2018 and the last day will be December 31, 2019.

If she fails to remain an eligible individual during this period, 12/1/18 to 12/31/19, then she must include in her 2019 income $2,750 which is the additional amount she contributed due to the last month rule. She also owes a 10% tax the $2,750 or $275. She is not required to amend her 2018 tax return. The adverse tax consequences would not apply if she was no longer an eligible individual on account of her disability or her death.

Testing period #2 arises when an eligible individual makes a qualified HSA funding distribution. We will assume we have the same 35 year older person.

An eligible individual may make a qualified HSA funding distribution as long as he or she has not previously made a prior qualified HSA funding distribution during his or her lifetime.

She may instruct her IRA custodian to withdraw $3,300 from her traditional IRA and remit the funds to her HSA custodian. The funds cannot be distributed to her. On her 2018 tax return she will not be taxed on the $3,300 even though the $3,300 is withdrawn from her IRA.

By making this qualified HSA funding distribution, she becomes subject to the rules applying to testing period #2. Her testing period begins with the month in which the $3,300 (i.e. the amount of the qualified HSA funding distribution) and ends on the last day of 12th month following that month. For example, the qualified HSA funding distribution is made on May 16, 2018, the testing period then ends on May 31, 2019.

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HSA Testing,
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If she fails to remain an eligible individual from 5/16/2018 to 5/31/2019, then she must include in her 2018 or 2019 income (whichever year she first fails to be an eligible individual) the amount of her qualified HSA funding distribution ($3,300). She also owes the 10% additional tax on this amount (e.g. $330 or $3,300 x 10%). The adverse tax consequences would not apply if she was no longer an eligible individual on account of her death or disability.

An individual must complete Part III of Form 8889 if one or both of these special testing period taxes is owed. If two individuals are married and both have HSAs, then both must complete their own Form 8889 and complete Part III, if applicable.

Contributions,
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apply, because it is the employee who is actually making the contribution for himself.

What administrative costs are associated with a payroll deduction program?

There will be costs associated with handling each employee's request, however, this cost should be nominal. An employer does not have any type of governmental reporting to submit under a payroll-deduction IRA program. The employer prepares an employee's Form W-2 in the usual manner regardless of whether or not an IRA program is in place. It is left up to the employee to properly reflect the tax effect of this traditional IRA contribution and/or Roth IRA contribution on his tax return. Since the employer has not made a contribution, it is generally not entitled to a deduction. However, any additional payroll costs the employer must pay to establish and operate the payroll program will be able to be claimed as a reasonable business deduction.

How does a payroll-deduction IRA work?

Susannah, age 25, works for Elite Tax Preparation Company which has offered its employees the opportunity to have deductions taken from their salaries to contribute to IRAs that the employees have set up for themselves. The employer makes the contributions by using electronic deposits. Susannah signs up for the program and has $125 per paycheck deposited into her Roth IRA. There are 24 payrolls per year. Her contributions total $3,000. Since the contribution limit for 2019 is $6,000 she would be able to contribute an additional amount of $3,000.

How does an employer end a payroll-deduction program?

It simply makes the decision to end the program. The employer will need to notify the employees of its discontinuance of the payroll deductions. If the employer uses a payroll service to assist with its payroll work, then the employer will want to notify this service provider also.

Is a payroll-deduction IRA program different from an Employer-Sponsored IRA plan?

Yes. The employer makes contributions with its funds under an employer-sponsored IRA plan, whereas the employer only transmits the employee's own funds under a payroll-deduction IRA program.

Summary.

You may wish to check with your business customers to see if they would want any assistance with operating a payroll-deduction IRA program. Although your best bet may be to offer assistance to employers without a 401(k) plan, there is nothing preventing a business with a 401(k) plan from also offering the payroll-deduction IRA program. Again, more people should be contributing to both 401(k) plans and making Roth IRA contributions.

People should be making both types of contributions and not just the 401(k) contribution. A payroll-deduction IRA program is a relatively simple way to increase the amount of contributions to Roth IRAs and traditional IRAs. There are both traditional IRA payroll-deduction programs and also Roth IRA payroll-deduction programs