THE Pension Digest

August 2019
Published Since 1984

ALSO IN THIS ISSUE –

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

Will the SECURE Bill Become Law?

Radical Changes Are Proposed for Certain IRA and Pension Beneficiaries

On May 23, 2019, the House of Representatives passed H.R. 1994 by a vote of 417-3. This bill has the title, "Setting Every Community Up For Retirement Enhancement Act of 2019." It was received by the Senate on June 3, 2019.

This article discusses the proposed law changes impacting IRAs; it does not address the proposed changes for 401(k), 403(b) plans and other employer sponsored plans.

The SECURE Act contains a radical IRA law change. Under existing law the beneficiary of an IRA owner who dies before his or her required beginning date is deemed to have elected to use the life distribution rule unless he or she elects to use the 5-year rule. The SECURE Act would require use of a 10-year rule rather than the 5-year rule for when an IRA owner dies before his or her required beginning date. The life distribution rule would no longer be available to such a beneficiary. Under the proposed 10-year rule, the inherited IRA must be closed within 10 years of the date of death of the IRA owner. The IRS will need to decide if it will allow the inherited IRA to be closed by December 31 of the year containing the 10th anniversary of the IRA owner's death.

The current rules (i.e. the life distribution rule) would continue to apply if the IRA owner dies on or after his or her required beginning date.

The purpose of this law change is to increase tax revenues. No longer would certain beneficiaries be able to stretch out distributions over their life expectancy. Forcing earlier distributions by beneficiaries means tax revenues will be collected earlier than otherwise would have occurred.

Also, the new rules do <u>not</u> apply to beneficiaries of an IRA owner who died before January 1, 2020. The existing RMD rules continue to apply. These existing beneficiaries or subsequent beneficiaries are treated as an eligible designated beneficiary (EDB) as discussed below.

The new rules do <u>not</u> apply to the following who are eligible designated beneficiaries (EDB) when an IRA owner dies after December 31, 2019:

1. a surviving spouse;
2. a child of the IRA owner who has not reached the age of majority;
3. a beneficiary who is disabled,;
4. a beneficiary who is chronically ill; and
5. a beneficiary who is not described in 1-4 and who is not more than 10 years younger than the deceased IRA owner.

That is, the existing RMD rules continue to apply to an EDB.

The exception applying to a beneficiary who is a minor is limited. Once the child attains the age of majority she or

Continued on page 2

SECURE,
Continued from page 1

he will have 10 years in which to close the IRA. In most states this is age 18.

Once an eligible designated beneficiary dies, any subsequent beneficiary would not be an eligible designated beneficiary. Any remaining balance in the inherited IRA must be distributed within 10 years after the death of the EDB.

There are four proposed changes impacting the making of annual IRA contributions.

1. Repealed would be the law which prevents a person age 70 1/2 and older from making a traditional IRA contribution. Any person with qualifying compensation would be eligible to make a traditional IRA contribution regardless of age. Example, Jane Doe age 76 is still practicing medicine and she would be able to make a traditional IRA contribution if she so desired.

This change would be effective for contributions for tax year 2020 and subsequent tax years.

2. The definition of compensation for purposes of being eligible to make an annual IRA contribution is being clarified to make clear that compensation includes any amount included in a person's income and paid to such person to aid the person in pursuit of graduate or postdoctoral study.

3. The definition of compensation for purposes of being eligible to make an annual IRA contribution is being clarified to make clear that compensation includes certain "difficulty of care payments." The general rule, in order to make an IRA contribution regardless if deductible or non-deductible, a person must have "taxable" income to support such contribution.

There would be a special rule for a person who excludes from gross income under code section 131 certain. The person will be eligible to make a traditional IRA contribution. Such a person would be eligible to make a non-deductible contribution to the extent of the lesser of the amount excluded or the maximum IRA contribution amount as reduced by the amount of compensation which is includible in income.

For example, Jane Doe, age 39, receives compensation of $11,000 from certain "difficulty of care payments." Jane is able to exclude $9,000 under section 131 and she includes $2,000 in her taxable income. She is eligible to make a non-deductible contribution of $4,000 (the lesser of $9000 or $6,000 less $2,000).

This change would be effective for tax years commencing after December 31, 2019.

4. There would be special rules for a person who takes an IRA distribution to assist with the birth of a child or an adoption of a child.

A. The 10% pre-age 59 1/2 tax would not apply to a person who takes an IRA distribution which qualifies as a "qualified birth or adoption distribution."

There is a $5,000 aggregate limit. The actual language is, "The aggregate amount which may be treated as qualified birth or adoption distributions by any individual with respect to any birth or adoption shall not exceed $5,000." We construe this limit as being a per person lifetime limit. Because this language is not totally clear we believe, the IRS or Congress should clarify.

Presumably, the individual will need to claim this exemption by completing and filing Form 5329.

B. A qualified birth or adoption distribution means any distribution from an IRA or other applicable retirement plan to an individual as long as the distribution is made during the 1-year period beginning on the date a child of the individual is born or on the date the legal adoption of an eligible adoptee child is finalized. An eligible adoptee is any person who has not attained age 18 or any person who is physically or mentally incapable of self-support. A child of a taxpayer's spouse is ineligible to be an eligible adoptee.

C. A taxpayer who has taken a qualified birth or adoption distribution may repay such distribution. This part of the law will also need to be clarified as the law does not define the repayment period. Presumably it is three years as it is for natural disaster distributions. A qualified repayment of a qualified birth or adoption distribution means the distribution is not taxable.

The change would apply to distributions occurring after December 31, 2019.

An individual's required beginning date would be changed to April 1 of the year following the year he or she attains age 72 rather than the year the individual attains age 70 1/2. This change would apply to distributions required to be made after December 31, 2019, for those individuals who attain age 70 1/2 after December 31, 2019.

Continued on page 8

Email Guidance – Furnishing Withholding Notices to RMD IRA Owners

Q1. have a question about Federal withholding on IRAs. We have clients that we do automatic distributions for either monthly, quarterly, or yearly. We either send them a check or deposited to an account that they have with us. Most are to covert here RMD for the year. Some take Federal withholding and some do not. Are we required to send out a Notice of Withholding to these clients during the year? I was reading an article that was talking about it and was confused. Thank you for your help.

A1. An IRA custodian does have the duty to furnish a "federal withholding reminder notice" to certain IRA owners receiving periodic distributions. Here are the rules as we understand them.

If an IRA custodian is making to an IRA owner 4 or more periodic distributions per year, it is required to send only one withholding reminder notice. Normally it is sent in late December (2018) or early January (2019) and it applies for the upcoming year (2019).

See the CWF form as attached. The concept applying to periodic IRA/pension is very similar to the employer's duty to annually furnish its employees with a "new" Form W-4 which the employee is to complete to instruct the amount the person wants withheld from payroll payments for the upcoming year.

If an IRA custodian is making less than 4 periodic payments per year, the IRA custodian has two rules to meet.

For example, many IRA owners take only one distribution per year, their RMD. Many will take this distribution in November or December.

Rule #1. The withholding reminder notice must be furnished to the IRA owner a reasonable amount of time so the person has the ability to change their instruction. The CWF form reminds the IRA owner what they previously instructed- withhold or don't withhold. The IRS has never defined what amount of time is reasonable. We at CWF believe at least 3-4 weeks. Only 1-2 weeks of notice would be unreasonable.

Rule #2. The withholding reminder notice can not be furnished more than 6 months in advance of the next scheduled periodic distribution. For example, an IRA owner scheduled to be distributed his or her next distribution on November 15 must be furnished the notice on or after May 15, 2019. That is, the withholding reminder notice can not be sent in January or February to this IRA owner.

The IRS has the authority to assess a fine of $10 for each failure to furnish the required withholding notice.

It can be argued the IRS should revise this rule to allow the IRA custodian to furnish the withholding reminder notice rule at the same time the RMD notice is furnished.

Email Guidance – SIMPLE-IRAs

Q1. Can you clarify the differences between the various SIMPLE-IRA account applications- CWF 940 Custodial Account Ap – Form 5305-SA, CWF 941 Trust Account Ap – Form 5305-S and CWF 942 Self-Directed Form 5305-SA?

A1. A person who participates in their employer's SIMPLE-IRA plan (including a one person business) must have a SIMPLE-IRA (plan agreement)to accept the employee's elective deferrals and the employer's matching or non-elective contribution. '

The custodial SIMPLE-IRA plan agreement form #940 restricts the investment of the contributions to the sponsoring bank's savings or time deposits.

The custodial self-directed SIMPLE-IRA plan agreement form #942 is best used by a financial institution without trust powers. The financial institution may affiliate with an investment firm so that an IRA owner may in addition to investing in the sponsoring bank's savings or time deposits invest in mutual funds or similar investments. The financial institution cannot offer any investment advice and must maintain accurate accounting records. The individual is responsible for his or her investment decisions.

The trust SIMPLE-IRA plan agreement form #941 permits the contributions to be invested in any investment

Continued on page 4

Email Guidance – Duties Related to IRA Distributions to a Foreign Person

Q-1 We have had an IRA owner die. She had designated three German citizens (her nieces) as her IRA beneficiaries. Each wishes to withdraw their share of the inherited IRA. What withholding duties apply to this situation?

A-1. There are withholding duties to be performed by an IRA custodian when a distribution will be made to an IRA beneficiary who is a foreign person.

The first main duty is – determine what percentage of the amount being distributed must be withheld, if any, for federal income tax purposes?

The second main duty is – how do we report this distribution to the IRS and the beneficiary and IRS reporting duties we have if withholding is required?

The standard rule is, 30% must be withheld unless the foreign person furnishes a Form W-8BEN or other applicable W-8 form claiming that a lesser amount is to be withheld. If less than 30% is to be withheld it will generally be because the foreign person will claim that a treaty provides for a lesser percentage, including 0%. The US/Germany treaty provides that 0% is required to be withheld from an IRA distribution to a German citizen.

A separate determination must be made to determine if there must be any withholding for state income tax purposes. Such a determination is beyond the scope of this discussion.

General Discussion

An IRA custodian/trustee has the duty to complete the 1042 forms even if a tax treaty means that there is no duty to withhold federal income tax with respect to a specific IRA distribution made to a foreign person. IRS procedures require the IRS (and the foreign person) to be informed of the IRA distribution by the IRA custodian/trustee.

In general, U.S. income tax withholding is a prepayment of an estimated tax liability which a person may have with respect to income subject to being taxed by the United States.

An IRA custodian/trustee prepares a Form 1042-S for each foreign person who receives an IRA distribution. Some of these forms for foreigners will have federal income tax withholding and others will have no withholding. There is no federal withholding required for your German beneficiaries.

Form 1042 is the transmittal form used by the IRA custodian/trustee to aggregate the information set forth on the individual 1042-S forms, including the aggregate amount withheld. Form 1042 serves the same purpose as Form 1096. Form 1096 is the transmittal form for the many 1099 forms. There may be times when the Form 1042 will be completed to show no income tax was withheld, but the form will show the total amount or distributions made to foreigners.

When an IRA custodian/trustee is required to withhold with respect an IRA distribution paid to a foreigner, the withheld amount must be transferred/paid to the IRS within certain time limits. Form 42-T is to be completed to show when the withheld income tax related to one or more 1042-S forms was required to be deposited with the IRS.

Your foreign beneficiaries must make the determination if they have a duty to file a U.S. income tax return because of their receipt of the IRA distribution or because of other income.

SIMPLE-IRAs,
Continued from page 3

authorized by federal law subject to the financial institution agreeing to such investment. This trust SIMPLE-IRA may either be managed (the institution is responsible for the investment decisions), directed (the individual is responsible for his or her investment decisions) or a combination approach.

Continued on page 5

Under Florida Law – Losing the Right to Exempt an IRA From the Bankruptcy Estate

Florida has very favorable laws protecting an IRA owner's IRA funds from being seized by creditors, including a bankruptcy trustee.

A Floridian IRA owner many times will be able to retain 100% of his or her IRA assets regardless of valid claims by a bankruptcy trustee or other creditor because Florida law in section 222.21 provides, in general, that any funds in an IRA or a qualified plan are exempt from all claims of creditor if the IRA meets certain requirements. However, this exemption is not an absolute right and will be lost if there is not compliance with the statutory requirements.

An IRA owner who might lose if they would be sued under their state law wants to establish their IRA in a state which protects a person's IRA from creditors. The safest approach would be to become a resident of such a state.

Similarly, an IRA owner who might need or want to file for bankruptcy wants to establish their IRA in a state which protects a person's IRA from creditors. The safest approach would be to become a resident of such a state.

Florida is such a state. Minnesota, Iowa, Michigan, Massachusetts and other "northern" states are not because such states place relatively low limits on the amount an IRA owner can protect from creditors.

On June 26, 2019, the Eleventh Circuit Court of Appeals ruled that the debtor and IRA owner did lose his exemption right under Florida law and that the amount in his IRA had to be transferred to his bankruptcy trustee. The case was, Keith A. Yerian v. Richard B. Webber, trustee, No. 18-10944.

The court found that he no longer was eligible to exempt his IRA under Florida laws from the bankruptcy estate because he failed to maintain his IRA according to the governing instruments as required by the Florida exemption law. He violated the prohibited transaction rules for IRS taxation purposes and he violated the provisions of the IRA plan agreement by engaging in the prohibited transactions.

On February 27, 2015, Yerian filed for Chapter 7 bankruptcy. He failed to disclose his IRA on the asset schedules that originally accompanied his petition. Later he amended his filings to disclose the IRA. At that time Yerian argued that Florida has exempted IRAs from bankruptcy administration as long as they were originally established with proper documentation.

The bankruptcy code provides a list of federal exemptions, but also permits a state to opt out and replace the federal blueprint with an exemption scheme of its own. 11 U.S.C.§522(b). The state of Florida has an exemption that includes IRAs as long as the debtor meets certain statutory requirements. FL Stat.§222.21.

Through the course of the court proceedings, it was determined that Yerian forfeited his exemption when he engaged in self-dealing transactions prohibited by the IRA's governing instruments. After establishing an IRA account, he treated the money as his own by purchasing a condominium and vehicles. By engaging in prohibited transactions he incurred over one hundred thousand dollars in tax penalties.

Section 408 of the Internal Revenue Code sets out six minimum requirements for the terms of the "written governing instrument" that legally establishes the IRA. An IRA is only tax exempt if it satisfies the requirements imposed by the Internal Revenue Code.

Florida law does not allow a debtor to claim an exemption for an IRA operated in violation of the federal tax code. The trustee disagreed with Yearn's view that the Florida exemption statute shielded even an IRA operated in violation of the federal tax code, as long as the IRA satisfied the requirements of §408(a) on paper.

It is obvious that Yerian violated the express terms of the IRA LLC Agreement even though he was permitted to make his own investments through an LLC. He signed the agreement in June of 2012 that contained language "I acknowledge that I have not and will not engage in any prohibited transactions within my retirement account or its asset holdings."

In summary, a Floridian IRA owner many times will be able to retain 100% of his or her assets regardless of valid claims by a bankruptcy trustee or other creditor. However, this exemption is not an absolute right and will be lost if there is not compliance with the statutory requirements. Mr. Yerian failed to comply.

Expansion of HSA Preventive Care Rules

The IRS issued Notice 2019-45 that provides an expanded list of preventive care benefits permitted to be furnished in conjunction with a high deductible health plan (HDHP).

On June 24, 2019 President Trump issued the Executive Order, "Improving Price and Quality Transparency in American Healthcare to Put Patients First." This included an order that the Secretary of Treasury issue guidance to expand the ability of patients to select HDHPs that can be used alongside an HSA, and to cover low-cost preventive care for individuals with chronic conditions.

Eligible individuals can establish Health Savings Accounts (HSAs) under section 223 of the IRS Code. Only the eligible individual is allowed to make contributions to an HSA or receive contributions from an employer to their HSA. To qualify, the HDHP must satisfy certain requirements with minimum deductibles and maximum out-of-pocket expenses.

Generally, HDHP benefits for any year can not be provided until the minimum deductible has been satisfied. However, the deductible does not apply to services provided pursuant to preventative care. The IRS is now issuing guidance that provides specified medications and services used to treat chronic diseases is qualifying preventative care.

The Treasury Department and the IRS have specified services and items that are treated as preventative care only when prescribed to treat an individual diagnosed with the associated chronic condition specified in chart below. This only applies when prescribed for the purpose of preventing the exacerbation of the chronic condition or the development of a secondary condition. If an individual is diagnosed with more than one chronic condition, all listed services and items applicable to the two or more conditions are preventive care. However, services and items not listed in the chart that are for secondary conditions or complications that occur notwithstanding the preventive care are not treated as preventive care for purposes of section 223(c)(2)(C).

Preventive Care for Specified Conditions	For Individuals Diagnosed with
Angiotensin Converting Enzyme (ACE) inhibitors	Congestive heart failure, diabetes, and/or coronary artery disease
Anti-resorptive therapy	Osteoporosis and/or osteopenia
Beta-blockers	Congestive heart failure and/or coronary artery disease
Blood pressure monitor	Hypertension
Inhaled corticosteroids	Asthma
Insulin and other glucose lowering agents	Diabetes
Retinopathy screening	Diabetes
Peak flow meter	Asthma
Glucometer	Diabetes
Hemoglobin A1c testing	Diabetes
International Normalized Ratio (INR) testing	Liver disease and/or bleeding disorders
Low-density Lipoprotein (LDL) testing	Heart disease
Selective Serotonin Reuptake Inhibitors (SSRIs)	Depression
Statins	Heart disease and/or diabetes

Prior guidance on preventive care resulted in the failure of some individuals diagnosed with certain chronic conditions to seek or utilize effective services. By addressing the need for necessary care, consequences of amputation, blindness, heart attacks and strokes can be reduced and lower medical expenses.

Supreme Court Limits a State's Power to Tax the Income of Certain Trusts

On June 21, 2019 the Supreme Court delivered the opinion of the court on a case to limit a State's power to tax a trust, North Carolina Department of Revenue vs. Kimberley Rice Kaestner 1992 Family Trust.

The court held that the residence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain to receive it.

Federal and state income tax laws are written to tax the income earned by an entity, whether that be a person, a corporation, an estate or a trust. A trust and the beneficiaries of a trust are separate tax entities and each may have its own tax liability with respects to its income. This case holds that in some situations a state may have the legal right to tax the income paid to a person (i.e the beneficiary) from a trust, but the state might not have the legal right to tax the income earned by the trust. The fact that a beneficiary lives in the state does not mean the state has the authority to tax the income earned by such trust.

The State of North Carolina assessed a trust tax of more than $1.3 million for tax years 2005 through 2008. During that period, a trust beneficiary who was a North Carolina resident had no right to, and did not receive, any distributions.

Under a law authorizing the State to tax any trust income that "is for the benefit of" a state resident, N. C. Gen. Stat. Ann. § 105-160.2, North Carolina sought to tax the Kimberley Rice Kaestner 1992 Family Trust that was formed for the benefit of Kaestner and her three children.

For the benefit of his children, Joseph Lee Rice III, formed a trust in his home State of New York and also appointed a New York resident as the trustee. The trust agreement granted the trustee "absolute discretion" to distribute the trust's assets to the beneficiaries. The trustee later divided Rice's initial trust into three separate subtrusts after his daughter, Kimberley Rice Kaestner, moved to North Carolina.

The trustee paid the tax of 1.3 million under protest even though the Trust didn't have a physical presence, make any direct investments, or hold any real property in North Carolina. The trustee then sued arguing that the tax as applied to the Trust violates the Fourteenth Amendment's Due Process Clause. The state courts agreed, citing Kaestners' in-state residence did not supply a minimum connection between the State and the Trust to support the tax.

The fourteen amendment's Due Process Clause limits States to imposing only taxes that "bear fiscal relation to protection, opportunities and benefits given by the state.'' Wisconsin v. J.C. Penney Co., 311 U.S. 435,444.

As the beneficiary, Kaestner has not received any trust income, has no right to demand that income and is uncertain of a specific share of the income while she has been residing in North Carolina. There is no evidence that the beneficiary(ies) may be able to count on receiving any specific amount of income in the future. North Carolina's counterarguments focusing solely on the Kaestner's residence for taxation and speculation of negative consequences on the state tax system were unconvincing and the Supreme Court ruled in favor of the trust.

In summary. The court held that the residence of in-state beneficiaries alone does not empower a State to tax a trust's income when that trust has no other contacts with the state.

SECURE,
Continued from page 2

Those individuals who are already subject to the RMD rules would remain subject to the old rules. That is, they will need to take RMDs for 2019 and subsequent years.

An RMD would apply for 2021 for any person attaining age 72 in 2021. It appears those individuals attaining age 71 in 2020 would not have any RMD for 2020.

Although the main provision to increase tax revenues is to shorten the time period during which the inherited IRA must be closed, there are other revenue increasing provisions.

There would be an increase in the penalty amount for failing to file a required tax return. The amount would change from $205 as indexed to $400 as indexed.

There would be an increase in the penalty amounts for failing to file certain retirement plan returns as set forth in Code section 6652(d), (e) and (h).

Code section 6652(h) sets forth penalties for failing to furnish the proper withholding notice form. This is IRS Form W-4P or a qualifying substitute form.An IRA custodian has the duty to comply with the IRA withholding notice rules and the withholding rules.

The current penalty is $10 for each failure to furnish an IRA owner or beneficiary with the proper withholding notice, but the total amount imposed on the person for all such failures is $5,000. The penalty amounts would increase to $100 for each failure to furnish the proper notice, but the total amount imposed on the person during any calendar year for all such failures is $50,000.

Code section 6652(e) sets forth penalties for failing to file certain returns required by code sections 6047 and 6058. The current penalty is $25 for each day during which such failure continues but the total amount with respect to any return is limited to $15,000. The penalty amounts would be increased to $105 for each day during which such failure continues but the total amount with respect to any return is limited to $50,000.

Code section 6652(d) sets forth penalties for failing to file certain returns required by code sections (a). This section requires a sponsor of a retirement plan where there are terminated participants with deferred vested benefits to file Form 8855 and provide certain information regarding such terminated participants. The administrator has a duty to file an initial form and then has the duty to file a revised form if there is a change in the person's status.

With respect to filing the initial form, the current penalty is $1 for each participant with respect to whom there is a failure to file, multiplied by the number of days which such failure continues, but the total amount with respect to any return is limited to $5,000. The penalty amounts would be increased to $2 for each participant with respect to whom there is a failure to file, multiplied by the number of days which such failure continues, but the total amount with respect to any return is limited to $10,000.

With respect to filing the notice of change of status form, the current penalty is $1 for each participant with respect to whom there is a failure to file, multiplied by the number of days which such failure continues, but the total amount with respect to any return is limited to $1,000. The penalty amounts would be increased to $2 for each participant with respect to whom there is a failure to file, multiplied by the number of days which such failure continues, but the total amount with respect to any return is limited to $5,000.

Substantial Increase in the Tax Credit for An Employer Establishing a New Retirement Plan.

Under existing law an employer may qualify for a $500 tax credit.

The credit is authorized when an employer establishes a new SEP or a SIMPLE-IRA plan or a 401(k) plan or other employer sponsored plan.

Current law would be changed so the credit would apply to the year the plan is established and the subsequent two years rather than just one year.

The credit for each year is the greater of $500 or the lesser of $5,000 or $250 for each employee who is not a highly compensated employee and who is eligible to participate in such plan. For example, an employer with 5 non-owner employees would a $1,250 credit fore tax years if it would set up a SEP or SIMPLE IRA plan. We expect this credit would induce many small business owners to do so.

This change would be effective for tax years commencing after December 31, 2019.