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Overview – The IRS' Proposed RMD Regulations, Rollover Regulations, Plus Other Related Regulations

IRS Issued its New Proposed RMD Regulation on February 24, 2022 Effective For 2022 RMDs

The IRS has proposed new RMD rules for IRAs, 401(k) plans, other pension plans, 403(b) plans and certain 457 plans. The new rules are to be used for 2022 RMD calculations, including the 50% tax when there is an excess accumulation of an RMD.

The IRS has proposed some changes which some in the public will not like. There are other changes which will be liked. The purpose of this article and articles in the April newsletter is to present a summary of the changes which affect IRAs. People should not assume all of these proposals will be adopted. Some should not be. The Treasury and the IRS have invited comments on the impact of these proposed regulation on small entities. The IRS should start by defining who or what is a small entity for purposes of these proposed regulations.

The IRS encourages a commenter to make their submission electronically. The IRS will give paper submissions consideration only to the extent practicable. Use the Federal eRulemaking Portal at wwwregulationsgov. Be sure to follow the on line instructions and reference IRS and REG-105954-20.

If you do submit a comment on paper send it to: CC:PA:LPD:PR (REG-105954-20), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington DC 20044.

Written or electronic comments must be received by the IRS by June 22, 2022 (90 days after February 24, 2022). The IRS is holding a public hearing on June 15, 2022. The IRS is trying to expedite the adoption of this proposed regulation as its final regulation. It should slow down the process.

Hopefully, the IRS will seriously consider what the IRA/pension and tax professionals suggest along with general taxpayers. The proposed RMD rules are too complicated. There is no need that they be this complicated.

The IRS position is - a regulatory flexibility analysis under the Regulatory Flexibility Act is not required for various reasons. The IRS believes and certifies that the regulations will not have a significant economic impact on a substantial number of small entities. Obviously, the IRS is wrong. It will affect many small entities - either small employers sponsoring retirement plans or IRA owners and beneficiaries. These new rules are going to affect many small plans and they affect millions of IRA owners and beneficiaries. The IRS tries to argue that the proposed regulations do not impose new compliance burdens and are not expected to result in economically meaningful changes. Obviously, they do impose economically meaningful changes and new burdens. Many of the IRS proposed beneficiary changes are being added to require beneficiaries to take their withdrawals sooner so more income taxes are paid sooner.

Financial institutions should be seeking help from their senators and trade associations such as the American Bankers Association and state banking associations. The IRS can and should be acting to simplify the rules.

RMDs for IRA Owners Age 72 or Older

An IRA owner has a required beginning date of April 1 of the year following the year he or she attains age 72. The rule which applies to some employer plans does not apply to IRAs. Some employer plans are written to defines a participant's required beginning date as the April following the year the person retires if after age 72.

An IRA owner born before July 1, 1949 has a required beginning date of April 1 of the year following the year he or she attained age 70½. A person attained age 70½ as of the date six calendar months after the person's 70th birthday.

The RMD rules for SEP-IRAs and SIMPLE IRAs are the same rules applying to traditional IRAs and not the rules applying to a qualified plan.

A Roth IRA owner does not have a required beginning date.

The formula used to calculate the RMD for an IRA has not changed. The 12/31 balance as of the preceding year is divided by a divisor. The IRS used to use the term, "applicable distribution period." The IRS now uses the term, "applicable denominator." Divisor and denominator are the same.

The account balance does not include the value of any qualifying longevity annuity contract (QLAC).

The 12/31 balance as of the preceding year is adjusted only in one situation. A rollover distribution or a transfer distribution occurs late in the year (November or December) so it is not reflected in the 12/31 balance, then the balance of the distributing IRA must be increased to reflect the outstanding distribution amount. There is no adjustment when the IRA owner makes a prior year contribution or recharacterizes an IRA contribution.

The divisor or applicable denominator comes from the Uniform Lifetime Table as revised by the IRS in 2020. There is no requirement to designate an individual as the beneficiary. In one situation the Uniform Life Table is not used. If the sole designated beneficiary of the IRA owner is their spouse who is more than 10 years younger, then the divisor is to come from the Joint Life Expectancy Table using their two ages for the applicable year. And the RMD denominator (divisor) is to be recalculated each year.

In general, any withdrawal by a IRA owner is applied to satisfy his or her RMD. Because the law provides that an RMD is ineligible to be rollover over, the first distributions of an IRA owner are used to satisfy his or her RMD. Once satisfied any additional distributions are eligible to be rollover over. However the following distributions from an IRA cannot be used to satisfy the IRA owner's RMD:

A. excess contributions plus the related income withdrawn before the due date under Code Section 408(d)(4);
B. excess contributions withdrawn after the due date under Code Section 408(d)(5);
C. Any corrective distribution of an excess SEP-IRA contribution plus the related income under Code section 408(k)(6);
D. Any deemed distribution pursuant to code section 408(e);
E. Any deemed distribution of a collectible pursuant to code section 408(m);
F. Any corrective distribution of Excess SIMPLE-IRA deferrals plus the related income and
G. Similar items as determined by the commissioner in revenue rulings notices and other published guidance.

The IRS should revise the regulation to expressly provide that an IRA owner may satisfy their RMD by making a qualified charitable distribution.

The Basic RMD Beneficiary Rules Under the SECURE Act

It is important to understand certain terms after the enactment of the SECURE Act. A designated beneficiary is a person. A trust, estate or charity is not a designated beneficiary. A designated beneficiary will either be an eligible designated beneficiary (EDB) or someone who is not an eligible designated beneficiary. A trust which meets certain rules will be treated as an EDB for purposes of certain RMD rules.

Who is an eligible designated beneficiary?

An eligible designated beneficiary is a designated beneficiary who as of the IRA owner's death is:

1. the surviving spouse of the IRA owner;
2. a child of the IRA owner who has not reached the age of majority;
3. disabled;
4. chronically ill; or
5. not more than 10 years younger than the IRA owner; or
6. A designated beneficiary of an IRA owner who died on or before December 31, 2019 is an EDB and is required to continue using the life distribution rule appling to them before the enactment of the SECURE Act. A beneficiary generally has the right to withdraw more than the RMD.

EDB Category #1. The surviving spouse of the IRA owner regardless of age. The status of being married is determined by applying federal law and state law.

EDB Category #2. A child of the IRA owner who has not reached the age of majority;

The IRS has proposed the following additional and clarifying rules.

1. The person must be a minor at the time the IRA owner dies.
2. Although the law uses the term age of majority which in most states is age 18, the IRS has chosen to override this by defining a person's age of majority as the day the person reaches their 21st birthday.
3. The law is that when a minor beneficiary attains the age of majority then the 10-year rule will apply. But what happens if there are multiple beneficiaries?

EDB Category #3. The beneficiary is disabled.

The IRS has proposed the following additional and clarifying rules.

1. The person must be disabled at the time the IRA owner dies.
2. The IRS is proposing to use the existing rules and procedures for defining when a person is disabled. The standard is - the individual is unable to engage in substantial gainful activity.

   The IRS makes clear a person who becomes disabled after the IRA owner's death is not disable for RMD calculation purposes.

   Apparently, a person who is disabled as of the day the IRA owner dies, but later improves so he or she is no longer disabled is to be treated as disabled for purposes of the RMD rules.
3. The IRS creates a special rule if the beneficiary is under age 18. Should this now be 21? The IRS creates a comparable standard rather than the standard. A minor beneficiary will be disabled if he or she has a medically determinable physical or mental impairment that results in marked and severe functional limitations which can be expected to result in death or be of long-continued and indefinite duration.
4. The beneficiary who is disabled must meet certain documentation requirements even though the beneficiary is also a minor. __
5. The IRS creates a safe harbor. If as of the date of death the commissioner of Social Security has already determined the beneficiary is disabled within the meaning of USC 1382c(a)(3). If so, the beneficiary is deemed disabled.
6. The beneficiary must furnish the IRA custodian/trustee with documentation confirming the disability no later than October 31 of the year following the year the IRA owner died. The documentation must include a certification by a licensed health care practitioner.

Although the law uses the term age of majority which in most states is age 18, the IRS has chosen to override

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this by defining a person's age of majority as the day the person reaches their 21st birthday.

The law is that when a minor beneficiary attains the age of majority then the 10-year rule will apply. There's special rules when there are multiple beneficiaries.

EDB Category #4. The beneficiary is chronically ill.

The IRS has proposed the following additional and clarifying rules.

1. The person must be chronically ill at the time the IRA owner dies.
2. The IRS makes clear a person who becomes disabled after the IRA owner's death is not chronically ill for RMD calculation purposes.
3. A person is chronically ill if the person is unable to perform at least two daily living for an indefinite period that is reasonable expected to be lengthy in nature.
4. The beneficiary must furnish the IRA custodian/trustee with documentation confirming the beneficiary is chronically ill no later than October 31 of the year following the year the IRA owner died. The documentation must include a certification by a licensed health care practitioner.

EDB Category #5. The beneficiary is more than 10 years younger. Note that a beneficiary who is older than the IRA owner is more than 10 years younger than the IRA owner.

EDB Category #6. A designated beneficiary of an IRA owner who died on or before December 31, 2019 is an EDB and is required to continue using the life distribution rule applying to them before the enactment of the SECURE Act. A beneficiary generally has the right to withdraw more than the RMD.

<u>What rules apply to a traditional IRA Beneficiary if the IRA owner died before his or her required beginning date?</u>

The 5-year rule applies if the beneficiary is not a designated beneficiary.

The 10-year rule applies if the beneficiary is a designated beneficiary or is a qualified (see-through) trust.

The life distribution rule applies if the beneficiary is an EDB, including an EDB trust. Presumably the special life distribution rule will apply when the deceased IRA owner is younger than their beneficiary.

<u>What rules apply to a traditional IRA Beneficiary if the IRA owner died on or after his or her required beginning date?</u>

The IRS has written its regulation in a unique manner. The IRS position is - a non-EDB beneficiary who is ineligible to use the life distribution rule when the IRA owner dies before their required beginning date is now required to use the standard life distribution rule when the IRA owner has died after their required beginning date. However, this distribution period cannot exceed 10 years and in some cases the distribution period might be less than 10 years.

The IRS approach is not clearly authorized by the SECURE Act. The IRS does not explain why they believe Code section 401(a)(9)(H((i)(I) as added by the SECURE Act authorizes or requires this two step approach:

The proposed RMD regulation set forth the following over-riding rule. An inherited IRA be closed (i.e. a full distribution) by the <u>earliest</u> of the following dates:

1. The end of the 10th calendar year following the calendar year the IRA owner died if the beneficiary is not an EDB;
2. The end of the 10th calendar year following the calendar year the IRA beneficiary (who was an EDB) died;
3. The end of the 10th calendar year following the calendar year a beneficiary who is a minor as of the date of the IRA owner's death attains age 21; or
4. The end of the calendar year in which the applicable divisor (denominator) would have been less than or equal to 1.0 if the divisor was determined using the beneficiary's remaining life expectancy. This deadline applies only if the beneficiary was an EDB and if the applicable divisor was being determined using the IRA owner's remaining life expectancy. That is, the IRA owner had designated an older beneficiary, but that beneficiary has now died. The remaining distribution period is based on the older beneficiary and not the deceased IRA owner.

There will be substantial additional discussion of the proposed RMD regulation in the April newsletter. The proposed RMD regulation is 275 pages

Email Guidance – What Forms are Completed for a Recharacterization?

Q-1. I have a client, Julie, who made a 2021 contribution to a traditional IRA of $6,000 in 2021. She is now in March of 2022 looking to open a Roth IRA and recharacterize that contribution to the Roth IRA.

She is looking to do this before she files her taxes for 2021. Could you walk me through this process?

Julie wasn't sure if it would be possible since we have already completed the reporting for 2021 contributions, and thought it might be reported for 2022 instead?

Also she was concerned about the interest, do you have a way to calculate that? The traditional IRA that she contributed the $6,000 into was an existing account so the interest that was deposited to the IRA will be off if we recharacterize his contribution.

A-1. I have sent you three forms which may be used. You and she should review the special explanation set forth on our Form 56-TREX.

I will discuss the related income topic later. For illustration purposes I am assuming there was $80.00 of earning with respect to the $6,000 contribution. The amount to be moved to the Roth IRA is $6,080.00.

She needs to instruct to do the "internal" recharacterization by completing our Form 54-TR1.

The concept of the law is - by doing a recharacterization before her tax filing deadlines she is treated as having made a Roth IRA contribution in 2021 for tax year 2021. If she has no other Roth IRA her 5-year period commenced on January 1, 2021.

Recharacterizations are form intensive.

IRS Reporting Forms

1. She is to receive a 2021 Forms 5498 by 5/31/2022 indicating she made a $6,000 contribution to her traditional IRA. Box 1 will be completed to show this $6,000 contribution.

   She should attach the special explanation to both her 2021 and 2022 tax returns.
2. She will receive a 2022 Form 1099-R by 1/31/2023 indicating there was a deemed withdrawal of the $6,080. Box 1 is completed with $6,060. Box 2a is completed with 0.00 and box 7 will be completed with a "R".

   She will need to complete her 2022 Form 1040 to show that her deemed IRA distribution from the traditional IRA is not taxable because this distribution was a recharacterized distribution.
3. She will receive a 2022 Form 5498 by 5/31/2023 indicating there was a deemed contribution of the $6,080. Box 4 is completed with $6,080.

Discussion of the related income topic.

In order for a person to use this beneficial tax rule, the income earned by the $6000 must be determined and transferred. A person wants to do this because ultimately the $80.00 will be tax-free when withdrawn from the Roth IRA whereas if it stays in the traditional IRA it will be taxed when withdrawn.

See the attached worksheet to be used to calculate the income. To complete this form one should know the amount of accrued interest in the account on the day the initial contribution was made and when the withdrawal occurs.

Understanding the Making of a Backdoor Roth IRA Contribution

The law expressly provides that individuals with high incomes are ineligible to make an annual Roth IRA contribution. However, the law permits an individual with any income, even a high income, to make a nondeductible traditional IRA contribution. Another law permits a person with a traditional IRA, SEP-IRA or SIMPLE IRA, regardless of income to make a Roth IRA conversion contribution.

So a person with a high income is able to make a nondeductible traditional IRA contribution and then convert that contribution into a Roth IRA. The net effect is the same as making a direct Roth IRA contribution. This is the back-door Roth IRA contribution.

Some people seem to think there is one transaction to make a back-door Roth IRA contribution. There isn't. There are always two transactions - make a nondeductible contribution to a traditional IRA and then convert it to a Roth IRA. Note, the person must not have

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any traditional IRA, SEP-IRA or SIMPLE IRA holding any taxable funds to make a true back-door Roth IRA contribution.

The second transaction (i.e. the conversion) may happen immediately after making the non-deductible contribution or it may occur later. Most individuals will want to do the conversion as soon as possible so that any earnings occur within the Roth IRA and not in the traditional IRA. Earnings within in a traditional IRA are always taxable.

A 2021 non-deductible traditional IRA may be made from January 1, 2021, through April 18, 2022. This non-deductible traditional IRA contribution must comply with the IRA contribution limit (lesser of 100% of compensation or $6000/$7000).

A 2021 conversion contribution must be made between January 1, 2021 through December 31, 2021. A 2022 conversion contribution must be made between January 1, 2021 through December 31, 2022.There is no conversion contribution limit other than the conversion amount cannot exceed the fair market value of the traditional IRA.

The tax consequences of these two transaction are easy to understand and to report on a person's tax return if both transaction occur within the same tax year and for the same tax year.

For example, a person who makes a $6000 non-deductible contribution on August 7, 2021 for 2021 and also converts it on August 7 2021 will prepare their tax return showing - the making of the $6000 nondeductible contribution on the 2021 Form 8606, the conversion withdrawal of $6000 on the 2021 Form 8606 and the 2021 Form 1040 and the fact that no portion of the $6000 is to be included in income because it is basis.

In the above situation the IRA custodian will prepare the IRS reporting forms as follow::

1. The 2021 Form 5498 for the traditional IRA will show in box 1 a contribution of $6000;
2. The 2021 Form 1099-R will show a distribution of the $6000 from the traditional IRA (box 1 and 2a showing $6000, box 7 with a reason code 2 if under 59½ and 7 if age 59½ or older, and
3. The 2021 Form 5498 for the Roth IRA will show in box 3 a conversion contribution of $6000.

The person must complete their tax return (Forms 1040 and 8606) and explain - a conversion was done but the taxable portion is 0.000 because the converted amount of $6000 was 100% basis. That is, there were no earnings.

The tax consequences of these two transactions becomes more complicated when both transactions do not occur within the same tax year and for the same tax year. There are two situations to be illustrated.

Situation #1. A person makes a $6000 non-deductible contribution on August 7, 2021 for 2021 and then waits until April 7, 2022 to convert it. There are $300 of earnings between August 7, 2021 and April 7, 2022. The person must report the making of the $6000 nondeductible contribution on his 2021 tax return. Although not required it is assumed the person converts the entire $6300.The person must report the conversion of $6300 on his 2022 tax return, He will complete the Form 8606 and Form 1040 to show that $300 is included in income but $6000 will be excluded as it is basis. In the above situation the IRA custodian will prepare the IRS reporting forms as follow:

1. The 2021 Form 5498 for the traditional IRA will show in box 1 a contribution of $6000;
2. The 2022 Form 1099-R will show a conversion distribution of the $6300 from the traditional IRA (box 1 and 2a showing $6300, box 7 with a reason code 2 if under 59½ and 7 if age 59½ or older,
3. The 2022 Form 5498 for the Roth IRA will show in box 3 a conversion contribution of $6300.

The person must complete their 2021 Form 8606 to report the making of a nondeductible contribution. The person must also complete their 2022 tax return (Forms 1040 and 8606) and explain - a conversion distribution was done. $6000 is not taxable as it is basis, but the $300 is taxable.

Situation #2. A person makes a $6000 non-deductible contribution on April 7, 2022 for 2021 and then immediately converts it The person must report the making of the $6000 nondeductible contribution on his 2021 tax return. He must complete his 2021 Form 8606. He will report the making of his conversion contribution of $6000 on his 2022 tax return. He must complete his 2022 Form 8606 to report this conversion and his 2022

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Form 1040 so that no portion of the distribution is included in his income. In the above situation the IRA custodian will prepare the IRS reporting forms as follow:

1. The 2021 Form 5498 for the traditional IRA will show in box 1 a contribution of $6000;
2. The 2022 Form 1099-R will show a conversion distribution of the $6300 from the traditional IRA (box 1 and 2a showing $6300, box 7 with a reason code 2 if under 59½ and 7 if age 59½ or older, and
3. The 2022 Form 5498 for the Roth IRA will show in box 3 a conversion contribution of $6300.

The person will prepare their tax return showing - the making of the $6000 nondeductible contribution on the 2021 Form 8606, the conversion withdrawal of $6000 on the 2022 Form 8606 and the 2022 Form 1040 and the fact that no portion of the $6000 is to be included in income because it is 100% basis.

The Interrelation of the Recharacterization Process and Making a Backdoor Roth IRA Contribution

Sometimes a person will make a Roth IRA contribution and then learn they are ineligible to make that Roth IRA contribution directly. The person wants to make a back-door Roth IRA contribution, if eligible. Set forth below is a discussion of such a situation.

Jane Doe made a contribution of $6000 to a Roth I RA on June 10, 2021. She thought she would be eligible to make such a contribution. She went to see her tax preparer in March of 2022 because she wanted to file her 2021 federal income tax return. Her tax preparer informed her that her permissible Roth IRA contribution limit for 2021 was 0.00 because her income was too high. Her tax preparer told her - go to the IRA custodian, do a recharacterization and whatever else needs to be done to make a back-door Roth IRA contribution. The $6000 has realized $15 of earnings.

The tax preparer thinks the back-door Roth IRA contribution can be done for 2021. It cannot be, at least not fully. See Situation #1 as discussed about. The nondeductible contribution is deemed made in 2021. However the conversion does not occur until 2022. Again it is assumed the entire $6015 is converted. Of this amount she will have to include the $15 in her income for 2022. The 10% additional tax does not apply to a conversion distribution.

In the above situation the IRA custodian will make the following IRS reporting:

1. The 2021 Form 5498 for the Roth IRA showing in box 10 a contribution of $6000;
2. The 2022 Form 1099-R showing the recharacterized distribution of $6015 from the Roth IRA (box 1 is $6015, box 2a is 0.00 and the reason code in box 7 is an "R") and
3. The 2022 Form 5498 for the traditional IRA showing in box 4 a recharacterized contribution of $6011.

Note that she may make a back-door Roth IRA contribution for 2022. As discussed above it will be simplest if she makes the non-deductible contribution of $6000 and the conversion in the same year, but that is not required.

Jane Doe has the duty to explain on her tax returns for 2021 and 2022 that she did a recharacterization.

In the above situation the IRA custodian will make the following IRS reporting:

1. The 2021 Form 5498 for the Roth I RA will show in box 10 a contribution of $6000;
2. The 2021 Form 1099-R will show the recharacterized distribution of $6000 from the Roth IRA (box 1 is $6000 and box 2a is 0.00) and
3. The 2021 Form 5498 for the traditional IRA will show in box 4 a recharacterized contribution of $6000.

Email Guidance – Direct Rollover of Designated Roth Funds into Roth IRA

Q-1. I have a question (I hope it will be an easy one) about distributions from a Roth account.

I have an employee who had been making payroll contributions to a Roth 401(k) that we offer in our retirement plan. She has recently retired and has rolled over the Roth balance of her plan to a new Roth IRA here, and wants to start taking distributions from that Roth account. The 5-year rule was met in the 401(k) plan, so do the distributions qualify as tax-free? My contact with our 401 k plan indicated that they would, but I wanted to double check with you to be sure that is correct.

A-1. There are two separate 5-year rules - one applies to the 401(k) plan and one applies to the Roth IRA.

I assume if she would have taken an actual distribution of her Designated Roth account (contributions plus earnings) then the distribution would have been tax-free because she was over age 59½ and she had met the 5-year rule.

An illustration. She contributed $30,000 to her Designated Roth Account and it increased to $50,000 because of earnings. If she had taken an actual distribution of the $50,000 it would be tax-free.

Because she directly rolled over the $50,000 into a Roth IRA the $50,000 is basis within the Roth IRA. When she takes a distribution from her Roth IRA there is the ordering rule - contributions or basis comes out first, conversion basis comes out second and earnings within the Roth IRA come out last. Basis is not taxed.

So, the first $50,000 she withdraws from her Roth IRA will come from the basis and will be tax-free. If she withdraws any of the earnings of the Roth IRA before she has met the new 5-year rule which applies to the Roth IRA, she would have to include the withdrawal of that income in her income. Once she has met the 5-year rule for Roth IRAs, the Roth IRA income too will be tax-free.

Has she discussed with her adviser? I realize she may need the funds to live. In my opinion withdrawing funds from a Roth IRA should be done only as a last resort because all income earned by the Roth IRA one day will be tax-free.

Q-2. The amount rolled in from the Roth 401 is $17,400, so that is now the basis of the new Roth IRA, which she can take out tax-free. (She wants to do $800 monthly, so that would be $16,800 through Dec. 2023.) If she then stops and leaves it sit, is that going to work out? She also added $14,000 for 2021 and 2022 contributions from her earnings. So she could leave the remaining Roth money in there until the 5 years has elapsed.

There is still a considerable amount in Traditional 401(k) that she will be able to use for living expense in additional to the Roth account.

A-2. She must act on the advice of her adviser.

What is the reason why she wants to withdraw funds from the Roth IRA? There is no requirement to do so even if she would be age 72 or older.

In my opinion, a person should withdraw all taxable funds from a traditional IRA before withdrawing anything from a Roth IRA.

The Roth IRA will earn tax-free income while she is alive and for 10 years thereafter for her beneficiary. She will pay tax on the earnings realized by the traditional when ultimately withdrawn. There are few situations under our income tax laws where a person can realize income and have that income not be taxed.

It may your bank and other banks in the next few years will start paying 3-6% on deposits and so the real value of a Roth IRA may be realized.