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Planning for Retirement Benefits: Recent Developments and Current Trends

2015-2

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This Seminar Handout discusses new developments in the area of estate and distribution planning for retirement benefits. "New" means occurring in approximately the last 15 months prior to the date on the first page. Background necessary to understand each development is briefly summarized in some cases. More detail regarding the underlying subject matter can be found in the authorities cited, or in the referenced section of the author's book *Life and Death Planning for Retirement Benefits*. The book is available as a paperback bound book (7th ed., 2011; www.ataxplan.com) or in a web-based electronic edition by subscription at www.retirementbenefitsplanning.com.

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Abbreviations Used in this Seminar Handout

§ Refers to a section of the Code, unless otherwise indicated.

¶ Refers to a section of the author's book *Life and Death Planning for Retirement Benefits* (7th ed., 2011; Ataxplan Publications), which can be purchased (bound version) for $89.95 plus shipping through www.ataxplan.com, through Amazon.com, or by calling 800-247-6553. The book is also available in a web-based electronic edition by subscription at www.retirementbenefitsplanning.com.

ATRA	American Taxpayer Relief Act of 2012.
Code	Internal Revenue Code of 1986, as amended through March 31, 2015.
DQP	Disqualified person. See PART IV of this Seminar Handout.
IRA	Individual retirement account or individual retirement trust under § 408.
IRS	Internal Revenue Service.
PT	Prohibited Transaction. See PART IV.
QRP	Qualified retirement plan under § 401(a).
Reg.	Treasury Regulation.
RMD	Required minimum distribution under § 401(a)(9).

I. IRS BLESSES ROTH CONVERSIONS OF AFTER-TAX MONEY IN SOME PLANS AND IRAS: IRS NOTICE 2014-54; REV. RUL. 2014-9.

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Recent IRS pronouncements have cleared the path for tax-free Roth conversions of after-tax-money in retirement plans for some individuals. To be among the lucky people who can do this, you must meet two requirements: First, you must participate in a qualified retirement plan (such as a 401(k) plan). Second, you must have after-tax money either in that plan or in a traditional IRA. If you have both those characteristics, you can convert the after-tax money to a Roth IRA tax-free with the blessing of the IRS.

Question: Abigail is retiring from Acme Widget. She has $35,000 of after-tax money in the Acme Widget Profit-sharing Plan. Her pretax balance in the plan is $200,000. Now that she is retiring, she will ask the company for a "direct rollover" of her plan balances to two IRAs. She will have the plan transfer the after-tax money directly to a Roth IRA and transfer the pretax money directly to a traditional IRA. Both transfers would be tax-free, and she would wind up with a nice Roth IRA of $35,000. Can she do this?

Answer: Until very recently, the answer to this appeared to be "no," at least as far as the IRS was concerned. In 2009, the IRS had issued a Notice indicating each direct transfer from a qualified plan to an IRA would be treated as a *separate distribution* from such plan, meaning that each transfer would carry out proportionate amounts of pre- and after-tax money. But this year they reversed field. The IRS issued a Notice specifically blessing this type of split transfer. As long as both transfers are

part of the same distribution event, the taxpayer's designation as to how much of the money transferred to each IRA is pre- or after-tax money will be respected.

By all means, therefore, someone in Abigail's position should absolutely do what she is planing to do—send the after-tax money via direct rollover to a Roth IRA, where it will start generating (eventually) tax-free returns. The pretax money can be sent to a traditional IRA via direct rollover if the employee does not want to have any income tax on the transaction and/or does not want to have income taxes withheld from the distribution. Abigail can also decide to convert the pretax money to a Roth IRA either now or later, but since that conversion would not be "free" it's obviously a much more difficult decision.

Question: Jim recently retired from Acme Widget. Like Abigail, he had $35,000 of after-tax money in the plan and $200,000 of pretax. Unlike Abigail, he requested that the company send the entire amount via direct rollover to a traditional IRA, and that transfer has been completed. He has no other IRAs. Now he wishes he had done the "Roth conversion" by having the after-tax money sent to a Roth IRA. Can he now simply transfer the $35,000 of after-tax money from the newly-created traditional IRA to a Roth IRA to achieve the "tax-free Roth conversion?"

Answer: Unfortunately no. Any distribution from a traditional IRA is deemed to come proportionately from the pre- and after-tax money in the participant's aggregated IRA accounts. This is sometimes called the cream-in-the-coffee rule: The pretax money is coffee, the after-tax money is cream, they are commingled in the IRA, and every time you take a "sip" (distribution) you are getting some of each. The ONLY exception to the cream-in-the-coffee rule (i.e., the only time you can separate the cream from the coffee) is when money is being rolled over from the IRA "upstream" into a qualified plan (as Winnie is doing—see the next question). Jim can take advantage of that exception, just like Winnie, IF he has a qualified plan he can roll IRA money into. But if he's totally retired now and does not participate in any qualified plan, he is stuck with his initial rollover decision. There is no way (under the current rules) for him to segregate the after-tax money in his IRA for purposes of a Roth conversion.

As a reminder, even if he somehow kept his after-tax contributions in one IRA separate from all the pretax money in (say) his "rollover" IRA, he would not be able to avoid the cream-in-the-coffee rule effect: For purposes of applying the rule, ALL of an individual's IRAs are aggregated (treated as a single account).

Question: Winnie has a $300,000 traditional IRA, of which $60,000 is after-tax money (her cumulative nondeductible contributions over the years). She has no other IRAs. She is starting a new job at Omega Gazingus Co. where she will be a participant in the 401(k) plan. The 401(k) plan has recently announced that it will accept employee rollovers from IRAs. She's heard this enables her to do a tax-free Roth conversion. Is that correct and how does it work?

Answer: As noted, normally any distribution from her IRA would be considered to come proportionately from the after-tax money (20%) and pretax money (80%) in the account. But there is one exception. The Tax Code allows pretax money, but not after-tax money, to be "rolled" from an IRA to a qualified plan. So the Code had to make an exception to the usual cream-in-the-coffee rule to accommodate this: Rollovers from an IRA to a qualified plan are deemed to come "first" out of the pretax money in the IRA.

That's been so for a while, but until recently it didn't really matter because many qualified plans did not accept rollovers from IRAs at all. There were no IRS pronouncements covering exactly how money could be rolled in that direction, and plan administrators didn't want to go into uncharted territory. That recently changed with the issuance of Rev. Rul. 2014-9, which spells out in detail exactly how an IRA owner can transmit pretax money from the IRA "upstream" to a qualified plan. With a clear roadmap of how to proceed, plan administrators are becoming more willing to accept this type of direct rollover from an IRA.

So Winnie needs to do the following: Have the IRA provider send a check for all or almost all of the pretax money in her IRA to the 401(k) plan, along with a certification from Winnie to the plan administrator that this is a rollover and is coming entirely from pretax money. Once the pretax money is safely transferred to the 401(k) plan, Winnie is left with a "stub" traditional IRA that is all or mostly after-tax money. She then converts this "stub" account to a Roth IRA totally tax-free (or very nearly tax-free if she didn't quite transfer all of the pretax money to the 401(k) plan).

Note: Eventually, Winnie can roll the pretax money back from the 401(k) plan to her traditional IRA, but she must be very careful NOT to do this before the end of the calendar year in which she did the Roth conversion: Doing so would reactivate the cream-in-the-coffee problem, because the taxable proportion of IRA conversions is partly based on the amounts in the IRA as of the *end* of the year, not at the time of the conversion itself.

Where to read more: See IRS Notice 2014-54, 2014-41 IRB (9/18/14) regarding "rules for allocating pretax and after-tax amounts among disbursements that are made to multiple destinations from a qualified plan." See Rev. Rul. 2014-9, 2014-17 IRB 975 (4/3/14) regarding the procedures for a direct rollover from a traditional IRA to a qualified plan. For a more complete writeup see ¶ 2.2.04 and ¶ 2.2.05 of *Life and Death Planning for Retirement Benefits*, as updated. The updated version is incorporated into the web-based edition of the book available by subscription at www.retirementbenefitsplanning.com. The update is also posted as a pdf at www.ataxplan.com.

II. IRS SEEKS INFORMATION REGARDING HARD-TO-VALUE ASSETS IN THE IRA, VIA NEW BOXES AND CODES FOR FORMS 5498 AND 1099-R

The IRS has added a new reporting requirement for IRAs: Beginning with 2014 reports (that will be filed in the first half of 2015), IRA providers may identify IRAs and IRA distributions that contain *assets without a "readily available" fair market value*. Presumably this indicates that the IRS is going to begin scrutinizing the valuations of IRA holdings and distributions. Regardless of past practices, IRA providers may need to start requiring annual appraisals of such assets, even though, until now, the IRS had seemed surprisingly uninterested in this subject.

Each year, IRA providers file with the IRS two annual returns pertaining to the prior year: Form 5498 (reporting the account's value as of the preceding year-end) and (if there has been a distribution from the account) Form 1099-R reporting the distributions made during the preceding year. In the 2014 edition of these forms (used to report 2014 distributions and year-end values), the IRS has added some new boxes and codes, pertaining to hard-to-value assets (or, as the IRS calls them, assets without a readily available FMV). The reporting regarding such assets will be optional

for the 2014 reports (to be filed in early 2015), but is expected to become mandatory at some future point. These reports will be used to help the IRS select which IRAs to audit.

Form 5498

Form 5498 must be filed by approximately June 1 each year for every IRA and Roth IRA. It tells the IRS: That this IRA provider (name, address, tax i.d. number) held an IRA for this taxpayer (ditto) in the prior year; the fair market value of the account as of the prior year-end; what contributions were received in the account in the prior year; and whether a distribution is required for the current year (i.e., whether the IRA owner is over age 70½).

Beginning in 2015 (reporting for 2014), the IRA provider may also report, separately, in new box 15a, the fair market value of "certain specified assets," namely, assets "that are not readily tradable on an established US or foreign securities market or option exchange, or that do not have a readily available FMV." In Box 15b, the IRA codes will indicate exactly which type(s) of non-tradable assets are held in this account. The instructions state: "Enter the code for the type(s) of investments held in the IRA for which the FMV is reported in Box 15a. A maximum of two codes can be entered in box 15b. If more than two codes apply, enter code H." Note: Use of these boxes and codes is optional for the 2014 year-reports (filed in early 2015).

The choices are:
A — Stock or other ownership interest in a corporation that is not readily tradable on an established securities market.
B — Short or long-term debt obligation that is not traded on an established securities market.
C — Ownership interest in a limited liability company or similar entity (unless the interest is traded on an established securities market).
D — Real estate.
E — Ownership interest in a partnership, trust, or similar entity (unless the interest is traded on an established securities market).
F — Option contract or similar product that is not offered for trade on an established option exchange.
G — Other asset that does not have a readily available FMV.
H — More than two types of assets (listed in A through G) are held in this IRA.

It has always been the case that Form 5498 required the IRA provider to report the "fair market value" of the IRA as of the preceding year-end. However, except for a rule dealing with certain deferred annuities, the IRS has never provided any specific valuation rules for IRAs. And, though I'm not aware of any published statistics, I have not heard previously of any IRS general effort to police IRA valuations. This history may have encouraged IRA owners and providers to be less than diligent in updating the account valuations of non-publically traded assets. See, for example, the *Gist* case discussed in PART V of this outline, where apparently valuations were ignored for a number of years.

Presumably now, whatever may have been the case in the past, IRA owners and providers must take the annual valuation requirement very seriously. What kind of evidence the IRS will require with respect to valuation is not yet known.

In a way, the IRS "doesn't care" what the IRA value is (i.e., it makes no difference for tax determination purposes) except in three situations:

- ✓ Whenever there is a noncash distribution, the distributed assets must be correctly valued so the distributee pays income tax on the right amount. The same is true for any "deemed" distribution such as occurs with a Roth conversion or prohibited transaction.

- ✓ If the account holder is subject to taking required minimum distributions (RMDs), for example in the case of an inherited IRA, or if the traditional IRA owner is over 70½, the total account value must be determined correctly in order to compute the required distribution.

- ✓ If the owner of the account dies, the account must be correctly valued for estate tax purposes. At least in this arena, however, the IRS does have extensive regulations and instructions pertaining to how to determine FMV.

For a living account owner who is under age 70½ and who does not take a distribution or convert his account to a Roth, the annual valuation exercise has no immediate tax implications—but it still must be done.

Form 1099-R

Unlike Form 5498, which must be filed every year, Form 1099-R is filed only for years in which a distribution or deemed distribution occurs from the IRA. And if a 2014 distribution is made in cash, or is made in assets that have a readily available market value (such as stocks listed on the NYSE), then preparation of the 1099-R for 2014 and future years will be no different from the prior years' form. The new rules kick in only if the distribution was an in-kind distribution of hard-to-value assets.

On Form 1099-R, the IRA provider fills in various boxes such as Box 1 (total distribution) and Box 2a (taxable amount). Box 7 of Form 1099-R is for "distribution codes" the IRA provider must use to provide the IRS with information about the distribution, such as to indicate that the distribution is on account of death or disability, or represents "current life insurance protection."

For 2014, a new distribution code is being added to be used in Box 7 when appropriate: Code K, for "Distribution of IRA assets not having a readily available" fair market value (FMV). The instructions for the new code state "Use Code K to report distributions of IRA assets not having a readily available FMV. These assets may include: stocks, short or long-term obligations, ownership interests in limited liability companies (LLCs), partnerships, trusts, or similar entities, not readily tradable on an established US or foreign securities market, real estate, or option contracts or similar products not offered for trade on an established US or foreign option exchange."

The instructions state that use of Code K is optional for 2014 1099-Rs. See 2014 Instructions for Forms 1099-R and 5498, p. 1.

What the IRS will now be able to police

With the new information it will be gathering, the IRS presumably will zero in on those Forms 5498 which reveal that (1) a minimum distribution was required and (2) the account holds hard-to-value assets. The participant may have taken his required distribution, and taken it in cash,

but if the account holds hard-to-value assets, the IRS may want to investigate the valuation of the hard-to-value assets. If the hard-to-value assets were undervalued when the RMD was computed, the participant probably did not take a large enough distribution and owes a 50 percent penalty.

Kevin Example: Kevin's IRA holds $200,000 of cash and an interest in a non-publically-traded partnership that cost Kevin $300,000 back when he bought it (inside the IRA) in 2008. In 2014, Kevin turns age 73, so his minimum distribution is 1/24.7th of the account value. On the IRA provider's books the partnership has always been carried at cost, so the "book value" of the IRA is $500,000 [$200,000 + $300,000]. 1/24.7th of $500,000 is $18,248, and that is what Kevin proposes to withdraw from his IRA (in cash) in 2014. Concerned about the apparently increased IRS interest in IRA valuations, the IRA provider requires Kevin to obtain an appraisal of the IRA's interest in the partnership. The appraiser concludes that the partnership was worth $450,000 as of 12/31/2013. That increases Kevin's RMD for 2014 to $26,316 ([$200,000 cash + $450,000 partnership interest]=$650,000, divided by 24.7 = $26,316). This is $8,068 more than Kevin had been planning to withdraw. If Kevin had relied solely on the "book value" of the IRAs assets, he would have risked a 50 percent penalty ($4,034) for not taking the full required distribution.

Technically, the reporting requirements have not changed—the IRA provider is now and always has been required to report the "fair market value" of the account on Form 5498 and the fair market value of any property distributed. In fact firms that have been updating valuations annually, using appraisals as appropriate, will not need to change their ways. But IRA owners and providers who have based valuations on rough estimates or historical cost, rather than valid regularly updated appraisals, should consider changing their procedures. The IRS may come calling!

One More Reason to File Form 5329!

Form 5329 is the form taxpayers must use to report any IRA-related penalties they may owe, such as the 10% penalty for premature distributions (under age 59½), excess contributions (6%), and the 50 percent penalty for failure to take an RMD. I recommend that every IRA owner and beneficiary file Form 5329 *every year* with his or her tax return (Form 1040)...even if you *don't* owe any penalty (or think you don't). There is no statute of limitations protection against IRS assertion of these penalties if no return was filed, and Form 5329 is the applicable return. *Paschall, Robert, et ux.*, 137 TC 8 (2011). If the IRA contains assets without a "readily available FMV" that is one more reason to want statute of limitations protection—to shield against later IRS claims that the assets were undervalued for RMD purposes.

The IRS also may use a Form 5498 showing hard-to-value assets to decide which IRAs to audit for the existence of *prohibited transactions*, especially in view of its recent court wins disqualifying (on prohibited transactions grounds) IRAs that owned operating businesses. See PART III below. Filing Form 5329 does *not* protect the IRA owner against attack on prohibited transaction grounds.

III. FINAL QLAC REGS: PREPARE FOR LONGEVITY ANNUITY GOLD RUSH?

Many retirees worry about running out of money in their later years. One solution is to hoard money (spend less) today because you might live beyond the average life expectancy. The problem with that solution is that it causes everyone to live below his possible standard of living even though not everyone will live long enough to have the problem.

The insurance industry's solution: For a lump sum payment that is relatively small while you are only in your 50s or 60s, buy an annuity now that doesn't start paying out until you reach your mid 80s. Such a "longevity annuity" enables you to spend more during your "young old years" without worrying that you will run out of money if you live too long. But that type of annuity could not, until now, be purchased inside a traditional IRA (or other defined contribution/individual account plan, such as a 401(k) plan) because of the rule that payments under a plan-owned annuity contract must begin by the required beginning date (RBD) (generally approximately age 70½).

The IRS has ridden to the rescue. Under proposed regulations issued in 2012, as modified and finalized effective July 2, 2014, up to 25 percent of the participant's account balance (but not more than $125,000) can be invested in a "qualified longevity annuity contract" (QLAC) without violating the minimum distribution rules. See Regs. § 1.401(a)(9)-5, A-3, § 1.401(a)(9)-6, A-17.

Definition of a QLAC

Reg. § 1.401(a)(9)-6, A-17, defines the qualified longevity annuity contract. A QLAC:

- Must begin its payments no later than the first day of the month next following the 85th anniversary of the participant's birth. A-17(a)(2).

- Must satisfy all requirements applicable to annuitized defined contribution plans *other than* the requirement that payments must start by the RBD. A-17(a)(3). For detail on these other requirements, see Reg. § 1.401(a)(9)-6 and the author's *Special Report: When Insurance Products Meet Retirement Plans* (www.ataxplan.com). The principle other requirements are (1) the rule that the contract must provide level payments paid annually (or more frequently) that do not increase (except within certain permitted limits, such as a COLA), (2) limitations on the survivorship benefit allowed, and (3) rules for how to compute the RMD with respect to the nonannuitized portion of the plan when only part of the account is "annuitized."

- May not provide a commutation benefit, cash surrender right, or other similar feature. A-17(a)(4).

- Must state that the contract is intended to be a QLAC. A-17(a)(6).

- Must not be a variable, equity-indexed, or "similar" contract except as may be later permitted by Treasury guidance. A-17(a)(7).

- Must limit death benefits as described below. A-17(c).

Dollar and percentage limits on QLAC purchases

The amount paid for QLACs may not exceed the lesser of $125,000 or 25 percent of the account balance. A participant can buy multiple QLACs in his/her traditional IRA(s) provided the cumulative total premiums paid for them does not exceed these limits. Note the following details about these purchase limits. Citations are to subsections of Reg. § 1.401(a)(9)-6, A-17, unless otherwise noted.

✓ The $125,000 amount will be adjusted upwards for inflation starting in 2015. A-17(d)(2)(I).

✓ Premiums paid for QLACs (or contracts intended to be QLACs) purchased in any other defined contribution plan for the participant's benefit are counted in applying the dollar limit. For example, if the participant spends $125,000 on a QLAC in her 403(b) plan account at work, she has used up her dollar limit and cannot buy any additional QLAC in the IRA. A-17(b)(2)(ii)(B).

✓ The 25 percent limitation is applied to the total account balance (including the value of any QLAC). Unlike the dollar limit, the percentage limit is apparently applied without regard to the account balance in other types of plans. A-17(b)(3). The Preamble to the regulation states that all traditional IRAs will be considered a single account for applying this limit, just as required minimum distributions taken from one traditional IRA can satisfy the distribution requirement with respect to other traditional noninherited IRAs owned by the same individual. See T.D. 9673 (7/2/14), Section II ("IRAs"), second paragraph. However, I cannot find this statement in the regulation itself.

Roth IRAs

The limitations on purchases of longevity annuities do not apply to Roth IRAs during the owner's life. That's because there is no lifetime minimum distribution requirement applicable to a Roth IRA, therefore, buying an annuity that does not start payments until much later than age 70½ is "not a problem" for a Roth IRA. See § 408A(c)(5); Reg. § 1.408A-6, A-14(d).

Longevity annuities held in a Roth IRA are not considered QLACs and do not count when applying the 25 percent/$125,000 limit on QLAC purchases in the participant's traditional IRA. A-17(d)(3)(ii). This regulation also provides rules for applying the limits after a QLAC owned by a traditional IRA is converted to a Roth.

Rules regarding death benefits under a QLAC

Since a QLAC is supposed to be insurance against living "too long," it makes no sense for the QLAC to provide a death benefit. The cost of providing a death benefit must necessarily reduce the true "longevity insurance" the contract can provide. But human nature being what it is, people only want to buy this product if it is heads I win tails you lose, so the regulation permits certain limited death benefits that can be provided in a QLAC. In general, the permitted death benefits must *either* be in the form of one of the following types of survivor annuity, *or*, alternatively, the contract

can provide a "return of premium" guarantee-type death benefit *in lieu of* any survivor annuity. (The contract could also provide no death benefit at all.) A-17(c)(4).

✓ If the participant's surviving spouse is the sole beneficiary, the contract can provide a life annuity to the surviving spouse provided the annuity payments do not exceed the annuity payments the participant would have received. A-17(c)(1).

✓ If the participant died before the annuity starting date of his own annuity, a greater survivorship annuity to the spouse-sole beneficiary is permitted if necessary to satisfy the qualified pre-retirement survivor annuity (QPSA) requirements of § 417 [this would not apply to IRAs, which are not subject to this requirement], and the survivor annuity must commence no later than the annuity to the participant would have commenced had he lived. A-17(c)(1)(ii).

✓ If the participant's surviving spouse is not the sole beneficiary, the contract can provide a life annuity to the surviving beneficiary. If the beneficiary is the same age as, or older than, or not more than two years younger than, the participant, the maximum annuity is the same annuity the participant would have received. If the beneficiary is more than two years younger than the participant, the amount of the maximum survivor annuity is reduced per a table in the regulation. A-17(c)(2

Using QLAC to defer RMD income

Some advisors are seeing a potential side benefit to purchasing a QLAC with the IRA: reduce (or rather, defer) RMDs. When an "annuitized" annuity contract is purchased inside an IRA, the IRS treats the contract and the "rest of the account" as *two separate retirement plans* for minimum distribution purposes. RMDs for the non-annuitized portion of the IRA are computed in the regular way, except that the annuity contract is not considered part of the "account balance" for this purposes. Meanwhile, all distributions received under the annuity contract are considered required minimum distributions with respect to the annuitized portion of the account. See Reg. § 1.401(a)(9)-5, A-1(e), § 1.401(a)(9)-8, A-2(a)(3); Reg. § 1.401(a)(9)-5, A-1(e), third sentence; § 402(c)(4)(B), § 403(b)(8)(A)(i), § 408(d)(3)(E).

By buying a QLAC in the IRA, the IRA owner "removes" up to $125,000 from his account balance, so his required minimum distributions from the nonannuitized portion of the account will be smaller than they otherwise would be. This feature may make a QLAC attractive to, say, an individual who is approaching age 70½ and still working, who wants to minimize RMDs for the near future. Of course once he reaches age 85 and payments start coming out of the QLAC his RMDs will effectively be larger than they otherwise might have been, but the client may figure he/she won't still be working then and the extra income will be easier to handle.

IV. IRS OPENS NEW ATTACK FRONT ON IRA PROHIBITED TRANSACTIONS
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Committing a "prohibited transaction" (PT) with your IRA causes instant disqualification of the account retroactive to the beginning of the taxable year. If you're not familiar with this subject, read IRC § 4975 and § 408(e)(2) and the Natalie Choate Special Report *Buyer Beware! Self-*

Directed IRAs and Prohibited Transactions 2014: What the T&E Practitioner Needs to Know, downloadable at www.ataxplan.com $39.95 (76 pages).

Once upon a time it seemed like the IRS was afraid to attack IRAs on prohibited transaction (PT) grounds. Having lost the *Swanson* case (106 T.C. 76 (1996) (including having to pay the other side's attorneys' fees!), and having the Department of Labor "overrule" them on who had jurisdiction of IRA PTs (see DOL Advisory Opinion 93-33A), the IRS tended to attack transactions it didn't like with everything under the sun except PTs: They'd use gift taxes, listed transactions, the kitchen sink, anything but PTs.

Times have changed. **In 2013, the IRS won two significant IRA PT cases**, successfully disqualifying the IRAs of Messrs. Peek, Fleck, and Ellis. These cases are significant in their own right (because they tell us how the IRA-PT disqualification penalty works, and about the payment of compensation by an IRA-owned business). They are also significant because they are the first recorded cases of the IRS successfully disqualifying IRAs on PT grounds. These cases show new IRS initiative crowned with success.

A. *Peek v. Comm'r*, 140 T.C. No. 12 (5/9/13): Tax Court Applies the Disqualification Penalty

This article was first published in electronic form by *Trusts & Estates* magazine in May 2013.

The recent case of *Lawrence F. Peek, et ux., et al., v. Commissioner*, gives us insights into how the IRS and the Tax Court view, and attack, prohibited transactions (PTs) involving an individual retirement account.

Overview: Mr. Peek and Mr. Fleck used their IRAs to buy and grow a business, Abbott Fire & Safety (AFS). The IRS contended that, in the course of acquiring and operating this business, they committed "prohibited transactions" that caused their IRAs to be disqualified. The Tax Court agreed with that assertion and concluded that the partners should therefore be taxed personally on the gain realized when the business was sold by the disqualified IRAs.

This article will look at the paths the IRS and the Court took to reach these conclusions, and what alternative paths they or the taxpayers might have taken.

Facts: Mr. Peek and Mr. Fleck were business acquaintances. However, they were not personally related to each other by blood or marriage, nor is it mentioned that they had any ongoing business relationship other than their co-ownership of AFS through their IRAs.

The two men created IRAs. These IRAs were apparently properly created and funded (with rollovers or transfers from other retirement plans), so at the "starting gate" each man had a "legitimate" IRA containing cash. The IRAs together formed FP Company, each IRA contributing $309,000 cash in exchange for 50 percent of FP's stock. Again, so far so good—no PT yet.

In September 2001, FP acquired from Sellers the assets of an operating business, AFS. The $1.1 million purchase price was paid with $850,000 of cash (which came from a $450,000 loan to FP Company from a credit union, plus $400,000 of the cash then held in FP Company), a $50,000 promissory note from FP Company to the broker, and a $200,000 note from FP Company to the Sellers. The $200,000 note (representing a little less than 20 percent of the total purchase price) was

secured by personal guarantees from Messrs. Fleck and Peek. Those guarantees were in turn secured by mortgages on their personal residences. This $200,000 loan, and its personal guarantees, "remained in effect until the sale...of FP Company in 2006."

In 2003 and 2004, Fleck and Peek converted their IRAs to Roth IRAs. In 2006, the Roth IRAs sold FP Company for over $3.3 million.

Holding: The Tax Court held that the loan guarantees were prohibited transactions under § 4875(c)(1)(B) (extension of credit between the plan and a disqualified person), and therefore the IRAs were disqualified, and therefore Peek and Fleck were taxable personally on the gain realized when their Roth IRAs sold FP Company. The Court ruled that, in view of this holding, it did not need to consider other PT arguments made by the IRS regarding the payment of compensation to Fleck and Peek by FP Company and payment of rental income to Mrs. Fleck by FP Company, or the IRS's claim of a § 4973 excise tax for excess IRA contributions.

IRAs and PTs and how they figure into this case. Although it is clear under the law that the prohibited transaction rules apply to IRAs[1], it's not always clear exactly HOW the rules apply to IRAs. The statute (§ 4975) is short and appears comprehensive, but it actually contains numerous gaps and ambiguities. There are several building blocks that must be lined up to create a PT...and once you successfully "build" the PT, it's not clear what the punishment is!

How IRA owners are subject to the PT rules

Here's an example of a statutory gap. § 408(e)(2)(A) provides that "If... the individual for whose benefit any individual retirement account is established...or his beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such account ceases to be an individual retirement account..." One of the transactions prohibited by § 4975 is the (direct or indirect) "lending of money *or other extension of credit* between a plan and a disqualified person."[2] A "disqualified person" (DQP) includes a "fiduciary" of the plan. A fiduciary includes, among other categories, someone who "exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets."[3]

Note that the IRA owner *qua* owner is not listed as a DQP. Yet it is the IRA owner (or beneficiary) who is punished by IRA disqualification for engaging in a transaction otherwise prohibited by § 4975. This dichotomy between punishment and transgression can be bridged by concluding that the IRA owner is punished only if, *in his capacity as fiduciary*, he violates § 4975. Others would conclude that the gap cannot be bridged and this represents simply a mistake in the

[1] § 408(e)(2)(A) says that IRA owners must not engage "in any transaction prohibited by section 4975." § 4975 prohibits transactions between a "disqualified person" and a "plan," and "plan" is defined to include an IRA. § 4975(e)(1)(B).

[2] § 4975(c)(1)(B).

[3] § 4975(e)(3)(A).

statute. But this particular glitch didn't matter in the *Peek* case because Peek was clearly both the owner (individual for whose benefit the IRA was established) and fiduciary of his IRA, as Fleck was as to his. So § 408(e)(2) tells us that if the owner (*as fiduciary*) commits a PT with his IRA, the punishment is disqualification.

Let's follow the process of establishing that a PT occurred here, and (if it did) exactly how the IRA owner is punished.

Establishing the elements of a PT for Peek and Fleck

The prohibited transaction winningly asserted by the IRS in this case was the "**extension of credit** between a **plan** and a **disqualified person**."

Was there an extension of credit? It is well established that a *loan guarantee* is an "extension of credit" within the meaning of §4975(c)(1)(B).

In *Arthur S. Janpol*[4], an auto dealership had a profit-sharing plan. The plan engaged in the business of financing auto sales for the dealership in the 1970s and 1980s. Messrs. Janpol and Berlin were the sole stockholders, as well as directors and officers, of the dealership, and were participants in the plan (the sole participants, after 1987). To finance its lending operation, the plan borrowed substantial amounts from Messrs. Janpol and Berlin. When the dealership was sold in 1986, the plan stayed in existence and started financing auto sales for other dealerships. For that purpose it borrowed $5 million (later increased to $10 million) from a bank, with the loan personally guaranteed at various points by Messrs. Janpol and Berlin.

The *Janpol* case stands mainly for the principle that the prohibition in § 4975 of loans "between" a plan and a party in interest includes loans from the party in interest[5] to the plan, not just loans from the plan to the party in interest.

Because *Janpol* involved loan guarantees as well as loans, it also stands for the rule that "an individual who guarantees repayment of a loan extended by a third party to a debtor is, although indirectly, extending credit to the debtor." The opinion points out that the term "extension of credit" is intended to broaden the statute to cover not just direct transactions such as a loan but indirect transactions such as establishing a line of credit (even if it is never drawn upon) or guaranteeing a loan (even if the guarantee is never activated). "The guarantee is, in effect, also a contract to make a loan to the" plan.

The Peek-Fleck situation is similar to *Janpol*, in that the IRA owners indirectly lent to their IRA-owned business by personally guaranteeing its loans, though (unlike in *Janpol*) Peek and Fleck did not also make direct loans to their retirement plans.

The legislative history of ERISA (which added § 4975 to the Code in 1974) confirms that "The conference substitute also generally prohibits the direct or indirect lending of money or other extension of credit between a plan and parties-in-interest. *For example a prohibited transaction*

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[4] 101 TC 518 (1993).

[5] When dealing with a qualified plan, the prohibitions apply to a "party-in-interest," which is equivalent to the "disqualified person" prohibitions with respect to IRAs.

generally will occur if a loan to a plan is guaranteed by a party-in-interest…," unless it falls within certain statutory exceptions for ESOPs.[6]

The personal loan guarantees given by Peek and Fleck, secured by mortgages on their homes, would accordingly be considered an "extension of credit," especially since (the opinion implies) FP Company could not have completed the purchase of AFS without these guarantees.

Although the leading case, *Janpol*, involved actual loans to an operating business as well as personal guarantees of the plan-owned business's loans, the Department of Labor (DOL) extends the PT label willy-nilly to virtually any piece of paper that contains the word "guarantee," regardless of whether there is any actual loan being guaranteed or any actual credit extended. For example, the DOL ruled[7] in, that a participant who signed a standard brokerage firm form granting the IRA provider a security interest in the participant's nonIRA account at the same firm, to secure any liabilities to the firm that his proposed new IRA account at the firm might incur, was committing a PT, even if the IRA never had any such liabilities. Similarly, in Advisory Opinion 2011-09A[8], the DOL opined that an IRA owner who signed an agreement whereby a brokerage firm was given a security interest in the IRA assets to secure the participant's potential future liabilities under a (taxable) futures trading account that the participant proposed to open at the same firm, would be engaging in a PT, and that this PT was not covered by a "class exemption" previously granted to extensions of credit in connection with routine plan operating costs.[9] This position of the DOL may be going too far; see *Daley, Jr. v. Mostoller* discussed elsewhere in this outline.

Was the extension of credit made *to the plan?* The Code prohibits an extension of credit "between" the IRA owner/fiduciary and the IRA itself. Mr. Peek's loan guarantee did not run from Mr. Peek to his IRA; it ran to FP Company, which was only 50 percent owned by Mr. Peek's IRA. Ditto for Mr. Fleck's guarantee.

The Court did not discuss the implication of the partial ownership by each IRA; rather it concluded, simply, that an extension of credit to an entity owned by the IRA is an "indirect" loan to the IRA itself, and the statute prohibits both direct and indirect extensions of credit.

This hasty conclusion skips over a whole body of law known as the plan assets rule. Not every transaction between an IRA fiduciary and an entity *partially* owned by that IRA is a PT. For example, if Mr. Peek's IRA had owned 10 shares of General Electric stock, and then Mr. Peek personally bought some GE bonds (thereby extending credit to an entity partially owned by his IRA), that would not be a prohibited transaction.

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[6] House Conference Report 93-1280, H.R. Conf. Rep. 93-1280 (1974); 1974-3 C.B. 415, 469.

[7] A.O. 2009-03A (10/27/09), http://www.dol.gov/ebsa/regs/aos/ao2009-03a.html

[8] (10/20/11), http://www.dol.gov/ebsa/regs/aos/ao2011-09a.html.

[9] The IRS has ruled a bit more leniently that it would not treat such a "boilerplate" cross-collateralization agreement as a PT unless and until the provision was actually enforced against one account or the other. IRS Announcement 2011-81, 2011-52 IRB 1052 (12/12/11).

Only if retirement plans own *a significant equity interest* in a non-publically-traded investment entity do the regulations generally "look through" the entity and treat the entity's assets as plan assets subject to the PT and ERISA fiduciary rules.[10] However, since a company is deemed to have "significant" retirement plan ownership if the entity is owned 25 percent or more by retirement plans, this line of argument does not help Peek and Fleck, since each IRA's 50 percent ownership would be considered "significant."

Who was the DQP? As discussed above, Peek and Fleck, as fiduciaries, were clearly DQPs as to their respective IRAs.

Ok it's a PT. Now what?

The Code is absolutely clear: If the IRA owner uses his IRA (or part of it) as *security for a loan*, the IRA (or the part used as security for a loan) is deemed distributed to him.[11]

In the case of *any other type of prohibited transaction* involving the IRA owner "or his beneficiary," the IRA loses its income tax exemption entirely (even if only part of the IRA was involved in the prohibited transaction). The entire account is deemed distributed as of the first day of the taxable year in which the PT occurred.[12] Accordingly, the IRA owner must include in his income for that year the total value of the IRA as of January 1 of such year as well as all income (e.g., interest and dividends) the IRA earned for the rest of that year.

This sounds draconian, especially considering that the entire account is apparently "disqualified" even if the PT involved only a small portion of the IRA's assets.[13]

But in fact the results and effects of this statutory disqualification are unclear, and it's not surprising that the court sort of just made up its own remedy to punish Peek and Fleck. When you try to apply the PT "remedy" (disqualification) to a situation like this you end up in a morass of contradictions and dead ends.

For example, if the Peek and Fleck IRAs were deemed distributed to them as of January 1, 2001, as dictated by IRS regulations, then that would be a nonevent, because the IRAs didn't even exist then (the IRAs were created in August 2001), so they had no value at all and the result would be taxable income of zero dollars in 2001 for this deemed distribution of nothing.

Suppose the regulation were to be interpreted to mean that Peek's and Fleck's IRAs were deemed distributed when they were created or when the loan guarantees were first put into place in August-September 2001. Such a deemed distribution would have resulted in taxable income to them

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[10] 29 CFR § 2510.3-101.

[11] § 408(e)(4).

[12] § 408(e)(2); Treas. Reg. § 1.408-4(d)(1).

[13] Notwithstanding the clear wording of the statute to the effect that the entire account is deemed distributed, at least one case ruled that only the amount actually involved in the PT was deemed distributed, not the entire IRA, which makes more sense. See *Gerald M. Harris*, TC Memo 1994-22.

of several hundred thousand dollars each. But the IRS notices of deficiency were issued in 2010, too late to attack a 2001 deemed distribution, assuming Peek and Fleck timely filed tax returns for 2001. So they "got away with" the deemed distribution in 2001. They cannot be punished, in 2010, for a PT that occurred in 2001, assuming they timely filed their 2001 income tax returns, even if the PT was not reported on those returns!

Does the hypothetical deemed income they should have reported in 2001 give them a "basis" in the IRAs, equal to the taxable income that they should have (but did not) report in the year the accounts were disqualified? Presumably not; Peek and Fleck did not assert any basis.

The IRS's position, stated in its notice of deficiencies, was that the FP Company stock was deemed to be owned personally by Peek and Fleck from 2001 on, because it was deemed distributed as a result of the PT in 2001. Therefore they should personally be taxed on the gain from the sale in 2006. The court agreed with that analysis.

But, but, but: Assuming the traditional IRAs "ceased to exist" in 2001, and Peek and Fleck actually owned the FP stock personally even though they didn't realize it.....what are we to make of the Roth conversions in 2006? Those constituted NEW contributions to NEW IRAs, namely, each partner's Roth IRA. Since those were not valid "rollovers," they should have been treated as "regular" contributions to the Roth IRAs, attracting the six percent excise tax for excess IRA contributions.[14] But the court dismissed whatever claims the IRS may have asserted in this case regarding the excess contributions penalty, apparently treating that as an alternative remedy, which became moot once the court chose the "personal sale" remedy.

The court emphasized that the loan guarantees were not "one and done" transactions....they remained in effect all the way from 2001 until the sale in 2006. Therefore the original IRAs *and the Roth IRAs* were both disqualified due to PTs.

But what difference does it make whether the loans were "ongoing" or not? Suppose the loan guarantees had been mere temporary bridge financing, and had been released in 2001? Would that somehow cause the IRAs to be "resurrected" for 2002 and later years, and therefore cause the later Roth conversions to be valid? It is not clear what conclusions the court draws from the "ongoing" nature of the loan guarantees. Perhaps that is why the court treated the Roth conversions, not as excess contributions, but as entirely nugatory transactions.

Presumably their payment of income taxes on the "Roth conversions" they thought they carried out in 2006 should have given Peek and Fleck some basis in the "Roth IRAs" they thought they had, going forward? Peek and Fleck did not assert they had any basis, according to the Court. This creates the possibility of paying income tax twice on the same money, once upon the "Roth conversion" and again when the FP stock was sold by the "Roth IRAs."

The IRS's other theories

The IRS apparently started its case against Peek and Fleck with the theory that the payment to them of compensation by the IRA-owned business (FP Company) constituted a prohibited transaction, as did (at least as to Mr. Fleck) the payment of rental income from FP Company to Mrs. Fleck. This was a great unanswered question in the area of IRA-owned businesses. Generally,

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[14] See § 4973(a), (f), as applied in the case of *Robert K. and Joan L. Paschall v. Commissioner, Docket # 10478-08, 25825-08* (7/5/11).

payment of reasonable compensation for services to the plan is an exception to the PT rules. But that exception is not available for certain types of plans...and it's not clear whether the PT exception is available for IRAs. The court wisely decided it didn't need to get into this discussion.

The IRS also apparently sought, in the alternative, to impose an excess contributions penalty on Peek and Fleck, presumably for making their "invalid" rollover to the Roth IRAs. This would have had to be an alternative argument. The IRS can't have it both ways. If the IRA is invalid, there cannot be a penalty for making an excess contribution to it, since the penalty applies only to contributions to IRAs and an IRA that has been disqualified is not an IRA. So you can face disqualification because of a PT, or you can face an excess contributions penalty, but not both, apparently.

Lesson for clients and practitioners

Operating a business inside an IRA is not illegal, but it is risky. Ordinary business transactions can easily become IRA-disqualifying PTs. The lack of clarity in the PT law as it applies to IRAs can sometimes be helpful in defending an accused client, though it didn't help Peek and Fleck.

You can't expect logic and consistency when the basic law is nonsense. Peek and Fleck gave secured personal guarantees for a $200,000 loan to their IRA-owned company extending over five years. But they apparently would have suffered the exact same punishment if they had lent $20 for an hour to pay for a filing fee at the loan closing!

If the client insists on using retirement assets to start a business, the route of investing through the startup company's own ESOP is considerably safer, because there are clearer exemptions from the PT rules for qualified plans than for IRAs. The IRS calls that approach "rollovers as business startups" and the IRS doesn't really like it much, but so far they haven't figured out exactly what's wrong with it.[15]

B. *Ellis v. Comm'r*, T.C. Memo 2013-245 (10/29/13): IRA-owned Business Cannot Compensate the IRA Owner

Some have proposed operating a business inside your IRA, where the profits can build up tax-free or tax-deferred (according to the promoter). One problem with this idea is that the IRA owner's working for, and receiving a salary from, a business owned by his IRA would (unless there is an exemption) constitute a prohibited transaction under § 4975(c)(1)(D) (transfer of income or assets of plan to a DQP).

There is an exemption that some think overcomes this problem: § 4975(d)(10) exempts "receipt by a disqualified person of any reasonable compensation for services rendered...in the

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[15] See Choate, Natalie B., *"ROBS?....or J-O-B-S? IRS Directive Addresses 'Rollovers as Business Startups,'"* Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter - Archive Message #471 (12/3/2008).

performance of his duties with the plan....” Does the statutory exemption of § 4975(d)(10) allow the IRA owner to work for, and receive reasonable compensation for such services from, the IRA-owned business? Probably not, for two reasons. One reason is, other sections of the statute could be interpreted to mean this exemption does not apply to IRAs.

The other reason: Even if this exemption applies to IRAs, it appears that the wording was intended to exempt compensation for *plan-related* services (such as investment advice or performance of plan-related administrative work). The exemption does not sound as though it is intended to apply to regular “work” for a business owned by the plan.

This interpretation was confirmed in the case of *Ellis v. Comm’r*, T.C. Memo 2013-245, docket No. 12960-1 (10/29/13). Mr. Ellis’s IRA owned shares of an LLC that operated a used car dealership. In 2005 and 2006, the LLC paid Mr. Ellis compensation for services as general manager of the dealership. The Court ruled that the exemption for “reasonable compensation” applies only for “services provided in the administration” of a retirement plan, not for services as general manager of a car dealership owned by the retirement plan.

IRS Publication 590 (*IRAs*) for many years, including the 2005 and 2006 editions that Mr. Ellis might have read, warned that there would be a prohibited transaction (PT) if the IRA owner took “*unreasonable* compensation” from his IRA for his management services (emphasis added). That’s certainly true...but don’t be misled by that statement into thinking that it’s perfectly ok to take *reasonable* compensation from your IRA! The IRS successfully prosecuted Mr. Ellis, and got his IRA disqualified, for the PT of taking compensation (for services as general manager) in the years 2005 and 2006 from the used car dealership he owned inside his IRA; there was no apparent claim that the compensation was *unreasonable*. (As of the 2013 edition *IRS Publication 590* has gone silent on the question of payment of compensation to the IRA owner.)

V. MAJOR IRA RULE CHANGE: IRS ANNOUNCEMENT 2014-15, : PUBLICATION 590 SUPERCEDED; *Bobrow v. Comm’r*, TC Memo 2014-21 (1/28/14)

Once-per-12-months IRA-to-IRA rollover rule has changed

Here is an extremely significant rule change for IRA owners: Effective for distributions after 2014, if you take a distribution from your IRA (“later distribution”), you cannot roll that distribution over to another IRA (or back into the same IRA) if you previously did a tax-free IRA-to-IRA rollover of another distribution (“earlier distribution”) that was received less than 12 months prior to the later distribution. In other words, you cannot do an IRA-to-IRA rollover of more than one distribution within any 12-month period.

What’s the rule change? Before this change, you *could* roll over that second distribution *if* the second distribution came from a different IRA—an IRA that was not involved in the first rollover. See *IRS Publication 590 (2013)*, p. 25, and Prop. Reg. § 1.408-4(b)(4)(ii). Now, starting in 2015, as a “grandfathering” type exception to the new rule, if the prior rollover was of a distribution made prior to 2015, and your 2015 distribution comes from an IRA that was not involved in the prior rollover, you still can do the second rollover...but this “grandfathering exception” will disappear at the end of 2015.

Why the change? The Tax Court, interpreting the Code in the *Bobrow* case, has decreed that the once-per-12-months rule applies to all IRAs in the aggregate. It does not apply on an IRA-by-IRA basis as the IRS had stated in *IRS Publication 590*. The IRS has announced it will follow the

Tax Court on this, but because the new rule is contrary to the IRS's own published position and statements in *IRS Publication 590*, and to give IRA providers time to gear up for it, the IRS will apply it only to distributions occurring after 2014.

REMINDER! AVOID (OR BEAT) THE ONE PER YEAR RULE

As a reminder, before and after the rule change, it is almost always better to use a direct IRA-to-IRA transfer (money goes straight from one IRA into the other IRA) rather than a "60-day rollover" (money is distributed from the IRA to the IRA owner, and the owner then deposits the money into the same or another IRA). There is no limit on the number of direct IRA-to-IRA transfers an individual can do or on their frequency. Even after a distribution is taken, it is possible to avoid the once-per-12-months rule by rolling the distribution into a different type of retirement plan (such as a 401(k) plan) or into a Roth IRA. The once-per-12-months rule does not apply to those types of rollovers. See ¶ 2.6.05 of *Life and Death Planning for Retirement Benefits*.

Background: The Code's rule and why it exists

§ 408(d)(1) provides that generally IRA distributions "shall be included in gross income by the payee or distributee" except as otherwise provided in the other parts of § 408(d). § 408(d)(3)(A) provides that the general inclusion rule does not apply to an IRA distribution that is rolled over into an IRA (§ 408(d)(3)(A)(i)) or into another type of eligible retirement plan (§ 408(d)(3)(A)(ii)) within 60 days.

However, there is an additional limitation on rollovers that are going *back in to an IRA* (as opposed to into a nonIRA eligible retirement plan): The rollovers-are-tax-free rule does not apply to an amount that was "received by an individual from an ...[IRA] if at any time during the 1-year period ending on the day of such receipt such individual received any other amount described in [§ 408(d)(3)(A)(i)] which was not includible in his gross income because of the application of this paragraph."

Or to put that into English, if you receive an IRA distribution (Distribution #1), and roll that distribution over tax-free into an IRA (either the same or a different IRA), you cannot do an IRA-to-IRA rollover of any other IRA distribution you receive within 12 months after the date of Distribution #1. You can roll such subsequent distributions over tax-free into some other type of eligible retirement plan (such as your employer's 401(k) plan, if it accepts rollovers). You can roll it into a Roth IRA (Roth conversion). But you cannot roll it into a traditional IRA, because you have used up your "once-per-12-months IRA-to-IRA rollover allowance."

As you can see, the Code seems to state that if you had a previous distribution within the preceding 12 months from *any* IRA, and you rolled it over tax-free to *any* IRA, then you are precluded from doing any further IRA-to-IRA rollovers for any other IRA distributions until that 12-month waiting period has expired. As we shall see, the IRS has applied this rule a little less strictly—on an account-by-account basis.

What is the purpose of the one-per-12-months limitation? Presumably it is meant to prevent an individual from using his IRA funds "outside" the IRA via continual rollovers:

Snidely Example: Snidely has a $110,000 IRA. He withdraws $50,000 on Day 1 and uses the money for personal or investment purposes. On Day 59, he withdraws another $50,000, and

immediate deposits it back into the IRA, to "erase" the Day 1 distribution via a "rollover." On Day 118 (i.e., less than 60 days after the second distribution), he takes the "first $50,000" out of his IRA again and immediately redeposits it, claiming it is a rollover of the second (Day 59) IRA distribution.

Clearly Snidely is using $50,000 of his IRA money for "outside" purposes while trying to avoid taxation of the $50,000 by continual rollovers. It's like kiting a check. Presumably the once-per-12-months rule was intended to prevent this. Snidely cain't do it!

The IRS's take: Rule applies account-by-account

But according to IRS Publication 590, it appears that if Snidely has enough multiple IRAs, he can "get there" by using rollovers from different IRAs, never tapping the same IRA twice. That's because IRS Publication 590 says the once-per-12-months rule does not apply to a second distribution that is rolled over to an IRA if the second distribution came from an account that was not involved in the first rollover. This interpretation follows the IRS's Proposed Regulation § 1.408-4(b)(4)(ii) (which however was never finalized).

IRS Publication 590 for many years (including the 2008 edition and the current 2013 edition—see p. 25) explains the rule as follows (emphasis added):

"**Waiting period between rollovers.** Generally, if you make a tax-free rollover of any part of a distribution from a traditional IRA, you cannot, within a 1-year period, make a tax-free rollover of any later distribution *from that same IRA*. You also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, *from the IRA into which you made the tax-free rollover*. The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over into an IRA."

"Example. You have two traditional IRAs, IRA-1 and IRA-2. You make a tax-free rollover of a distribution from IRA-1 into a new traditional IRA (IRA-3). You cannot, within 1 year of the distribution from IRA-1, make a tax-free rollover of any distribution from either IRA-1 or IRA-3 into another traditional IRA. However, the rollover from IRA-1 into IRA-3 does not prevent you from making a tax-free rollover from IRA-2 into any other traditional IRA. This is because you have not, within the last year, rolled over, tax free, any distribution from IRA-2 or made a tax-free rollover into IRA-2."

Using the Publication 590 rule to "kite checks"

If the once-per-12-months rule does not apply to distributions from different accounts, it starts to appear that Snidely could accomplish his "check-kiting" objective if he has enough money in IRAs to keep taking new distributions of $50,000 every 59 days that come from different IRAs. But it takes an awful lot of money and an awful lot of IRAs to keep the money afloat:

Distribution #1: Snidely has $50,000 in each of seven different IRAs, IRAs A, B, C, D, E, F, and G. On Day 1 he withdraws $50,000 from IRA A, and spends the money for personal or investment purposes.

Distribution #2, Rollover #1: On Day 60 (within 60 days after Distribution #1), he withdraws $50,000 from IRA B and immediately deposits it in IRA Z, hopefully (he believes) accomplishing a tax-free rollover to erase the distribution from IRA A on Day 1. But now he has a day-60 $50,000 distribution from IRA B to worry about.

Distribution #3, Rollover #2: On Day 120 (within 60 days after the distribution from IRA B), he withdraws $50,000 from IRA C (which was not involved in the prior rollover) and forthwith rolls it into IRA Y. He now (he hopes) has erased Distribution #2 via a tax-free rollover, but now he has Distribution #3 to worry about.

Distribution #4, Rollover #3: On Day 180 (within 60 days after the distribution from IRA C), he withdraws $50,000 from IRA D (which was not involved in any of the prior rollovers) and immediately deposits it IRA X. He hopes he has now erased Distribution #3 from IRA C. But you guessed it, it is still only 180 days since Distribution #1, so:

Distribution #5, Rollover #4: On Day 240 (within 60 days after the distribution from IRA D), he withdraws $50,000 from IRA E (which was not involved in any of the prior rollovers) and immediately deposits it IRA W. He hopes he has now erased Distribution #4 from IRA D.

Distribution #6, Rollover #5: On Day 300 (within 60 days after the distribution from IRA E), he withdraws $50,000 from IRA F (which was not involved in any of the prior rollovers) and immediately deposits it IRA V. He hopes he has now erased Distribution #5 from IRA E.

Distribution #7, Rollover #6: On Day 360 (within 60 days after the distribution from IRA F), he withdraws $50,000 from IRA G (which was not involved in any of the prior rollovers) and immediately deposits it IRA U. He hopes he has now erased Distribution #6 from IRA F.

Distribution #8, Rollover #7. After Day 365, once he has gotten past 12 months after Distribution #1, he can take a $50,000 distribution from the original rollover-recipient account, IRA Z, to do a rollover within 60 days after distribution #7.

Theoretically, under the pre-2015 rule, Snidely could keep this perpetually in motion by always having enough different IRAs that there is always one IRA account available that was not involved in any rollover in the prior 12 months. But that would require at least seven different IRAs and at least seven times as much retained in the IRAs as was taken in the original distribution. In other words if you have $350,000 in your IRAs, you could have theoretically under the pre-2015 rule have spent $50,000 of it without ever having to pay tax on the $50,000 by perpetually rolling the remaining $300,000 of your IRA money around from one IRA to another. *Theoretically* you could have done that under the pre-2015 "IRS Publication 590 rule." But as a planning technique, it's not terribly realistic. I've never heard of anyone's even trying it. So maybe the IRS figured it was ok to have this rule because (1) it theoretically can be abused, but that takes a lot of money and trouble and (2) if you really apply the rule the way it's written in the Code it's a terrible trap for the unwary, punishing people who are doing perfectly innocent transactions and not trying to be Snidelys:

Granny Example: Granny has two IRAs, IRA A with Florida Bank A and IRA B with Florida Bank B. She is moving from Florida to Minnesota to enjoy the fine climate during her retirement years. She opens IRA C with Minnesota Bank C. She cashes out her IRA with Bank A and mails the money to Bank C. A week later she cashes out her IRA at Bank B. She cannot roll this second distribution over to any IRA according to the Code because she already did one IRA-to-IRA rollover of a distribution received within the preceding 12 months. But using the IRS's pre-2015 more sensible approach she *could have* rolled the second distribution to IRA C because the second distribution came from an account that was not involved in the first rollover. In fact, the IRS recently gave a favorable ruling on very similar facts in PLR 2013-48017.

Bobrow case upsets the applecart

Unfortunately for the Grannys of this world, along came someone who wanted to be "Snidely," and the Court threw him out and threw out IRS Publication 590 and Prop. Reg. § 1.408-4(b)(4)(ii) along with him.

Mr. Bobrow was a tax attorney. He even represented himself in this Tax Court case. He had two IRAs at Fidelity, IRA #1 and IRA #2. His wife had one IRA there (IRA #3). They also had two taxable accounts there, husband's individual account and a joint account.

On 4/14/08, Mr. Bobrow withdrew $65,064 from IRA #1. On 6/6/08, he withdrew $65,064 from IRA #2. On 6/10/08 he transferred $65,064 from his individual (taxable) account to IRA #1, thereby (he believed) completing a tax-free rollover of the 4/14/08 distribution from IRA #1. On 7/31/08, Mrs. Bobrow took $65,064 out of her IRA (#3). On 8/4/08, the couple transferred $65,064 from their joint account to husband's IRA #2, thereby (they believed) effectively completing a tax-free rollover of the 6/6/08 distribution.

There was dispute about whether and when the third distribution (the distribution to wife from her IRA #3) was "rolled back" into wife's IRA. That seems to have been a factual dispute about amounts and dates, not of interest to the rest of the world.

The main bone of contention, of wider interest, concerned husband's two purported rollovers. The IRS contended that the 6/10/08 deposit of $65,064 to one of husband's IRAs was an effective rollover of his *second* IRA distribution (6/6/08), and that the IRA contribution of 8/4/08 was an ineffective late rollover of the *first* IRA distribution (4/14/08).

I am not aware of any other situation in which the IRS has tried to "overrule" the taxpayer's decision as to which distribution is being rolled over. As it happens the Court ignored this IRS argument and decided the case based on the "plain language" of the Code (backed up by legislative history said the Court) to the effect that, regardless of how many IRAs a person has, and regardless of whether distributions come from the same account or different accounts, an individual cannot roll over, to an IRA, more than one IRA distribution received within a 12 month period. Because of that rule, one of Mr. Bobrow's rollovers was no good.

Which one? The Court ignored the IRS's attempted rearrangement and treated Bobrow's rollovers the way he treated them. The Court found that the 6/10 deposit was a rollover of the 4/14 distribution. Therefore the 6/6 distribution was fully includible in his gross income. Oh and it was also subject to the 10 percent penalty because he was under age 59½. ....and a 20% accuracy penalty was also imposed because the couple could produce no "substantial authority" supporting their position that the once-per-12-months limit applied on an account by account basis. (Curiously IRS Publication 590 is not mentioned).

The Court overruled IRS Publication 590; IRS responds

The IRS was not looking to throw out its own Publication 590/Prop. Reg. interpretation that applied the once-per-12-months rule on an account-by-account basis. The IRS wanted to use its ingenious but entirely novel argument that the IRS, not the taxpayer, decides which distribution is being rolled over at any particular time. The IRS also tried on the theory that they could trace the money involved in the first rollover and it didn't come from the first distribution because that first-distribution money had already been spent. That's a losing argument too because money is fungible and there is no requirement (when cash is being rolled over) that the cash must be the same cash you took out of the IRA when you got the money that is being rolled over. That notion is just absurd.

But the IRS wanted to have their cake and eat it too. Mr. Bobrow did his serial rollovers exactly by the book (his second IRA distribution came from an IRA that was not involved in the first rollover; it was neither the distributing nor the receiving account in the first distribution-rollover, it was an entirely different IRA). Nevertheless, the IRS could see he was "kiting" and trying to use the rule to keep some money out of his IRA for more than 60 days. So they went after him and they got more than they bargained for—the Court threw out the IRS's own rule that Mr. Bobrow had so scrupulously followed!

The IRS now had to backpedal and get rid of its own rule. But to do so suddenly or retroactively would cause huge problems for IRA providers not to mention IRA owners. So the IRS came up with a compromise in IRS Announcement 2014-15. The once-per-12-months rule will be applied with regard to all of the taxpayer's IRAs on an aggregated basis, not on an account-by-account basis, after 2014. The new rule will not apply to distributions prior to 2015.

The new rule was therefore to be prospective-only—for the rest of us. For one person in the universe the rule would appear to be effective retroactively—Mr. Bobrow, whose second rollover was disallowed. However, the IRS generously backed off and (even though it had won the case) allowed Mr. Bobrow to have a valid second rollover.

Shadow of Bobrow? Other areas where the IRS ignores the Code...

The one-per-year rule is not the only Code provision the IRS has ignored or liberalized in its attempt to provide a more administratively feasible regime for retirement plan distributions. There are several instances of that approach in the IRS's regulations dealing with retirement benefits. Are these other IRS-created variations from the statute *also* invalid, leaving our clients exposed to taxes and penalties based on the actual statutory rule?

It is hard to envision circumstances in which these rules would come up for court challenge, since these are IRS rules and the IRS accordingly supports them. If both the IRS and the taxpayer support and follow the rule, who's going to challenge it? But that's presumably what Mr. Bobrow thought when he structured his series of IRA-to-IRA rollovers exactly in compliance with the IRS's own example in IRS Publication 590, and the IRS nevertheless attacked his rollovers as invalid—using a slightly different theory!

Here are some examples of the IRS's writing its own rules that don't conform to the Code.

♦ **"Early retirement" exception from 10% penalty:** There is generally a 10 percent "extra tax" imposed when a participant takes a distribution from his or her retirement plan prior to reaching age 59½. See § 72(t). There are more than a dozen exceptions to this general rule.

One exception is that the 10 percent penalty does not apply to distributions from a qualified or 403(b) plan made to a participant "after separation from service after attainment of age 55." § 72(t)(2)(A)(v), (3)(A). Although the statute just quoted clearly limits the exception to distributions made after a separation from service occurring after the employee's 55th birthday, IRS Notice 87-13, 1987-1 C.B. 432, A-20, provides that the separation from service can occur on or after *January 1* of the year the employee reaches age 55. This more liberal IRS rule also appears in PLR 2002-15032 and IRS Publication 590. Will some unfortunate taxpayer who retires in the year he reaches age 55, but before his actual 55th birthday, get hit with the 10 percent penalty after all?

- ♦ **"At-least-as-rapidly" rule junked:** The Code provides that, if the participant dies after his required beginning date (RBD), the remaining portion of the participant's benefits "will be distributed at least as rapidly as under the method of distributions being used" to calculate the participant's RMDs during life. § 401(a)(9)(B)(I). This is called the "at-least-as-rapidly rule." The regulations pay lip service to the rule (see Reg. § 1.401(a)(9)-2, A-5), *but make no attempt to comply with it.* When a participant dies after the RBD the rate at which he was taking (or was required to take) his lifetime RMDs has *no bearing whatever* on the determination of RMDs after the year of his death. The "at-least-as-rapidly rule" has been administratively repealed by the IRS.

- ♦ **Joint life expectancy of participant and beneficiary ignored:** The Code says that, beginning at age 70½, the participant must start drawing down his account in annual instalments over the joint life expectancy of himself and his designated beneficiary. § 401(a)(9)(A)(ii). But the minimum distribution regulations follow that rule *only* if the designated beneficiary is the employee's spouse who is more than 10 years younger than the employee. In the case of all other participants, benefits are withdrawn using the Uniform Lifetime Table to calculate RMDs, regardless of the life expectancy of the participant's designated beneficiary, and regardless of whether the participant even *has* a designated beneficiary.

- ♦ **IRS, unlike the Code, allows an election:** When a participant dies before his RBD, it appears under the Code that the 5-year rule applies *only* if there is no designated beneficiary, and that the life expectancy method *automatically* applies if the participant left his benefits to a designated beneficiary. See § 401(a)(9)(B)(iii), (iv). The regulations use a different approach. Under the regulations, the plan can permit the designated beneficiary of a participant who died before his RBD to *choose* between the 5-year rule and the life expectancy payout method. Reg § 1.401(a)(9)-3, A-1.

These are a few examples of the IRS's freeform drafting of the rules governing retirement benefits. Let's hope the IRS never pulls another *Bobrow* and challenges its own rules in Tax Court, because if they do the entire world of retirement plan distributions could suffer a meltdown.

VI. THE LEAST MOST IMPORTANT CASE OF 2014: *CLARK V. RAMEKER*, 134 S.Ct. 2232 (6/12/14).

Unless you just came in from Mars, you know that in the *Clark* case in 2014 "the Supreme Court took away the bankruptcy exemption for inherited IRAs." While the case is an interesting exercise in statutory interpretation, and a reminder that creditors "never give up," it is (in my opinion) the 2014 development with absolutely the least possible impact on estate planning for retirement benefits. But I know I'm wrong and many estate planning attorneys have told me so.

Background: Since 2005, the federal bankruptcy Code has granted generous exemptions for "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under Sections 401, 403, 308, 408A..." (Etc.). Heidi Heffron-Clark inherited an IRA from her mother. Heidi filed for bankruptcy and listed the inherited IRA (then worth $300,000) as an exempt asset. The bankruptcy trustee disagreed with this classification, asserting that an inherited IRA, though it is an account exempt from taxation under § 408, is not "retirement funds" and therefore not eligible for the exemption.

Different courts around the country have come to different conclusions on this point, creating a conflict in the circuits, which is how the case wound up in the U.S. Supreme Court. The justices unanimously agreed with the bankruptcy trustee and Heidi's inherited IRA was handed over to her creditors.

Is this case important? Most people are not facing bankruptcy and most people do not own inherited IRAs. So for most people this case is of zero interest. For the small group of desperate debtors clinging to inherited IRAs this case is obviously very important and very bad news.

But is this case important for *estate planning*? I say no. Any client who is concerned about potential creditors' claims against his desired IRA beneficiary should leave that IRA to a trust for the chosen beneficiary, not outright to him or her. But that was just as true before *Clark* as it now is after *Clark*. In no way did *Clark* change the advice you or I would give to this estate planning client—unless the following scenario applies to you:

Script of hypothetical pre-*Clark* client interview?

Estate planner: To whom do you wish to leave your IRA?

Client: I would like to leave my IRA to my son Junior, but I am very concerned about his vulnerability to creditors' claims. He is in a high-risk business and gets sued all the time. If I name him as beneficiary of my IRA could his creditors reach that asset?

Estate planner: Don't worry about a thing! There is a generous federal bankruptcy exemption for IRAs! So if he gets sued and files for bankruptcy he can just claim that exemption! Of course he could get sued in court and not be entitled to file for bankruptcy at all, but let's just ignore that risk, shall we? Because many states also have exemptions for IRAs, and some of them do allow that exemption to apply to inherited IRAs, so encourage your son to live in one of those states, ok? And of course there is litigation all over the country about whether an *inherited* IRA even qualifies for that federal bankruptcy exemption, but hopefully your son will live in a jurisdiction that holds they

are exempt. And of course eventually the Supreme Court will take the case and I'm positive they will hold that inherited IRAs qualify for the exemption, so you don't have a THING to worry about!

Would you have said that? I hope not. A spendthrift trust is still the best protection for creditor-vulnerable beneficiaries...just as it was before June 12, 2014.

But I know I'm wrong. I know the *Clark* case is extremely important. I know this because a financial reporter called me about the case and asked whether this case meant everybody should immediately review their estate plan. I patiently explained, as above, why the case did not mean that. Her headline on the story was, "Supreme Court case necessitates estate plan reviews." And a prominent estate planning lawyer told me he has had a flood of calls from clients anxious to review their estate plans because of the *Clark* case. The press coverage has created the impression that the Supreme Court has said every beneficiary's inherited IRA asset must be immediately liquidated and paid over to somebody's creditors. If it gets clients to update their estate plans it's a good thing (even if it's for the wrong reason)!

VII. AMERICAN TAXPAYER RELIEF ACT (ATRA) CHANGES AFFECTING RETIREMENT PLANNING

A. In-Plan Roth Conversions Expanded

History: In 1998 Roth IRAs were born. Roth IRAs were the only type of retirement plan that could generate income tax-free distributions (beyond return of the taxpayer's own after-tax contributions).

Then, beginning in 2006, it was decreed that qualified plans and 403(b) plans could also get in on the Roth game, permitting "designated Roth accounts" (DRACs) inside 401(k) and 403(b) plans. But DRACs could be funded only by means of elective deferrals (i.e., new contributions made by "salary reduction" agreement with the employer). Existing plan balances in "traditional" 401(k)/403(b) accounts could not be converted to Roth accounts.

That changed with the Small Business Jobs Act of 2010, which permitted (after September 27, 2010) existing traditional plan balances in 401(k) and 403(b) (and, after 2010, 457) plans to be converted, inside the plan, into DRACs. See § 402A(c)(4). But such conversions were permitted *only* for funds that the employee would have been permitted to take out of the plan. Since "elective deferral" accounts cannot be distributed prior to separation from service (or attaining age 59½), younger employees who were still employed were effectively frozen out of Roth conversions for their *existing* 401(k)/403(b)/457 balances.

So in-plan Roth conversions, pre-ATRA, had a very small potential "market." The only person who could convert existing plan balances to Roth status was someone who also had the right to take the money out of the plan, such as a person who had separated from service (or retired), or who (though still employed) was over age 59½ (in a plan that permitted in-service distributions or Roth conversions).

The market was even smaller than that because, among those who could get their money out of the 401(k) plan and wanted to do a Roth conversion, most would be better off converting to a Roth IRA rather than doing a Roth conversion totally "inside" the 401(k) plan. A conversion to a Roth IRA can be reversed up until October 15 of the year after the year of the conversion (see ¶ 5.6

of *Life and Death Planning for Retirement Benefits*), whereas an in-plan Roth conversion is irrevocable.

The latest step in the dance is ATRA: Effective for 2012 and later years, a plan that has a DRAC program can allow the employee to transfer *any* amount from his traditional plan account(s) to a DRAC in the same plan, even if such amount could not legally be distributed to the employee at the time of such transfer. § 402A(c)(4)(E)(i). ATRA's change vastly expands the number of people and plan dollars eligible for Roth conversion, by adding all still-employed employees who are under age 59½ to the list of potential Roth converters. This group of people does not have the alternative of converting to a Roth IRA, because (unless they quit their jobs) they can't get their money out of the 401(k) plan prior to age 59½, so it's either do an in-plan Roth conversion or do NO Roth conversion.

Will there be a mad rush of people taking advantage of this new option? It seems unlikely. How many under-age 59½ individuals are champing at the bit to make an irrevocable election to prepay income taxes on their retirement plans? We'll find out!

B. Estate Tax Changes

ATRA 2012 took the temporary estate/gift tax regime that was in effect for the years 2011–2012 and (with one change) made it permanent.

From now on, the federal estate tax exemption is $5 million per person, adjusted for inflation. As of 2013 the exemption is already up to $5,250,000. This is permanent (unless Congress changes its mind again).

This huge new exemption is also now permanently "portable" between spouses, meaning that the first spouse to die can leave his or her exemption to the surviving spouse.

The new maximum federal estate tax rate is 40 percent (up from 35% in 2011–2012, but down from 45% in some prior years).

The gift tax annual exclusion is up to $14,000 per recipient as of 2013.

These changes have an enormous favorable impact on estate planning for married couples with substantial retirement benefits. In the past, a wealthy couple whose wealth was largely in retirement plans had to make a tough choice. Either leave the retirement benefits to the surviving spouse to get the huge income tax benefits of the spousal rollover (but lose out on estate taxes, because the surviving spouse's estate would be that much larger and have only one "exemption" available to shelter it); or leave the benefits to a "credit shelter trust" to save estate taxes (but suffer a substantially accelerated payment of income taxes due to loss of the spousal rollover).

Those problems are "gone with the wind." Now a couple whose combined assets are under $5.25 million don't even have to think about federal estate taxes at all. And a couple whose combined assets are greater than that, and who have substantial concentration in retirement plans, can eat their cake and have it too: The first spouse to die can leave his/her retirement benefits to the surviving spouse (thereby potentially getting the benefits of the spousal rollover) *and* leave his estate tax exemption to the surviving spouse (so he/she will have a double exemption to shelter all the inherited assets, thereby saving estate taxes).

C. Income Tax Changes

ATRA delivered several income tax increases that, together with the 3.8% income tax on net investment income (part of the Patient Protection and Affordable Care Act of 2010; see Part X of this Outline), which became effective in 2013, hit higher incomes hard. The following chart shows the levels of adjusted gross income or taxable income at which these new tax-increasing provisions kick in:

	Single (Note 1)	**Married Filing Jointly** (Note 2)	**Trust or Estate** (Note 3)
3.8% Income Tax on Investment Income Begins (§ 1411)	$200,000	$250,000	$12,300 (2015)
Phase out of Itemized Deductions and Personal Exemptions Begins (§ 68; § 151(d))	$250,000	$300,000	N/A
39.6% Tax Rate (& 20% Rate on Divs. & Capital Gain) Begins (§ 1)	$400,000	$450,000	$12,300 (2015)

Notes to Table:

(1) For a single individual, the "3.8% income tax on net investment income" and "phaseout of itemized deductions and personal exemptions" begin at $200,000 and $250,000 of *adjusted gross income* respectively. The 39.6% tax rate (and 20% rate on qualified dividends and capital gain) begin at $400,000 of *taxable income*.

(2) For married filing jointly taxpayers, the "3.8% income tax on net investment income" and "phaseout of itemized deductions and personal exemptions" begin at $250,000 and $300,000 of *adjusted gross income* respectively. The 39.6% tax rate (and 20% rate on qualified dividends and capital gain) begin at $450,000 of *taxable income*.

(3) For a trust or estate, the "3.8% income tax on net investment income" begins at $12,300 of *undistributed net investment income* for 2015. The 39.6% tax rate (and 20% rate on qualified dividends and capital gain) begin at $12,300 of *taxable income* for 2015. The "phaseout of itemized deductions and personal exemptions" does not apply.

If you are a married-filing-jointly taxpayer, you need to remember three numbers: $250,000, $300,000, and $450,000.

If you are a single taxpayer, remember $200,000, $250,000, and $400,000.

If you are a trust or estate, you only need to remember: $12,300 for 2015.

These numbers represent, respectively, the levels at which the following bad tax-increasing things happen to you:

At the lowest level ($200,000 for single individuals, $250,000 for married filing jointly, $12,300 for trusts and estates), the 3.8% income tax on investment income kicks in. If your income exceeds this threshold, then you will pay an extra 3.8% income tax on your "net investment income" (or, if less, your total income in excess of the threshold). Investment income includes interest, dividends, annuity payments, and gains. It does not include retirement plan distributions, but since plan distributions are included in the threshold it may not make much difference to you that they are technically not subject to the tax. See "E" below for details on the 3.8% income tax on net investment income.

The next set of tax hikes hits at $250,000 of AGI for singles, $300,000 for married couples filing jointly. Once AGI exceeds those levels, your itemized deductions start being phased out under § 68 and your personal exemptions are phased out under § 151. This particular tax grab does not apply to trusts and estates.

The final attack starts at $400,000 of taxable income for single taxpayers ($450,000 for married filing jointly) (and a mere $12,300 for trusts and estates for 2015). This is the new top income tax bracket of 39.6%.

The Patient Protection and Affordable Care Act of 2010, including the "reconciliation" provisions that were enacted with it, impose numerous new taxes to finance the massive new entitlements and bureaucracies created by the law (nicknamed "Obamacare"). For example, the "Medicare" tax as of 2012 was 2.9 percent (including both the "employer" and "employee" shares, with the "employer" share being tax-deductible for the employer), imposed on wages and self-employment income. Beginning in 2013, an additional .9 percent income tax must be paid (by the employee or self-employed individual) on wages and self-employment income in excess of $200,000 ($250,000, in the case of married taxpayers filing a joint return).

Thus, the "high earner's" top marginal tax bracket on compensation income as of 2012 was 37.9 percent (35% income tax plus 2.9% "Medicare" tax). In 2013 and later years, it will be 43.4 percent (39.6% income tax plus 3.8% "Medicare" tax). For each additional $1,000 the individual earned, as of 2012, he gave the feds $379.00. Starting in 2013, the feds will take $434.00 of that marginal $1,000, an additional $55. Plus state tax of course (in many cases).

"Matching" that 3.8% "Medicare tax" on compensation income is the ACA's new 3.8% income tax on net investment income, the "NIIT."

VIII. WHAT'S NEXT: PROPOSALS FOR NEW LEGISLATION

The portion of this section dealing with the President's budget proposal was previously published as an article in the Newsletter of *InterActive Legal*, the company that offers the leading drafting system-software for estate planning lawyers.

Washington always has some new ideas for how to change the rules applicable to retirement benefits.

One perennial favorite idea is to solve all our problems by adding a new type of retirement plan (or some other new type of tax-sheltered savings plan). Never mind that we already have dozens of types of such plans (in the retirement field, IRAs, Roth IRAs, SEPs, 401(k) plans, 403(b) plans, defined benefit plans, ESOPs, profit-sharing plans...elsewhere, Health Savings Accounts, Flexible Spending Accounts, 529 Plans, and on and on and on). It appeals to the legislative mind to start some NEW kind of "plan" or "account" to get people to save for some favored goal. *If only* we had one more new type of special account poverty would end!

Here are some of the current crop: Tom Harkin proposes the "**USA Retirement Fund**" which would *for the first time!* give workers not now in any plan (there are 75 million such people he says) the opportunity to earn a safe and secure pension benefit! And shield them from market volatility! Automatic payroll deductions....up to $10,000 contribution by the worker....up to $5000 by the employer....savers credits for low-income participants....etc. etc.

Rep. Hinojosa of Texas wants to add RAYS to the Tax Code, under his proposed "**Roth Accounts for Youth** Savings Act of 2014." The Bill would allow parents to create Roth IRAs for their dependants. Of course there would be complicated interrelated limits on the amount permitted to be contributed, partly based on how much compensation the dependant had, and special rules for divorced parents, as well as a provision prevent these accounts from being counted as resources for welfare benefit purposes.

Not to be outdone, President Obama proposes the "**MyRA**," for "My retirement account." It would apparently be a subset of the Roth IRA, but funded with government iou's!

President Obama's 2014 Budget Proposal contains five other provisions that would, if enacted, impact retirement benefits.[16] He would:

- Eliminate the "stretch" IRA concept by requiring a five-year maximum payout period for inherited retirement benefits.

- Prohibit additional contributions to any IRA, 401(k) plan, or other defined contribution plan for an individual whose combined plan balances already exceed $3.4 million.

- Limit the value of the tax deduction for contributions to retirement plans (among other deductions) to 28 percent, regardless of the individual's actual tax bracket.

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[16] The terms of the President's proposals are taken from the "General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals" (cited in this article as the "Green Book") which can be found in "pdf" format at: www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.

- Eliminate the requirement of taking annual minimum distributions for an individual whose total account balances are under $75,000.

- Allow beneficiaries to do a "60-day rollover" for inherited retirement benefits.

The President's budget is sometimes considered a mere "wish list," and several of these proposals have appeared in President Obama's prior budgets without achieving enactment. Nevertheless it is useful to examine these ideas, since some of them some day may become law. The first one, "killing the stretch," raises questions for estate planners regarding how to anticipate law changes when we draft trusts for our clients.

A. Kill the Stretch!

The President's proposal would "require non-spouse beneficiaries...to take inherited distributions over no more than five years."[17] Essentially, the "5-year rule" that now applies only when a participant dies before his required beginning date with no "designated beneficiary"[18] would apply to almost all inherited benefits.

Rationales for killing the stretch (and why they are wrong)

The justification stated for this proposal is that our law "gives tax preferences for retirement savings accounts primarily to provide retirement security for individuals and their spouses. The preferences *were not created with the intent of providing tax preferences to the non-spouse heirs of individuals*. Because the beneficiary of an inherited account can be much younger than a plan participant or IRA owner, the current rules allowing such a beneficiary to stretch the receipt of distributions over many years permit the beneficiary to enjoy tax-favored accumulation of earnings over long periods of time." Emphasis added.

This same proposal has been previously advanced by Senator Max Baucus, whose reasons for suggesting it were (similar to President Obama's justification) to bring the law back into line with the purpose of the tax Code's retirement provisions which is to provide for retirement, not wealth transfer, while also raising revenue and (of course) simplifying the rules.

Unfortunately, all three of those justifications are wrong.

With no death benefits, people won't save

It's true that the purpose of the Code's retirement plan provisions is to encourage people to save for their retirement years, but it's not true that providing a substantial benefit to the participant's heirs is inconsistent with that purpose. Building a legacy for future generations is a major motivation for people to save. Society can benefit from that urge to save for future

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[17] See p. 163 of Green Book (p. 173 of "pdf" version).

[18] See Chapter 1 of *Life and Death Planning for Retirement Benefits* for explanation of the "minimum distribution rules" applicable to retirement benefits, including explanation of the 5-year rule.

generations, if the result is that people save adequately for their later years. Presumably in recognition of that fact of human nature, a significant death benefit has always been a component of the Code's retirement-savings rules.

The ancestor of today's minimum distribution rules was the "incidental death benefit rule," which has decreed (since the inception of the tax-favored retirement provisions of the Code) that retirement benefits had to be distributed to the owner, upon retirement, in a form that would cause at least half of the benefits' value to be distributed to the owner during his/her lifetime. Not 100%, *half*! Thus a 50 percent death benefit "wealth transfer" component for heirs was considered "incidental" and has *always* been part of the retirement plan-tax savings "deal."

If a 5-year across the board payout is mandated for retirement plan death benefits, many individuals will probably reduce or eliminate their retirement plan contributions. A prudent saver will not wish to place money in a format that will generate an income tax "meltdown" upon his death. Rather, the prudent saver seeks to invest in a way that will provide for himself in his future retirement years and leave an inheritance for his heirs. "Straight" life annuities, though seemingly the ideal way to provide retirement income, are not terribly popular just because they do not provide any inheritance for the annuitant's descendants.

Few "non-spouse heirs" actually stretch

Also (except possibly by discouraging people from contributing to plans), ending the stretch payout will not raise significant revenue. Despite the allure of the stretch IRA, very few stretchouts (in my experience) actually get implemented. Most beneficiaries want immediate cash, not a stretch payout. Even when the participant plans for a long term stretch payout to his beneficiaries, what happens in most cases is that the participant lives a long time and spends the money down during life. A participant who dies "young," typically leaves the benefits to a surviving spouse who rolls them over and then spends them down during his long overlife. So how many substantial stretch payouts to young beneficiaries actually get implemented? Not that many!

The world's most complicated simplification

Finally, even though a fixed term payout period for everybody would theoretically be simpler than the life expectancy payout, it isn't (at least as proposed by President Obama), because the 5-year term is too short. It means the law then has to contain lots of exceptions. The President's proposal contains seven!

There are exceptions (5-year payout does not apply) for (1) disabled beneficiaries, (2) chronically ill beneficiaries, (3) the surviving spouse, and (4) any beneficiary who is close in age to the decedent. A minor beneficiary (5) could use the life expectancy payout method, except he would have to switch to a 5-year payout upon reaching majority. The life expectancy payout period would be preserved to the extent embodied in any irrevocable annuity payout initiated prior to 2014 (6).

Finally, a beneficiary of someone who died before 2014 could continue his "grandfathered" life expectancy payout (Exception #7), but the payout period would switch to the 5-year rule for successors to that original beneficiary. Note that this seventh exception would require keeping the entire complicated system of today's life expectancy payout rules "alive" for potentially *80 more years* after the life expectancy payout was supposedly "killed!" 80 years is the life expectancy of

a newborn baby beneficiary named by a participant who died just before 2014 who would be "grandfathered" under the President's proposal.

Whew! Whatever that is, it's not simplification!

How does this affect our planning and trust-drafting?

The proposal to kill the stretch reminds us of the hazards of building an entire estate plan or trust document around a fragile Code provision. Though planning for a stretch payout makes sense for a client's existing retirement benefits, it might not be wise to encourage massive or disproportionate accumulations in tax-favored retirement plans based on the hope of achieving a post-death stretch payout that could be eliminated with the stroke of a pen. Balance makes sense here as usual.

Here's how the kill-the-stretch proposal would affect particular clients' estate plans:

Already deceased: Since the President's proposal would not apply in this situation (until after the death of the original beneficiary), any stretch that is already in payout status as of 2014 should have few worries. A trust document that spells out the current minimum distribution rules might have to be reformed to reflect the new requirement that the payout would switch over to a 5-year rule on the original beneficiary's death. Possibly the purchase of life insurance on the life of the original beneficiary would cushion tax losses caused by his premature death.

New clients and revisions of existing plans: If the President's proposal becomes law, trusts that are named as beneficiary of retirement plans may have to be rethought out and revised to reflect the fact that the stretch payout is no longer an option. The biggest problem would be the high income tax brackets applicable to trusts. Under today's stretch payout rules, the high bracket can be avoided (without giving the individual beneficiary immediate access to the entire plan) by using a conduit trust. The trustee controls the IRA, and dribbles out minimum distributions to the human "conduit" beneficiary gradually over the beneficiary's life expectancy. With no life expectancy payout available, the stark choice for many participants would be between leaving benefits to a trust (with a punishing income tax rate) or outright to an individual beneficiary who (though in a lower income tax bracket) is potentially improvident or creditor-vulnerable. Leaving benefits to an (income tax-exempt) charitable remainder trust that gives a creditor-proof lifelong payout to the individual beneficiary may become a popular compromise.

The client who doesn't update his plan: Finally, what will become of the clients who have estate plans built on the expectation of a stretch payout (using a conduit trust), but fail to update their estate plans prior to dying? Obviously that could produce a very bad situation, and suggests the importance of urging and reminding clients to update regularly. A "conduit trust" could produce a very unfortunate result if it simply requires that all retirement plan distributions received by the trustee be forthwith transmitted to the individual beneficiary.

What is preferable is, in drafting a conduit trust, to limit the "conduit" requirement to ONLY retirement benefits that otherwise qualify for a life expectancy payout. With that limiting clause included, benefits paid out to the trust under a mandatory 5-year rule would not be subject to the conduit requirement. Thus the disaster of an immediate total payout of the benefits (when the client was expecting a gradual life expectancy payout) is avoided. But even if the trust contains that

(highly desirable) language limiting the "conduit" requirement to benefits that qualify for a life expectancy payout, the client should still update his estate plan as soon as possible if the President's proposal becomes law, to review other alternatives for disposition of the retirement benefits.

What would President Choate do?

Many people ask me[19] what I would do to improve, reform, or simplify our current life expectancy payout system. My answer: I agree with the President and Senator Baucus that a fixed-term payout period would be preferable to the incredibly complicated and chance-y life expectancy payout method we have now, but five years is too short (in my opinion). It discourages savings and necessitates numerous exceptions.

I would suggest, instead, replacing the life expectancy system with a mandatory 21-year fixed term payout period for all post-death benefits (and keep the spousal rollover as the sole exception). That's a long enough payout period (in my opinion) to fairly be applied retroactively to beneficiaries of people who are already deceased (if the 21 years begins upon enactment); that way, we don't have to keep the existing life expectancy payout rules in operation for another 80 years. 80 more years with a dual minimum distribution system is ridiculous!

21 years would also be a long enough period so people wouldn't be discouraged from saving in retirement plans. It would be long enough to allow minor beneficiaries to get to adulthood. I would suggest not having special minimum distribution rules for the disabled and the chronically ill; give them lower tax rates or higher exemptions if needed, but not their own special minimum distribution system!

My proposal would truly simplify, fairly and without the need for numerous exceptions, and it would eliminate the "designated beneficiary" lottery system we now have. That's what I would do if I were president!

B. Capping Contributions

The concept of this proposal (a new one—it did not appear in the President's previous budgets) is simple and fair: Our law gives tax breaks to individuals to encourage them to save for retirement. Once a person has saved up plenty of money for his/her retirement through such tax-advantaged plans, we should stop offering tax incentives for that person to save even more. The person can save more if he/she wants to, but why should the taxpayers subsidize such further savings?

Under a tax-qualified defined benefit pension plan, the largest pension an employer can fund for any employee is $205,000 per year for life starting at age 62. Therefore, says the President, once an individual has accumulated enough in all of his/her collective defined contribution plan accounts to provide a pension of $205,000 a year, he/she should not get to make further tax deductible or tax-favored contributions, any more than an employer can get tax deductions for funding more than that size pension.[20]

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[19] Not really.

[20] See p. 165 of Green Book (p. 185 of "pdf" version).

This sounds perfectly reasonable and fair. Unfortunately, in my opinion, it is not a good idea. The proposal amounts to killing a mosquito with a sledgehammer, in view of the following considerations:

- ✓ This proposal would require an entirely new information-gathering and enforcement mechanism. Right now the only person who knows how much you have in all your various defined contribution plans (your IRAs, your 401(k) accounts at all past and present employers, your 403(b) accounts, etc.) is you (and possibly the IRS). Under this proposal, that information would need to be gathered for every employee in every 401(k) (or other defined contribution) plan before the employer could contribute! Because your employer could not contribute more to your 401(k) plan if you already have $3.4 million in some IRA someplace else. This would require information gathering and reporting on tens of millions of IRA owners and 401(k) plan participants, to catch....who?

- ✓ There are relatively very few people who have more than $3.4 million in their defined contribution accounts. There are probably thousands of such people who have accumulated "too much," but that's a drop in the bucket compared to the millions and millions who have "too little." So this newly-created giant dragnet will snare just a few people. The President hints darkly that some people have dodged the contribution limits by participating in multiple retirement plans sponsored by unrelated employers. Really? How often have you seen an employee accruing, in one year, maximum plan contributions under the plans of multiple unrelated employers? I believe that phenomenon is actually very rare.

- ✓ Adding to the complication of this hugely invasive new rule is the fact that the $3.4 million is a moving target with multiple moving components: The defined benefit and defined contribution maximums change annually for inflation. The value of the participant's investments fluctuates, so one year he might be subject to the cap but the next year (due to losses) he can contribute again. As interest rates go up (or down), the lump sum amount required to fund a $205,000 per year pension goes down (or up). And the hypothetical pension we're targeting isn't a straight single life pension—it's a joint and survivor annuity with the participant's spouse! So employers trying to contribute for their employees must know, not only how much the individual has in all his other retirement plan accounts, but also who he's married to (and the spouse's date of birth), the latest inflation-adjusted limits, and the effect of current interest rates on the cost of pensions.

- ✓ The rumor is that this proposal was inspired by the report that Presidential candidate Mitt Romney's IRA was worth tens of millions of dollars. Ok let's say that's true. If a new client walked in to your office today and said "I have $50 million in my IRA, what should I do?" how likely is it that you would urge her to put MORE money into that IRA? In other words, we're trying to prevent the super-rich from putting $6,500 into an IRA or $51,000 into a profit-sharing plan....but if their IRAs are that large they don't want to put more in anyway! So it's the plan administrators (and the guy or gal with just $3.4 million) that get punished, NOT the "whales" with the $10 million and up IRAs.

  My advice? Mr. President, forget this one!

C. Limit Value of Tax Deductions to 28%

Here's another proposal that sounds deceptively simple. The President bemoans the fact that tax deductions for mortgage interest, charitable contributions, etc. "reward" high-income taxpayers more "generously" than lower-income taxpayers. A $100 deduction potentially saves the "millionaire" (taxable income over $400,000) $39.60, but writing a check to charity for the same amount saves someone whose taxable income is only $36,900 just $15.

I have an instant simple solution for this terrible injustice: Invert the tax rates. Provide that the first $36,900 of taxable income is taxed at 39.6% and income over $400,000 is taxed at 15%. That way the millionaire will only save $15 by making a $100 charitable deduction and the poor man with under $39,600 will save $39.60. But the President does not adopt this simple and commonsense reform.

Instead the President proposes to limit the value of a tax deduction or exclusion to only 28%, regardless of the individual's actual tax bracket. Thus, the millionaire who gives $100 to charity will see his income tax bill shrink by only $28, not the full $39.60 his current tax bracket would normally entitle him to. After all (proponents say), you were satisfied with a $28 deduction value in the Reagan years (when the highest tax rate was 28%), so you should still be satisfied with it!

There is no logic to the comparison with the Reagan years and tax rates. The tax rate under Reagan left the individual with much more of his own money in his own pocket than is possible under today's tax rates, even before you get into the value of deductions. There's a square-peg-round-hole quality to trying to graft yesterday's deduction savings onto today's higher tax rates. The two things have nothing to do with each other. Whether or not he takes any deductions, the high-income individual has much less money in her pocket under President Obama's income tax regime than she did under Reagan's, and the "limit deduction value" wheeze is just an attempt to grab even more dollars from the American public.

What has this got to do with retirement benefits? The "deduction limit" would apply not just to the usual itemized deductions like state taxes, it would also apply to retirement plan contributions that are now excluded from income. If you are in the 39.6% bracket, and your employer contributes $10,000 to your profit-sharing account (which event normally would have no current effect on your tax bill), you will now face an income tax bill of $1,160 on the contribution. That's the difference between a $10,000 income exclusion at the 39.6% bracket versus the 28% bracket.

You may have no choice in the matter of whether your employer sets money aside for you in the retirement plan, and you may have no way (short of quitting your job) to access this money that the employer has set aside for you, but you have to pay tax on it nevertheless. By the way what if the contribution is not vested? What if you pay tax on it then forfeit it due to changing jobs? The proposal does not discuss that scenario.

This new proposed income tax on retirement plan contributions would not be a total loss for the taxpayer. The President's proposal provides that if you have to pay some income tax on your employer's contribution to your retirement plan you should get a basis in the plan to that extent!

Consider for a moment the prospect of keeping track of each client's basis in all of his or her retirement plans arising out of paying partial income tax on employer contributions to the plans....all I can say is, "good luck with that!"

D. No RMDs for Participants with less than $75,000

This proposal appears under the "simplification" section of the budget, but is (like the previously discussed proposals) not very simple. In fact it's just one more attack on "the rich" while blindly trying to help the not rich.

After describing the present minimum distribution rules as being intended to assure that "taxpayers who have accumulated substantial tax-favored retirement assets" "in fact" use those assets for retirement, the President bemoans the fact that these rules also apply to "millions of senior citizens with only modest tax-favored retirement benefits," even though the President knows that these particular millions of people are "highly unlikely to try to defer withdrawal and taxation of these benefits for estate planning purposes."

The proposal would allow a participant whose aggregated IRA and tax-favored retirement plan accumulations are not worth more than $75,000 to not take required minimum distributions.[21]

Like most "simplifications" the President's proposal is not very simple: Though Roth IRAs are not subject to the lifetime minimum distribution rules, the individual's Roth IRAs would be counted towards his $75,000 threshold. Annuitized defined benefit plans would *not* count towards the threshold. Strangely, this modest break would not apply to anyone who is already over age 70½ at the end of 2013. A partially phased-out RMD requirement would apply to the fellow who has balances between $75,000 and $85,000 (that's the person I feel most sorry for here).

Finally, there is no mention of whether inherited plans would or would not count towards the $75,000 threshold, or whether beneficiaries who have less than $75,000 total in their inherited and noninherited plans would be entitled to skip RMDs, though it is mysteriously stated that the proposal would be effective "for taxpayers who die on or after ...2013 before attaining age 70½.

This proposal illustrates the folly of micro managing social issues from an office in Washington. What is the basis for using $75,000 as the threshold....are people with $76,000 "wealthy" and likely to try to use their IRAs for (gasp) estate planning? As with all these types of rules there is an arbitrary number set based presumably on some particular case a Congressman heard about. Yet there is no recognition that a person's wealth and tendency to do estate planning cannot be deduced solely from the size of his IRA. Suppose Senior Citizen X has no assets other than a $200,000 retirement plan, which must be her sole support for the rest of her life. Too bad—she's lumped in with the "wealthy" and must take minimum distributions annually. In the next apartment is Senior Citizen Z. She has a net worth of $10 million, but her only retirement plan is a $75,000 IRA. She is exempt from minimum distributions under this proposal.

One wag has pointed out that most people who would be entitled to skip RMDs under this rule are probably exactly the people who cannot afford to skip taking their RMDs, so the proposal may provide virtually no benefit to anyone.

This proposal is complicated, burdensome, silly, and (probably) ineffective to help those it is intended to help.

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[21] See p. 215 of Green Book (p. 225 of "pdf" version).

E. Allow Rollovers for Non-Spouse Beneficiaries

This is a sensible rule designed to eliminate a "trap for the unwary." Currently, nonspouse beneficiaries can move inherited retirement benefits from one plan to another (e.g., from an inherited qualified plan to an inherited IRA) only by means of a direct plan-to-plan transfer (also called direct rollover). If the money is distributed out of the inherited plan or IRA to the beneficiary's taxable account, it is a taxable distribution and (under present law) that distribution cannot be rolled back in to another plan or IRA by the nonspouse beneficiary. Only the participant and surviving spouse are granted the privilege under present law to take money that has been distributed out of a plan or IRA and put it back (within 60 days) into another plan or IRA by means of a tax-free "rollover."

The President's proposal would allow nonspouse beneficiaries the same "60-day rollover" privileges now granted to the participant and spouse.[22] The rollover could still be made only to an inherited IRA, not to the beneficiary's own IRA.

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Proposals D and E have appeared in previous Obama budgets, without achieving enactment. Proposals B–E would not appear to create any need for changes in the estate plan. Only Proposal A should send estate planners scurrying to their forms and existing client plans to make sure the plan would survive the "death of the stretch" should it come to pass.

IX. WHAT'S NEW IN HARDSHIP WAIVERS OF 60-DAY ROLLOVER DEADLINE

The IRS issues lots of Private Letter Rulings to individuals and trusts regarding IRAs and other retirement benefits. Unfortunately they are not always consistent with each other. This Section looks at the recent crop of PLRs in which the IRS grants (or denies) hardship waivers of the 60-day rollover deadline. The first two subsections focus on recent PLR "flip-flops."

A. No Waiver Granted for Erroneous Tax Advice! Except Sometimes....

In PLR 2006-17039, the IRS refused to grant a hardship waiver where a participant took a distribution of employer stock from his company plan, not intending to roll it over because his advisor told him the distribution qualified for the special "net unrealized appreciation" (NUA) treatment (see ¶ 2.5 of *Life and Death Planning for Retirement Benefits*). After the 60-day rollover deadline had passed, he found out the distribution did *not* qualify for NUA treatment. Says the IRS "We do not believe that Congress intended to permit the Service to retroactively correct tax treatment choices which do not produce the expected benefits even though…these choices were the result of erroneous advice" by the financial consultant. But in PLR 2011-44040, the participant was GRANTED a waiver where he received erroneous information from his employer about the taxable status of part of his LSD/NUA stock distribution.

And more recently in **PLR 2013-11043 (3/15/13)**, an individual (age 91) took a distribution from his IRA, planning to roll it over to a different financial firm for investment reasons. But his

[22] See p. 217 of Green Book (p. 227 of "pdf" version).

accountant advised him more than once that this distribution would be tax-free because the income could be offset against some losses the individual had incurred in the same year, so the individual did not roll over the distribution. However, when it came time to prepare the income tax return, the accountants realized that the capital losses could not in fact be offset against the ordinary income of an IRA distribution. The IRS granted a waiver of the rollover deadline because the failure to complete the rollover within 60 days "was due to misleading tax advice from his CPA."

Is there any way to distinguish between PLR 2006-17039 on the one hand and PLRs 2011-44040 and 2013-11043 to justify the different results? Possibly. In PLR 2006-10739 the taxpayers would not have taken a distribution in the first place if they had not received the erroneous tax advice—so the erroneous tax advice related to the distribution, not the rollover. In PLRs 2011-44040 and 2013-11043, the individuals always intended to roll over the taxable portion of such distributions. They were misled about the extent to which the distributions were taxable and thus they were "prevented" by this erroneous advice from completing their intended rollovers.

See also **PLR 2012-01018 (1/6/12)** (widow received erroneous tax advice; allowed a waiver of the rollover deadline). She also was deterred by the erroneous advice from rolling over.

B. The 60-day Rollover Deadline Does (Not?) Apply to Direct Rollovers

§ 401(a)(31) applies to distributions from qualified retirement plans (QRPs), typically arising when the employee separates from service. It generally requires a QRP to transmit a departing employee's money directly (via "trustee-to-trustee transfer") into an IRA established for the employee unless the employee opts OUT of such treatment. The Code calls this direct transfer of funds from a QRP to an IRA a **direct trustee-to-trustee transfer**. § 401(a)(31)(A)(ii). The IRS (and this outline) call it a **direct rollover**. See, *e.g.*, Reg. § 1.401(a)(31)-1.

The IRS permits plans to carry out the direct rollover by cutting a check payable to the recipient IRA provider while *actually sending the physical check to the employee himself* (see Reg. § 1.401(a)(31)-1, A-4). Inevitably, some individuals who receive these direct rollover checks will lose them or just fail to act on them for some reason. Or the employee might even die between the time the check leaves the QRP and the time it arrives in the IRA.

Question presented: If the employee sits on the check for more than 60 days (or dies while the check is in transit), is it now too late to roll that distribution into the recipient IRA? After all, a rollover *generally* must be completed no later than "the 60th day following the day on which the distributee received the property distributed." § 402(c)(3)(A); § 408(d)(3)(A).

The answer: The IRS has given opposite answers to this question over the years.

Back in 2004, two separate ruling requests involved these facts: An employee requested that his plan balance be transferred by means of a direct rollover into another plan. A check *payable to the transferee plan* was mailed to the employee, who did nothing with it for more than 60 days. Then each employee applied to the IRS for, and received from the IRS, a waiver of the 60-day rollover deadline. Thus they were allowed to complete their "direct rollovers." But, significantly, the IRS did consider that there had been a "distribution" of the plan balance, since the employee received the check—and therefore the employee had to request a hardship extension to be able to complete

the rollover more than 60 days after the plan sent him the check. See PLRs 2004-24009, 2004-39049.

Fast forward to 2010. Again two individuals seek IRS rulings, reciting similar situations to those the IRS considered in 2004…but they get a different answer.

In PLR 2010-35044, the participant, age 52, suffered from severe mental disability and physical health problems, leading to termination of his employment. He opened an IRA at "Financial Institution B" and "verbally" requested a direct rollover of his account in the employer's retirement plan into this IRA. He received from the plan a check payable to the order of Financial Institution B "FBO" (for benefit of) the participant. The check was annotated "Total distribution—direct transfer—IRA." The plan issued a Form 1099-R for this distribution, coded as a direct rollover with no withholding of income tax.

Due to his failing health and mental condition the participant never delivered the check to Financial Institution B. He died more than 60 days after the check was distributed out of the employer's plan, never having delivered the check to the IRA provider. His executor sought to deposit the check into the IRA account that the decedent had opened to receive the check. The questions were: whether the executor would need a hardship extension of the 60-day rollover deadline (see § 402(c)(3)(B), § 408(d)(3)(I), and ¶ 2.6.07 of *Life and Death Planning for Retirement Benefits*) to complete this rollover on the decedent's behalf…or would have to return the check to the plan, with attendant confusion about the tax treatment of the already-reported "distribution" (and thereby resurrecting the plan beneficiary designation for the account)…or could simply deposit the check in the rollover IRA WITHOUT a hardship extension.

The IRS ruled that, because this distribution was in the form of a direct rollover, "it was *not subject to the 60-day rollover requirement*." Emphasis added. Therefore no "hardship extension" was needed. The IRS allowed the deceased participant's executor to deposit the check into the decedent's IRA.

That ruling confirmed PLR 2010-05057, in which another employee waited beyond 60 days before depositing his direct rollover check into the recipient IRA. In this one, the employee was still alive and he himself was requesting the ruling, rather than the ruling's being sought by an executor on behalf of a deceased participant as in PLR 2010-35044. The IRS allowed the employee to deposit the check in the rollover IRA, ruling that "The distribution check was given to Taxpayer A, but made out to Company B, FBO Taxpayer A; thus the check was not payable to Taxpayer A and Taxpayer A lacked control over the check and could not have disposed of it." The 1099-R issued by Company A was coded for a direct rollover. "In short, *Taxpayer A never received a distribution subject to the 60-day rollover requirement…*". Emphasis added.

It makes sense that a direct rollover is not subject to the 60-day deadline; the money is never distributed "to" the employee, because he receives a check he can't possibly cash. So these two 2010 PLRs represented a welcome about-face in IRS policy. Under the IRS's 2010 policy, it seemed to be no longer be necessary to seek an IRS "hardship extension" in this situation.

But that was 2010. Fast forward to 2013. In 2013 the IRS went back to its 2004 position! If your direct rollover check is not deposited into the recipient IRA account within 60 days, you gotta get a hardship waiver to complete the rollover!

In **PLR 2013-11041 (3/15/13)**, the participant requested direct rollover of her funds from her employer's Plan X into an IRA. Plan X issued two checks payable directly to the custodian of the participant's IRA, but mailed the checks to the participant, unfortunately to the wrong address. The participant did not receive the checks in time to deposit them into the IRA within the 60-day deadline. The IRS granted her a waiver of the deadline to the company's error.

....But but but....what about the two PLRs in 2010 that said the 60-day deadline doesn't even apply to a direct rollover???? I guess 2010 has been forgotten and we're back to the dark ages (2004).

C. 60 Days Start with the Initial Check? Or the Replacement Check?

What if the participant never receives the check the plan sends him?

The IRS has issued inconsistent PLRs on this question too. In PLRs 2004-30031 and 2004-36017, the IRS ruled that, if the distribution check is never received, there has been no distribution (the 60-day rollover period, in PLR 2004-30031, being measured from the date of the replacement check that the plan issued to replace the lost check).

But then in PLR 2004-47042 the IRS ruled that the 60-day rollover deadline was measured from the date of the original (lost) check, *not* the date of the replacement check.

The Tax Code (§ 408(d)(3)(A)(i)) says the deadline is "the 60th day after the day on which he [i.e., the participant or surviving spouse] receives the payment or distribution." Reg. § 1.408-4(b)(1) says the same. So, based on the Code and its own regulation, the IRS was right in PLRs 2004-30031 and 2004-36017 and wrong in 2004-47042.

In 2013, the IRS reverted to the correct position: In **PLR 2013-30047 (7/26/13)**, the participant was notified by his plan in December 2, Year 1, that it had sent him a check for his benefits. He notified the plan that he had not requested a check and furthermore he never received the check. On February 29, Year 2(?), the company sent him a replacement check, which he deposited on the following March 30 into an IRA account. He sought a waiver of the 60-day rollover deadline (apparently assuming that the date of the distribution was the date the *first check* was supposedly sent to him), on the grounds that he had been the full time care giver of "Individual B" during this period. The IRS denied the waiver on the grounds that he didn't need one because he had completed the rollover within 60 days of the distribution!

D. No Rollover Allowed Before Distribution Is Made!

2014-12020 (3/21/14). P had a SEP-IRA at FI-B. On 7/28/10, he applied for a new Roth IRA annuity with FI-C. On 8/10/10 he completed a request for conversion of the entire balance of the SEP-IRA to the new Roth IRA he had applied to set up. Impatient with delays in the transfer process, on 9/29/10 he sent a check from his taxable account for "Amount 3" to FI-C to go into the new Roth IRA. Unfortunately FI-C managed to open a nonqualified annuity for P rather than a Roth IRA so that's where the money went.

On 10/1/10 FI-B finally sent P a check from the SEP-IRA which he put into his checking account. On 10/11/10, P sent an unspecified amount of money ("Amount 4") to FI-C along with instructions to change the Roth IRA to a traditional IRA (recharacterization). FI-C put this money also into the nonqualified annuity. The total of Amounts 3 and 4 is Amount 2. When P discovered

the error in April 2012 he withdrew Amount 4 from FI-C, and sought a waiver of the 60-day deadline for both of his attempted IRA deposits with FI-C.

The IRS granted the waiver for the deposit of Amount 4 due to the errors of FI-C. With respect to Amount 3, however, that deposit was made before P received the distribution he was supposedly rolling over. Since at the time of the deposit there was no distribution to "roll over," the IRS refused to grant the waiver. Gotta feel sorry for this guy—if the financial institution hadn't screwed up the rollover (by putting P's deposits into a taxable account rather than into the Roth IRA they were supposed to go into) the IRS would never have had any way of knowing that P made his "rollover" before the date of the distribution he was supposedly rolling over!

E. Other Routine Waivers Granted

Meanwhile, more routine PLRs granting waivers of the 60-day rollover deadline continue to be issued in a steady stream:

2014-07027 (2/14/14). Erroneous information given. P had a plan loan outstanding with his employer's 401(k) plan. His employment was terminated but for a while he continued to receive paychecks with loan payments deducted from them. When the paychecks stopped, he was erroneously told by a financial advisor that he didn't need to do anything about the loan. In fact the loan (as required by the loan documents and explained in the summary plan description) was paid off by a deduction from his 401(k) account when he stopped making payments. That payoff was considered a distribution. P was unaware of it. The IRS granted him a waiver because of the erroneous advice of the financial advisor.

2014-07026 (2/14/14). P unaware of distribution. P retired from Employer in 2009. In 2013, while P was out of the country for an extended period of time, the plan administrator of the Employer's plan sent a letter addressed to P at his U.S. address that he had to take his money out of Employer's plan within 60 days because P had attained age 65 (this was a plan rule, not an IRS rule). P did not get any of his mail during his absence. The plan did not attempt to communicate with him otherwise than via this one letter (i.e., did not email or phone him). The plan mailed a check for the balance in P's account, minus withheld income taxes, to P's U.S. address, where it remained unopened and uncashed until P returned in June 2013. P received the letter when he returned from abroad in June, at which time he promptly (within 7 days) deposited the check in an IRA. The IRS waived the deadline with respect to the money that P had already deposited in the IRA, and also with respect to the withheld income taxes.

2013-25022 (3/26/13: Medical. Taxpayer, who suffered dementia as diagnosed by 2 physicians, withdrew from his IRA. He was not capable of making financial decisions. His wife held his power of attorney, did not discover the withdrawal until the following April when preparing tax return. Granted permission to make late rollover using the power of attorney.

2013-27023 (4/8/13): Medical. Taxpayer received distribution and, while considering how to reinvest it, suffered an injury (during the 60-day rollover period) that required her to receive "home medical care for 10 days and her using a support walker." She was "unable to wear a shoe for several weeks" and was "prescribed pain medication ....which affected her ability to manage her

financial affairs." Plus she is "of advanced age" (unspecified) and had no family living nearby. Waiver granted.

2013-27020 (4/9/13): Financial institution error. When the CDs in P's IRA at F.I. "C" matured, she met with a representative of the F.I. to move the funds to a new investment, still in an IRA. She did not want to take a distribution, she wanted to keep the money in an IRA, but the rep of the F.I. was in a hurry and prepared forms for transferring to a taxable account, and didn't give her time to read them. She didn't discover the error until she got a 1099-R at tax prep time. Waiver granted.

2013-27021 (4/9/13): Financial advisor error. In March, the participant met with his "financial advisor's assistant" to arrange taking the 2012 required minimum distribution (RMD) from his IRA, "Amount 1." He requested a distribution of a certain amount of cash plus enough shares "from Fund F" (to be distributed in kind) so that the total distribution would equal Amount 1. Instead, the assistant caused all shares of Fund F to be distributed, thus causing the distribution amount to exceed the RMD by "Amount 3." The participant did not discover the error until October. Waiver granted.

2013-30046 (7/26/13): Illness, family trauma: Taxpayer was overwhelmed by husband's death, by her 10 years as his care giver during his illness, by her own depression and physical ailments including near blindness, making her incapable of making financial decisions; thought the IRA she inherited and cashed out was a life insurance policy, didn't realize it was in fact a taxable IRA distribution until preparing her tax return the following April.

2013-11039 (3/15/13): Financial institution error: The participant, on 10/20/11, called his financial institution/IRA custodian and requested an IRA distribution of a specified dollar amount (e.g. "One thousand dollars"). By mistake the IRA provider transferred to the participant's taxable account the specified number of SHARES of some fund or company rather than the specified number of DOLLARS. Apparently these shares were worth more than $1 each, so the distribution was of a much larger dollar amount than had been requested. The participant did not discover this until he received his account statement in January 2012. He sought from the IRS, and received, permission to do a late rollover of the excess distribution due to financial institution error. [Why don't people review their accounts online at least monthly, or whenever a transaction has been requested? This error could EASILY have been fixed within 60 days if the participant had bothered to read his account statements.]

2013-11042 (3/15/13): Financial institution error: A company made a plan distribution to a deceased employee's surviving spouse. Ignoring the requirements of § 402(f)(1), the plan administrator didn't bother to tell the widow about her rollover options for this distribution (just told her she could choose between a lump sum distribution and an annuity). Waiver granted due to financial institution error. Similar is **PLR 2012-04025 (Jan. 27/2012)**: An employee received a distribution or several distributions from the terminating retirement plan of his former employer, but failed to timely roll over the distributions due to lack of or incorrect information from his former employer and/or his tax advisor. Waiver granted.

2013-11037 (3/15/13): Mental problem: A husband and wife both sought waivers. The wife had handled all their financial affairs, but her mental condition deteriorated and while she was in that

state she had withdrawn all the funds from both spouses' IRAs. She did not understand what she was doing, and did not believe people who tried to explain the consequences of these withdrawals to her. The IRS granted a hardship waiver to allow the funds to be returned to the IRAs. **PLR 2013-11038 (3/15/13)** similarly involved a hardship waiver due to a deteriorated mental condition.

2013-09026 (3/1/13): Financial institution error: The primary investment in the participant's IRA was "Investment X" (let's say). The financial institution serving as custodian of the IRA notified the participant at some time during Year 1 that it might not want to serve as custodian for this particular investment in the future. The participant spoke with the financial institution and its accounting firm about this and they said they were "looking into" ways to resolve the problem so they could remain as custodian. The participant heard no more about it until....the following January (Year 2) when she received a 1099-R indicating the investment had been distributed out of the IRA in November, Year 1! Yes, the custodian had simply distributed the investment out of the IRA into a taxable account with no notice whatsoever to the participant either before or after the distribution! Waiver granted.

2012-46044 (11/16/12): Financial institution error: The participant had many accounts at the financial institution including apparently both inherited IRA account(s) and regular IRA account(s). The participant sought to transfer funds from one regular IRA into another, but the financial institution by mistake transferred the funds into one of the inherited IRAs. Since that was not a permitted rollover, the taxpayer had to remove that erroneous contribution from the inherited IRA and (with permission from the IRS, which he received) roll the money into a regular traditional IRA in his own name. .

F. No Waiver for "DIY" Errors

The IRS tends to deny the grant of a hardship waiver when the 60-day rollover deadline is missed simply because of the taxpayer's own carelessness. When there's no handy financial advisor or financial institution error to point the finger at. When there's no extraneous hardship like an illness, catastrophe, death in the family, etc. that caused the taxpayer to miss the ball. When the taxpayer simply blew it (though sometimes the taxpayer alleges these factors are present it appears they just don't believe the taxpayer's story). The IRS in these cases recites that "none of the factors" listed in Rev. Proc. 2003-16 (the Revenue Procedure that established the procedures and standards for hardship waivers of the 60-day rollover deadline) is present.

Despite the following PLRs, a couple of more recent PLRs seem to show more leniency towards participant errors! Stay tuned for this possible changing trend....

2013-31012 (8/2/13). A tax preparer mentioned to her client that the client might be able to cash out *some* of her IRA tax-free if she had enough deductions to offset the income, and "provided a brief example" of this planning idea. Taxpayer (stressed out by her husband's recent death) misunderstood this advice, cashed out her whole IRA, spent the money, then sought a late rollover when confronted with the tax consequences of the distribution. The stress was documented by

"letters from several health providers." Wavier denied. Failure to understand tax advice is not one of the factors outlined in Rev. Proc. 2003-16.

2013-28036 (4/18/13): Taxpayer's own errors. Both husband and wife had IRAs at "Institution C." Both were unhappy with the investment choices and/or fees at Institution C, and (according to them) they verbally instructed Institution C to send the funds to IRAs established for them at Financial Institution E. However they did not have IRAs at F.I. "E," so the funds were transferred into Wife's taxable account at F.I. "E," where they languished until after expiration of the 60-day rollover window. The spouses did not submit any evidence that they had even applied to open IRAs at F.I. E, nor did they explain why they had not noticed the mistake on the regular financial statements they received with respect to the taxable account at F.I. E. Waiver denied.

2013-09023 (3/1/13) : Taxpayer's own errors. A husband and wife both withdrew funds from their IRAs at "Credit Union E" and placed the funds in their taxable accounts at the credit union. The withdrawal form they signed clearly flagged the 60 day rollover requirement. Apparently the couple did not realize how high the taxes would be on these distributions until they prepared their joint tax return the following year. Their only claim of hardship was inadequate disclosure of the 60-day rollover requirement, but the IRS found that they did have notice of that deadline and declined to grant a waiver.

2012-50031 (12/14/12): Taxpayer's own errors. "Taxpayer A" was dissatisfied with the returns he was receiving on his IRAs invested with Financial Institution A (FI-A) and discussed the problem with his financial advisor "Individual I" who worked at FI-A. The advisor told him that FI-A could not get him a better rate and that he would need to withdraw his funds from FI-A and deposit them elsewhere. Although the participant apparently intended to roll the funds into new IRAs at the new financial institutions he had selected (FI-B and FI-C), he in fact deposited the funds into taxable joint accounts with his wife. And of course he didn't discover this mistake until he received 1099-Rs the following year showing full taxable distribution of the IRA.

What is unusual is that the advisor, Individual I, gave the participant an affidavit to submit to the IRS in which Individual I said he failed to adequately advise the participant about the tax effects and the rollover procedures, and "ensure that the funds were actually deposited into rollover IRAs" as the customer intended. Nevertheless the IRS refused to grant a waiver, saying that "Individual I had no duty to ensure that the rollovers were completed correctly once the funds were distributed to Taxpayer A." The taxpayer "assumed the risk" of attempting the rollover without the benefit of professional advice. Waiver denied!

2012-06023 (2/10/12): Taxpayer's own errors. Taxpayer A (age 86) *said* the reason his missed the deadline was that he was told by an employee of the IRA provider-company from which he took the distributions to be rolled over that he had 90 days to complete the rollover. But Taxpayer A had no "documentation" of this "alleged financial institution error" other than his own statement. I guess the IRS didn't believe his story—another lying old codger!—so they denied the waiver.

X. OTHER MISCELLANEOUS CASES AND RULINGS

A. *El v. Comm'r*, 144 T.C. 9 (3/12/15): Burden of Proof on Premature Distributions Tax; Deemed Distribution Resulting from Plan Loan

Summary: The *El* case is an important reminder of the importance of keeping records and annually filing Form 5329 for your retirement benefits. YOU, the IRA owner (or plan participant) have the burden of proof if the IRS asserts income taxes or "additional taxes" by virtue of your retirement plan activities....and (though not involved in the *El* case) the IRS is never time-barred from asserting these taxes if you don't file Form 5329!

Discussion:

Distributions from retirement plans are generally includible in gross income. There is an exception for a loan to the employee from the qualified retirement plan (QRP) if the loan meets the requirements of § 72(p)(2)(A)(ii). A qualifying loan is treated as a loan rather than a taxable distribution. One of the requirements of the Code section on plan loans is that the total amount loaned to the employee may not exceed the greater of $10,000 or one-half of the employee's vested balance in the plan. [It also may not exceed $50,000, even if the vested balance exceeds $100,000, but that limit was not involved in this case.] If the plan loan exceeds the permitted amount, the excess is treated as a distribution not a loan.

Mr. El took a loan from his employer's QRP in 2009. The amount of his total loans from the plan following this loan was $12,802, which was more than half of his plan balance ($17,017/2 = $8,535.50) and more than $10,000. Therefore the IRS treated the excess ($2,802) as an income-taxable distribution and also assessed the 10 percent additional tax under § 72(t) (sometimes nicknamed the "premature distributions penalty") due on distributions made prior to age 59½ not otherwise excepted. So far the case is not exceptional.

One issue in the case was who had the burden of establishing the initial facts with respect to § 72(t). Normally the burden of proof in tax cases starts with the taxpayer. He must present some evidence in support of his position. Once the taxpayer presents "credible evidence" on a factual issue, the burden of proof shifts to the IRS with respect to that issue. § 7491(a)(1), General Rule.

However, a different rule applies to *penalties*. Specifically, "Notwithstanding any other provision of this title," the IRS has the "burden of production" regarding any "penalty, addition to tax, or additional amount imposed by this title." § 7491(c). In other words, when dealing with a penalty, the IRS has to produce evidence to start the process–they can't just assert the penalty then sit back and demand the taxpayer prove the penalty doesn't apply.

So who had the burden of proof regarding the § 72(t) 10 percent assessment against Mr. El, the tax that is often referred to as "the 10 percent penalty" on pre-age 59½ distributions?

The Tax Court considered this subject at length after asking the parties for supplemental briefs on the point. The Court concluded that ***the taxpayer had the usual burden of proof with respect to the 10 percent tax***. The Court stated that the tax is consistently called an "additional tax" or a "tax," never a "penalty, addition to tax, or additional amount." Therefore Mr. El, not the IRS, had the initial burden to present credible evidence on whether § 72(t) applied.

Here are some points of interest regarding this decision:

✓ The IRS sought an alternative ruling: If the Court had held that the 10 percent § 72(t) tax was a penalty, the IRS wanted it to rule that, nevertheless, the taxpayer would have the initial burden of evidence with respect to any *exception* the taxpayer claimed with respect to such penalty. The Court didn't need to get to that question since it did not rule that the tax was a "penalty."

✓ Oddly, Mr. El's age was not mentioned in the record! He may have been over 59½ for all we know!

This ruling (which was cited favorably in another Tax Court case a few days later, *McKnight v. Comm'r*, T.C. Memo 2015-47 (3/16/15)) reminds us that on every retirement plan issue I can think of *the taxpayer has the initial burden of proof.* If every "excise tax" and "addition to tax" is, like the 10 percent tax under § 72(t), just an *additional tax* and not an *addition to tax* or a penalty, the taxpayer therefore will have the initial burden on:

♦ Whether a plan distribution occurred.

♦ Whether a "deemed distribution" has occurred from a retirement plan by virtue of such events as an improper loan (as in *El*) or (in the case of an IRA) a prohibited transaction between the IRA and its owner.

♦ Whether a distribution is subject to the "additional 10 percent tax" under § 72(t) for pre-age 59½ distributions.

♦ Whether the taxpayer is liable for the six percent penalty, excuse me, *additional tax* for making an excess contribution to his IRA. § 4973(a).

♦ Whether the taxpayer is liable for the 50 percent penalty, excuse me, *additional tax* for failure to take a required minimum distribution. § 4974.

B. 2014-37025, 2014-37034 (9/12/2014). Waiver of 50% tax on failure to take RMD from inherited IRA due to reasonable cause (litigation)–but no postponed starting date.

These interesting rulings involving the same fact situation discuss several interesting questions. Usually requests for waiver of the 50% excise tax are filed and granted (or denied) privately, without publication of the IRS's decision. This rare PLR illustrates what the IRS considers reasonable cause and reasonable steps to remedy the shortfall (see ¶ 1.9.03).

Participant died 1/20/2006 at age 77, leaving his IRA partly to his longtime friend "B," and partly to his medical care provider "D." Friend B and the participant's ex-wife C brought a court case challenging the designation of care provider D. Assets of the IRAs were frozen pending the outcome of the litigation and it was not possible for B and C (who ultimately prevailed) to take RMDs until the case was settled June 16, 2010.

C (in PLR 2014-37025) and B (in PLR 2014-37034) asked, first, that they be allowed to delay the start of RMDs until the settlement date. This request was apparently denied. They then

asked for a waiver of the 50% excise tax for failure to take the RMD for the years prior to the settlement agreement. This was granted, because the ongoing litigation and dispute about who was entitled to the account constituted reasonable cause for failure to take the RMDs, and because the taxpayers would take the "shortfall" by the end of 2014.

Finally, the IRS ruled that the caregiver-D's life expectancy was the Applicable Distribution Period because she was the beneficiary as of the date of death and had not disclaimed prior to the Beneficiary Finalization Date. There is no mention of the relative ages of B, C, and D.

C. PLR 2015-11036: Spousal Rollover Through Trust and/or Estate

As explained in great detail in ¶ 3.2.09 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011), the IRS has been generous, in private letter rulings, in allowing a surviving spouse to roll over, to the surviving spouse's own IRA, benefits of the deceased spouse that are payable to the deceased spouse's estate or trust as beneficiary (or payable to the trust as beneficiary of the decedent's estate that is beneficiary of the decedent's retirement plan), provided that the surviving spouse has the right to withdraw the benefits from the estate or trust and pay them to him/herself without the approval of a third party and without being required to meet some standard for distributions. The unbroken record of IRS approvals of such rollovers goes back through dozens of rulings from 1993 to date.

Another recent ruling in the string is **PLR 2015-11036** (12/18/14). The deceased husband left ten IRAs to his estate as beneficiary. The estate was payable to "Trust C" which in turn (after settlement of debts, expenses, and taxes) was payable to "Trust D." The surviving spouse "became the sole trustee of Trust C upon" the decedent's death. The surviving spouse was entitled to all income of Trust D, and had the unlimited right to withdraw all principal of Trust D on demand. She exercised her right to demand payment to herself of all the IRAs, and proposed to transfer the "proceeds" of these IRAs into one or more IRAs set up in her name. The IRS ruled that she could roll over the proceeds of these IRAs into her own IRAs.

Thus, the ruling is totally normal and consistent with prior PLRs. One continues to wonder why the IRS will not issue this principle in a form that can be cited as authority such as a Revenue Ruling or regulation.

Another important point about this PLR: It appears that the spouse was causing each of the 10 IRAs to distribute its funds, then rolling each distribution into her own IRA(s) within 60 days. These distributions occurred in 2014. Under the pre-2015 IRS interpretation of the once-per-12-months rule, these were permissible rollovers because each distribution came from a different account. If the distributions had occurred in 2015 presumably only one rollover would have been allowed; see the *Bobrow* case discussed elsewhere in this outline.

XI. TRUSTS, RETIREMENT BENEFITS, AND THE 3.8% "NIIT"

This article focuses on the interplay of retirement plan benefits and fiduciary income tax rules with respect to the net investment income tax. For a complete explanation of how the 3.8% separate income tax on net investment income applies to trusts and estates, see Blattmachr, J., Gans, M., and Zeydel, D., "Imposition of the 3.8% Medicare Tax on Estate and Trusts," 40 *Estate Planning* 4 (April 2013). I am indebted to those authors for their comprehensive explanation.

§ 1411, effective in 2013, imposes a new 3.8% income tax (in addition to regular income tax and AMT) on net investment income. This tax is nicknamed the "net investment income tax" (NIIT). The tax applies to individuals and, in a slightly different way, also to trusts and estates.

The IRS issued proposed regulations December 5, 2012.

The IRS issued final regulations December 2, 2013. See T.D. 9644. The final regulations are effective for taxable years beginning after December 31, 2013, except that §1.1411-3(d) applies to taxable years beginning after December 31, 2012.

A. Meet the NIIT: Our Fourth (At Least) Separate Income Tax System!

This tax increase, which was imposed on us by the Patient Protection and Affordable Care Act of 2010, is captioned the "Unearned Income Medicare Contribution." It has been described as an extension of the "Medicare" tax (previously imposed only on wages and self-employment income) to investment income. However, unlike the basic 2.9%/3.8% Medicare tax applicable to compensation income, it is not withheld, nor is it divided into an "employer" and "employee" share. Nor are the proceeds of this tax in any way earmarked or set aside to fund the costs of Medicare or any other program. It is simply a 3.8 percent income tax applied to a certain class of income of "high-income" taxpayers. See § 1411, effective for years after 2012.

The tax applies to "net investment income" of individuals whose modified adjusted gross income (MAGI) exceeds a certain "threshold amount." Investment income includes "interest, dividends, annuities, royalties, and rents" and "net gain" attributable to the disposition of property. The "threshold amount" is modified adjusted gross income of $250,000 for "A taxpayer making a joint return…or a surviving spouse…." The threshold is half that amount for a married taxpayer filing separately; and $200,000 for any other individual taxpayer. Note that:

✓ These income thresholds are not adjusted for inflation. § 1411(b).

✓ Distributions from IRAs, Roth IRAs, qualified plans, 403(a) and 403(b) arrangements and 457(b) plans are NOT subject to the NIIT. § 1411(c)(5). However, income-taxable distributions from such retirement plans are included in threshold amount, so the net effect will be the same in many cases as if they were subject to the tax. (Nontaxable distributions from any type of retirement plan, including qualified distributions from Roth plans and IRAs, do not count towards the threshold because they are not included in gross income.)

Chris Example: Chris and his wife have MAGI of $200,000 in 2013, including $50,000 of interest and dividends, before taking any IRA distributions. At this point they are not subject to the NIIT, because their MAGI is below the $250,000 threshold. Then Chris takes $100,000 from his IRA (all pretax money). This increases their MAGI to $300,000, putting them above the threshold by $50,000. Their entire $50,000 of interest and dividends are now subject to the NIIT.

✓ "Modified adjusted gross income" means AGI increased by certain foreign items. § 1411(d). Unlike the income threshold for taxing Social Security benefits, the threshold for this tax on NII does NOT include municipal bond interest. Compare § 1411(d) with § 86(b)(2)(B).

✓ Alimony and Social Security benefits are exempt from the NIIT. Reg. § 1.1411-1 (d)(4)(ii).

The NIIT system applies in a slightly different way to trusts and estates; see below.

Before the entrance of the NIIT, our tax code already contained at least three different systems for determining and taxing personal income. There is the "regular" income tax (see § 1 *et seq.*); the "FICA" tax system applicable to wages and self-employment income (§ 3101 *et seq.*); and the alternative minimum tax (AMT; § 55). Each of these taxes has its own way of determining income (*e.g.*, certain 401(k) contributions are excluded from income for purposes of the regular income tax, but includible for purposes of the FICA tax) and its own allowable deductions (*e.g.*, the charitable deduction can reduce your income for purposes of the regular tax but not for purposes of the FICA tax; certain other deductions are disallowed for purposes of the alternative minimum tax).

Has Congress introduced, with § 1411, still another system for computing and taxing personal income? Apparently yes. The NIIT is a separate tax applied only to a particular type of income, namely, investment income.

The definition of the income subject to NIIT does allow some deductions from the regular income tax system to be taken in transforming gross investment income into net investment income, namely, "deductions allowable by this subtitle which are properly allocable to such" gross investment income. It is not clear from this (very short) statute whether that offset is limited to deductions directly tied to the investment income (such as investment management fees), or whether broader non-investment-related deductions could also be applied to reduce NII. Congress seems to have left it up to the IRS to answer that question as well as many others left up in the air in the statute.

According to the regulations, the IRS is trying to use the "regular" income tax system as much as possible for applying the NIIT: "Except as otherwise provided, all Internal Revenue Code provisions that apply for chapter 1 purposes in determining taxable income (as defined in section 63(a)) of a taxpayer also apply in determining the tax imposed by section 1411." Reg. § 1.1411-1(a).

However, despite this statement, the actual computation of the NIIT does not allow use of, *e.g.*, the charitable deduction to offset the NIIT as it applies to individuals. See Reg. § 1.1411-4(f). Only certain deductions under § 62 and § 63 that are in the nature of investment expenses "properly allocable" to the NII can be used to reduce NII.

Example: Alan, who is single, has $300,000 of adjusted gross income, all of which is investment income. He donates $125,000 of his income to the Red Cross. His taxable income for purposes of the regular income tax is $175,000. But his taxable net investment income is apparently still $100,000 (the amount of his AGI in excess of the $200,000 threshold amount). The charitable gift does not reduce his NII, so he owes $3,800 of NIIT.

Thus as with the FICA tax, and as with the 10 percent "additional tax" on "premature" (pre-age 59½) distributions from a retirement plan, it is theoretically possible for an individual to owe NIIT even if he doesn't owe *any* regular income tax.

With that background, let's see how the NIIT applies to trusts. As we shall see, unlike "Alan," a *trust* can use the charitable deduction to reduce its NIIT.

B. Contrast Individual and Trust Systems

An individual is subject to a 3.8% tax on the lesser of (1) his net investment income (NII) and (2) his adjusted gross income (AGI) in excess of a certain "threshold" amount. The thresholds ($250,000 for married taxpayers filing jointly, $200,000 for singles, etc.) are set high enough to that low-income individuals are not subject to the NIIT at all.

A trust (or estate; the same rules apply to both) is in a very different position. First, rather than a high "threshold" amount designed to exclude low-income taxpayers, a trust gets into NIIT territory if its income is high enough to put the trust in the highest "regular" income tax bracket. Under § 1(e), that level is $7,500 indexed for inflation. As of 2015, the $7,500 has increased through indexing to $12,300.

Second, the trust is not taxed on its "NII" as an individual is; rather it is taxed only on its *undistributed* NII. So for a trust the NIIT is 3.8% of *undistributed NII*, or 3.8% of its AGI in excess of $12,300, whichever is less. § 1411(a)(2). As we shall see, this allows a trust to in effect use a charitable deduction to reduce its NIIT even though an individual cannot do that.

With expiration of the "Bush tax cuts" (resulting in the top "regular" income tax bracket returning to 39.6%), the addition of the NIIT means that trusts and estates will pay a 43.4 percent tax on net investment income beginning at $12,300 of taxable income.

C. The Big Question: Which Distributions "Carry Out" NII?

The statute left two questions unanswered regarding trusts and the NIIT:

✓ First, if the trust is taxable on its "undistributed NII," are we to presume that the beneficiary who receives a distribution from the trust that is deemed to include NII must include such NII in his or her NII for purposes of such beneficiary's NII tax? The Code doesn't say so, but the regulation does say so and accordingly fills this statutory gap. See Reg. § 1.1411-3(e)(1).

✓ Second, if a trust makes a distribution to a beneficiary, how do we determine whether that distribution "carries out" NII? For example, if the trust receives $5 of NII (subject to the NIIT) and a $5 IRA distribution (exempt from the NIIT), and distributes only $5 to the beneficiary, how do we know which class of income that distribution came out of?

This question is more difficult. The Code gives no clue about how to determine which distributions reduce and which do not reduce the trust's NII. How to get from "NII" to "undistributed NII" is therefore entirely up to the IRS to determine, apparently.

Just as we have had, before the birth of the NIIT, three different systems for taxing personal income, the IRS has long had, in its regulations, two separate elaborate systems for figuring out what type of income is "carried out" via distribution from a trust to the trust beneficiary: The "DNI" (distributable net income) system of § 651–§ 652, § 661–§ 663, tells us how taxable income is or is not carried out to individual beneficiaries, and there is a second "system" with different rules for determining whether taxable income is carried out to a charitable beneficiary via the charitable deduction under § 642(c).

Not surprisingly, the IRS wants to graft the NIIT onto the existing rules for DNI and the fiduciary charitable deduction rather than create a whole new system for the new tax. As the IRS said in its Preamble to the proposed regulations, "Undistributed net investment income is a section 1411 term used solely for estates and trusts (and not individuals), and is not defined in section 1411. The proposed regulations conform the taxation of estates and trusts under section 1411 to the rules of part I of subchapter J to avoid double taxation of net investment income and the taxation of amounts distributed to charities."

In the case of a distribution of DNI under section 651 or section 661 that consists of both net investment income and excluded income, the distribution must be allocated between net investment income and excluded income in a manner similar to § 1.661(b)-1 as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income.

The regulation gives an example of a trust that receives interest income, capital gain, and an IRA distribution. The interest and IRA distribution comprise DNI but the capital gain (being allocated to principal for trust accounting purposes) does not enter into DNI. See Reg. § 1.1411-3(e)(5), Example 1.[23] The interest income and the capital gain are included in NII, but the IRA distribution is not NII. A distribution to the income beneficiary carries out NII and NII-exempt income in the same proportions as the interest income and IRA distribution bear to the total DNI.

D. Governing Instrument Provision Could Change Things

A trust funded with retirement benefits is going to be in a tough position. The retirement plan distributions, if held in the trust, are going to be taxed at the highest income tax rate (39.6%) if the retained income exceeds a mere $12,300. NII retained in the trust will be taxed at an even higher rate. If funds are being accumulated for a an individual beneficiary whose income is not subject to these rates, there will be a high price to pay for that accumulation.

How will estate planners and trust drafters meet this challenge? How can funds be preserved and protected for low-income beneficiaries at the lowest tax cost? Some paths to consider include:

✓ **Roth conversions.** Roth IRA distributions can be accumulated in a trust at no income tax cost. A client who proposes to leave his retirement plans to an accumulation trust for individual beneficiaries, and who is not in the highest income tax bracket himself, might consider converting his traditional retirement plans to Roth accounts now, at his lower bracket, rather than leaving the benefits to be taxed at the highest possible rate when distributed after his death to a trust.

✓ **Distribute investment income, retain retirement benefits: Drafting stage.** A trust could mandate that investment income be distributed to individual beneficiaries, and direct

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[23] The proposed regulation contained a similar example but suffered from an error: The example erroneously treated an IRA distribution as being includible in DNI only to the extent it was allocable to income for trust accounting purposes. See Prop. Reg. § 1.1411-3(f), Example 1. In fact, taxable retirement plan distributions are includible in DNI regardless of their status for trust accounting purposes. § 643(a); Reg. § 1.663(c)-5, Examples 6 and 9; and CCA 2006-44016. This error was corrected in the final regulation.

accumulation only for retirement benefits. That could work if the individual beneficiaries are not subject to the NIIT (because their income is below the individual NIIT thresholds). Such an allocation of a specific class of income is respected for income tax purposes if and only if it has independent economic effect. See Regs. § 1.643(a)-5(b) and § 1.642(c)-3(b).

✓ **Distribute investment income, retain retirement benefits: Administration.** If this type of mandate is not included in the governing instrument, a trustee will not be able to pick and choose which type of income an individual beneficiary receives, because of the pro rata rule. However, the trustee could to a limited extent time distributions from retirement plans to keep taxes down. For example, even if the trust's minimum distribution for the year was only $2,000, the trustee might withdraw from the IRA, and retain in the trust, $12,300 [2015 rates], to soak up the lower tax brackets.

E. Charitable Remainder Trusts

Charitable remainder trusts are of course income tax-exempt and are accordingly also exempt from the NIIT. With the "regular" income tax, the trustee is required to keep track of what types of income it receives (ordinary income, capital gain, tax-exempt income, and return of principal). Then when the trustee makes distributions to the individual trust beneficiary, the trustee essentially regurgitates these income types on a worst-first basis, and the beneficiary reports the distribution on his or her income tax return accordingly. § 664(b).

The IRS faced the problem of how to layer the NIIT onto this existing system. In its proposed regulation, it proposed that the trustee would have a separate tracking system for net investment income it received, and then distributions to the individual beneficiary would carry out NII "first" and carry out NIIT-exempt income or principal only when all NII had been distributed. See Prop. Reg. 1.1411-3(c)(2).

There were two problems with this proposal. One was practical: Trustees were already sorting their receipts into four separate "buckets," and this would have required them to set up a new and separate system for tracking NII vs. NIIT-exempt income. The second problem is that the Code itself indicates that all ordinary income is deemed distributed before any capital gain is distributed. Thus, according to the Code, retirement plan distributions (which are NIIT-exempt ordinary income) would be deemed distributed before any capital gain was deemed distributed.

The final regs defer to many commentators and use the existing system to track NII. The trustee will continue to sort receipts into the traditional four "buckets," but within each bucket the trustee will track NII vs. NIIT-exempt income. In effect there will now be six buckets: Ordinary income that is NII, ordinary income that is NOT NII (i.e. taxable retirement plan distributions, and pre-2013 investment income), post-2012 capital gain (it is NII) and pre-2013 capital gain (not NII), tax-exempt income (not NII), and return of principal (not NII). The "buckets" will be "emptied,"in that order, i.e., within each type of income the NII is deemed distributed first. An election is allowed to enable the trustee to choose between different methods of tracking NII.

F. Planning implications

Because of the new distinction between "investment income" (which potentially attracts the NIIT) and "retirement plan distributions" (which are exempt from the tax), it becomes critically important for–

- ✓ Fiduciaries to track the different types of income they receive, and take advantage of opportunities to reduce the NIIT via timing of distributions from a retirement plan and to beneficiaries; and for

- ✓ Estate planners to consider whether a client's trust instrument, if not yet irrevocable, should be revised to direct different treatment for different classes of income to minimize the NIIT.