

IRAs and Qualified Retirement Plans

Chapter 8

Roth IRA Recharacterizations

Conf. Version

Eliminates Roth IRA recharacterizations to traditional IRAs "for tax years beginning after Dec. 31, 2017".	
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Supp

Fish
(CA 9 10/19/2017)

IRA UBTI Losses Are
Not Deductible By IRA
Owner

3

8-2

PLR 201707001
(Released 1/17/2017)

IRS OKs Spousal IRA
Rollovers From A Trust
The Spouse Controlled

4

Facts

- Decedent's Roth and Traditional IRAs named "The Trust" as the IRA beneficiary.
- Surviving spouse is trustee and sole-beneficiary of the trust
- Likely a California estate.

5

The surviving spouse sought to either:

- 1) Treat the IRAs as her own or
- 2) To rollover distributions, tax free, into her own Roth and Traditional IRAs.

6

Key IRS Holdings

- 1) "Taxpayer, as the surviving spouse of Decedent, may not treat Decedent's Roth IRAs or traditional IRA as her own, because the Trust was named as the beneficiary of each of the IRAs."

7

- 2) "However, because Taxpayer is the trustee and sole beneficiary of the Survivor's Trust... Taxpayer is effectively the individual for whose benefit the accounts are maintained."

8

Accordingly, if Taxpayer receives a distribution of the proceeds of Decedent's Roth IRAs and Decedent's traditional IRA, she may roll over [tax free] the distribution (other than [RMDs]) ... into a Roth IRA and a traditional IRA established and maintained in her name."

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PLR 201706004
(Released 2/10/2017)

8-4

Judicial Change in
Beneficiary Of Decedent's
IRA Provides Path for
Rollover to Surviving
Spouse

10

Explains how the spousal rollover rules work when the first spouse dies before the RBD

11

Facts

- The decedent's IRA C named a **nonexistent living trust** as beneficiary.
- The surviving spouse, "B", sought to rollover "[d]ecedent's IRA C to her own IRA."

12

- Per Decedent's Will, decedent's entire estate was left to the surviving spouse (not a pour over will).

13

- The surviving spouse, B, will obtain a state court order approving the change of beneficiary designation from trust to surviving spouse.

14

IRS Holdings

- “The court order cannot create a ‘designated beneficiary’ ... because [surviving spouse] was not the designated beneficiary of IRA C as of the date of Decedent's death.”

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Because Decedent died before the required beginning date and without a "designated beneficiary" the entire interest in IRA C must be distributed using the 5-year rule.

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“Any amounts payable from IRA C to [surviving spouse] in years 1 - 4 following the year in which decedent died are not [RMDs] and are eligible for rollover [tax free] by [surviving spouse] at a time that [surviving spouse] is the beneficiary under IRA C.”

17

“On or after January 1 of the fifth year following the year in which Decedent died, any amount payable from IRA C to [surviving spouse] is not eligible for rollover because it is a required minimum distribution....”

18

Summers

8-5

TC Memo 2017-125
(June 26, 2017)

Early Distribution
Penalty Applied When
Taxpayer Split IRA
With Ex-Wife; No QDRO

19

Background

Reg 1.408-4(g)(1) states that the transfer of an individual's interest, in whole or in part, in an IRA to his or her former spouse under a **valid divorce decree or a written instrument incident to such divorce** shall not be considered to be a distribution from an IRA to such individual or the former spouse.

20

Observation

Unlike a qualified plan (which requires a QDRO), with an IRA, the distribution need only be pursuant to a "valid divorce decree or a written instrument incident to such divorce".

21

Facts

- At the time of his divorce, Taxpayer, Jeremy, filed a petition for divorce in Arizona.
- His divorce petition requested that "[t]he proceeds of IRA should be divided 50% to Petitioner and 50% to Respondent."

22

In late April 2013, “a month before the divorce decree was entered”, Jeremy withdrew the total proceeds of the IRA, \$17,378 and transferred half to Karie.

23

- Because the taxpayer distributed the IRA before the divorce decree was entered, the distribution was fully taxable to him
- Jeremy conceded taxability but fought the 10% too-early Sec. 72(t) penalty.

24

Section 72(t)(C)
creates an
exception from the
penalty for
distributions
pursuant to a
QDRO.

25

Tax Court Holding
No QDRO so no sec.
72(t)(2)(C) protection from
the 10% penalty.

Observation:

- Better reason for same outcome: Sec. 72(t)(2)(C) does not apply to IRAs (per sec. 72(t)(3)(A)).

26

Omoloh

8-7

TC Summary Opinion
2017-64 (8/16/2017)

Taxpayer Failed to
Convince the Tax Court
that he was 59-1/2.

27

Facts

Taxpayers sought to
avoid the sec 72(t)
10% penalty for IRA
distributions by
proving he was older
than 59&1/2

28

Judge Carluzzo Holding for IRS

“We share [IRS’s] concerns with the accuracy of the information shown on the birth certificate, **information [taxpayer] apparently provided to the issuing Kenyan agency during the pendency of this case.**”

29

McGaugh
(CA 7 6/26/2017)

8-8

IRS Loses; No IRA
Distribution Despite
Taxpayer Directing IRA
Purchase

30

Facts

- In summer 2011, taxpayer asked **Merrill Lynch** to use money from his IRA to purchase 7,500 shares of stock issued by **First Personal Financial Corporation (FPFC)**.
- **Merrill Refused.**

31

- McGaugh called Merrill Lynch and initiated a **wire transfer of \$50,000 from his IRA directly to FPFC**, on October 7, 2011.
- On November 28, 2011, FPFC issued a stock certificate titled "**Raymond McGaugh IRA FBO Raymond McGaugh**", which it mailed to Merrill Lynch.

32

- Merrill Lynch characterized the wire transfer as a **taxable distribution** and issued a **Form 1099-R** for \$50,0000
- IRS agreed with Merrill.

33

- IRS' primary argument was that McGaugh **"constructively received funds from his IRA when he directed Merrill Lynch to wire them at his discretion to FPFC."**

34

Holding for Taxpayer

- **Affirming the Tax Court**, the Seventh Circuit concluded that McGaugh **did not “direct a distribution to a third party; he bought stock.”**
- **“That is a prototypical, permissible IRA transaction.”**

35

Information Letter *2017-0018*

8-10

(Released June 30, 2017)

IRS Payout From Failed
Financial Institution
Escapes The One-
Rollover-Per-Year Limit

36

PLR 201715001
(4/14/2017)

8-11

Contributions To Two
Plans Had To Be
Aggregated And Thus
Violated Section 415(c)
Limits

37

The PLR illustrates how plans maintained by **controlled group members (brother-sister professional corporations)** are aggregated for purposes of the annual contribution ceiling of \$50,000 in section 415(c) (for 2012)

38

*Block Developers LLC
et al*, TC Memo 2017-
142 (July 18, 2017)

8-11

Overfunding of Roth
IRAs Leads to Section
4973 Penalty.

39

Background

*"In Repetto v.
Commissioner*, T.C. Memo.
2012-168, the taxpayer's
Roth IRA formed a 'service
corporation' that received
'service' payments **but
didn't actually perform any
services for the taxpayers'
business."**

40

“We looked behind the label and found that the service payments were
‘nothing more than a mechanism for transferring value to the Roth IRAs.’
We then recharacterized those payments as contributions.”

41

Tax Court Holding for IRS

“We do acknowledge that the substance-over-form doctrine is not something the Commissioner can use to pound every Roth IRA transaction he doesn't like.

42

The Sixth Circuit recently reversed one of our decisions rooted in the doctrine. See *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2017), rev'g T.C. Memo 2015-119. In *Summa*, the taxpayers had a similar setup: a business entity whose sole purpose was to transfer money into Roth IRA accounts.

43

But there the entity was a domestic international sales corporation.

Because a DISC's congressionally sanctioned purpose was tax avoidance, the Sixth Circuit held that neither the Commissioner nor the courts had any basis to recharacterize the transactions at issue according to their substance.

44

But Summa's facts are not the [Block Developers']; LLCs, unlike DISCs, are meant to have a real business purpose. The Sixth Circuit in Summa specifically okayed the use of the substance-over-form doctrine in cases where taxpayers used a corporate form that lacked any substance to facilitate a tax-avoidance scheme.

45

It wrote that *Repetto* was such a case. Today we find that the ... Block Developers are, in this important way, just like the taxpayers in *Repetto*."

46

*Plaza Staffing Services,
Inc. v. IRS*, Doc. No.
6881-12R (Tax Court
Order 8/17/2017) 8-14

ESOP Disqualified For Failing
Qualified Plan Minimum
Participation Standards

47

Dr. Zapolanski was the
sole shareholder of Paza
Corporation.

He transferred the stock
to an ESOP so
Zapolanski was the
ESOP's sole participant
for 1999

48

Zapolanski also owned 100% of another corporation, Golden Gate (a controlled group), that had non-highly compensated employees who met the requirements for the ESOP but were not participants in the ESOP.

49

IRS sent Paza corporation a final non-qualification letter, in which IRS disqualified the ESOP for the 1999 plan year and all subsequent years.

50

Tax Court Holding for IRS

Section 410(b)(1)(B) requires qualified plans to benefit "a percentage of employees who are not highly compensated employees which is at least 70 percent of the percentage of highly compensated employees benefitting under the plan."

51

"All employees of all corporations which are members of a controlled group of corporations" are treated like they are employed by one single employer."

(Section 414(b))

52

This means that 100% of highly-compensated employees (Zapolanski) at Paza were benefitting under the ESOP. So, the plan needed to also benefit 70% of the non-highly compensated employees of Golden Gate.

53

Conclusion: The Tax Court agreed with IRS that Paza's ESOP was disqualified for the 1999 plan year and all subsequent years.

54

*DNA Pro Ventures, Inc.
Employee Stock 8-16
Ownership Plan v. Comm.,
(CA 8 05/09/2017)*

CA-8 Upholds
Disqualification Of ESOP
Based On Stock Allocation
To Officer Who Drew No
Salary

55

Background

For the tax year at issue,
the 2008 plan year, a
participant's annual
additions were limited to
the **lesser** of \$40,000 or
**100% of the participant's
compensation.**

(Section 415(c)(1))

56

A qualified plan is
disqualified if it
makes a
contribution **in**
excess of the
section 415 limit
(Section 401(a)(16))

57

Facts

Dr. Prohaska, the founder of DNA Pro Ventures, Inc. (a C corporation) **received no compensation as an officer or employee of DNA in 2008**; yet, **1,150 shares** of DNA common stock was **allocated to Dr. Prohaska's ESOP** account as an employer contribution.

58

8th Circuit Holding

The Eighth Circuit agreed with the Tax Court and IRS that the ESOP was not qualified and the Trust's income was not exempt from tax in calendar years 2008-2011.

59

Information Letter

2016-0072

8-17

(Released 12/30/2016)

Plan Administrator Can
Decide RMD Payment
Date

60

Trimmer
148 TC No. 14 8-17
(April 20, 2017)

IRS Abused Discretion
In Denying Request For
Hardship Waiver

61

Facts

While suffering from major depressive disorder after retiring from the NYPD **in 2011**, taxpayer received two distributions from his retirement accounts but did failed to roll them over into another qualified retirement account within the requisite 60-day period.

62

Tax Court Holding

In "the facts and circumstances of this case, it would be "against equity or good conscience", within the meaning of I.R.C. sec. 402(c)(3)(B), to deny [Taxpayers]' request for a hardship waiver; the two distributions are excluded from [Taxpayers]' 2011 gross income."

63

Observation

Rev Proc 2016-47 (8/24/2016) now provides provided a self-certification procedure designed to help taxpayers who inadvertently miss the 60-day time limit.

"Serious illness" is an acceptable reason.

64

*IRS EP Issue Snapshot:
Identifying Highly
Compensated Employees
in Initial or Short Plan
Year (4/21/2017)* **8-18**

How To Apply Qualified
Plan HCE Tests To Initial
Or Short Plan Year

65

*Information Letter
2016-0081* **8-18**
(Released 12/30/2016)

Post-Retirement
Payments Were
Subject To Self-
Employment Tax

66

*IRS Tax Exempt and
Government Entities
Division Memo, 8-19
"Computation of Maximum
Loan Amount under §
72(p)(2)(A)" (Apr. 20, 2017)*

IRS Provides Solution for Lack
of Legal Clarity With
Multiple Loans

67

*Pritchard
TCM 2017-136 8-20
(07/10/17)*

Section 72(t) Additional 10%
Tax Applies Where IRA
Owner Voluntarily Drew from
IRA to Pay Back Taxes (not
the same as an IRS levy)

68

Frias
TC Memo 2017-139
(July 11, 2017)

401(K) Plan Loan Taxable
Because Repayments Fail
Substantially Level
Amortization Requirement

69

Background – Cure Period

Reg. 1.72(p)-1, Q&A-10(a)
provides that a **failure to make
any installment payment when
due violates the level
amortization requirement in §
72(p)(2)(C)** and results in a
deemed distribution at the time
of such failure.

70

However, the regulations also provide that a plan administrator may allow a **cure period** (lasting not later than the last day of the calendar quarter following the calendar quarter in which the required installment payment was due).

71

Facts

- Frias missed her first several loan payments and **failed to catch-up during the cure period.**
- However, **the loan from her 401(k) was repaid in full.**

72

Holding

The entire loan was a
**taxable distribution in
2012**

(Form 1099R for
\$40,065)

+

10% Penalty

73

CCA 201736022
(Aug. 30, 2017)

8-22

CCA Explains How To
Cure Missed Employer
Plan Loan Payments
(also describes a replacement
loan technique)

74

Gowen

8-24

TC Summary Opinion
2017-57 (July 24, 2017)

CPA Who Defaulted on
401(k) Plan Loan Owes
Income Tax and
Penalties

75

Facts

The taxpayer "holds a master's degree in taxation and is a certified public accountant."

According to the Tax Court he "considers himself to be an expert in the field of income tax, having been employed by several large, international accounting firms, including Ernst & Young, PricewaterhouseCoopers, and KPMG."

76

- He defaulted on his loan payments on Aug. 30, 2012.
- End of cure period 12/31/2012.
- Form 1099R from Merrill Lynch for 2012 showed a distribution of \$46,703.

77

- The taxpayer argued, that the six month cure period ended in 2013, so income in 2013 not 2012.

78

Holding

“Petitioner ignores the plain language of the regulation in making his argument. The regulation makes no mention of a six-month cure period.”

79

- Taxable retirement distribution of \$46,703 in 2012.
- 10% Sec. 72(t) Penalty
- 20% Accuracy-related Penalty

80

*IRS Tax Exempt and
Government Entities Division
memo, "Substantiation
Guidelines for Safe-Harbor
Hardship Distributions from
Section 401(k) Plans"*

(Feb. 23, 2017) **8-27**

IRS Auditors Told How To Audit
401(k) Plan Hardship
Distributions

81

8-27

*Treasury Ends
myRA Program
(7/28/17)*

82



Treasury Winds Down myRA 7/28/17



- Started in 2014
- Admin costs almost \$70 million
- Low participation - WSJ says 20,000 (Cost Gov't \$3,500 per person)
- Private market solutions exist
- Close or transfer account
 - Treasury to contact account holders
 - FAQs - <https://www.myra.gov/faqs/phasing-out-the-myra-program/>

8-28

*IRS Website on
Exceptions to
Tax on Early
Distributions*