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Firm News

MMPPH congratulates Judy Bae on becoming President of the Pan Asian Lawyers of San Diego (PALSD). In 2017, Judy hopes to broaden PALSD's reach beyond one specific ethnic group so as to include anyone who has an interest in expanding diversity and advancing civility and professionalism in San Diego's legal community.

Judy is also serving as Chair of the Estate Planning, Trust & Probate section of the San Diego County Bar Association in 2017.

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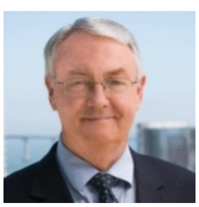

Alternatives For Surviving Spouse Of Deceased IRA Owner: Rollovers May Not Be The Best Option

by Bradford N. Dewan, J.D., MBA

On July 2, 2008, apparently at the request and direction of the surviving spouse, Suzanne, Wachovia transferred $235,495 from Mr. Thomas Ozimkoski, Sr.'s IRA to Suzanne's traditional IRA, which was also with Wachovia. This represented virtually all of Mr. Ozimkoski Sr.'s IRA.

On July 14, 2008, Suzanne received a distribution of $141,997.43 from her IRA.

On July 15, 2008, Suzanne wrote a personal check to the decedent's son from a prior marriage, Thomas Jr., for $110,000 to make the payment required under the settlement agreement.

Suzanne also received additional distributions from her IRA in 2008, namely: (1) $20,099.74 on August 14th, (2) $12,000 on December 4th and (3) $500 on December 15th. Thus the total distributions received by Suzanne in 2008 was $174,597.17.

In 2009 Wachovia issued a Form 1099-R to Suzanne with respect to the distributions from her IRA in 2008. The Form 1099-R represented the distributions in 2008 were early distributions with no known exception because petitioner had not reached the age of 59 ½ in 2008.

Suzanne did not report any of her IRA distributions as income on her 2008 federal tax return.

In November 2010, the IRS issued a notice of deficiency to Suzanne for her alleged failure in not reporting and paying tax on the distributions from her IRA in 2008. In addition, the IRS determined that she was liable for the 10% penalty for early withdrawals from the IRA, a late filing fee, and an accuracy-related penalty for an underpayment attributable to a substantial understatement of income tax.

Suzanne argued in the Tax Court that the distributions should not be included in her income because Thomas Jr. was entitled to $110,000 of Mr. Ozimkoski, Sr.'s IRA through the probate litigation and the ensuing settlement agreement.

The Tax Court opined that under Florida law the only two scenarios in which Wachovia could have correctly frozen Mr. Ozimkoski, Sr.'s IRA pending the outcome of the probate litigation were that: (1) his estate was the named beneficiary of the IRA, or (2) there was no named beneficiary of the IRA. The Tax Court noted that Wells Fargo (the successor to Wachovia) did not have Mr. Ozimkoski, Sr.'s IRA beneficiary designation form.

The Tax Court then stated that under either scenario Wachovia incorrectly rolled over the entire IRA of Mr. Ozimkoski, Sr. to Suzanne's IRA. It noted that an IRA beneficiary designation cannot be reformed after the IRA owner dies and cites the Treasury Regulations: "In order to be a designated beneficiary, an individual must be a beneficiary as of the date of death".[1] Consequently, the Tax Court determined that Suzanne was not a named beneficiary of Mr. Ozimkoski, Sr.'s IRA on the date of his death and therefore cannot be named a designated beneficiary after his death. The Tax Court then stated that Wachovia should have distributed the IRA assets to Mr. Ozimkoski, Sr.'s estate because either it was named as the beneficiary or there was no named beneficiary and because the settlement agreement makes no direction as to the disposition of the IRA. The Tax Court then determined that it had no jurisdiction to unwind the transfer of funds to Suzanne's IRA. As a result, once the funds were transferred to Suzanne's IRA, any distributions to her would be taxable.

The Tax Court made it a point to note that it was unclear how Suzanne's probate attorney counseled her to comply with the payment obligation under the settlement agreement – as the personal representative of Mr. Ozimkoski, Sr.'s estate, as an IRA beneficiary, or as a surviving spouse. What was clear to the Tax Court was that Suzanne's probate attorney failed to counsel her on the full tax ramifications of paying Thomas, Jr. $110,000 from her own IRA after the rollover from her husband's IRA. The Tax Court concluded that the distributions Suzanne received were from her own IRA and therefore had to be considered taxable income to her for 2008.

Since Suzanne had not reached the age of 59 ½, the Tax Court sustained the additional tax on early withdrawals. Importantly, the Tax Court noted that a relevant exception to this additional tax is found in IRC section 72(t)(2)(A)(ii), which provides that distributions "made to a beneficiary (or to the estate of the employee) on or after the death of the employee" are not subject to the 10% additional tax.

The Tax Court then noted that it had previously held that a beneficiary loses the entitlement to claim the exception if the beneficiary rolls over the funds from the deceased spouse's IRA into his or her IRA and thereafter withdraws funds from his or her IRA.[2] In one of the cited cases, Gee v. Comm'r, the taxpayer rolled over a distribution from her deceased husband's IRA into her separate IRA upon her husband's death. Four years later, the taxpayer received a distribution from her IRA. The spouse claimed that the distribution was an amount received from her deceased husband's IRA and therefore was exempt from the 10% additional tax on early distributions under IRC Section 72(t)(2)(A)(ii) as a distribution to beneficiary upon a decedent's death. The Court did not

[1] Treas. Reg. 1.401(a)(9)-4, A-4(a)

[2] Gee v. Comm'r, 127 T.C. 1, 4-5 (2006); Sears v. Comm'r, T.C. Memo. 2010-146

agree and instead held that when the beneficiary rolls over funds from the deceased spouse's IRA into her own IRA, the funds become the beneficiary's own and any subsequent distributions are no longer occasioned by the death of the spouse. The Court reasoned that the amount received from the taxpayer's deceased husband's IRA lost its character as a distribution made to a beneficiary upon a decedent's death once the taxpayer transferred the funds to her separately owned IRA. Thus such distributions do not qualify for the "beneficiary exception" referenced above.

The Tax Court noted that, similar to the facts in Gee, in 2008, Wachovia transferred $235,495.46 from Mr. Ozimkoski, Sr.'s IRA into Suzanne's IRA. Suzanne then took four separate distributions in 2008, all of which were before she had reached the age of 59 ½.

The Tax Court emphasized again that Gee made it clear that once the assets in the decedent's IRA were transferred into the taxpayer's IRA, any subsequent distributions were no longer occasioned by the decedent's death and were not made to the taxpayer as a beneficiary of the decedent; therefore the exception to the early withdrawal penalty did not apply.

Therefore, the Tax Court found that Suzanne was liable for the IRC section 72(t) additional tax for early withdrawals for the distributions from Suzanne's IRA in 2008.

The Tax Court also sustained the late filing penalty, as well as the accuracy-related penalty with respect to the tax on the distributions in excess of the $110,000. However, the Tax Court held that Suzanne had reasonable cause and acted in good faith in not reporting the $110,000 that she used to make the payment to Thomas, Jr. so it did not impose the penalty with respect to the tax on $110,000 of the distributions.

<u>ANALYSIS</u>:

A surviving spouse normally determines that it is advantageous to rollover funds from the deceased spouse's IRA into his or her own IRA. With the funds in his or her own IRA, the surviving spouse is able to defer any required distributions until his or her required beginning date (April 1st of the year following the year he or she reaches age 70 ½), select and name his or her own desired beneficiaries (i.e. not restricted to the beneficiaries named by the deceased spouse), benefit from a longer stretch out of the RMDs as compared to remaining as a beneficiary, and have the option to convert the Traditional IRA to a Roth IRA.

However, if the surviving spouse did the rollover, there would be a 10% additional tax on any distributions made before age 59 ½. One of the exceptions to this rule is for distributions after the death of the IRA owner to the beneficiary of that IRA.

Consequently, a surviving spouse can avoid the 10% early withdrawal tax by remaining as a beneficiary of the deceased spouse's IRA and not doing a rollover into his or her own IRA.

Generally, however, a beneficiary is required to commence taking RMDs over his or her own life expectancy in the year following the year of the death of the IRA owner.

But, significantly, a spouse named as beneficiary is not required to take RMDs until the year the deceased spouse would have reached his or her required beginning date if he or she had survived until then.

In addition, another benefit is that if the surviving spouse remains as a beneficiary but dies before the deceased spouse would have reached his or her required beginning date, beneficiaries named by the surviving spouse may take the RMDs based on their own life expectancies as if the surviving spouse had rolled the funds into his or her own IRA.

Thus the surviving spouse needs to consider the various factors described below before doing a rollover of funds into his or her own IRA:

1. If the deceased spouse dies before

age 70 ½, and the surviving spouse is under age 59 ½, the surviving spouse generally should remain as beneficiary of the inherited IRA, not roll over the funds into his or her own IRA, and thus retain various options. By not doing the rollover, the surviving spouse can take distributions if needed without incurring the 10% penalty tax on early withdrawals. But if the funds are not needed, the surviving spouse need not take any distributions since they are not required until the deceased spouse would have reached the age of 70 ½ . If the deceased spouse's account was in a qualified pension plan, the surviving spouse can elect to rollover the funds in that account into an "inherited IRA" with the surviving spouse as the beneficiary of that inherited IRA.

2. If the surviving spouse remained as a beneficiary under the above scenario, then when the deceased spouse would have reached age 70 ½ and the surviving spouse becomes 59 ½, the surviving spouse should rollover the funds in the deceased spouse's IRA into his or her own IRA. With RMDs for the surviving spouse, as the beneficiary of the inherited IRA, now being required, doing the rollover will give the surviving spouse greater discretion as when and how much as to any distribution that may be desired without a 10% penalty for early withdrawal until the surviving spouse reaches the age of 70 ½ and RMDs must begin.

3. If the deceased spouse died after becoming 70 ½ and the surviving spouse is older than 59 ½ it is likely most beneficial for the surviving spouse to roll over the funds from the deceased spouse's IRA into his or her own IRA. Once becoming 70 ½, the RMDs for the surviving spouse will be determined under the Uniform Lifetime Table rather than the Single Life Table applicable to "beneficiaries" and allow for greater "stretch-out" of the RMDs.

4. If the deceased spouse died after becoming 70 ½ but the surviving spouse has not reached 59 ½ , the surviving spouse must evaluate whether to roll over the funds in the deceased spouse's IRA into his or her own IRA or remain as a beneficiary in an "inherited IRA". If the surviving spouse does the rollover into his or her own IRA, then RMDs will not be needed until age 70 ½ but any withdrawal before reaching age 59 ½ will be subject to the 10% penalty on early withdrawals. However, if the surviving spouse remains as a beneficiary of the inherited IRA, he or she will be required to start taking distributions in the year after the year of the deceased spouse's death but any RMDs or additional distributions, if needed, will not be subject to the 10% penalty tax on early withdrawals.

It is unfortunate that Suzanne apparently did not receive any professional advice regarding the tax consequences of using the funds that had been rolled over into her IRA to comply with payments to Thomas Jr. under the terms of the settlement agreement. As an example, if Suzanne had been aware of the tax consequences of withdrawing funds from her IRA to pay Thomas Jr., then she probably would have attempted to negotiate a smaller amount than the $110,000 she agreed upon. Indeed, she might have agreed to withdraw $110,000 from her IRA but only pay Thomas Jr. an amount after deducting projected taxes on that distribution.

In contrast, it appears that Thomas Jr. did receive tax advice since he made it clear to Suzanne and Wachovia that he did not want an inherited IRA to be part of the funds he was to receive under the settlement agreement. It might be reasonable to assume that Thomas Jr. was advised that since his father had not listed any beneficiary for his IRA and thus his estate would be the default beneficiary all funds in the inherited IRA would have to be distributed to him by the end of the fifth year following his father's death and all such distributions would be taxable.

SUMMARY

In summary, it is important for a surviving spouse to consider a number of factors before deciding whether to rollover the funds from the deceased spouse's IRA into his or her own IRA or remain as the beneficiary of the inherited IRA. Importantly, there is no time limitation or restriction on when a surviving spouse can roll over the funds from the inherited IRA into his or her own IRA. Thus the surviving spouse has great flexibility in determining when is the most appropriate and beneficial time to do the rollover.

FEDERAL TAX UPDATE

by DeEtte L. Loeffler, J.D., LL.M., Taxation

Status of Proposed Estate and GST Tax Repeal. A temporary repeal of the federal estate and generation-skipping taxes may become a reality in 2017. Bills have been introduced in both the House and the Senate, with some differences. Both bills (H.R. 631 and S.B. 205) would eliminate the estate and generation skipping transfer taxes, but retain the federal gift tax with a lifetime exemption of $5 million per taxpayer, indexed for inflation. The income tax basis step-up would also be retained for most types of assets received from a decedent. The top tax rate on gifts would also be reduced from 40% to 35%. Finally, no estate tax would apply to distributions from a Qualified Domestic Trust (QDOT) made more than 10 years after the bill is adopted. QDOTS are marital trusts held for the benefit of a taxpayer's non-US citizen spouse.

SB 205 (only) would also treat transfers to a trust as an immediate gift under IRC §2503 unless the trust is treated as wholly owned by the donor or the donor's spouse. This could have a chilling effect on the use of grantor trusts for making gifts.

Any repeal of the estate tax would have to be temporary because of the *Budget Reconciliation Act*. The Byrd rule requires any tax cut to be offset by tax increases, and forces the "sunset" of such legislation at 10 years. Although neither bill currently includes a 10-year sunset provision, we anticipate one will be added and so reintroduce uncertainty into long-term estate planning.

Other Interesting Federal Tax Bills Introduced. Several interesting tax bills have been introduced this term and will bear watching. One bill to reduce the federal deficit would end the practice of allowing taxpayers to allocate $3 of their taxes to the Presidential Election Campaign Fund (which also funds pediatric medical research). HR 133, introduced in January by Representative Tom Cole (R) of Oklahoma, would eliminate this option. The bill would direct $63,002,400 of funds currently in the account to the 10-Year Pediatric Research Initiative Fund, and would transfer the balance to the general treasury.

The Free Speech Fairness Act, introduced in the Senate as SB 264 by Senator James Lankford of Oklahoma, and in the House as HR 781 by Representative Steve Scalise (R) of Louisiana, would amend current law to allow charities to comment on political campaigns if the statements are made "in ordinary course of carrying out [the charity's'] tax exempt purpose." Under a 1954 law commonly known as the Johnson Amendment, an organization registered under IRC Section 501(c)(3) "may not attempt to influence legislation as a substantial part of its activities and it may not participate in any campaign activity for or against political candidates." Charities that violate the current rule run the risk of losing their tax exempt status under IRC Section 501(c)(3).

HR 836, the HOME Act, would create a limited "standard deduction" for taxpayers claiming a home office. Under current law, taxpayers are permitted to use a standard method to determine the deduction, or a "simplified method" that requires much less record keeping. This bill would substantially limit the deduction to the lesser of $1,500 or the taxpayer's income from the business. Under current law, the deduction may potentially be much higher.

STATE TAX NEWS

by DeEtte L. Loeffler, J.D., LL.M., Taxation

New Road Taxes Likely. Governor Brown and Democrat lawmakers are working together to craft a package of tax increases to pay for the more than $10 million in deferred maintenance on roads and other infrastructure. The proposals are likely to include a per mile tax on drivers, rather than an increase in the gas tax. A bill should be proposed by the April 6th legislative break.

New Protections for ABLE Accounts. SB 218 would protect ABLE accounts upon the death of the disabled owner from Medi-Cal and other state recovery claims arising after the account was established. It would also allow the account owner to designate another ABLE account to receive the remaining account assets.

Video Streaming Tax. As many as 46 California cities are currently considering imposing a tax on fee based video streaming services (like Netflix and Hulu). At present, no such taxes have been adopted. On January 31, 2017, the Streaming Tax Relief of Entertainment And Movies (STREAM) Act of 2017 (AB 282) was introduced by Assembly Member Sebastian Ridley-Thomas. The bill would add a provision to the tax code prohibiting local tax on video streaming services for the next six (6) years. The goal of the bill is to prevent such internet based fee services from being taxed like a utility. Chicago recently imposed a utility tax ("cloud tax") on such services.

New Tax on Opiates RXs? State legislators have introduced two separate bills to combat prescription drug abuse. AB 1512 would impose a one-cent-per-milligram tax on prescription opioids imported for sale in California and use the funds to pay for drug treatment centers. It is anticipated the bill would raise the cost for patients by a few dollars per month. SB 419 takes a different approach, prohibiting the prescription of oxycodone to those under the age of 21 years in an attempt to reduce the number of young addicts.

Tax Deduction Proposed for Pet Medical Bills. AB 942 would allow pet owners to deduct half of their medical care costs for their dogs and cats, including vaccinations, check-ups, surgeries, x-rays, prescriptions, up to $2,000. No other types of animals are covered by the bill.

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