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APRIL 2017 NEWSLETTER

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Firm News

We would like to welcome our new receptionist, Michele Enger to MMPPH. She is a Cal Poly Alumni and has worked many years as a Pre-K teacher as she moved about the world with her husband who was in the military. Two of her favorite places to live were Hawaii and Germany. In fact both her daughters were born in Germany. In her spare time she loves to spend time with her family, especially her 5 grandchildren. Her hobbies include travel and beach walks.

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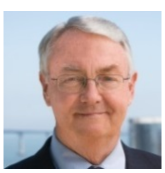

IRS APPROVES SPOUSAL IRA ROLLOVER EVEN THOUGH SPOUSE NOT LISTED AS THE DESIGNATED BENEFICIARY

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

In a recent Private Letter Ruling[1], the IRS recognized a post-death state court order that reformed an IRA beneficiary designation form. Historically, the IRS has been unwilling to recognize post-death reformations of a beneficiary designation form if such reformation affects the Required Minimum Distributions ("RMDs"). But this PLR did not involve a change in RMDs; rather, it addressed the issue of a spousal rollover when the surviving spouse was not listed as a beneficiary on the beneficiary designation form.

FACTS:

The IRA owner ("Decedent") died owning an IRA held by an independent IRA Custodian. The beneficiary forms on file with the Custodian provided that the pay on death beneficiary for the IRA was an inter vivos trust created by the Decedent. However, there was no evidence the Decedent created this trust. The Custodian did not keep a copy of the trust in its file when it accepted the Decedent's beneficiary designation. Decedent was survived by his spouse ("Spouse"). Spouse was unable to find any evidence that Decedent created a trust, and his Last Will did not refer to a trust. The Will provided for Decedent's entire estate to go to Spouse, and she wanted to rollover the Decedent's IRA to her own IRA.

According to the PLR, the Probate Code of State D (the state in which both Decedent and Spouse resided) has a provision that allows a court to order a retroactive change in a beneficiary designation in certain limited circumstances (which are not specified in the PLR). Spouse informed the IRS she intended to obtain court approval to change the beneficiary designation for the IRA from the trust to herself and then accomplish a rollover.

Importantly, because the beneficiary forms on file with the Custodian still listed a trust as beneficiary, the Custodian refused to release the balance of the IRA to Spouse unless she obtained a court order from the appropriate state court to modify “the terms of a governing instrument in a manner that is not contrary to the transferor’s probable intention” in order to achieve a transferor’s (i.e. Decedent’s) tax objectives (i.e. allowing a tax free spousal rollover by Spouse). The above quoted clause is probably one of the limited circumstances in which the state court could order a retroactive change in a beneficiary designation.

Based on these facts and conditional on the state court’s order approving the change of beneficiary designation on the IRA from the trust to Spouse under the authority in that state’s statutes, Spouse requested the following rulings:

1. That with respect to Spouse, the IRS would not treat the IRA as an inherited IRA as that term is defined in Section 408(d)(3)(C)(ii) of the Internal Revenue Code (“Code”);
2. That Spouse would be treated as the “distributee” or “payee” of the IRA for purposes of Section 408(d)(3) of the Code (and thus be allowed to do a tax-free rollover); and
3. That Spouse could roll over the IRA distribution once received, and that as long as the rollover was timely, the IRA distribution would not be included in Spouse’s gross income, pursuant to Section 408(d)(1) of the Code, for the year in which the distribution occurred.

RELEVANT LAW

The PLR then provides a recital of applicable rules for a spousal IRA rollover.

Under Section 408(a)(6) and the regulations thereunder, rules similar to the rules of Section 401(a)(9) apply to the distribution of the entire interest of an individual for whose benefit the IRA is maintained.

Section 408(d)(1) provides that, except as otherwise provided in Section 408(d), any amount paid or distributed out of an IRA shall be included in gross income by the “payee” or “distributee”, as the case may be, in the manner provided under Section 72.

Section 408(d)(3) provides that Section 408(d)(1) does not apply to any amount paid or distributed out of any IRA to the individual for whose benefit the account is maintained if: (i) the entire amount received is paid into an IRA for the benefit of such individual not later than the 60^{th} day after the day on which he receives the payment or distribution, or (ii) the entire amount received is paid into an eligible retirement plan for the benefit of such individual not later than the 60^{th} day after the date on which the payment or distribution is received.

Section 408(d)(3)(B) permits an IRA owner to only do one “rollover” during any 1-year period.

Section 408(d)(3)(C)(i) provides that, in the case of an inherited IRA, Section 408(d)(3) shall not apply to any amount received by an individual from such account (and no amount transferred from such account to another IRA shall be excluded from gross income by reason of such transfer), and such inherited account shall not be treated as an IRA for purposes of determining whether any other amount is a rollover contribution. [These adverse consequences of an inherited IRA are why Spouse wanted the IRS to confirm that the IRA would not be treated as an inherited IRA.]

Section 408(d)(3)(C)(ii) provides that an IRA will be treated as inherited if the individual for whose benefit the account is maintained acquired the account by reason of the death of another individual, and the recipient was <u>not</u> the surviving spouse of the prior owner. [Since Spouse was the spouse of Decedent, then this served as a basis for the IRA not being treated as an inherited IRA].

Section 408(d)(3)(E) provides that the rollover provisions of Section 408(d) do not apply to any amount required to be distributed under Section 408(a)(6). [This rule is that RMDs may not be rolled over. Importantly, this rule, as described below, will limit the time period in which Spouse will be able to rollover distributions from the IRA without those distributions being treated as taxable RMDs which cannot be rolled over.]

Section 1.408-8, Q&A-1(a) of the Treasury Regulations ("Regulations") provides that an IRA is subject to the RMD rules under Section 401(a)(9). In order to satisfy Section 401(a)(9), the rules of Section 1.401(a)(9)-1 through 1.401(a)(9)-9 of the Regulations must be applied, except as otherwise provided.

Section 401(a)(9)(B)(ii) provides that a trust (i.e. IRA account) will not constitute a qualified trust under this Section unless the plan provides that, if an employee (in this case IRA owner) dies before the distribution of the employee's interest has begun (i.e. before the "required beginning date" – April 1 of the calendar year following the calendar year in which the IRA owner attains age 70 ½), the entire interest of the employee must be distributed within 5 years after the death of such employee (i.e. IRA owner).

Section 1.401(a)(9)-3, Q&A-2 of the Regulations provides that in order to satisfy the 5-year rule described above, the employee's (i.e. IRA owner's) entire interest must be distributed by the end of the calendar year which contains the fifth anniversary of the date of the employee's (i.e. IRA owner's) death.

Section 401(a)(9)(E) provides that for purposes of Section 401(a)(9), the term "designated beneficiary" means any individual named by the employee on the form as the beneficiary.[2]

Section 1.401(a)(9)-4, Q&A-4, of the Regulations provides, in relevant part, that in order to be a designated beneficiary, an individual must be a beneficiary as of the date of the employee's death. Generally, an employee's designated beneficiary for purposes of determining the distribution period for the RMDs after the employee's death will be determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the date of death (that is, have not received their entire interest before that September 30).

RULING

Based on these rules, the IRS made several findings that will become effective once the state court changes the beneficiary designation on the IRA from the trust to Spouse.

1. Spouse is the individual for whose benefit the IRA is maintained. Spouse acquired the IRA by reason of Decedent's death. Accordingly, <u>Decedent's IRA is not an inherited IRA for purposes of Section 408(d)(3) with respect to Spouse.</u> (Emphasis added)
2. <u>The court order cannot create a "designated beneficiary" for purposes of Section 401(a)(9) because Spouse was not the designated beneficiary of the IRA as of the date of Decedent's death. Accordingly, there is no "designated beneficiary" for the IRA for purposes of Section 401(a)(9).</u> (Emphasis added).
3. Decedent died before the Required Beginning Date for IRA distributions, and without a "designated beneficiary." Accordingly, the entire interest in the IRA must be distributed using the 5-year rule described in Section 401(a)(9)(B)(ii). Under this rule, any amounts payable from the IRA to Spouse in years 1-4 following the year in which Decedent died will **not** be Required Minimum Distributions and so <u>will be eligible for rollover by Spouse at a time that Spouse is the beneficiary of the IRA,</u> provided the distribution meets the other rollover requirements under Section 408(d), and, pursuant to Section 408(d), if rolled over, the amounts distributed from the IRA will **not** be included in Spouse's gross income, with respect to the year in which the distribution occurs. However, on or after January 1 of the fifth year following the year in which Decedent died, any amount payable from the IRA to Spouse would

not be eligible for rollover because they would be a Required Minimum Distribution and so would be included in Spouse's gross income with respect to the year in which the distribution occurs. (Emphasis added)

SUMMARY

Although Spouse did not ask about this in her PLR request, the IRS ruling states that the five-year rule was the only death distribution option available because the IRA owner died before his Required Beginning Date, and the life expectancy option is available only if the individual was a beneficiary on the date of the IRA owner's death and remains a beneficiary as of September 30 of the year following the year of death.

In this case, Spouse will not be the beneficiary of the funds until the state probate court approves the changing of the beneficiary from the trust to Spouse. Therefore the life expectancy option was not available.

However, very interestingly, the PLR did permit, upon the issuance of the state court order changing the beneficiary of the IRA, the spouse to take a death distribution from the Decedent's IRA and roll over the funds to her own IRA without any adverse tax consequences. But, the PLR stated that if a distribution is received by Spouse in the fifty year after the Decedent's death, it would not be eligible for a rollover because in the fifth year following the year of the IRA owner's death (i.e., Decedent's death), the entire IRA must be distributed. Therefore, a distribution that is received in that year is RMD. As the cited rules state, an RMD is not rollover-eligible.

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[1] PLR 201706004.
[2] Only individuals may be "designated beneficiaries" for purposes of Section 401(a)(9).

FEDERAL TAX UPDATE
by DeEtte L. Loeffler, J.D., LL.M., Taxation

IRS Audits Declined in 2016. The IRS reports audits of individual tax returns fell by almost 16% in 2016. Of the 244 million tax returns and other forms filed, the IRS only audited 1 million of them. They also filed 9% fewer liens than in 2015. During this period the IRS collected more than $3.3 trillion in taxes and issued more than $426 billion in tax refunds.

Possible HSA Contribution Increase. Congressman Jeff Fortenberry (R-NB) has introduced a bill that would increase the contribution limits for Health Savings Accounts and would permit them to be used for private health care arrangements. H.R. 1280 would increase contributions from $2,250 for an individual and $4,500 for a family (indexed for inflation to $3,400 and $6,750 in 2017) to the amounts listed under IRC Section 223 for High deductible plans (i.e., $5,000 for an individual and $10,000 for a family). The bill would also permit HSAs to be used to pay for fixed fee agreements with doctors and for other prepaid medical care services, and would exempt such arrangements from the definitions of "health plans" or "insurance."

Fitness Plans Proposed as Health Care. As an incentive for people to become healthier, HR 1267, the *Personal Health Investment Today Act*, introduced by Representative Jason Smith, (R-MO), and Senate Bill 482, introduced by Senator John Thune (R-SD), would allow taxpayers to deduct up to $1,000 per year incurred for "qualified sports and fitness expenses." Under the bill, gym memberships, registration fees for exercise classes, exercise videos, and even home gym equipment, could be deducted. Private clubs and those that offer golf, hunting, sailing and riding are specifically excluded.

IRA Rollovers to Charity. HR 1337 would allow IRA owners to make tax free rollovers of up to $400,000 per year directly to charity from an IRA account. Under current law, such rollovers to charity are limited to $100,000. Introduced by Representative Kevin Cramer (R-ND), the bill would also allow rollovers to split interest entities (i.e., charitable remainder annuity trusts, unitrusts, or charitable gift annuities) so long as no one other than the taxpayer and spouse own an income interest and their interests are not assignable.

STATE TAX NEWS

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

New Infrastructure Tax. CA's infrastructure problems continue to grow. It is estimated that the state now has a 10-year $130 billion maintenance shortfall, while local governments have an estimated shortfall of $73 billion. SB 1, introduced by Senator Jim Beale (D-SJ), may help to address this by raising an estimated $5.1 billion per year. The bill would increase the gas tax (already one of the highest in the nation) by 12 cents per gallon over the next three years. It would also impose a $100 fee on zero emission vehicles (i.e., electric cars) starting in July of 2020. Finally it would double the diesel excise tax (a 20 cent increase) and increase the diesel sales tax by 4 cents per gallon. The average driver would pay an extra $65 per year in gas (based on average CA mileage of 13,476 per year, and 25 miles per gallon).

Proposed State Death Tax Unlikely. In late February, Senator Scott Weiner (D-SF) proposed a bill to reinstate California's estate tax if Congress eliminates the federal estate tax. If adopted, SB 726 would impose a tax on transfers of more than $5.49 million from a decedent. The bill is unlikely to be successful because not only would it need to be approved by the legislature and signed by Governor Brown, but the voters would then have to approve the new law. In 1982, voters passed Propositions 5 and 6 which repealed California's estate tax and prohibited the legislature from imposing another one without voter approval.

Retail Sales Tax on Services Proposed. SB 640, which would impose a sales tax on certain retail services, was introduced by Senator Robert Hertzberg (D-LA). The bill is designed to broaden the tax base and make tax collection more predictable. The tax would be imposed on all retail services except "health care services, education services, child care, rent, interest, and services represented by very small businesses." Salons and barbers are concerned this tax would make their services unaffordable to some people or cause them to be unable to earn enough money. The bill is currently poorly defined. It currently provides that taxes collected could be used for such things as infrastructure, "workforce", health care and education.

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