TAX FACTS INTELLIGENCE

The National Underwriter Company April 2015

annuities • life/health insurance • investments • retirement plans • estate planning/taxation • employee benefits • federal income tax

In Focus: Case Study—Retirement Accounts

The rules governing inherited IRAs can be confusing to even the most financially knowledgeable client, and when a client inherits an IRA that has already been treated as an inherited IRA, determining distribution requirements can become even more difficult if the client is unfamiliar with the rules.

Your client, Janice, inherited an IRA from her recently deceased husband, David. In looking through David's files, Janice has discovered that David had inherited that IRA from his mother, and has been taking distributions from the account based upon his life expectancy. Janice contributes to her own IRA, but is not yet required to take distributions from her account and would like to consolidate her accounts to the extent possible. She has read that a spouse may be entitled to treat a deceased spouse's IRA as his or her own, and would like to consider consolidating David's inherited IRA with her traditional IRA. How do you advise?

EXPERT ANALYSIS USING TAX FACTS ONLINE

Inheriting an IRA creates a complicated set of issues that may be difficult for even the financially astute taxpayer to work through—the number of beneficiaries, timing of the owner's death and relationship of the beneficiaries are all issues that interact to create a maze when determining an inherited IRA's future. These complications are magnified dramatically upon inheriting someone else's inherited IRA. Inheriting an inherited IRA presents a situation that doesn't currently receive much attention, though taxpayers are increasingly likely to face these issues given the vast amount of wealth now stored in retirement accounts.

As a first step, Janice should first re-register inherited, inherited IRA in her name (i.e., the name of the deceased beneficiary's beneficiary (the "successor beneficiary")) in order for her, as the successor beneficiary, to take required minimum distributions (RMDs) from the account in the future. Determining how these RMDs are calculated is where the rules become complicated, however.

Tax Facts Online can help sort out these complex rules. Tax Facts Online Q 3634 discusses the RMD requirements for IRAs generally, and Tax Facts Online

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Tax Facts Q 3610. When are IRA funds subject to attachment in bankruptcy?

***Running v. Miller,* No. 13-3682 (8th Cir. 2015)**

The Eighth Circuit recently upheld a bankruptcy appellate panel decision, finding that an annuity purchased with funds rolled over from a taxpayer's traditional IRA was exempt from his bankruptcy estate because the annuity complied with the IRC Section 408 requirements for qualified individual retirement annuities.

This was held to be the case despite the fact that the taxpayer paid an initial lump sum for the annuity that exceeded the annual contribution limits under IRC Sections 219(b). The court agreed with the taxpayer's argument that the amounts rolled over from the IRA into the annuity did not constitute premium payments, so that the IRC 408(b) prohibitions against fixed premium amounts or premiums that exceed the Section 219 annual limits were not violated.

As a result, under the Eighth Circuit's logic, funds from a traditional IRA can be rolled over into a qualified individual retirement annuity without losing the bankruptcy exemption traditionally granted to IRA funds.

LIFE/HEALTH INSURANCE

Tax Facts Q 409.02. Under the ACA, can an employer reimburse an employee for the cost of individual health insurance coverage?

Notice 2015-17

The IRS has issued transition relief for certain small employers that delays the applicability of the $100 per day penalty that generally applies under the Affordable Care Act when an employer reimburses employees for individual health insurance premium expenses.

This relief applies to employer-sponsored healthcare arrangements that are: (1) employer payment plans discussed in Notice 2013-54 (such as HRAs or arrangements that reimburse employees for individual premiums) if the employer is not an applicable large employer under IRC Section 4980H(c)(2); (2) S corporation healthcare arrangements for more-than-2 percent shareholders; (3) Medicare premium reimbursement arrangements; and (4) TRICARE-related health reimbursement arrangements (HRAs).

Pursuant to this guidance, small employers (those that employ fewer than fifty full-time employees) will not subject to the $100 per day excise penalty for reimbursing employees for individual health insurance premiums, as well as premiums for Medicare Part B or Part D coverage, through June 30, 2015.

RETIREMENT ACCOUNTS

Tax Facts Q: 3999. What is a responsible plan fiduciary?

***Tibble v. Edison International*, Docket No. 13-550**

The Supreme Court is currently considering arguments in a case that could expand the application of a strict fiduciary duty to financial advisors who work with individuals' retirement accounts. The question presented to the court involves the operation of the six-year statute of limitations imposed by ERISA with respect to 401(k) investment advice.

The defendant claims that the six-year standard means that the plaintiffs are only entitled to sue over issues relating to investment choices that were offered in the previous six years. The plaintiffs, on the other hand, claim that the 401(k) advisor has a fiduciary duty with respect to monitoring and altering those investment choices that is ongoing.

Essentially, the plaintiffs argue that the defendants breached a fiduciary duty to act in the best interests of their clients by offering higher cost "retail" investment options, rather than the lower cost "institutional" shares of the same funds. Further, the plaintiffs argue that the plan administrators breached their duties by failing to monitor and update investments on an ongoing basis in order to further the best interests of plan participants.

While the Court could choose to address only the narrow statute of limitations issue, rather than the applicability of a strict fiduciary standard, deciding that an ongoing duty applies to extend the firm six-year period would, by implication, change the role of 401(k) plan advisors.

INVESTMENTS

Tax Facts Q 7538. How is a shareholder taxed when securities are abandoned?

***Pilgrim's Pride v. Commissioner*, 2015-1 USTC 50,211**

The Fifth Circuit recently reversed a Tax Court decision, finding that a taxpayer was required to treat a loss resulting from abandoned securities as an ordinary loss because IRC Section 1234A does not apply to the abandonment of capital assets.

In this case, the taxpayer rejected an offer to purchase its securities, finding that it would obtain a greater tax benefit by abandoning the securities instead. The taxpayer abandoned the securities and claimed an ordinary loss of nearly $100 million.

The Fifth Circuit, in reversing the Tax Court, agreed with the taxpayer's argument that Section 1234A applies only to a contractual or other derivative right to property, rather than to inherent property ownership rights. In so deciding, the Fifth Circuit rejected the Tax Court finding that Section 1234A applies to property rights inherent in intangible property, such as securities, as well as any derivative contractual rights.

Therefore, the taxpayer was required to treat the loss as an ordinary loss because Section 1234A does not apply to the abandonment of capital assets under the Fifth Circuit's reasoning. The Fifth Circuit also rejected the argument that IRC Section 165(g) requires the loss to be treated as a capital loss, holding instead that Section 165(g) applies only to worthless securities and that the securities at issue in this case were not worthless when they were abandoned.

EMPLOYMENT BENEFITS

Tax Facts Q 326. How are benefits offered to domestic partners or same-sex spouses treated for tax purposes?

***Roe v. Empire Blue Cross Blue Shield*, 589 Fed. Appx. 8 (2nd Cir. 2014)**

Despite the Supreme Court decision in *Windsor* that requires same-sex spouses to be treated as spouses for employee benefit purposes, the Second Circuit recently ruled that if a plan provides benefits that are not mandatory, same-sex spouses can permissibly be excluded from participation.

The plaintiff in this case sued her hospital-employer after it refused to allow her same-sex spouse to enroll in its self-insured health plan, which, by its terms, excluded same-sex spouses and domestic partners. The Second Circuit found this exclusion to be permissible, holding that the *Windsor* mandate applies only in situations where ERISA or another federal law mandates spousal benefits.

The Court distinguished this situation from one in which benefits were mandated. For example, in the case of a plan required to offer joint-and-survivor annuities to spouses of all participants, same-sex spouses would be granted equal rights in states where same-sex marriages are recognized.

In this case, the entity sponsoring the self-insured health plan was a private actor and, rather than defining "spouse," the plan at issue excluded an entire category of spouses. Because the benefits provided were not mandatory and ERISA contains no anti-discrimination provision that would prevent the exclusion, the Second Circuit upheld the plan's terms.

ESTATE PLANNING/TAXATION

Tax Facts Q: 703. When is an estate tax charitable deduction allowed?

***Est. of Belmont v. Commissioner*, 144 TC No. 6 (2015)**

The Tax Court recently denied an estate tax charitable deduction where the amount of the donation was not permanently set aside, and there was a possibility that expenses for litigation relating to the settlement of the estate could deplete the funds that would otherwise be donated.

The Tax Court found that, under Treasury Regulation Section 1.642(c)-2, unless, based upon the terms of the instrument and the facts of the case, the possibility that the amount would not be available to satisfy the donation was so remote as to be negligible, the amount could not be treated as having been permanently set aside so as to allow the deduction.

In this case, the court found that the estate had already depleted a portion of its funds in settling estate-related litigation, supporting the finding that the possibility of further depletion was not so remote as to be negligible. As a result, the court denied the estate tax charitable deduction.

FEDERAL INCOME TAXATION

Tax Facts Q 8609. Can a taxpayer defer recognition of gain under the like-kind exchange rules if the exchange is made between related parties?

***North Central Rental & Leasing LLC v. United States*, 2015-1 USTC 50,217**

The Eighth Circuit recently found that two taxpayer entities were not entitled to nonrecognition treatment for the exchange of property because the transaction unnecessarily involved intermediaries so as to circumvent the related party rules of IRC Section 1031(f).

The two companies in this case were closely related, both in terms of ownership structure and management, so as to be subject to the Section 1031(f) related party rules. The companies established a like-kind exchange program through which the first company sold its used equipment to third parties (qualified intermediaries). The third party intermediaries would subsequently send the sale proceeds to the second company, which then purchased new equipment and transferred that equipment back to the first company.

The court found that the two companies could have exchanged property directly, but, because of the related party rules, would have been required to hold the property for two years before the exchanges could qualify for nonrecognition treatment. The court found that, because the qualified intermediaries were unnecessary and appeared to have been involved in the transactions only to avoid the related party rules, the transactions did not qualify for nonrecognition treatment.

Expert Analysis from page 1

Qs 3637 and 3638 outline the requirements for lifetime and after-death distributions, respectively. Q 3641 explains the special rules that apply to allow a surviving spouse to treat the IRA as his or her own account.

As a spousal successor beneficiary, however, Janice is unfortunately not entitled to use the special rules that typically apply to allow the surviving spouse to treat the IRA as his or her own account—based upon the logic that Janice, as the surviving spouse-successor beneficiary, was not the spouse of David's mother, the original account owner. Instead, Janice (regardless of whether she was surviving spouse or non-spousal beneficiary) is required to take RMDs from the account based upon whatever method David, as the original beneficiary, had been using upon his death.

As a result, in this case, as in many cases, the inherited, inherited IRA will be distributed to the successor beneficiary based upon the life expectancy of the deceased original beneficiary, David. The options that David, as the original beneficiary, could have chosen are discussed in the paragraphs below.

Most taxpayers know that the rules governing inherited IRAs generally allow taxpayers to "stretch" the tax-deferral associated with these accounts by providing for distribution of the account value over a period of years following the original account owner's death. However, there are several options that the beneficiary can choose from in taking his or her RMDs from the inherited IRA.

If the original account owner died after he or she began taking RMDs, a non-spousal account beneficiary must either take distributions based upon his or her own life expectancy or based upon the original account owner's life expectancy—whichever is longer. If the owner died before he or she began taking RMDs, a non-spousal account beneficiary must either take distributions based upon his or her life expectancy or exhaust the account funds within five years of the original owner's death.

An original spousal beneficiary has the additional option of rolling the inherited IRA funds into his or her own IRA and treating them as if they were traditional, non-inherited IRA funds.

The option chosen by the original beneficiary of an inherited IRA is the option that the successor beneficiary to that inherited IRA will be required to use in order to exhaust the account funds—the successor beneficiary's own life expectancy is not a factor.

The rules governing inherited IRAs are complicated enough, and when faced with an inherited, inherited IRA, many advisors simply aren't certain as to how to proceed. Knowing the rules in this thorny area can help the advisor establish his or her value to the taxpayer in handling this type of difficult situation.

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OPINION—Thumbs Up/Thumbs Down

What are your thoughts on:

1. The potential impact of the resolution of the fiduciary v. suitability issue for financial producers if the Supreme Court decides in favor of a fiduciary standard?
2. The problems surrounding the implementation of the ACA premium tax credit?
3. A recently introduced proposal that would allow taxpayers to transfer their retirement account RMDs to health savings accounts (HSAs), tax-free?

Bloink's Response

1 In terms of liability exposure, this would be a major transition in the industry—instead of focusing on whether the arrangement is suitable for the client, the fiduciary-advisor must act in the client's best interests, and the fiduciary standard brings with it a long line of settled law governing the liability of advisors who fail to act in this manner. I don't think a fiduciary standard is a negative, and with the regulatory community behind it, it's coming—but I do think this expansion could limit the availability of financial advice for the middle class, at least until advisors become more comfortable in their new roles.

2 Administration of the premium tax credit has obviously proven complicated, but it was one provision of the ACA that probably couldn't have been postponed if the law was going to accomplish its goal of making health coverage affordable for lower income taxpayers. The IRS has done what it can to mitigate the impact for taxpayers who received incorrect reporting information, but holding on to these taxpayers' returns while awaiting correct information is one step that only exacerbates the problem.

3 Whether or not this proposal will become reality, I don't know—but postretirement health expenses are some of the largest costs that retirees will face after they start taking distributions from retirement accounts, and anything we can do to encourage proper planning for those expenses is going to help in the long run.

Byrnes' Response

1 Applying a fiduciary standard to financial producers would require an adjustment period, but we have to consider that more and more middle class clients are relying on these producers' advice as they make decisions that will determine their future financial security. The importance of this advice cannot be overlooked, and I think we need a correspondingly strict standard of responsibility.

2 The whole concept of paying the premium tax credit in advance to the insurer is supposed to help lower income taxpayers avoid out-of-pocket up-front costs—which recognizes that they can't afford those costs to begin with. Regardless of how complicated administration of the advanced payment system has been, proposals to eliminate it can't be implemented without imposing a serious hardship on lower income taxpayers.

3 When retirees can't afford the cost of their health care—whether because of high deductibles or prescription expenses that may not be covered by a traditional Medicare plan—the government could eventually end up with the tab if Medicaid kicks in. Forgoing the tax revenue derived from RMDs and allowing retirees to take care of their own expenses using a tax-free HSA seems like a smart move to me.

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Courses may be followed via web-conferencing.

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SEVEN TOPICS OF INTEREST

Our format will also include recent tax developments related to seven core subjects. These subjects will always be listed on the first page for easy reference.

OPINION BY BLOINK AND BYRNES

You've probably heard of "thumbs up-thumbs down" in the entertainment context. Tax Facts is an industry leader in tax analysis, and as such is breaking new ground with its dual professor tax debate. Professors Robert Bloink, J.D. and Assoc. Dean William Byrnes, J.D., will provide commentary on various tax topics.

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