Non-Compliant IRA Trusts and Circular 230 Issues

A Special Report by

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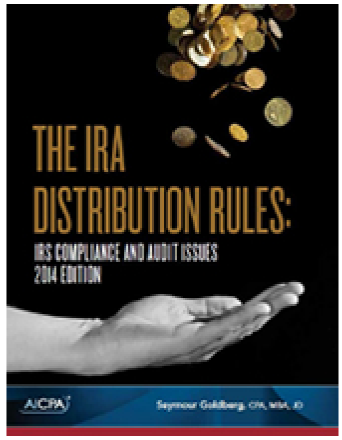
Author of



The IRA Distribution Rules: *IRS Compliance and Audit Issues*

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SEYMOUR GOLDBERG, CPA, MBA, JD, is a senior partner in the law firm of Goldberg & Goldberg, P.C., Woodbury, New York. He is Professor Emeritus of Law and Taxation at Long Island University. Mr. Goldberg is the recipient of the American Jurisprudence Award in Federal Estate and Gift Taxation from St. John's University School of Law. Mr. Goldberg has taught many CPE courses on taxation and pension planning at the state and national level and has taught CLE courses for the New York State Bar Association, local bar associations and law schools. He is the recipient of outstanding discussion leader awards from both the American Institute of Certified Public Accountants and the Foundation For Accounting Education. He was formerly associated with the Internal Revenue Service. Mr. Goldberg has been quoted in the New York Times, Forbes, Fortune, Money Magazine, U.S. News & World Report, Business Week, and The Wall Street Journal. He has been interviewed on CNN, CNBC and WCBS. Mr. Goldberg has been a member of the Northeast Pension Liaison Group and a member of the IRS Long Island Tax Practitioner Liaison Committee, and has been involved in conducting continuing education outreach programs with the IRS on the retirement distribution rules. Mr. Goldberg has authored manuals for the American Bar Association, the American Institute of Certified Public Accountants and other organizations. Mr. Goldberg wrote an amicus (friend of the court) brief in the inherited IRA Supreme Court case, Clark v. Rameker.

Non-Compliant IRA Trusts and Circular 230 Issues

Many individuals have accumulated a considerable amount of wealth in their individual retirement accounts (IRAs). This can happen because the IRA account holder rolled over or directly transferred retirement assets that were accumulated in his/her qualified plan accounts such as a 401(k), a 403(b) arrangement or a 457(b) governmental plan to his/her IRA account.

These retirement accounts may represent the major portion of a taxpayer's wealth and must be considered in developing an estate plan for the client. Often clients are concerned about the welfare of their beneficiaries after they are gone.

As a result of the Supreme Court opinion in Clark V. Rameker issue on June 12, 2014, it was held that inherited IRAs are not considered to be "retirement funds" that are protected under the bankruptcy code. This opinion is significant especially if the nonspouse beneficiary of an inherited IRA account has actually or potential problems with his/her creditors.

Some states have enacted legislation that protects inherited IRAs from creditors of the nonspouse beneficiary. These states include Alaska, Arizona, Florida, Missouri, North Carolina, Ohio and Texas. The nonspouse beneficiary, however, must satisfy certain domiciliary requirements in order to protect his/her inherited IRA accounts in a protected state. There is nothing to stop additional states from amending their laws from time-to-time to protect inherited IRAs from creditors of the nonspouse beneficiary.

The Supreme Court did not address the issue regarding a spouse beneficiary who treats the IRA as a beneficiary IRA and does not transfer or rollover the IRA into a spousal rollover IRA. It is generally best for the surviving spouse to transfer or rollover the deceased spouse's IRA to his/her own IRA to the extent permitted by law. The surviving spouse, however, may not roll over or transfer an unpaid required minimum distribution attributable to the deceased IRA owner to his/her own IRA.

Many consultants suggest that IRA trusts be established for the nonspouse beneficiary of an inherited IRA from an asset protection point of view. If the deceased IRA owner's account is payable to a spendthrift trust, then the trust should be protected from creditors of the trust beneficiary under section 541(c)(2) of the Bankruptcy Code.

If an IRA trust is used for asset protection purposes, but fails to meet the IRS stretch payment rules, then the trustee of the non-compliant IRA trusts may have significant liability issues with both the trust beneficiaries and the IRS.

The problem is that in order to take advantage of the stretch payment rules with respect to an IRA trust, the IRA trust must satisfy certain IRS post-death trust compliance rules and also must be drafted in a manner that satisfies the IRS regulations and IRS letter rulings. If a trust involves an IRA QTIP trust, then it must also satisfy Revenue Ruling 2006-26.

Accordingly, there are stringent rules that apply to an IRA trust for a nonspouse beneficiary and there are much more complex rules that apply when an IRA trust is created for the benefit of a surviving spouse if a QTIP IRA trust is involved. A credit shelter IRA trust can be established for a surviving spouse, as well.

The author has reviewed a number of existing IRA trusts for nonspouse beneficiaries and found them to be non-compliant from an IRS standpoint and/or from a drafting point of view.

In order to satisfy a key IRS compliance rule regarding any type of IRA trust, the trustee must file certain paperwork with the IRA financial institution by no later than October 31 following the year of the IRA owner's death.

The trustee must send a copy of the IRA trust to the IRA or the trust certification paperwork to the IRA financial institution by no later than the October 31 deadline.

The post-death IRS trust documentation requirement must be satisfied with the IRA institution by no later than October 31 following the year of death of the IRA owner. Under the IRS rules the trustee of the trust must either:

1. Provide the IRA institution with a final list of all beneficiaries of the trust (including contingent and remainderman beneficiaries) with a description of the conditions on their entitlement as of September 30th of the calendar year following the calendar year of the IRA owner's death; certify that, to the best of the trustee's knowledge, this list is correct and complete and that certain requirements described in the regulations are satisfied; and agree to provide a copy of the trust instrument to the IRA institution upon demand; or

2. Provide the IRA institution with a copy of the actual trust document for the trust that is named as a beneficiary of the IRA owner under the IRA agreement as of the IRA owner's date of death.

The author generally recommends that the second method be used, since it is often less complicated than the first.

No matter which method is used, the trustee should document the fact that the paperwork was timely satisfied with the IRA institution by the October 31 deadline. This should be done with a transmittal letter that is sent to the IRA institution by certified mail, return receipt requested.

The failure of the trustee to satisfy the post-death IRS trust documentation requirement is a fatal error. It prevents the trustee from using the life expectancy of the appropriate trust beneficiary in determining the required minimum distributions that must be made from the deceased IRA owner's account to the IRA trust. There is currently no method available under the IRS rules to remedy this oversight.

The author has been involved in continuing education programs involving IRA trusts for over 15 years and has found that many advisors are not aware of the October 31 post-death IRS compliance deadline regarding IRA trusts.

This is not only a problem for the IRA advisor but is also a major problem for the practitioner who prepares the fiduciary income tax return for the IRA trust.

If it turns out that the trustee of the IRA trust is improperly using a stretch payment of the trust beneficiary incorrectly, then the trustee can have significant liabilities to the trust beneficiaries and to the IRS. This can occur because the trustee failed to timely satisfy the post-death IRS trust documentation requirement.

Obviously, the fiduciary income tax return preparer of the IRA trust should look into this issue and advise the trustee accordingly. If the fiduciary income tax return preparer finds out about this fatal error after the October 31st deadline, then the fiduciary income tax return preparer must immediately advise the trustee about the issue.

Example 1

Facts

Assume John, an IRA owner, designated an IRA trust as the beneficiary of his IRA. His grandson, Joey, is the trust beneficiary of the IRA trust. Assume that John died on July 1, 2006 at age 68. Joey is age 18 in 2006. Further assume that the IRA trust started to receive required minimum distributions from John's IRA commencing in 2007 based on Joey's IRS single life expectancy as determined in the year after John's death. Since Joey is age 19 in 2007, the trustee assumed that the single life expectancy of Joey as determined in 2007 could be used in determining the stretch IRA distributions to the IRA trust. As a result the trustee uses the IRS single life expectancy table for an individual age 19 in determining required minimum distributions that is made from John's deceased IRA to John's IRA trust for the benefit of Joey. The IRS single life expectancy for an individual age 19 is 64.0 years.

Assume that Jack, the trustee of John's IRA trust failed to timely file the post-death IRS trust documentation paperwork with the IRA institution by the October 31, 2007 deadline. Jack was never advised to do so by his then professional advisor.

Question 1:

May the trustee of John's trust use Joey's term-certain IRS single life expectancy of 64.0 years commencing in 2007 in determining the required minimum distributions that are made from John's deceased IRA to John's IRA trust?

Answer:

No. According to the IRS regulations, the post-death IRS trust documentation requirement (among other requirements) must be timely satisfied in order to use the IRS single life expectancy of Joey in determining the required minimum distributions that are made to John's IRA trust.

Question 2:

Based on the violation of the October 31, 2007 deadline requirement, by when must John's IRA be paid to John's IRA trust?

Answer:

By no later than December 31, 2011.

John died on July 1, 2006 at age 68. This date of death is before John's required beginning date. Since John's IRA trust does not satisfy one of the rules that allows Joey's IRS single life expectancy to be used, it is as if John died before his required beginning date without a designated beneficiary. In essence, John's IRA trust is a non-compliant IRA trust.

Since John died before his required beginning date without a designated beneficiary, the five-year rule is operative. John's IRA trust must receive John's entire IRA account by no later than December 31, 2011.

Question 3:

Assume that Murray is the new IRA advisor to the trustee of John's IRA trust and is also a CPA who is retained to prepare John's IRA trust fiduciary income tax returns for the year 2014. Also assume that John's IRA trust for the calendar years 2012 and 2013 reflects stretch payments based on the use of Joey's remaining term-certain single life expectancy. Murray CPA finds out from Jack trustee in 2014 that Jack trustee never filed the post-death IRS trust documentation paperwork with the IRA institution.

What action should Murray CPA take?

Answer:

Murray CPA must immediately notify Jack, the trustee of John's IRA trust about the potential tax penalties that can be imposed on the trust.

For example, if the balance in John's IRA as of December 31, 2011 amounts to $300,000, then the potential tax penalty is a 50% penalty excise tax on the shortfall amount of $300,000. Therefore, the 50% potential excise tax penalty amounts to $150,000.

Under the five-year rule, John's entire deceased IRA account balance had to be paid out to John's IRA trust by no later than December 31, 2011.

Since this was not done, then Jack the trustee has a major IRS excise tax penalty problem to the extent of $150,000 plus delinquency penalties and interest.

Question 4:

What should Murray CPA recommend to Jack trustee to possibly mitigate the $150,000 excise tax penalty?

Answer:

Murray CPA should tell Jack trustee to immediately close out John's deceased IRA account in its entirety and pay it to John's IRA trust. This would trigger a fiduciary income tax liability in 2014 to the extent such IRA distribution is not paid to Joey under the terms of John's IRA trust.

After that is done, the Jack trustee should file a Form 5329 for the calendar year 2011 for the John IRA trust and request that the 50% excise tax penalty of $150,000 be waived.

According to the regulations, the IRS can waive the 50% penalty excise tax on the basis of reasonable error. The penalty can be waived by the IRS if the payee establishes to the satisfaction of the IRS the following:

1. The shortfall in the amount of the distributions was due to reasonable error; and

2. Reasonable steps are being taken to remedy the shortfall.

The IRS instructions to IRS Form 5329 explains the procedure for filing for the waiver.

It is important that John's IRA be closed out as soon as possible after the error is discovered by Murray CPA in 2014. This assumes that Jack trustee acted promptly as well after Murray CPA brought it to his attention.

Question 5:

If Jack trustee is not cooperative in making the correction and filing the Form 5329 for 2011, then what should Murray CPA do?

Answer:

Murray CPA should indicate to Jack trustee that according to the 2011 Tax Court opinion in Paschall v. Commissioner, that there is no statute of limitations on an IRA excise tax in the absence of filing a Form 5329 for 2011. In effect, the IRS can assert the 50% penalty excise tax at any time if a Form 5329 is not filed with the IRS for 2011, the year of the shortfall.

Question 6:

If Jack trustee fails to cooperate with Murray CPA's suggestions, then what must Murray CPA do?

Answer:

Murray CPA cannot prepare a 2014 fiduciary income tax return for John's IRA trust improperly using Joey's remaining term-certain single life expectancy. Murray CPA must resign from the engagement once Murray CPA knows of the error and Jack trustee refuses to take the action that Murray CPA suggested.

This resignation is necessary from both an ethics point of view as well as under the rules that are found in Circular 230.

Question 7:

What provision under Circular 230 is on point?

Answer:

Treasury Department Circular No. 230 covers regulations governing practice before the Internal Revenue Service, Section 10.21. Knowledge of Client's Omissions is applicable and states as follows:

"A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service knows that the client has not complied with the revenue laws of the United States or has made an error or omission from any return, document, affidavit or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error or omissions."

Question 8:

What additional provision in Circular 230 should Murray CPA be concerned with?

Section 10.22 in Circular 230 covers diligence and states in part as follows:

"(a) In general a practitioner must exercise due diligence –

(1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters …."

In addition, practitioners should be aware of other provisions effective June 12, 2014 in Circular 230.

As of June 12, 2014, new final regulations were issued by the IRS with respect to Circular 230. Section 10.35 is one of the changes that is of major importance to practitioners and follows:

§10.35 Competence

"(a) A practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service. Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged. A practitioner may become competent for the matter for which the practitioner has been engaged through various methods, such as consulting with experts in the relevant area or studying the relevant law.

(b) Effective/applicability date. This section is applicable beginning June 12, 2014."

Author's note

Practitioners may be in violation of the Circular 230 provisions if they are not aware of the IRA compliance issues. These issues may include improper rollovers, excess contributions, required minimum distribution violations and improperly preparing a fiduciary income tax trust return of a non-compliant IRA trust.

Example 2

Facts

Assume the facts in Example 1 except that John died in 2006. Assume that John would have attained age 75 in the year of his death had he not died. John died after receiving his entire required minimum distribution for the calendar year 2006. Also assume Jack the trustee of John's IRA trust failed to timely file the post-death IRA trust documentation paperwork with the IRA institution by the October 31, 2007 deadline.

Question 1:

Can Jack trustee receive IRA distributions from John's deceased IRA over Joey's single life expectancy which is a 64.0 year term-certain period commencing in 2007?

Answer:

No. See previous discussion regarding this fatal noncompliance error that was made by Jack trustee with respect to John's IRA trust.

Question 2:

Over what period may Jack trustee receive required minimum distributions from John's deceased IRA?

Answer:

Since John died in 2006 after his required beginning date, then Jack trustee of John's IRA trust may receive required minimum distributions under the remaining life expectancy rule. This remaining term-certain period is a 12.4 year period commencing in 2007 and reduced by one for each year thereafter.

Note

Had John died in 2006 prior to receiving his entire required minimum distribution for the year 2006, then the unpaid required minimum distribution for 2006 must be paid to John's IRA trust as well.

Question 3:

How is the remaining term-certain period of 12.4 years determined?

Answer:

Since John died after his required beginning date having a non-compliant IRA trust as the beneficiary of his IRA, then for post-death IRA distributions, you look tentatively at the attained age that John would have reached in the year of death had he not died. You then take the following steps:

1.	John's attained age in 2006 had he not died (assume age 75)	75
2.	IRS single life expectancy (used to determine post-death IRA distributions if John died on/or after his required beginning date when you have a non-compliant IRA trust as the beneficiary of an IRA)	13.4
3.	The remaining term-certain period for distributions from John's deceased IRA to the non-compliant IRA trust is 13.4 years -1 or 12.4 years commencing in 2007	12.4

Note:

The term-certain period commencing in 2007 is 12.4 years and is reduced by one for each year thereafter.

The 64.0 year term-certain period with respect to Joey's life expectancy is lost because of this non-compliance error.

Please note that the remaining life expectancy rule described above applies when an IRA owner dies on or after his/her required beginning date having designated as his/her beneficiary the estate, a non-compliant IRA trust or a nonspouse beneficiary who is older than the IRA owner.

Note:

An IRA trust can be non-compliant as well if the IRA trust is not properly drafted. This could happen if the provisions in the IRA trust document do not satisfy the IRS regulations and/or IRS rulings.

Example 3

Facts

Martin, an IRA owner, designates as his IRA beneficiary the Martin IRA trust for the benefit of his daughter, Jane. Martin is age 72 in the year of his death. His date of birth is October 15, 1941. He died on November 1, 2013. He received his entire required minimum distribution from his IRA for the calendar year 2013 before the date of his death. The IRA trust provides that Jane receive the income from the IRA trust each year. The trust remainderman of the Martin IRA trust is the XYZ Charity. Jane is age 19 in 2013 and the trustee of the IRA trust is Clark.

Clark, trustee has been advised by his IRA advisor Jeff to timely file the IRA trust with the IRA institution by the October 31, 2014 deadline. Clark trustee does so and believes that Jane's term-certain single life expectancy can be used in determining the required minimum distributions that can be made to Martin's IRA trust.

Jane is age 20 in 2014 and her IRS single life expectancy is 63.0 years. Steve CPA relying on the IRA advisor calculates the required minimum distribution based on the 63.0 year stretch payment period and $9,206.00 is received by Martin's IRA trust in 2014. This computation is based on Martin's deceased IRA account balance as of December 31, 2013 of $580,000 divided by 63.0 ($580,000 ÷ 63 = $9,206). Steve CPA then tells Clark trustee to pay out the $9,206 from the Martin's IRA trust to Jane and deducts that amount on the fiduciary income tax return for the calendar year 2014.

Question 1:

May Clark trustee use Jane's single life expectancy in determining the required minimum distributions that must be made to Martin's IRA trust?

Answer:

No. According to the IRS rules, Jane is an income beneficiary and not the beneficiary of the required minimum distributions according to the terms of the IRA trust. If the trust beneficiary of an IRA trust is an income beneficiary, then under the IRS rules, the single life expectancy of the oldest beneficiary of the IRA trust is used in determining the required minimum distribution payout period. Since the XYZ Charity is the trust remainderman, then there is a stretch payment rule problem since a charity has no life expectancy. The charity is considered to be the oldest trust beneficiary. Because of this issue, the 63.0 year life expectancy of Jane cannot be used for IRA trust stretch payment purposes.

Question 2:

Assume the facts in Example 3 except that Clark trustee of Martin's IRA trust has discretion pursuant to the terms of the IRA trust to invade principal on behalf of Jane.

Would that change your answer to question 1?

Answer:

No. Clark as trustee has discretion to invade principal but is not mandated to pay the required minimum distributions to Jane each year. Under the IRS rules, the single life expectancy of Jane may not be used in determining the stretch payments to Martin's IRA trust. This is so since Jane is not considered to be the oldest trust beneficiary. Charity is the oldest beneficiary based on the facts in this question and example.

Question 3:

Based on the above, over what term-certain period must Clark as trustee use in determining the required minimum distributions that must be made from Martin's deceased IRA to Martin's IRA trust?

Answer:

Clark as trustee of Martin's IRA trust uses the deceased IRA owner's remaining life expectancy. These rules were previously explained. This is so because Martin died after his required beginning date at age 72. Under the remaining life expectancy rule, Clark trustee can receive required minimum distribution over at 14.5 year term-certain period commencing in 2014 and reduced by one for each year thereafter.

Question 4:

Assume that Clark trustee of Martin's IRA trust received a $40,000 required minimum distribution during the calendar year 2014. This was determined by dividing Martin's deceased IRA account balance as of December 31, 2013 of $580,000 by 14.5 ($580,000 ÷ 14.5 = $40,000) of $40,000.

How much must Clark trustee pay to Jane, the mandated income beneficiary of the Martin IRA trust for the calendar year 2014?

Answer:

Under the state trust laws the definition of income for fiduciary accounting purposes if often not the same as the definition of income for income tax purposes. Most jurisdictions define trust accounting income to be 10% of the required minimum distribution amount that is paid to the IRA trust. Accordingly Clark trustee would distribute 10% of $40,000 or $4,000 to Jane, the mandated income beneficiary for the calendar year 2014.

Question 5:

What drafting approach could have been used to allow Martin's IRA trust to use Jane's term-certain single life expectancy in determining the required minimum distributions that are paid from Martin's deceased IRA account to Martin's IRA trust.

Answer:

If the IRA trust document provided that the required minimum distributions must be paid to Jane each year and Clark trustee timely satisfied the post-death IRS trust documentation requirements by the October 31, 2014 deadline, then Martin's IRA trust can use the term-certain single life expectancy of Jane. Thus, the Martin IRA trust could then receive required minimum distributions from Martin's deceased IRA account over a 63.0 year term-certain period commencing in 2014. This number would then be reduced by one for each year thereafter.

<u>Author's comment</u>

If the two rules described above are met, then the life expectancy of all other trust beneficiaries are ignored and Jane's term-certain single life expectancy account is used in determining the required minimum distributions from Martin's deceased IRA to Martin's IRA trust.

Question 6:

Should Steve CPA know about the state trust law's 10% rule when he prepares the fiduciary income tax return for the Martin IRA trust?

Answer:

It would appear yes. The AICPA "Practice Guide for Fiduciary (Trust) Accounting, A Guide for Accountants Who Perform Fiduciary Accounting Services" issued December 2007 by the AICPA Tax Division, states in part in the Executive Summary as follows:

- Fiduciary tax return preparers must realize that taxable income and fiduciary accounting income are not the same. Accountants who unwisely prepare tax returns using only Forms 1099 and a check register face undaunted malpractice exposure to trustees and beneficiaries. Recent IRS regulations recognize changes in fiduciary accounting concepts in tax return reporting.

- Reading and understanding the terms of the trust instrument and/or will is the initial step in preparing a fiduciary accounting. The instrument overrides local law (e.g. statutes in the state of the trust's or estate's situs).

- Accountants who perform fiduciary accounting services need to be knowledgeable of the Uniform Acts and Model Codes as adopted in the state of situs because these provisions and case law provide guidance as to local law if the trust or will is silent or poorly drafted. Seeking advice or counsel from knowledgeable attorneys can also be helpful and resourceful.

As noted in the Introduction to the Practice Guide, the challenges facing accountants who provide accounting and services for trusts and estates include a lack of familiarity with estates, trusts and fiduciary accounting principles, and a lack of consistency among the 50 states and the District of Columbia because each has its own statutes and legal interpretations varying from state to state. CPAs would do well, therefore, to familiarize themselves with the rules in these areas.

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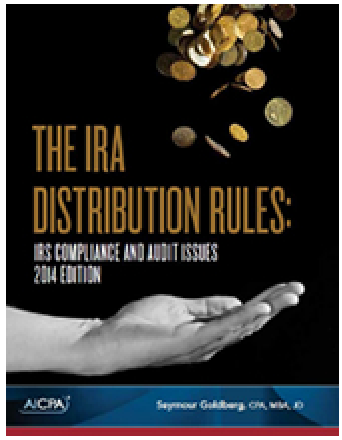

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