LAGOS
WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

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ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

GOT MORE QUESTIONS?
WE'VE GOT MORE ANSWERS!

A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Clients are full of questions related to taxes. They often ask advisors about tax issues related to

- IRAs,
- the Tax Cut and Jobs Act,
- Social Security benefits, and
- life insurance and annuities.

Sometimes advisors need to turn to other resources for answers to those questions.

At Advanced Underwriting Consultants (www.advancedunderwriting.com) the advanced sales attorneys answer questions from life and financial professionals every day. We have published some of their frequently asked questions and answers in the past. They have shared some of their more recent conversations with financial professionals, which we have transcribed and included below.

Please keep reading to find out more and contact me with any questions.

Regards,
Michael W. Lagos, CFP®

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GOT MORE QUESTIONS?
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THE QUESTIONS AND ANSWERS

Traditional and Roth IRAs

Question: My client turned 70 ½ in 2018 but has waited until February 2019 to take her first required minimum distribution (RMD) from her IRA. How can I get the IRA custodian to amend the 1099-R to show the distribution is taxable in 2018?

Answer: You can't. The custodian will correctly report the distribution as taxable in 2019, even though the distribution is for the RMD obligation in 2018.

A special rule allows the account owner to delay her first RMD for an IRA until April 1 of the calendar year following the year in which she turns 70 ½. The taxpayer could have taken the RMD anytime in 2018 or as late as the April 1, 2019 deadline.

While a distribution taken at any time during that window satisfies the 2018 RMD obligation, the RMD will be taxed in the calendar year it is actually taken. If this client waits until March 2019 to take her first RMD, she'll have to take a second taxable RMD in 2019—prior to the December 31 deadline.

Question: I have a client turning 70 ½ this year in 2019. I know she is still eligible to contribute to a traditional IRA for 2018 but not for 2019. If she opens a new IRA and contributes $7,000 for 2019, will she have to take a required minimum distribution for 2019 from that account?

Answer: No.

IRS Publication 590-A Individual Retirement Arrangements clarifies that an individual can make contributions to an IRA for a given year until the due date for filing the tax return for that year, not including extensions. In other words an individual generally has until April 15, 2019 to make a contribution to an IRA for 2018.

Publication 590-B gives us the rules for determining when required minimum distributions must start and how to calculate them. An individual must receive at least a minimum amount from their IRA beginning with the year she turns 70 ½. In order to figure the amount for the required minimum distribution, the account balance as of December 31 for the preceding year is divided by the applicable distribution period or life expectancy factor for the individual.

In this case the individual client made the initial contribution in 2019 for year 2018. Since the account was opened in 2015, there is no account balance as of December 31, 2018. Because there is a zero account balance as of December 31, 2018, there is no required minimum distribution due for 2019 from this account. The client will have to take required minimum distributions from this account in 2020 and for the following years.

Question: I have a client that inherited a Roth IRA from her husband. She is younger than 59 ½ and would like to treat the account as inherited. What will her required distribution obligation be?

Answer. A surviving spouse may choose to treat an inherited IRA as a beneficiary IRA. An advantage of doing so is that if the survivor is young than age 59 ½, she would avoid the 10 percent early distribution penalty. If, on the other hand, she were to treat the inherited IRA as her own, the penalty will apply to any taxable portion of a distribution taken before age 59 ½.

Typically when an individual has a Roth IRA, the taxpayer is not required to take required minimum distributions (RMDs) from the account during lifetime. But when an individual *inherits* a Roth IRA, the beneficiary must begin taking distributions from the account unless the beneficiary is the surviving spouse and chooses to treat the account as her own.

IRS Publication 590-B tells us:

> If a Roth IRA owner dies, the minimum distribution rules that apply to traditional IRAs apply to Roth IRAs as though the Roth IRA owner died before his or her required beginning date.

If a surviving spouse chooses to treat an inherited IRA as a beneficiary account and the original account owner had not reached his required beginning date before death, a special rule applies. The following can be found in IRS Publication 590-B.

> **Special rules for surviving spouse.** If the owner died before his or her required beginning date and the surviving spouse is the sole designated beneficiary, the following rules apply.
>
> **Year of first required distribution.** If the owner died before the year in which he or she reached age 70 ½, distributions to the spouse do not need to begin until the year in which the owner would have reached age 70 ½.

In the case where a surviving spouse chooses to treat an inherited *Roth IRA* as a spousal beneficiary Roth IRA, she will need to begin taking distributions from the beneficiary account when the original owner would have turned 70 ½. If the original account owner had attained age 70 ½ before death, the distribution would be determined using the Single Life Table and the surviving spouse's age.

It may be worth considering the sequence of nonqualified Roth IRA distributions in order to make an informed decision as to whether treating an inherited Roth IRA as a beneficiary account for a surviving spouse is beneficial. In order for distributions from a Roth to be completely income tax free, they must be qualified. A distribution is qualified if the account holder is age 59 ½ or older and the first Roth IRA contribution occurred at least five years before the distribution. Both requirements must be met. If the account owner is less than 59 ½ years old or the first contribution occurred less than five years before the distribution, nonqualified distributions will be distributed as follows:

1. regular contributions first,
2. rollovers and converted amounts on a first-in-first-out basis, and
3. earnings attributed to contributions

In other words a taxpayer would have to exhaust contributed amounts before they would potentially be subject to taxation and the early distribution penalty. Depending on the amount of actual contributions, it may make more sense for a surviving spouse, even one below age 59 ½, to treat an inherited Roth IRA as her own. But each individual's circumstances and needs are different.

Question: My 74-year-old client failed to take a required minimum distribution from her IRA before the end of 2018. Does she have to prepay the penalty tax when she asks the IRS for relief from the 50 percent penalty?

Answer: No.

If the client fails to take the RMD by the deadline, the IRS imposes a special penalty tax of 50 percent on the amount that should have been distributed. The penalty tax may be waived if

- the taxpayer convinces the IRS that the failure to take the RMD was due to reasonable error, and

- that reasonable steps are being taken to fix the problem.

A taxpayer applying for relief from the penalty tax must file IRS Form 5329 for the year in question and attach a letter of explanation.

Here is what the instructions for Form 5329 say (with added bolding of the key language of step 2):

> Waiver of tax. The IRS can waive part or all of this tax if you can show that any shortfall in the amount of distributions was due to reasonable error and you are taking reasonable steps to remedy the shortfall. If you believe you qualify for this relief, attach a statement of explanation and file Form 5329 as follows.

1. Complete lines 52 and 53 as instructed.
2. Enter “RC” and the amount you want waived in parentheses on the dotted line next to line 54. **Subtract this amount from the total shortfall you figured without regard to the waiver, and enter the result on line 54.**
3. Complete line 55 as instructed. You must pay any tax due that is reported on line 55.

The instructions are thus explicit that penalty tax for any failed RMD should not be prepaid if the taxpayer is requesting a waiver.

Question: I have a client that has already begun taking required minimum distributions (RMDs) from her IRA. Can she still perform a 60-day rollover?

Answer. Yes, but she must adhere to some rules. IRS Publication 590-A tells us:

> Amounts that must be distributed during a particular year under the required distribution rules are not eligible for rollover treatment.

In other words RMDs cannot be rolled over. While that seems simple enough, things can get tricky. For instance if a taxpayer has an IRA and is taking required minimum distributions that she wishes to roll over to another account by 60-day rollover, she must either:

- take the RMD before the rollover;
- leave the amount calculated for the RMD in the account to be taken later; or
- distribute the whole account and keep the amount needed to satisfy the RMD while rolling over the rest of the account.

If an amount that represents the RMD is rolled over, it will be considered an excess contribution. Excess contributions are subject to a 6 percent penalty tax per year, for every year they remain in the account. In order to avoid the penalty, excess contributions must be withdrawn from the account by the due date of the taxpayers tax return along with any income earned because of the excess contribution.

When performing a 60-day rollover, taxpayers should keep in mind that if the rollover is performed from an IRA, they will not be eligible for another 60-day rollover from any IRA they have for a 12-month period. If a taxpayer completes a second 60-day rollover from an IRA within the 12-month period, the second rollover will be treated as a taxable distribution. However, taxpayers can complete an unlimited number of direct transfers, trustee-to-trustee transfers, or 60-day rollovers from employer-sponsored plans such as 401(k)s, and 403(b)s.

Tax Cut and Jobs Act (TCJA)

Question: I have a client who is sole proprietor of his law firm. He believes he does not qualify for the new 20 percent pass-through income tax deduction for his business income. Is he right?

Answer: It depends on his taxable income.

The TCJA creates a 20 percent tax deduction for the income of pass-through businesses—including S corporations, partnerships, and proprietorships—for most middle-income business owners and for certain high income owners if the right conditions are met. Since the client is the owner of a proprietorship, he owns the kind of pass-through business that might be eligible for the deduction.

The TCJA lists three main circumstances that can affect the availability of the pass-through deduction:

1. The pass-through business owner’s taxable income is below certain thresholds.
2. The pass-through business owner is engaged in a certain kind of business.
3. A pass-through business owner above the income threshold pays wages or has depreciable assets.

A phase-out of the pass-through deduction is complete at $210,700 ($207,500 in 2018) for single taxpayers and at $421,400 ($415,000 in 2018) of taxable income for those married filing jointly.

Owners of professional services businesses who have income in excess of the pass-through income thresholds are prevented from taking advantage of the Section 199A deduction. The TCJA refers to the excluded activities and Specified Service Trades or Businesses (SSTBs). A law firm falls squarely within the definition of an SSTB.

So, in the context of the question, the availability of the deduction is dependent solely on the taxpayer's total taxable income and filing status. If, for example, the client is single with taxable income from the business of $150,000 (with no other taxable income), the client will qualify for an income tax deduction of $30,000.

On the other hand, imagine the client has the same business income but is married and the spouse has $300,000 of taxable income of her own. Under those circumstances the client will be entitled to no deduction because

- taxable income is in excess of the threshold and
- the client is engaged in an SSTB.

Social Security

Question: If my client receives Social Security survivor benefits from her deceased spouse and then gets remarried, is she still eligible for the survivor benefits?

Answer: It depends.

If your client remarries before age 60, she cannot receive survivor benefits as a surviving spouse while married. If, however, remarriage occurs after age 60, the client will continue to qualify for benefits on her deceased spouse's Social Security record.

If the client remarries after 60 and stays married long enough to become eligible for spousal benefits, she may be eligible for three types of benefits: one based on the deceased spouse's record, another based on the new spouse's record, and the third based on her own record. While she may be eligible for three different types of benefits, the Social Security Administration will generally pay ONLY whichever benefit is highest.

Depending on her current age, your client may be able to file a restricted application to collect a certain type of benefit now and then switch to a higher benefit later.

Life Insurance and Annuities

Question: If a business transfers ownership of a key person policy to that key person upon their retirement, is there a tax consequence?

Answer: Yes.

When a business transfers a life policy to an employee without consideration, the entire value of the policy is taxable to the employee as compensation in the year of the transfer. If the employee purchases the policy from the business, the value of the policy above the purchase price is considered compensation in the year of the transfer. This is taxable just as any other form of compensation would be.

This kind of transfer is governed by IRC Section 83 and its regulations, which says in part:

> (a) General rule
>
> If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—

> (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over
>
> (2) the amount (if any) paid for such property. . . .

It goes on to define property and specify that:

> In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section.

These sections taken together confirm that there is a taxable consequence for transferring a business-owned life insurance contract to the insured employee. Before a business transfers a life insurance policy to an employee, both parties should consider the tax consequences of doing so.

Question: One of my clients inherited a nonqualified deferred annuity (NQDA) from her mother. Does she have to liquidate the contract within five years?
Answer: Not necessar ily.

Revenue Code Section 72(s)(2) tells us a nonspouse beneficiary must take distributions from an inherited nonqualified annuity

1. at least as rapidly as under the method of distribution in effect at the owner's death, or

2. completely within five years of the owner's death.

However, if the beneficiary is an individual and the beneficiary annuitizes the NQDA over his lifetime beginning within one year of the owner's death, he will be considered to be in compliance with the distribution rules. This rule allows the taxpayer the ability to stretch the income tax result over his lifetime, and because of annuitization tax rules, each distribution will be partly a recovery of basis and partly a taxable distribution. Private Letter Ruling 200313016 approved three *non-annuitization* methods for a nonspouse beneficiary to comply with the stretch rules of Section 72(s)(2):

- Amortization calculation method
- Annuitization calculation method
- RMD calculation method

These calculation methods are similar to those approved by Section 72(t). The RMD method produces the lowest initial payout to the beneficiary. Unlike the annuitization method, the distributions are likely to be taxed gain first as the beneficiary receives them. In another Private Letter Ruling 201330016, the IRS allowed a nonspouse beneficiary to perform a tax -free Section 1035 exchange of an inherited nonqualified annuity for another inherited nonqualified annuity. Following the exchange, the taxpayer still has to meet the distribution requirements of the old contract, but the exchange might allow the taxpayer to have an investment better suited to her needs than the inherited contract.
Check with the carriers involved before attempting a Section 1035 exchange of an inherited NQDA to make sure they are equipped to handle the transaction. Also check with the receiving carrier to be sure it can perform any desired inherited NQDA stretch administration.

Question: I have a client that wants to name a trust as beneficiary of her nonqualified deferred annuity. Will the stretch options be similar to an inherited IRA left to a trust?

Answer. An NQDA policy owner may want annuity funds directed to a testamentary trust, for example, for the benefit of his children in the event of his death. Based on current rules, it appears that directing nonqualified annuity proceeds to a trust will require that the annuity be completely distributed—and taxed—within five years of the policy owner's death. However, not everyone agrees with that conservative interpretation.

Here's an excerpt from Revenue Code Section 72(s), which is the source of information about NQDA stretch:

> (s)Required distributions where holder dies before entire interest is distributed
>
> In general A contract shall not be treated as an annuity contract for purposes of this title unless it provides that—
>
> (A) if any holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and
>
> (B) if any holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.
>
> Exception for certain amounts payable over life of beneficiary If—
>
> (A) any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary,
>
> (B) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and
>
> (C) such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe, then for purposes of paragraph (1), the portion referred to in subparagraph (A) shall be treated as distributed on the day on which such distributions begin.
>
> Special rule where surviving spouse beneficiary
>
> If the designated beneficiary referred to in paragraph (2)(A) is the surviving spouse of the holder of the contract, paragraphs (1) and (2) shall be applied by treating such spouse as the holder of such contract.
>
> Designated beneficiary
>
> For purposes of this subsection, the term "designated beneficiary" means any individual designated a beneficiary by the holder of the contract.

Section 72(s)(1) and (2) say there are two NQDA stretch choices—five year, or stretch based on the beneficiary's life expectancy—if it begins within a year of the account owner's death. Section 72(s)(4) says the second choice is available if an individual is a beneficiary of the contract.

Since a trust is not an individual, we'd need something extra from the IRS that says a trust can be treated like a person for the purpose of NQDA stretch. Those that say a trust can stretch an inherited NQDA would point to the regulations on see-through trusts that exist for inherited IRAs. The rules on see-through trusts can be found in Treasury Regulation 1.401(a)(9)-4, Q&A-5. The IRA stretch regulations are specific, and they constitute direct authority for allowing certain kinds of trusts to stretch inherited IRAs. Unfortunately, those regulations say nothing specific about trust-inherited NQDAs.

There are no regulations—or any other kind of direct authority that we know of—that would extend the logic of see-through trusts to inherited NQDAs. We have heard that one or more carriers have decided to extend the logic nonetheless. We suspect they feel that if the IRS were ever asked about see-through trusts in the context of inherited NQDAs, the IRS might decide that such trusts should be treated as individual beneficiaries for the purpose of Code Section 72(s)(4). However, in the absence of specific authority, we believe the only safe stretch when a trust is beneficiary of an inherited NQDA is five-year liquidation.

CONCLUSION

Life insurance professionals' and financial advisors' clients ask questions on a wide range of tax topics. The questions answered in this newsletter may help readers expand their expertise and affirm what they already know.

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Building Protecting and Perpetuating Family Wealth

LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.

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