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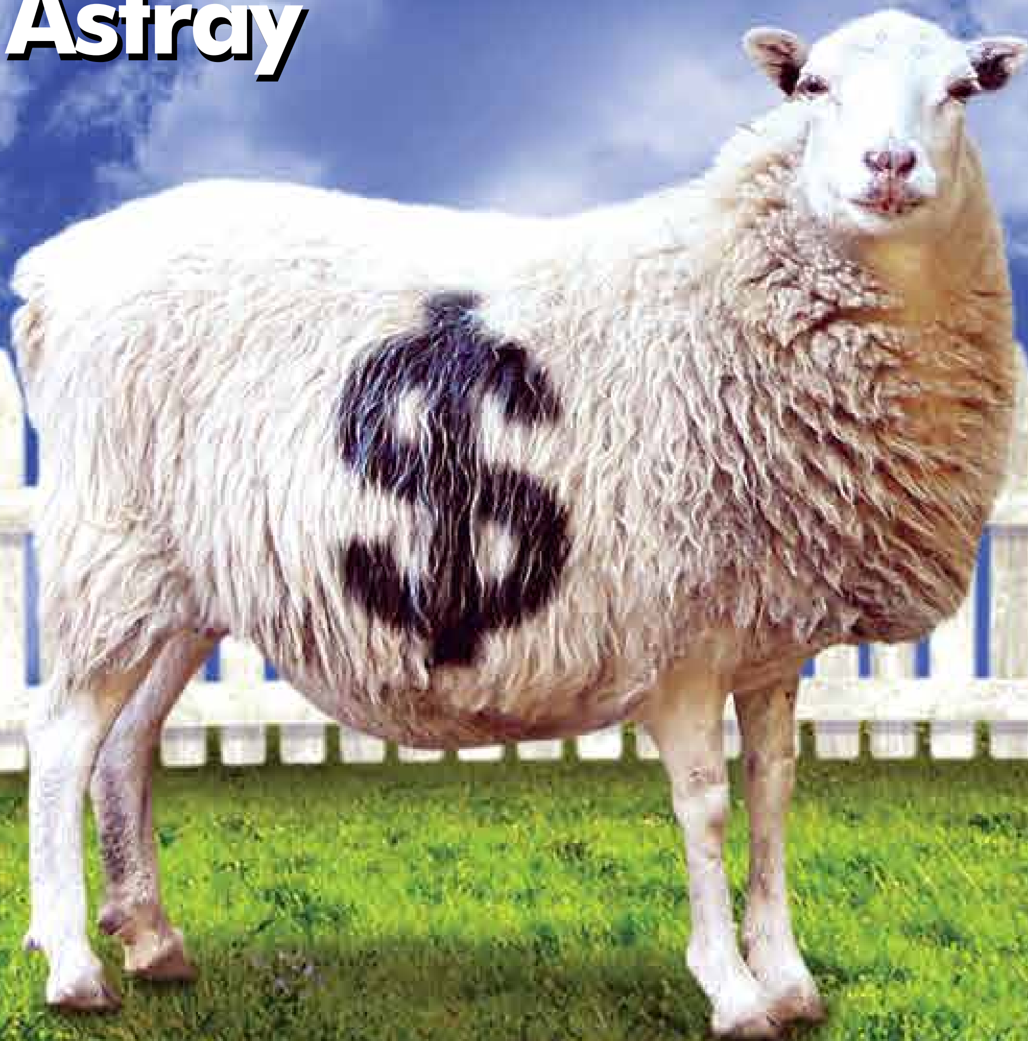
Don't Let IRA Assets Go Astray



Cover Story

Don't Let IRA Assets Go Astray

What to Expect in 2018

by
Peter Desmond Hopkins, CPA, MS
Cover & Rossiter

It is no secret that Delaware's many advantages entice clients to establish relationships with Diamond State bankers and other advisers. Often, new clients are so impressed with the professionalism they observe in Delaware that they move all their financial assets here, and this may include individual retirement accounts (IRAs).

Even the most diligent Delaware banker could fall into a situation where something goes terribly wrong with an IRA. It may be faulty instructions or identification by the disbursing institution or an error by the client. No matter the cause, IRA funds sometimes end up in the wrong place, and a mistake can be costly. A distribution could be taxed at the top federal rate of 37% tax plus a 10% penalty. The client's resident state may also tax (and even penalize) the inadvertent distribution. Once the funds are outside the IRA, they no longer grow tax-deferred (or tax-free for Roth IRAs).

Fortunately, there are exceptions to the 10% penalty, and there are even ways to fix a failed rollover. Recent guidance published by the IRS throws a lifeline to many failed rollovers. Why not update our understanding of the IRA rollover and early distribution penalty rules?

Penalty exceptions

By default, the 10% penalty (technically, an "additional tax") applies to all distributions made before the account owner reaches age 59½. Amounts that are properly rolled over from one IRA to another are not taxable and not subject to the penalty. Distributions after the death of the account owner are not subject to the penalty, even if the account owner had not yet reached 59½.

The penalty is not targeted at the disabled or those who retire before age 59½. A person with a physical or mental impairment, who is consequently unable to engage in substantial gainful activity, may be exempt from the penalty. Regulations describe the specific criteria needed to qualify as disabled.

A series of substantially equal periodic payments withdrawn from an IRA is not subject to the penalty. Typically, this exception is used by those who retire early, but it can be used by folks who are still working. The payments need not be level; they can increase over time, provided they are considered "substantially equal" under one of a calculation methods permitted by the IRS. If the payments deviate from the calculation method chosen either within five years

of the first payment or before the account owner reaches age 59½, a recapture tax applies.

Certain distributions over which the account owner had no control are exempt from the 10% penalty. These include IRS levies and qualified domestic relations orders. However, distributions need not be voluntary to cause a penalty. For example, if a bankruptcy trustee invades a debtor's IRA to pay debts of the estate, the withdrawal is subject to the penalty, unless an exception applies.

An individual may elect to treat funds transferred from an IRA to a health savings account (HSA) as a nontaxable distribution and a nondeductible HSA contribution up to that individual's HSA contribution limit for that year. The election may be made only once per lifetime. A valid election exempts the distribution from the 10% penalty.

There are several life event exceptions to the penalty including education expenses, the purchase of a home, medical expenses, health insurance premiums of the unemployed, reservists called to active military duty and natural disasters.

An individual may claim an exemption from the penalty up to the amount of qualified higher education expenses paid in the same year. These expenses may be for the IRA account holder's own education or for his or her spouse, children or grandchildren. The expenses must be paid directly; paying down a student loan does not count. Tuition, fees, books, supplies and equipment may be included. Room and board can be counted as well, but the allowable amount may be limited.

Up to $10,000 of an IRA distribution can be exempt from the penalty, if the funds contribute to the acquisition of a new principal residence for the account holder or his or her spouse or the children, grandchildren or ancestors of either of them. The acquisition must take place by the 120th day after the distribution. This so-called "first-time homebuyer" exception applies, if the new homeowner and spouse, if any, had no ownership interest in a principal residence during the two-year period before the new home acquisition. Each individual has a $10,000 lifetime limit on IRA distributions that may qualify for this exception.

If an IRA distribution fails to meet the first-time homebuyer exception because of a delay or cancellation of the purchase or construction, the amount withdrawn may be rolled over up to the 120th day after the distribution and thereby avoid the 10% penalty. IRA distributions are exempt from the penalty up to the amount of an individual's (and spouse's, if filing a jointly) deductible medical expenses after taking into account the adjusted gross income limitation (7.5% in 2018, 10% thereafter). The account holder does not need to itemize deductions to qualify for the exception.

IRA distributions to those who have been receiving unemployment compensation for at least 12 weeks used to pay health insurance premiums are exempt from the penalty. Self-employed people qualify, if they would have been entitled to unemployment benefits had they not been self-employed. IRA distributions must be made no more than 60 days after employment resumes to qualify.

Reservists called to active duty in the United States military for at least 180 days or for an indefinite period may take penalty-free distributions from their IRAs from the date of the order until the close of the active duty period.

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IRAs

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IRA distributions of up to $100,000 to an individual whose principal place of abode was located in the disaster areas created by Hurricanes Harvey, Irma and Maria are not subject to the 10% penalty, if they are made after the date of the relevant hurricane and before 2019.

Rollovers

A rollover entails the movement of assets from one tax-advantaged account to another with no immediate tax consequences. Assets in most qualified plans can be rolled over to other qualified plans or to IRAs. Balances in nongovernmental Section 457(b) plans cannot be rolled over. Assets in IRAs can be rolled over to other IRAs. Only otherwise taxable amounts from IRAs may be rolled over to qualified plans. After-tax amounts in traditional IRAs (such as nondeductible contributions) may only be rolled over to other traditional IRAs. Roth IRAs may be rolled over to other Roth IRAs. After-tax amounts in qualified plans (such as Roth 401(k) balances) may be rolled over to other qualified plans that agree to separately account for the after-tax amounts. Alternatively, these may be rolled over to the appropriate type of IRA, depending on the type of after-tax money in the plan. Tax-free treatment for a partial rollover is available up to the amount rolled over.

A rollover generally must be completed within 60 days of the distribution. The best way to accomplish this is a trustee-to-trustee transfer. This ensures everything happens at once. However, clients often withdraw funds by check, before they know what they will do with the money. They may hold on to the check or deposit it into a bank account. Suddenly, 60 days have come and gone, and the client has a problem.

There are five categories of exceptions to the 60-day rule. The first is a failed first-time homebuyer distribution, as mentioned above. The rollover period for this type of distribution is 120 days.

If a distribution is made by check from an account that becomes frozen during the 60-day rollover period, the rollover period may be extended. Days the account is frozen are added to the end of the 60-day period, and the rollover period cannot end earlier than 10 days after the freeze ends.

For those who are called to the battlefield in service to our country, the 60-day clock stops running until 180 days after they have either left the combat zone or been discharged from the hospital after suffering combat-related injuries, whichever is later. If hospitalization is inside the United States, it is limited to five years in applying this rule. There is no time limit on hospitalization abroad. Days in missing in action status count as time in a combat zone. The spouse of anyone entitled to claim this exception is entitled to the same extension of the rollover period. However, spouses may not count time spent in a United States hospital.

The IRS is authorized to provide relief to individuals in federally declared disaster areas, and that relief generally includes a blanket extension of the 60-day rule. After a disaster occurs, the IRS issues a notice describing which taxpayers qualify and the procedures to be followed to claim relief.

The fifth and final exception is based on hardship. The law directs the IRS to waive the 60-day rule in cases of casualty, disaster or other events beyond the reasonable control of the individual, if enforcing the rule would be against equity or good conscience. In enacting this hardship waiver provision in 2001, Congress provided examples of situations where it thought a waiver should apply: a distribution made by check that has not yet been cashed, errors committed by financial institutions, death, disability, hospitalization, incarceration, restrictions imposed by foreign countries and postal errors.

Prior to August 2016, an individual seeking a hardship waiver generally had to request a private letter ruling (PLR) from the IRS. The only exception was where a financial institution that received the funds prior to expiration of the rollover period made an error that caused the rollover to fail, even though the client followed proper procedures. In such a case, an automatic waiver was granted, as long as the funds were credited to the IRA within one year. Now, new IRS rules permit clients to self-certify that they qualify for a hardship waiver in any of the following circumstances:

1. An error by the financial institution receiving the contribution or making the distribution.
2. The distribution in the form of a check was misplaced and never cashed.
3. The distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan.
4. The account holder's principal residence was severely damaged.
5. The account holder's family member died.
6. The account holder or a family member was seriously ill.
7. The account holder was incarcerated.
8. Restrictions were imposed by a foreign country.
9. A postal error occurred.
10. The distribution was made on account of an IRS levy, and the levy proceeds have been returned.
11. The disbursing plan or institution delayed providing information that the receiving plan or custodian required to complete the rollover, despite the taxpayer's reasonable efforts.

If an individual provides self-certification, the assets may be rolled over, and the receiving trustee or plan administrator will not be held responsible for accepting an ineligible rollover, unless the self-certification was known to be untruthful.

If the individual fails to self-certify, and the rollover happens anyway, the IRS has authority during a later audit to grant retroactive relief, if appropriate.

For failed rollovers not described in the situations listed above, requesting a PLR remains necessary in order to obtain a waiver. The IRS generally denies waivers to those who used the funds for personal purposes.

Advice for institutions receiving tax-advantaged funds

The best practice is to use trustee-to-trustee transfers for rollovers. The banker can offer to review distribution request forms prior to their submission or suggest the client have his or her tax adviser do so. The banker needs documentation establishing the type of funds that are leaving the other IRA or qualified plan to ensure there is an appropriate account to receive them. Questions or uncertainties about the disbursing IRA or plan must be resolved prior to requesting the distribution. The client's tax adviser can be an invaluable asset

to the banker. The tax adviser may have intimate knowledge of the client's holdings and help keep things on course.

If the banker encounters a failed rollover, he or she must first determine whether it can be repaired by self-certification. If so, the banker should obtain self-certification from the client and preserve the document as long as the account remains open. Alternatively, the banker may consult with the client's tax adviser regarding seeking a PLR. The amount of the failed rollover must be weighed against the expected cost and the likelihood of success of the PLR request.

If a client faces an early withdrawal penalty, it is important to check all the exceptions. For example, a client who erroneously took an early distribution from an IRA may have paid higher education expenses for a grandchild in the same year. If not, the client may prefer to do this rather than pay the penalty.

Scholar and philosopher Nassim Nicholas Talib said, "Banking is a very treacherous business, because you don't realize it is risky, until it is too late. It is like calm waters that deliver huge storms." Delaware bankers understand that knowledge, patience and diligence will lead to smooth sailing.

Peter Hopkins is a Manager in the Tax Department of Cover & Rossiter where he focuses on trusts and estates. Peter joined Cover & Rossiter in 2015, and has established a reputation for his excellent analytical skills, broad technical knowledge and commitment to optimizing his clients' tax situation. Prior to moving to Delaware in 2015, Peter practiced public accounting for over 20 years in New York City. During that time, he served on both the Interstate Taxation Committee and the International Taxation Committee of the New York State Society of Certified Public Accountants. Peter authored taxation articles for The CPA Journal and served as an instructor for Foundation for Accounting Education seminars. Peter earned a Bachelor of Business Administration in Public Accountancy from Baruch College in 1988. He completed his Master of Science in Taxation in 1995, at Baruch College as well. Peter has been licensed as a CPA in New York since 1991, and also holds a permit to practice in Delaware. He is a member of the American Institute of Certified Public Accountants. Cover & Rossiter is one of the first and most respected full-service CPA & advisory firms in the area, providing tax, audit, trust and accounting services to businesses, nonprofits, families and individuals.