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Top 5 IRA Rulings of 2016

Written for those serious about making smart choices

Every year, Congress, the Tax Court and the IRS team up to add or change laws and rules related to the tax code. Often these adjustments include changes to how we handle our IRAs. And sometimes even, these changes end up being really good for us.

I have reviewed a list of changes and boiled it down to topics that will particularly affect serious investors. The type of people I work with. With that introduction out of the way, lets dive right into it!

1. 60 Day Rollover Relief - Hardship Exceptions

Previous to 2016, when rolling over money from one IRA account to another, the tax law permitted 60 days time to get this done. And previous to 2016, the IRS was very strict and limiting in terms of exceptions to this rule.

Taxpayers who violated the 60 day time table, and who wanted to avoid the penalty, had to resort to requesting a Private Letter Ruling from the IRS. This process is very expensive (Filing fee = $10,000).

Now thanks to Revenue Procedure 2016-47, the IRS permits taxpayers to “self-certify” relief from the penalties of rolling over assets after the 60 day window has passed. As long as the taxpayer can claim one of 11 specified “hardships” as their reasoning.

These hardship conditions include:

- Financial institution errors
- Serious illness
- Misplaced check
- Mistaken account type
- Death in the family

And 6 more. If you’re reading this and you’re caught in this situation, call me asap or get the full scoop including the relief self certification form from the IRS here:

https://www.irs.gov/pub/irs-drop/rp-16-47.pdf

2. Qualified Charitable Distributions (QCD) Made Permanent

it may surprise average people but many higher net worth people I talk to have assets that do not throw off high taxable income. Therefore, even though their assets total $3 million+, their 1040 looks somewhat average.

Because of this, they can still qualify for certain tax benefits and avoid certain tax penalties by keeping their adjusted gross income (AGI) as low as possible.

One area that people with large IRA balances can continue to avoid extra taxation is by using the Qualified Charitable Distributions strategy which Congress has made PERMANENT in 2016.

This especially works well if you are already charitably inclined. Let's take an example:

You have an IRA balance of $1,000,000 and you turn 70 1/2 years old this year. You are faced with a required minimum distribution of $36,496 this year from your IRA. Unfortunately this income puts your total 1040 income at a place where your Medicare premiums spike, and you get hit with other taxes and lost deductions. At the same time, you are someone who contributes $10,000 or $20,000 or more annually to charity. Rather than claim that income, and then contribute to your charity, you could use the Qualified Charitable Deduction Provision and get the same deduction but keep your adjusted gross income lower. AND YOU MIGHT EVEN AVOID SOME EXTRA TAXES AND FEES! Look at how this would work in the table below.

Effects of RMD on AGI	Scenario A -no QCD	Scenario B - QCD
Income excluding IRA RMD	$75,000.00	$75,000.00
RMD - Required Minimum Distr.	$36,496.00	$36,496.00
Adjusted Gross Income	$111,496.00	$75,000.00
2015 Medicare Premium - single	$267.90	$134.00

Note: Medicare Premiums can jump when income exceeds $85,000 and much more above $107,000 for single people (see table below right). This table assumes 100% of RMD is donated to charity. See https://www.medicare.gov/your-medicare-costs/part-b-costs/part-b-costs.html

Summary

This is an excellent tool for those with incomes that are high enough that their deductions get phased out or expenses increase (Medicare example). The QCD doesn't get phased out so for some, this ruling could give you a deduction where you didn't qualify for one before.

In conclusion, in my experience, successful people are generous with their time and their money. It's how many become successful - having the abundance attitude. Changing the QCD to a permanent state is semi-hidden gem in the tax code for generous people who normally don't get too many tax breaks.

If you're in 1 of these 5 groups, here's what you'll pay:

If your yearly income in 2015 (for what you pay in 2017) was			You pay each month (in 2017)
File individual tax return	File joint tax return	File married & separate tax return	
$85,000 or less	$170,000 or less	$85,000 or less	$134
above $85,000 up to $107,000	above $170,000 up to $214,000	Not applicable	$187.50
above $107,000 up to $160,000	above $214,000 up to $320,000	Not applicable	$267.90
above $160,000 up to $214,000	above $320,000 up to $428,000	above $85,000 and up to $129,000	$348.30
above $214,000	above $428,000	above $129,000	$428.60

3. Thiessen v Commissioner: Tax Court Ruling Against Prohibited Transactions in Self Directed IRAs

Investors getting personally involved in investments in self directed IRAs can cause the IRA to "blow up" and become instantly 100% taxable. The traps are easy to fall into because self directed IRAs offer some tempting possibilities.

A self-directed IRA is an IRA where the IRA account holder controls or "directs' the investments. Meaning the custodian will not advise or restrict where you invest typically (the good ones might toss you a warning if you are trying to do something super dumb). If you tell the IRA custodian to send a check for 50,000 dollars to invest in an A round venture capital fund raise, they will typically simply send the check.

On the other hand, a typical IRA custodian limits your investments to the funds at that firm or to listed stocks and bonds on a brokerage account. If you asked them to send the VC check, they wouldn't do it. The reason people use self-directed IRAs is to invest outside the mainstream.

There are a number of interesting cases where self directed IRAs were used to create enormous tax avoidance bonanzas to investors.Two of the more well known are Max Levchin and Peter Theil. Levchin, former CEO of Yelp, bought Yelp shares cheap in his Roth and watched his Roth IRA balloon to 95 million dollars - all tax free. Theil, former CEO of Paypal, and well-known early Facebook investor, bought shares of both companies cheap (pre-IPO) and watched them explode in value tax free in his Roth.

Therefore, it's no surprise that high net worth investors would be curious about ways they could earn better returns in their IRAs. Many readers of this report, maybe even you, have seen ads for "self directed IRAs" online or via seminar or mailing. Typically, people get attracted to self directed IRAs due to the ability to buy real estate inside an IRA (not a real estate fund - an actual house or building!).

It seems appealing to want to "do better" than the stock market and try alternative investments. Rolling over that 401k you've had for years with a balance > $1 million and buying a house or stock in a privately held corporation is tempting. A good story often is.

So what did Thiessen and his wife do wrong? they used their self directed IRA to invest in a holding company. They also took out a loan through the holding company to buy another company. Then they made the mistake - they guaranteed that loan personally. By mixing personal guarantees and IRA assets, they engaged in a "prohibited transaction" which caused their entire IRA balance to become immediately taxable.

The general idea with IRA assets is that the IRA owner must keep arms length from the IRA assets. The IRA owner:

- can't guarantee loans - this means that you can't take out a typical mortgage when buying real estate in your self-directed IRA because a typical mortgage would likely be guaranteed by you.
- can't own shares in a business and control the business. You can't invest in a startup with your IRA funds where you are the CEO and controlling shareholder.
- Can't work for the company the IRA owns. You can't buy a pub them be the GM and collect a salary from that pub.
- Can't take income from real estate owned by the IRA. the rent has to stay in the IRA!

This list of prohibited transactions is not exhaustive but you get the idea. You can't treat the IRA funds like they're non IRA funds. Otherwise you are engaging in some kind of self dealing which is prohibited.

I would recommend a very small list of reputable self directed IRA firms if you go in this direction. And I would recommend consulting with advisors versed in this infrequently used IRA option.

4. DOL Fiduciary Ruling and Compensation to Trustees and Advisors of Trusts Holding IRA Assets

You may come to a point where you serve as trustee of a trust. If that is the case, be especially careful if it's an IRA trust or if the trust is beneficiary of retirement money in any way.

With the fiduciary rule, which at the time of this writing has been postponed by President Trump, the Department of Labor ("DOL") is putting more scrutiny on fees investors are paying. This translates to a recommendation of caution if you are managing a trust and charging a trustee fee.

The challenge is this:

If the trustee fee is reasonable, but an investment manager is hired who also charges a fee, and then the combined fee becomes what the DOL might consider unreasonable, then you serving as trustee may be held responsible.

Two DOL advisory notices serve as guidance in this situation (hat tip to Ed Slott):

1. DOL Advisory Opinion 2009-02A
2. DOL Advisory Opinion 2005-10A

Both of these offer guidance as to what might serve as a reasonable fee. The first opinion deals with trustee fees paid to a grandson who was the ultimate beneficiary of the IRA trust after his father passed away (ok if reasonable based on resident state law). The second opinion shares the idea that investment advisory fees would be ok as long as the trustee fees were reduced to make the combined fee reasonable.

Also be aware that these opinions are also a few years old. The idea of low cost index investing has accelerated since the financial crisis of 2008 and really picked up steam after 2012. the idea of what is reasonable in terms of fees is likely getting smaller!

5. PLRs Allow Very Late Roth Re-characterizations

A common "problem" when you're moving up in your career is increasing income. Many people contributing to their Roth IRA do so annually and many do not notice when their taxable income exceeds the limit when Roth contributions are no longer permissible. The result of continued contributions is thousands of dollars of <u>excess</u> Roth contributions.

These excess contributions are subject to a 6% annual penalty which can add up over the years. The IRS, in a couple of Private Letter Rulings (PLR 201603048 & PLR 201627008) allowed taxpayers to remove excess contributions without penalties. In one case, a taxpayer made Roth contributions for years when her income was too high. Due to poor advice from her tax professional, the IRS waived penalties.

In the second case, a taxpayer rolled his 401(k) assets over to his IRA - but his financial institution rolled it accidentally into his Roth IRA. I won't say it but there are only a few companies that run many 401(k)s and also individual IRAs and Roth IRAs on the same system. And I can guess which firm this might have been. But I digress. Subsequently, It wasn't discovered until 15 years later but the IRS allowed the Roth to be re-characterized as traditional IRA because the financial firm made the error.

These PLRs offer multiple lessons for the high income earner and for most taxpayers in general. The importance of good advice, proper paperwork handling and being aware of the benefits and limitations of the tax code. Check your historical IRA contributions if you have any doubt about their legitimacy. You can also have your tax team research this for you.

Have Questions? Want to Know More?

Do you have questions about IRA tax laws? Or simply looking for a little free advice? Chris would be happy to talk with you. You can reach Chris here:

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