RETIREMENT PLANNING

Systemic IRA Trust Compliance Issue Can Have Big Tax and Penalty Impact

Post-death rules governing IRAs, particularly those involving trusts, are complicated and if not strictly adhered to can lead to severe ramifications for the intended beneficiaries. One such rule, often referred to as the "documentation rule" may not seem that complicated at first glance, but failure to meet its requirements can result in confiscatory penalties, as noted by our IRA expert commentator, Seymour Goldberg. Mr. Goldberg is the senior partner in the law firm of Goldberg & Goldberg, P.C. in Long Island, New York. He is Professor Emeritus of Accounting, Law and Taxation at Long Island University and has conducted continuing education programs with the IRS and well over 50 such programs over the last 15 years or more for practitioners (attorneys and CPAs) on IRA compliance issues. He has written two practitioner guides for the American Bar Association on IRA Compliance Issues as well. He has also written dozens of articles and several manuals on the subject area. Mr. Goldberg can be reached at 516-222-0422 or by email at info.goldbergira@gmail.com. You may also visit his website at TrustEstateProbate.com.

Wolters Kluwer: There are many rules governing the holding and distribution of IRAs after the account owner has died. In addition, further rules apply specifically to IRAs involving trusts. Could you describe for our readers what the post-death documentation rule entails?

Mr. Goldberg: In general, the trustee must provide documentation concerning the trust to the financial institution holding the IRA no later than October 31 following the year of death of the IRA owner.

There are two basic ways in which this can be accomplished. The first is to 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.

The second method is to simply 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.

I ordinarily recommend the second method basically because it is simpler. In addition, regardless of which method is used, it is important for the trustee to document the fact that the requirement was satisfied in a timely manner. In this regard, I recommend sending a transmittal letter to the IRA institution by certified mail, return receipt requested.

Wolters Kluwer: And, what are the ramifications of failing to comply with this rule?

Mr. Goldberg: First, the ability to stretch the IRA distributions out over a particular beneficiary's lifetime will be lost because the trustee will not be able to use the life expectancy of the respective beneficiary in computing the required minimum distributions from the deceased IRA owner's account.

Wolters Kluwer: Aren't there penalties imposed as well?

Mr. Goldberg: Yes, and they form what is basically a one-two punch. First, there is an interim penalty of 50 percent of the difference between the amount that should have been distributed under the RMD rules and what was actually distributed (see Reg. §54.4974-1). The second punch comes under Reg. §54.4974-2, Q&A-5, which states that:

If there is any remaining benefit with respect to an employee (or IRA owner) after the calendar year in which the entire remaining benefit is required to be distributed, the required minimum distribution for each calendar year subsequent to such calendar year is the entire remaining benefit.The impact of this combination could rapidly wipe out the entire balance of an IRA account.

Wolters Kluwer: And, does this issue pose problems for persons other than the trust's beneficiaries?

Mr. Goldberg: Yes, because if the trustee is using the wrong distribution scheme the trustee may be liable to the trust beneficiaries as well as to the IRS. In addition, whoever is preparing the Form 1041 for the trust should be checking on this requirement and notifying the trustee as to whether the trust is compliant.

I have found for the most part that practitioners were not aware of the post-death IRA trust documentation rules. In addition, in every case that I inherited I found that none of the trustee's were aware of the post-death trust documentation rules as well.

Wolters Kluwer: Based on your experience, how many IRA trusts are in existence today and how serious is this particular problem?

Mr. Goldberg: Literally thousands of them exist and the potential for systemic error is enormous. Based on my experiences over the last 15 years or more as both a practitioner and an instructor, I have found that many trusts may not have satisfied the post-death IRA trust documentation rules. [See further discussion below.]

Wolters Kluwer: So, what is the solution?

Mr. Goldberg: In addition to educating practitioners and financial institutions on the specifics of the rule going forward, I have suggested to the IRS that the Service consider this as a systemic issue and implement a voluntary compliance program on this significant noncompliance issue. In my many training programs I have found for the most part that practitioners were not aware of the post-death IRA trust documentation rules. In addition, in every case that I inherited I found that none of the trustee's were aware of the post-death trust documentation rules as well. In that event I directed that the trustee immediately timely comply with the trust documentation rules. I have had a number of cases where the trustee had to cure the defect just a few days before the October 31st deadline. In a number of cases the trustee came to me after the deadline. This resulted in massive adverse tax consequences to the trust. In addition, I have found that very few practitioners, financial advisors, and consumers have read the requirements involving IRA trusts that are found in IRS Publication 590-B [See Publication 590-B (Jan. 24, 2019), Distributions from Individual Retirement Arrangements (IRAs) for use in preparing 2018 Returns, at page 12, *Trust as beneficiary*, items 1-4 inclusive].

Please note that item 4, second sentence is not provided for under the IRS regulations. The financial institution maintaining the IRA account may not be aware of the IRS post-death IRA trust documentation rules. The burden is on the trustee of the IRA trust to be aware of the IRS post-death IRA trust documentation requirements.

I advised the IRS as to this issue when I worked with the IRS as a pro bono advisor at the request of then Congressman Steve Israel.

Wolters Kluwer: Assuming the IRS is not willing to institute a voluntary compliance program, is there any other avenue for relief?

Mr. Goldberg: It is possible for the trustee to request a waiver of the penalty. In order to do so, the trustee would have to immediately withdraw all the shortfall amounts and file Forms 5329 (Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts) for all the shortfall years and request waivers of the penalty for each year based on reasonable error and that reasonable steps have been taken to remedy the shortfall by the trustee taking out the shortfall amounts of X dollars on, let's say April 1, 2020.

The trustee would have no choice if the IRS fails to initiate a voluntary compliance program that has reasonable sanctions. It would be a nightmare for many trustees if they had to withdraw massive amounts of funds from the IRA to avoid the 50-percent penalty issues described above based upon what is basically an inconsequential and innocent mistake regarding the IRS post-death IRA trust documentation rule. Further I have found that many financial advisors don't know about the post-death trust documentation rule and I find myself having to write a memo to them describing the rule in every case after the death of the IRA owner.

Consistent Basis

Wolters Kluwer: Is there any other significant issue with respect to IRAs that you feel is being overlooked currently?

Mr. Goldberg: One issue that I believe few people have considered is the consistent basis requirement as it pertains to Roth IRAs. If you recall, under a 2015 amendment to Code Sec. 1014(f), the basis of any property acquired from a decedent is not to exceed the value of the property as determined for estate tax purposes. This requirement applies to property with respect to which an estate tax return is filed after July 31, 2015. If there was no determination of the property's value for estate tax purposes, then the basis of the property shall not exceed the value identified in a statement furnished under Code Sec. 6035(a).

Under the reporting requirements, the executor of any estate required to file an estate tax return must furnish to the IRS, and to each person acquiring an interest in property included in the decedent's gross estate, a statement identifying the value of each interest in such property as reported on the estate tax return (Code Sec. 6035(a)(1)).

These rules contain potential pitfalls involving Roth IRAs. The first concerns failure to list the Roth IRA on Schedule A of Form 8971 (Information Regarding Beneficiaries Acquiring Property from a Decedent). According to the proposed regulations, failure to list the account results in the Roth IRA having zero basis. And, a similar problem could arise with a nonqualified annuity or with a traditional IRA that holds after-tax dollars stemming from nondeductible contributions.

The second problem is a bit subtler. Assuming you have a situation where a decedent dies holding a Roth IRA for which the five-year holding period requirement has not been met. In listing this asset on Schedule A of Form 8971 how do you reflect basis because Schedule A does not provide a way to list a bifurcated asset? One approach may be to list the date-of-death value on Schedule and then provide the basis information and the fact that the five-year holding period has not been satisfied in a detailed footnote.

Finally, one more caveat is that currently neither the proposed regulations nor the Instructions to Form 8971 provide a mechanism for filing a supplemental Form 8971 and Schedule A to list items that were erroneously omitted from the original filing.