125 YEARS 1890 – 2015 STIFEL

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WHAT IF I MISSED A REQUIRED MINIMUM DISTRIBUTION?

According to IRS Publication 590, a missed Required Minimum Distribution (RMD) is referred to as an "excess accumulation." As such, an excess accumulation is subject to a 50% excise tax on the amount not distributed as required. In this scenario, there are a few options available for the IRA holder.

The IRA holder may report the tax by using IRS Form 5329. This form is used to report tax on excess contributions, early distributions, and excess accumulations. When filing Form 5329, the IRA holder cannot use Form 1040A, Form 1040EZ, or Form 1040NR-EZ. The Form must be completed and attached to a Form 1040 or Form 1040NR for the tax year with excess accumulation.

An IRA holder may also request to waive the tax. In the cases of reasonable error, and the IRA holder is taking the necessary steps to remedy the insufficient distribution, a request may be made to waive. In this scenario, the IRA holder must complete a statement of explanation and complete Form 5329 according to the "Waiver of Tax" instructions. The IRS will review the information and render a decision to either grant or deny the request for waiver.

Lastly, an IRA holder may be exempt from the 50% excise tax if the traditional IRA is invested in a contract issued by an insurance company that is in state insurer delinquency proceedings. The contract must experience reduced or suspended payout due to this state's status. The IRA holder must use all traditional IRA assets to satisfy as much of the RMD as possible. In the case of a cancellation of the reduction or suspension of payouts, the IRA holder must make up the amount of any shortfall in a prior distribution. In this scenario, the shortfall must be made up by December 31 of the calendar year following the year the IRA holder receives increased payments.

It is highly recommended, if any amount of a RMD has been missed, the IRA holder must work with his or her tax advisor and follow the proper procedures for an acceptable solution.

REMEMBER THE REQUIRED MINIMUM DISTRIBUTION

As the end of the calendar year changed over, there are many items that individuals must address again throughout this year, such as Required Minimum Distributions (RMDs). However, depending on an individual's age, he or she may have an additional option for RMDs. Traditional IRA holders are required to begin taking distributions from their IRA in the year in which they reach age 70½ (Prop. Treas. Reg. 1.401(a)(9)-1, B-1). However, IRA holders may choose to delay the first RMD until April 1 of the year following the year they turn age 70½ (Prop. Treas. Reg. 1.401(a)(9)-1, B-1). If the first distribution is delayed, a second payment for the second (current) year's RMD must be made by December 31 in the same year.

To determine the RMDs, the prior year-end balance of each IRA is divided by an individual's Uniform Life Expectancy (ULE) factor. The ULE factor is derived from the individual's age at the end of the year (i.e., ULE factor for age 71 is 26.5 according to IRS Publication 590).

Custodians of IRAs usually inform of pending RMD amounts and provide calculations for their clients. Recently transferred IRAs may be tricky to calculate, as an individual will have to provide the prior year-end balance from their previous custodian to their new custodian. Rarely will the amount transferred in be equal to the prior year-end balance.

The same rule of mandatory distributions applies to Qualified Retirement Plans (QRPs). However, the required beginning date for QRPs is April 1 of the calendar year following the later of the year in which the participant turns age 70½ or the calendar year in which the participant retires (Treas. Reg. 1-.401(a)(9)-2, A-2(a)). This is an optional provision which plan sponsors may elect to include in their plan. Participants who own five percent or more of the business do NOT have this option to delay RMD until retirement and are subject to RMDs from the plan upon reaching age 70½ (Sec 1.401(a)(9)(C)).

Remember the Alternative Method

When IRA holders begin taking RMDs from their IRA, an alternative method may be used. Under Prop. Treas. Reg. 1.408-8, an IRA holder must satisfy the RMDs separately from each IRA owned. However, an exception to this rule allows an IRA holder to determine the RMDs for each IRA separately and then remove all or a portion of the RMDs from any one or more of the IRAs.

Note that this alternative method only applies to two types of retirement plans, IRAs and 403(b) tax-sheltered annuities. However, distributions from 403(b) plans may not be used to satisfy IRA RMDs and vice versa. In addition, the alternative method may not be used to satisfy RMDs from qualified plans, such as 401(k) plans. Each QRP must satisfy the RMD requirement independently.

Summary

If an IRA holder has more than one IRA, the alternative method does not alter the amount that the individual must remove each year, but gives an individual the flexibility to select the IRAs from which RMDs are taken.

ROLL EMPLOYER STOCK INTO AN IRA?

There is a little known strategy available to participants in employer-sponsored retirement plans, 401(k)s, profit sharing, and ESOP, who hold shares of employer stock as part of their retirement plan assets. In certain situations, the strategy may result in significant tax savings. If an employee is eligible to take a distribution and is considering a rollover of these shares into an IRA, he or she should be educated on how this strategy could be a benefit before making a decision to do a rollover. Once the shares are rolled to an IRA, this election is no longer available.

NUA

The Net Unrealized Appreciation (NUA) election is an alternative to an IRA rollover. Instead of rolling the shares into an IRA, the shares are distributed directly to the individual or transferred to a non-IRA account. The individual will owe just a portion of the tax at the time of the distribution, as only the cost basis of the shares is subject to tax (and potentially an early withdrawal penalty) at this time. The value of the appreciation (from the date of purchase of the shares in the plan to date of distribution from the plan) is not taxable until the shares are liquidated as explained in detail below.

How It Works

To qualify for the special tax treatment, an individual must receive the stock as part of a lump-sum distribution made within a single tax year. The non-employer stock investments in the plan may be rolled into an IRA to avoid current taxation on that portion of plan assets. To take advantage of the NUA election, the following requirements must be met:

1. The employer stock must be distributed (in-kind) from the qualified retirement plan.
2. The shares are held in certificate form or on deposit in a taxable **(not IRA)** account.
3. The individual pays ordinary income tax **on the basis** in the year of the distribution (the basis is the value of the stock at the time it was acquired by the plan). The employer/plan recordkeeper will calculate the basis.
4. If the individual is not yet age 59½ (or 55 and separated from service), a 10% penalty will be due on the value of the cost basis of the stock.
5. The value of the securities at the point of distribution minus the original basis is the NUA. No tax will be due on the NUA until the securities are liquidated. Upon liquidation, the **NUA** will be taxed at the applicable **long-term** capital gains rate no matter how long the stock was held outside of the plan.
6. Any additional appreciation of the stock, after the date distributed from the plan, is taxed at the **long-term or short-term** capital gains rate, depending upon how long the stock was held outside of the plan. To qualify for the long-term rate, the stock must be held for one year or longer.
7. If the individual dies while still owning the distributed stock, upon liquidation of the shares, the heirs will pay the applicable long-term capital gain rate on the original NUA. Gains realized from the time the stock was distributed from the plan until the date of death receive a stepped-up basis. Gains after the date of death are subject to normal tax treatment after the step up.

Other Considerations

In addition to the requirements listed above, there are other concerns to consider, such as:

- Will the individual have sufficient funds outside of the distribution to pay the income tax without having to sell the employer securities?
- How long does the individual intend to hold the stock?
- Will the individual’s portfolio become too heavily concentrated in the employer’s stock?
- How volatile is the stock, and does the volatility match the individual’s risk profile?
- Will tax rates change in the future?
- Will state taxes, which have to be taken into consideration, be an issue?

Closing Comment

Even though the NUA strategy may seem like a tax-wise move for those who have highly appreciated employer securities, it’s not for everyone, as the rules are complex. It can result in tax savings by assessing NUA at the capital gains rates, rather than ordinary income tax rates. It also gives the individual control over when taxes are paid (when the shares are liquidated). However, it’s also important to consider that the 10% penalty is charged for early withdrawals, and dividends are taxable while the stock is held outside of the plan or an IRA.

Should employer stock be rolled to an IRA or distributed in order to make the NUA election? Individuals should consult with a professional tax advisor before any decisions are made.

CASH BALANCE PLANS ON THE RISE

The cash balance plan is a special type of defined benefit (DB) plan. It is generally suited to highly successful business owners, age 45 plus, who welcome the opportunity to make required, substantial tax-deductible contributions for a minimum of five years.

A DB plan works exactly as the name indicates; the benefit is defined. Business owners can fund for a maximum benefit of up to the lesser of 100% of their income or $210,000 (2015) per year during retirement. An actuary calculates how much must be contributed each year to fund for the future benefit. There is no limit to the amount that may be contributed and deducted, as long as it is actuarially necessary to fund for the benefit. Hence, DB plans offer the largest tax deductions of any qualified plan.

The Cash Balance Surge

Among DB plans, the cash balance plan is gaining prominence. The 2014 National Cash Balance Research Report* showed a 22% increase in new cash balance plans in 2012. This increase was faster than 401(k) plans, which went up just 1% despite ongoing economic recovery. There were 9,648 cash balance plans active in 2012, up from 7,926 in 2011. The 22% increase was pointedly greater than industry projections of 15% growth. Also, cash balance plans continue to replace traditional DB plans, now making up 25% of all DB plans, up from 2.9% in 2001.

Differences With Traditional DB Plans

Cash balance plans are like traditional DB plans in many ways. For example, they have plan assets pooled in one account; however, they have some unique features and differences:

- A cash balance plan's benefits can be easier to explain to employees than traditional DB plans. This is because, despite the pooled account, a participant has a "hypothetical account" balance representing the amount of their benefit just like in a defined contribution (DC) plan (profit sharing, 401(k)).
- The hypothetical account balance is equal to the employee's accrued benefit, but it is called hypothetical because no such account actually exists.
- Deposits are made to the pool, but are credited to a participant's hypothetical "account" based on a plan-dictated percentage of compensation and an interest crediting rate (ICR) which does not exceed a "market rate of return."
- The ICR can take a number of forms, such as 30-year Treasury rates, the interest rate on long-term investment-grade bonds, a stock market index, such as the S&P 500, or the actual rate of return, provided that the plan's assets are diversified to minimize volatility. In September of 2014, the IRS released final regulations that apply to plan years that begin on or after January 1, 2016, allowing plan sponsors using the actual rate of return to create different investment strategies for different groups of participants; for example, using a more conservative portfolio for longer-term employees. The final regulations also allow an ICR to have a fixed rate of up to 6%, while the 2010 proposed regulations had a maximum of 5%.
- A potential downside of a cash balance plan is that 100% vesting must be achieved after three years of service; traditional DB plans can allow 100% vesting after six years.

Different Than DC: Plan Assets

Many employers choose to have a DC plan's assets held on a retirement plan daily recordkeeping platform. This is because DC plans generally have individual accounts, and the participants will make their own investment decisions. The platforms can offer the investment choices and information (often via a state-of-the art internet site) to make it easy for the employer to comply with 404(c) and other ERISA requirements, thereby reducing the employer's fiduciary exposure. Since cash balance plan assets are pooled, the aforementioned features may have no application. So, a single brokerage account is typically a suitable fit.

Different Than DC: Desired Return on Investments

In a DC plan, the greater the return on investments, the greater the retirement benefit. Accordingly, many employers choose an investment menu appropriate to help participants achieve a strong rate of return which is commensurate with their risk tolerance. However, with a cash balance plan, retirement benefits are determined by a plan formula. Therefore, an employer chooses investments that match the plan actuary's assumed rate of return to achieve those benefits. These assumptions may be tied in large part to the ICR.

An Investment Policy Statement (IPS) provides the DB plan's general investment goals and describes the strategies that should be employed to meet those objectives. An IPS is not required, but it is strongly recommended as a way for plan sponsors to record their fiduciary due diligence and give guidelines for investment selection.

Replacing or Adding to a DC Plan

Business owners with a traditional defined benefit plan may find a cash balance plan better suited to their business. Highly profitable business owners with a DC plan can consider making substantially larger tax-deductible contributions per year by replacing their DC plan with a cash balance plan or by adding a cash balance plan.

**Source: Analysis performed by Kravitz, Inc., using data from IRS Form 5500 filings via the Judy Diamond Associates, Inc. database. The 2012 plan year data is the most current available. Additional data on defined contribution and defined benefit plans comes from Private Pension Plan Bulletin Abstracts by the U.S. Department of Labor Employee Benefits SecurityAdministration (EBSA), 2001-2012 Reports.*

IRS: PLAN SPONSORS MUST TRACK LOANS AND HARDSHIP DISTRIBUTIONS

The IRS recently issued a release on its web site reminding plan sponsors that they are ultimately responsible for the administration of their retirement plans. Even if a plan sponsor has hired a third-party administrator (TPA), it is up to the plan sponsor to keep up with the recordkeeping requirements, including those of loans and hardship distributions. Often, the TPA will keep all pertinent records, but in the event documentation goes missing, the plan sponsor is liable – not the TPA.

If a retirement plan allows participant loans, the sponsor must retain records for each loan in either paper or electronic format. The records should include the following:

- Evidence of the loan application, review, and approval process
- An executed plan loan note
- Evidence of loan repayments
- If a defaulted loan, evidence of collection activities and related Form 1099-R
- Some plans allow for residential loans that may be paid back in 30 years, compared to 5 years for a non-residential loan. If a participant requests a loan to purchase or construct a primary residence, the plan sponsor must obtain documentation of the purchase prior to loan approval.

For hardship distributions, the plan sponsor must keep the following records, in paper or electronic format:

- Documentation of the hardship request, review, and approval
- Documentation that demonstrates the employee's immediate and heavy financial need
- Documentation showing the hardship distribution was made in accordance with the plan provisions and Internal Revenue Code
- Proof of the distribution made and related Form 1099-R

The IRS does not consider it sufficient that participants retain their own documentation. Participants may terminate employment and/or fail to keep the documentation, which makes it inaccessible during an IRS audit.

Additionally, some TPAs allow participants to self-certify online that they meet the criteria to receive a hardship. While it is permissible to electronically certify that a hardship distribution was the sole way to alleviate a hardship, it is not allowed to show the nature of the hardship. Therefore, the plan sponsor must request and retain information on the nature of the hardship.

While TPAs hired by plan sponsors should be aware of these regulations and will usually retain all of the aforementioned paperwork, the plan sponsor must keep its own documentation and cannot rely on the TPA in the event of an IRS audit. To see the complete IRS release, visit http://www.irs.gov/Retirement-Plans/Its-Up-to-Plan-Sponsors-to-Track-Loans-Hardship-Distributions

TREASURY DEPARTMENT EASES CORRECTION METHODS FOR AUTO ENROLLMENT AND AUTO ESCALATION PLANS

The Department of the Treasury and the IRS issued guidance intended to ease the administration of 401(k) and other retirement plans that offer automatic enrollment and contribution increases. Automatic enrollment forces employees into the plan unless they choose to opt out. Automatic escalation starts the employee deferring at a certain percentage of compensation and then increases that percentage on an annual basis. Since both auto enrollment and auto escalation can greatly improve retirement readiness, regulators are attempting to encourage sponsors to implement these features in their retirement plans.

Sometimes in plans that offer these features, employees are mistakenly not enrolled in the plan or are enrolled at the wrong deferral rate and can miss out on earnings and employer matching contributions. With the new guidance, plan sponsors can correct the missed deferrals without having to notify the IRS as long as the correction is made to the participant's account within 9½ months from the end of the plan year in which the error occurred. The Treasury Department also included pre-approved calculation methods, also known as "safe harbors," for computing the amount of employer match that may have been missed.

Previously, infractions with auto enrollment and auto escalation could threaten the tax-preferred status of retirement plans, and the corrections were considered by many in the industry to be too costly. After hearing comments from plan sponsors, their advocates, and recordkeepers on the issue, the Treasury Department and IRS issued the new correction methods, which are effective immediately but will expire at the end of 2020. To see the specific details on the regulations, visit http://www.irs.gov/pub/irs-drop/rp-15-28.pdf.

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