

Tax Topics

by Blanche Lark Christerson

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IRS clarifies Pension Protection Act provisions. On August 17, 2006, the Pension Protection Act was enacted. This broad legislation dealt with employee pensions, retirement accounts, tax-exempt organizations and charitable giving. Questions have arisen about some of its provisions. To help address these, the IRS issued Notice 2007-7 on January 10, 2007 in a Q&A format. The Notice, in turn, raised a few more questions that the IRS addressed in a “special edition” of its Employee Plans News on February 13, 2007. We’d like to focus on several of the points raised in both of these releases regarding non-spousal “rollovers” of qualified plan benefits, as well as what the Notice said about direct charitable contributions from IRAs.

Non-spousal “rollovers” of qualified plan benefits. There was much joy in Mudville when the Pension Protection Act made the following possible: as of 2007, the non-spouse beneficiary of your employer-sponsored retirement plan, such as a 401(k) or profit-sharing plan, can direct the plan trustee to transfer your account into an “inherited IRA.” Thus, at your death, your non-spouse beneficiary (such as your child or life partner) won’t be locked into what may be the plan’s limited distribution options – such as receiving your entire account as a lump-sum or within five years of your death. Instead, by transferring the account into an inherited IRA, your daughter, for example, can stretch payments out over her life expectancy, starting the year after your death, and give herself the same distribution options she’d have if she inherited the rollover IRA you funded with your 401(k).

That’s the long and short of the provision. So what has made people so agitated?

Questions 11 and 12 of the Notice’s section on non-spousal rollovers ask whether qualified plans can offer a direct rollover. Answer: yes. Q-14 asks whether a plan is *required* to offer a direct rollover to a non-spouse beneficiary. Answer: no. (Uh-oh.) The News reinforces this response, and states that “the rollover must be accomplished by a direct trustee-to-trustee transfer...and the retirement plan must provide for this type of rollover” (emphasis added). The News further states that “a plan may, but is not required to, offer a direct rollover of a distribution to a nonspouse designated beneficiary.”

Well, nuts – that’s not what we wanted to hear! Even though the new law permits non-spousal rollovers of eligible retirement plans to inherited IRAs, the IRS pronouncements appear to make them optional: as stated above, plans may, but need not, offer the rollover. It’s hard to believe that this approach is consistent with the law’s intent.

It’s also unfortunate that the pronouncements don’t offer any transitional relief: a non-spousal rollover is apparently a no-go unless the underlying plan documents permit it. While that may not be an issue for future plan documents, where the employer can make a conscious choice about whether to offer non-spousal rollovers, existing plan documents will be silent on this unless they’ve been amended. That’s because such rollovers weren’t even a blip on the radar screen until the Pension Protection Act, and didn’t become effective until this year.



So what to do if you'd like your non-spouse beneficiary to be able to rollover your 401(k) into an inherited IRA at your death? The short answer is to hope that your employer's plan documents will be amended to permit this. The other is to rollover your account to an IRA instead of leaving it with your employer. That assumes, however, that you've either left that employer or are retired: if you're still an employee of the shop that runs your 401(k), you can't roll it over yet, since such "in-service" distributions aren't allowed.

The bottom line: new plan documents will need to address non-spousal rollovers, and existing plan documents seemingly should be amended to do the same. (It would be nice if the IRS and the Labor Department came out with an expedited procedure for doing this.) If you're a non-spouse beneficiary trying to avail yourself of the rollover, you need to hope that the plan administrators will honor the law's intent – assuming the underlying plan documents are still silent on the matter.

Tax-free IRA distributions to charity. The Pension Protection Act also introduced a short-term benefit: for 2006 and 2007, you can contribute up to \$100,000 from your IRA to charity. You must be at least 70 ½ and your gift must go to a "public" charity, such as your alma mater or favorite museum (supporting organizations, private foundations and donor-advised funds don't count). The distribution counts towards your "required minimum distribution" but isn't taxable to you; it also isn't eligible for a charitable income tax deduction. In addition, the IRA trustee must make the distribution "directly" to the charitable organization.

These rules seem straightforward enough, but some questions arose. Here are a few of them:

1. What does a "direct" distribution from the trustee mean? In other words, can the trustee cut the check to the organization but give it to you to deliver?
2. Can you make a distribution from an "inherited IRA" – as in one that you inherited from Dad – or can it only come from an IRA which you have always owned?
3. Can you use the distribution to satisfy a pledge to a charitable organization? Does it matter that it is an existing pledge?

The Notice answered these questions as follows:

1. It's OK for the trustee to cut the check to the organization but give it to you to deliver. The contribution will still be deemed a "direct payment" to the organization.
2. Yes, you can make charitable contributions from an inherited IRA, as in one that you inherited from Dad. You just can't make them from a SIMPLE IRA or a SEP IRA, both of which are employer-sponsored plans.
3. Yes, you can use the contribution to satisfy a pledge, even an existing one, to a charitable organization. The distribution will not be considered a "prohibited transaction" and therefore won't be subject to an excise tax. That's what the Department of Labor, which has jurisdiction over qualified plan excise taxes, told the Treasury Department and the IRS.

Reporting the distributions. If you took advantage of this provision last year and made a charitable contribution from your IRA, you may have been a little surprised when you received your 2006 1099-R from the financial institution that handles your IRA. That is because the institution reported the entire amount as taxable to you. How come? Why didn't the form reflect the non-taxable nature of the distribution? The answer is that early on in the game, folks in the securities industry got worried. How on earth were *they* supposed to know whether the distribution was a "qualified charitable distribution"? Would they be expected to verify the charity's standing and whether anything was received in exchange for the contribution? Would they really be on the hook for this?

The IRS understood the industry's concerns, and instead left it up to the taxpayer to appropriately report the distribution on his tax return. In other words, if you made a charitable contribution from your IRA last year, report the full amount of the distribution (and any other dollars that came out of your IRA) on line 15a of your 2006 Form 1040; report the *taxable* amount of the distribution, however, on line 15b. If the entire amount went to a qualified charity, then report nothing on line 15b.

In general, this is proving to be a trying filing season for both taxpayers and the IRS. The reason is simple: the Service didn't have enough time to incorporate all of the 2006 tax law changes into its published forms. Between the Pension Protection Act, which was enacted in mid-August of last year, and the Tax Relief and Health Care Act, which didn't become law until December 20, 2006 and extended a number of expired provisions, the Service has had to scramble with instructions on where to put what. For example, a teacher claiming the \$250 above-the-line deduction for educator expenses – one of the benefits revived in the Health Care Act – is supposed to put that on line 23 of his 2006 Form 1040, along with the code "E." That may not sound like a big deal until you realize that line 23 is where you are instructed to enter your deduction for an Archer Medical Savings Account. This is not the only example of this year's patchwork approach to reporting.

Let's hope that next year is easier!

Tax patents. Many of you may not realize that if you have a tax idea, you may be able to patent it. It doesn't matter that it may be based on the plain language of the tax code, if you can successfully claim that your idea represents a "business process" that is useful, novel and non-obvious, you may be able to register it with the U.S. Patent and Trademark Office (there are about 49 tax patent strategies to date, and more in the pipeline). This means that if some unwitting soul suggests "your" idea to a client and the client implements it, you can sue for patent infringement. The most well-known case among tax practitioners has to do with GRATs (grantor retained annuity trusts) funded with stock options. It involved the CEO of Aetna, and was recently settled.

We don't really want to get into the details of tax patents except to say that they're there, and that quite a few people are unhappy about them. This includes Sen. Carl Levin (D-MI), who introduced a massive bill in the Senate on February 17, 2007: The Stop Tax Haven Abuse Act (S. 681). As is obvious from the bill's name, it goes after perceived abuses in so-called "tax haven" jurisdictions. Interestingly, it also has a provision that would prohibit the Patent Office from granting a patent for an invention that is "designed to minimize, avoid, defer, or otherwise affect the liability for Federal, State, local or foreign tax."

The rationale for the provision is two-fold: first, there is a concern that a tax patent legitimizes what may be an aggressive and questionable technique. Second, there is the public policy issue. As Mr. Levin put it in his Senate floor statement when he introduced his bill in February,

If a single tax practitioner is the first to discover an advantage granted by the law and secures a patent for it, that person could then effectively charge a toll for all other taxpayers to use the same strategy, even though as a matter of public policy all persons ought to be able to take advantage of the law to minimize their taxes. Companies could even patent a legal method to minimize their taxes and then refuse to license that patent to their competitors in order to prevent them from lowering their operating costs. Tax patents could be used to hinder productivity and competition rather than foster it.

We suspect that a number of practitioners are in Mr. Levin's camp, and have been extremely concerned about what they view as the proliferation of tax patents for "routine" tax strategies. It would not be surprising to see some form of this legislation pass. (For more details on tax patents, see the November/December 2006 issue of the ABA's *Probate & Property*.)

The wisdom of Chuck Grassley. Senator Chuck Grassley (R-IA) is now the ranking member of the Senate Finance Committee. That is, because the Republicans are now the minority in the Senate, Mr. Grassley is the senior Republican member of the Senate Finance Committee, and no longer its Chairman. Mr. Grassley has been responsible for many changes in the tax code and brings a practical, common sense approach to his law-making. He's a straight-talking kind of guy, and has little tolerance for what he thinks is flim-flammy. Given how influential Mr. Grassley is, we thought you might be interested in reading some of what he's had to say on the Senate floor.

On the AMT (alternative minimum tax) – Mr. Grassley has called the AMT a "complete policy failure" and wants to see it repealed before it snags about 35 million taxpayers by the end of the decade. In mid-February, he made a series of presentations to the Senate about the AMT, giving a soup-to-nuts breakdown of its flaws and the need to permanently get rid of it. Here's part of what Mr. Grassley said on February 15, 2007:

The AMT...takes more than a taxpayer's money: it steals their time as well. As I have said before, the IRS estimates that taxpayers spend an average of 63 hours computing the AMT tax liability. The AMT is truly a very cruel way to raise revenue...[It is also] a phony revenue source, and should not be offset [if it's repealed] since the AMT collects revenues it was never meant to collect in the first place.

On the "tax gap" – the tax gap refers to the difference between the approximately \$290 billion in taxes that should be collected and those that *are* collected. Because Democrats are again following the "pay-go" regime, which requires offsets for tax benefits and spending, the tax gap takes on added importance as a way to potentially pay for the Democratic agenda. Mr. Grassley feels the tax gap can only go so far. Here's part of what he said on March 13, 2007:

I find that the tax gap is one of those issues here in Congress that is a little like the weather: Everyone wants to talk about it but no one is doing anything about it. But the way people talk around here, they view that the tax gap is a "cure-all." Have to pay for

AMT? Tax gap. Want to expand spending on health care? Tax gap. Balance the budget? Tax gap. Given the amount of faith people have put into it, tax gap has suddenly become one of those magic elixirs the peddlers used to sell in the old west. "It will cure what ails you" was the slogan the slick salesmen used to say. And so the tax gap has become the elixir for all fiscal problems. I'm surprised folks don't think the tax gap can cure baldness.

...there is a lot of smoke and mirrors when it comes to the tax gap. But you can't use smoke and mirrors to pay for tax cuts or to decrease the deficit...Tax gap proposals shouldn't be used for spending. The tax gap is appropriately viewed as unfairly placing a heavier burden on compliant taxpayers. So if we enact tax gap closers, they should be used to reduce taxes, or reduce the deficit -- not increase spending.

...let me conclude by saying you can have a blue moon, you can have blue cheese, you can even have blue suede shoes, but when it comes to balancing the budget you can't do it with blue smoke. And that unfortunately is what so much of the tax gap is right now -- blue smoke.

On that note, we wish you all good luck with the looming April 17 deadline for filing your personal income tax returns!

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April 7520 rate issued. The IRS has issued the April 2007 applicable federal rates: the April 7520 rate is 5.6%, down .20% (20 basis points) from March's rate of 5.8%. The April short-term rates are also down somewhat: the annual rate is 4.90%, the semiannual rate is 4.84%, the quarterly rate is 4.81% and the monthly rate is 4.79%. (The March annual rate was 5.06%, its semiannual rate was 5.00%, its quarterly rate was 4.97% and its monthly rate was 4.95%.)

Blanche Lark Christerson is a managing director at Deutsche Bank Private Wealth Management in New York City, and can be reached at blanche.christerson@db.com.

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