IRS Weighs-In on RMDs, Fees

Tax experts discuss rulings on uncashed distribution checks, advisors' annuity fees.

By Melanie Waddell | September 24, 2019

Advisors should pay attention to a recent IRS ruling on uncashed distribution checks because it may require clients to take required minimum distributions (RMDs) early, warns IRA expert Ed Slott. The IRS recently warned missing or unresponsive retirement plan participants that uncashed distribution checks from qualified retirement plans are taxable.

"If the IRS really intends to apply the distribution rule to all company plan payouts, advisors will need to advise clients to request distributions," including RMDs, "early enough in the calendar year to avoid any cross-year confusion, so the client will know that the distribution applies to the prior year, even if cashed or received early the next year," Slott explained.

Revenue Ruling 2019-19, issued on Aug. 14, applies to a participant who receives, but neither cashes nor rolls over, a distribution check. "Because Internal Revenue Code Section 402(a) provides that any amount actually distributed from a qualified retirement plan is taxed under Section 72 in the year distributed (subject to the rollover rules), the ruling holds that the participant is taxed on the distribution check in the year she receives it, even if she does not cash it," Eversheds Sutherland attorneys explained in a recent alert.

Slott added that if the IRS also intends "to apply the rule to IRA distributions, that would be another reason for advisors to persuade their clients to take qualified charitable distributions (QCDs) early in the year, to avoid the same confusion as to which year the distribution applies — to the year distributed or the year the check was cashed."

IRS is ruling that the distribution will be recorded in the year distributed, even if not cashed until a later year, the attorney added. There will be times, however, where a plan sends a distribution check to an ex-employee and the address on file is not correct, Slott continued.

Maybe because the ex-employee moved, or "it may be that the employee does not eventually receive the check until a year later. That employee will have a tax problem, since under this ruling that employee will have been deemed to have received the check and will owe tax for the year of distribution. That will be a continuing issue for these employees," he said.

Slott warns: "Advisors who have clients that leave companies and expect future distributions from that company's 401(k) should immediately update the company with any change of address so they receive timely distributions."

Rev. Rul. 2019-19, Slott explained, was intended to address a question that has long been faced by plan administrators: "What are their withholding and reporting obligations when they issue a check that goes uncashed? The IRS made clear that those obligations arise in the year of distribution and are not changed by the fact that the check is not cashed."

Does the taxation ruling apply to IRAs as well as to workplace plans? "The IRS gave no indication that the ruling also applies to distributions from IRAs," Slott said. "However, the IRS did not specifically say that the ruling is limited to Section 401(a) plans," or 401(k)s.

Annuity Fees - The IRS recently reversed course in private-letter rulings, allowing Nationwide and Lincoln Financial to treat the payment of an advisory fee from a variable, fixed indexed or hybrid nonqualified annuity as a nontaxable distribution. The move has been hailed by fee-only advisors as a means for them to get compensated for their advice.

Over the last 10 years, "the most consistent piece of friction that advisors have come to us about [is] how not being able to take their fee out of a nonqualified annuity was really a headache for them in using this type of product," Craig Hawley, head of Nationwide Advisory Solutions, said in an interview.

The IRS ruling essentially conforms the tax treatment of properly structured advisory fees from nonqualified annuities with those from qualified accounts such as 401(k)s, 403(b)s and IRAs, which typically are not treated as taxable distributions, Nationwide explained.

Slott explained that the IRS' ruling is a good one, "for both advisors and consumers," for two reasons. Under this ruling, which Slott says is "for Nationwide only, the nonqualified annuities will receive the same treatment that IRS has allowed for IRAs and 401(k)s, where paying the fees directly from the account would not be considered a taxable distribution, but rather an expense of the account, eliminating any potential tax on a fee, which would be a double expense."

Also, "since investment fees are no longer deductible under the new tax law — The Tax Cuts and Jobs Act — (before 2018 some taxpayers who itemized deductions could deduct those fees), paying the fees from the account (the annuity) could effectively restore the deduction since the fees are being paid with funds that might otherwise be taxable when withdrawn, reducing the tax bill at that point," he said.

Slott pointed out that "no two annuities are exactly alike. Other annuity companies or clients cannot rely on this [Nationwide or Lincoln IRS] ruling, but it does provide insight on how IRS would rule on an annuity with the same features."

Tax Context - Historically, Hawley explained, the IRS has "interpreted how advisory fees should be taxed depending on whether the advice was being given on a qualified account or on a nonqualified account."

In the qualified account, in any qualified plan or if an annuity had been funded with an IRA or 401(k), "the IRS took the position that the advice was part of the plan itself, and therefore was not deemed to be a taxable distribution," Haley said. “A customer could get advice from an advisor in those accounts and would not be taxed on paying for that advice,” he added.

On the nonqualified side, the IRS “took the position that the money was coming out of the annuity, whether the customer took that money and bought a house with it, paid their mortgage, paid for their groceries or paid for investment advice, it was all the same — they were going to get a taxable distribution.”

Impact on Advisors - Nationwide Advisory Solutions has been one of the only carriers with a technology platform that gives advisors an automated solution to receive their fee directly from the annuity, Hawley said. But the “favorable ruling on the tax treatment of advisory fees is another milestone in our mission to truly meet the unique needs of RIAs, fee-based advisors and the clients they serve.”

Darin Shebesta, vice president of Jackson/Roskelley Wealth Advisors in Scottsdale, Arizona, explained that he sees the IRS’ move as “a step in the right direction.” The ruling “helps level the playing field to allow all types of advisors to make annuities available as a strategy for clients. It reduces the barrier for fee-only advisors to be compensated for their advice.”

Advisory fees for the nonqualified annuity cannot exceed 1.5% of its cash value, according to the IRS ruling. The ruling applies only to fee-based nonqualified annuities, for which the advisor does not receive a commission related to the sale, according to Nationwide, and the fee is paid with respect to the investment advice received by the contract owner specifically related to the non-qualified annuity.

By including the 1.5% cap, Hawley said, the IRS “wanted to make sure that it was only advice tied to the annuity,” and that the advisor would not “be able to pull the entire fee from the money they’re managing outside of the annuity tax free.”

Lincoln Financial Group also received an IRS private letter ruling on the matter, and Hawley suspects other carriers will get a letter of our own, if they haven’t already. “Operationally we’re already prepared to deal with this, whereas I suspect some carriers will have some work to do,” Hawley said.

Tad Fifer, vice president and head of RIA distribution at Lincoln Financial Group, said in a statement that Lincoln’s advocacy “for this [IRS] decision underscores the focus we’ve placed on understanding the unique needs of this channel, and simplifying advisor experiences as they continue to provide protected lifetime income for their clients. Lincoln is pleased with the favorable decision from the IRS and believes this new ruling will make it easier for investment advisors to incorporate nonqualified annuity solutions as part of their planning strategies.”