

SECURE Act 2.0 - Penalties and the Statute of Limitations

Thursday, October 19, 2023

Take-Away: File IRS Form 5329 annually to gain the shortest IRS statute of limitations when it comes to contributions to retirement accounts and taking required minimum distributions (RMDs) from retirement accounts.

Background: We know from past missives that there is a 6% excise tax, per year, assessed on an *excess contribution* to a retirement account. [IRC 4973.] We also know that there is a 25% excise tax when a required minimum distribution (RMD) is not taken from a retirement account, referred to as an *excess accumulation*, but it is assessed only once. [IRC 4974.] The IRS assessment of these excise taxes is part of the SECURE Act 2.0 changes to the Tax Code, which provides some relief to individuals who made *excess contributions* to their IRA, or who failed to take their required minimum distribution (RMD) for the calendar year from their retirement account.

Form 5329: Whenever there is the potential for an *excess contribution* to a retirement account, or an *excess accumulation* within a retirement account, e.g., the failure to take a *required* minimum distribution (RMD), the account owner is required to file Form 5329. Filing this Form that starts to protect the account owner from a later IRS audit in search of an excise tax. Sadly most folks do not file this Form 5329 each year because they think that they have not made either an *excess contribution* to their retirement account, nor have they incurred an *excess accumulation* in their retirement account since they took their RMD for the year as told to them by their IRA custodian. Neither Form 1040 nor Form 5329 indicates the time limit on IRS assessment of these excise taxes, or how the account owner's failure to file Form 5329 could lead to an unlimited time in which the IRS might assess the excise tax.

3-Year Statute of Limitation: As a general rule IRC 6501(a) provides that the IRS must assess any tax no more than three (3) years after the return with respect to such tax was filed. Yet there are multiple exceptions to IRC 6501(a) found in IRC

6501(b), where the 3-year statute of limitations expands to six years, and in some cases there is no 'outer limit' to when the IRS can assess the excise tax. For example, assume that the individual believes that he/she took the correct amount from their IRA as their RMD for the calendar year. Therefore, they report \$0.00 as an *excess accumulation* in their IRA on Form 5329 for the year. IRC 6501(b) provides that "*if the return (relevant to the applicable excise tax) omits an amount of such tax properly includible thereon which exceeds 25% of the amount of such tax reported thereon, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment at anytime within 6 years after the return is filed.*" [IRC 6501(e)(3).] Consequently, if the individual reports \$0.00 on their filed Form 5329 and there is later a determination that the wrong amount was taken as the RMD, then the account owner will be subject to a 6 year limitations period even though they timely filed Form 5329 on which they reported the \$0.00 amount.

Example: In *Robert K. Paschall et ux v. Commissioner*, 137 Tax Court, 8 (2011), following the advice of a promoter, Robert converted \$1.3 million of his IRA to a Roth IRA. Unfortunately, at the time of the conversion, Robert's income exceeded \$100,000 which at that time was the limit when an individual could convert a traditional IRA to a Roth IRA. Consequently, Robert's Roth IRA conversion was not permitted due to his income level, which then resulted in an *excess contribution* to the Roth IRA. This *excess contribution* was never reported by Robert on his Form 1040, nor did Robert ever file a Form 5329 which is the required return to report excise taxes. [Regulation 301.6501(e)-1(c)(4).] The IRS finally caught up with Robert more than six years later. Robert's defense was that his *excess contribution* to the Roth IRA was discovered well beyond the 3-year limitations period when he filed his income tax return where the Roth conversion should have been reported as part of his taxable income for the year. The Tax Court held that an invalid Roth IRA conversion is treated as a 'regular' (or non-rollover) contribution to an IRA, such that Robert's conversion of \$1.3 million to the Roth IRA on the advice of his 'advisor'/promoter, was in fact an *excess contribution* subject to the 6% excise tax, assessed annually, until his excess contribution is corrected. 6% on \$1.3 million for six or more years resulted in a whopping excise tax that Robert owed the IRS.

SECURE Act 2.0: The SECURE Act 2.0 [Section 313] adds a new provision to the Tax Code, IRC 6501(l)(4), that provides an additional statute of limitations period to protect against some, but not all, excise taxes, when the account owner fails to file a Form 5329. The apparent Congressional intent behind IRC 6501(l)(4) is to protect those unwary account owners who failed to protect themselves by filing a Form 5329. Specifically-

3-Year Limitations Period: This new statute of limitations to assess an excise tax is 3 years. The statute applies when a Form 5329 is not filed by the retirement account owner.

Effective Date: This new limitations period is effective in 2023 and future years.

No Retroactive Effect: There is no retroactive effect with the adoption of IRC 6501(l)(4), nor any 'capped' amount of excise tax due, for an account owner's failure in prior years to report a transaction that results in an excise tax arising from the failure to report it on a Form 1040 or Form 5329. Accordingly, there could be many retirement account owners who continue to incur a growing *excise tax* liability despite this new rule.

Limited Relief: While the availability of IRC 6501(l)(4) is better than nothing, it still does not provide as much protection as would be the case if the retirement account owner had actually filed a Form 5329.

A. **6-Year Limitation if only Form 1040 is Filed:** For purposes of the 6% *excess contribution* excise tax [IRC 4973] only, IRC 6501(l)(4) is extended to six years, instead of three years, if the individual relies on his/her filed Form 1040 as the *applicable return*, and not Form 5329. Filing Form 5329 keeps the statute of limitations to assess the excise tax at 3 years.

- B. Property Contribution: If the *excess contribution* involves an IRA's acquisition of property at less than fair market value, this new 3-year assessment relief under IRC 6501(I)(4) simply does not apply. [IRC 6501(I)(4)(D).]

- C. RMDs Only From IRAs: If it is an *excess accumulations* exposure to a excise tax, e.g., the failure to take a correct RMD for the year, the relief granted by IRC 6501(I)(4) only applies to RMDs from an IRA. If an individual who does not receive his/her full RMD from a retirement account owes the 25% excise tax regardless of whether the shortfall involves a qualified plan, 403(b) account, or an IRA. If a Form 5329 was filed, it would protect missed RMDs from any of these retirement plans.

Practical Steps: Since most retirement account owners are not aware of any *excess contribution* or *excess accumulation* with respect to their retirement account, it is difficult to envision how that owner can fully disclose the transaction on their Form 1040- an event that they were completely unaware of. To limit this exposure to an *excess accumulation* excise tax arising from the account owner's failure to take a full RMD from their retirement account, the account owner could attach year-end statements from all of their retirement accounts along with their birth certificate to show their age, which in the aggregate might then constitute *adequate disclosure* with respect to their RMDs and to protect them from some reporting errors, e.g., their IRA custodian gave them the incorrect RMD amount for the year. Similarly, if the account owner discloses all of his/her IRA contributions made during the calendar year, along with the amount of the owner's compensation income, and how the maximum contribution amount was calculated, that might also constitute *adequate disclosure* for the *excess contributions* excise tax. Probably much more simple would be to report the transaction on Form 5329 rather than supplement the Form 1040 with additional information. More importantly, if an IRA owner purchases in a private purchase transaction property, the IRS will probably investigate how that purchase price was determined to confirm if it was the '*acquisition of property below market value.*' To expose that IRA property acquisition to the shortest possible limitations period for the *excess contribution*

excise tax , the IRA owner must file a Form 5329 to gain the protection of the 3-year limitations period.

Conclusion: While the appearance of IRC 6501(4) is helpful to protect retirement account owners from 'hidden' excise tax assessments, in light of the statutory exceptions to that new 3-year limitations rule, it is probably best for the account owner to always file Form 5329 whenever there is a contribution to a retirement account or the account owner is subject to the required minimum distribution (RMD) rules.