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The Connection

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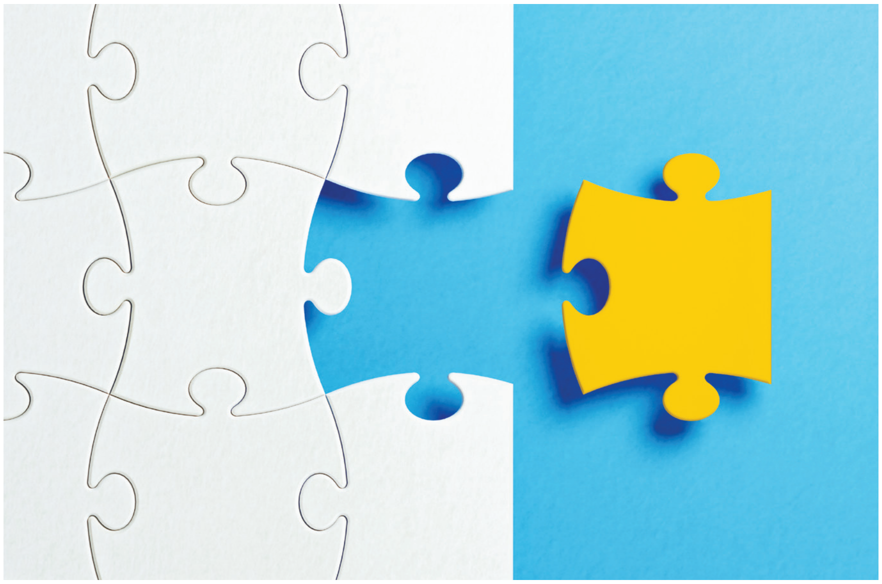
In this issue



Department of Labor fiduciary rule – Where are we now?

Beginning in 2015, the Obama administration took steps toward implementing a "fiduciary" standard with respect to certain investment advice. This new standard was intended to replace the long-standing "suitability" standard. Under the suitability standard, if an advisor's recommendation of an investment was suitable to the client's stated needs and objectives, it was considered appropriate. The latter standard had been criticized over the years as not being consumer oriented and effectively enabling many investment advisors to give advice that tended to favor them monetarily, rather than being in the best interests of their clients.

A crucial point about the Obama Administration's DOL rule was that it was limited to advice concerning retirement accounts and did not apply to investment accounts or other investments funded with after-tax dollars. Although the hope at the time was that the SEC would soon follow suit with similar rules on a broader basis, that never occurred during the Obama years.

Wolters Kluwer

Formal rules were first issued on April 6, 2016. Generally, these rules required that those providing investment advice with respect to retirement accounts must do so in the best interest of the client, rather than for the benefit of the advisors or the firms employing them. More specifically, the rule required that when giving advice on retirement plans, advisors could no longer earn compensation from consumers unless they agreed to do so pursuant to a best interest contract exemption (BICE) agreement with the client. The BICE essentially committed the advisor to a fiduciary standard of giving advice in the best interest of the client. In addition, the BICE required the advisor to earn only "reasonable" compensation and to provide certain disclosures and transparency about the products and compensation involved.

Although the fiduciary rule had many proponents, it also had detractors, including organizations representing the securities industry, as well as the U.S. Chamber of Commerce.

> "The BICE essentially committed the advisor to a fiduciary standard of giving advice in the best interest of the client."

The Obama era rule was originally to take effect April 10, 2017, with a transition period until Jan. 1, 2018. After numerous delays and protracted litigation, coupled with the start of the Trump administration in 2017, the rule was never fully implemented.

A different approach

With the passing of the regulatory torch to the Trump Administration, the DOL did not fully abandon the idea of implementing tougher standards for those providing investment advice to retirement plans, participants and IRA owners. However, this iteration attempted to accomplish its goal in a much different way than the Obama era rule.

Originally proposed July 7, 2020, and finalized Dec. 15, 2020, the most recent DOL fiduciary rule reinstates a five-part test for determining whether a person has provided investment advice for purposes of the Employee Retirement Income Security Act (ERISA) of 1974 and is thus considered a fiduciary.

The five-part test referred to above was originally contained in a 1975 regulation that was to have been replaced by the 2016 DOL fiduciary rule. Under the 1975 regulation, for advice to constitute "investment advice," a financial institution or investment professional who is not a fiduciary under another provision of the statute must:

1. render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property;
2. on a regular basis;
3. pursuant to a mutual agreement, arrangement or understanding with the plan, plan fiduciary or IRA owner;
4. that the advice will serve as a primary basis for investment decisions with respect to plan or IRA assets;
5. and that the advice will be individualized based on the particular needs of the plan or IRA.

A financial institution or investment professional that meets this five-part test and receives a fee or other compensation, direct or indirect, is considered an investment advice fiduciary under Title I of ERISA and under the Internal Revenue Code.

PTE 2020-02

The new rule also created a prohibited transaction class exemption (PTE 2020-02) for investment advice based on what are referred to as "impartial conduct standards" – consumer protection standards aimed at ensuring investment advisors maintain certain basic standards of fair dealing.

As described by the DOL, the basic aim of PTE 2020-02 is to promote investment advice in the best interest of retirement investors (e.g., plan participants, beneficiaries and IRA owners). The primary emphasis of the exemption is on mitigating conflicts of interest and ensuring retirement investors receive prudent and loyal advice. The exemption was designed to provide a broader and more flexible compliance option to investment advisors, broker-dealers, banks and insurance companies and their employees and agents than existed in earlier prohibited transaction exemptions. Specifically, PTE 2020-02 provides relief for several types of transactions and compensation that may not have been covered by prior exemptions. The preamble to PTE 2020-02 indicates that the reinstated 1975 fiduciary regulation can extend to advice to roll assets out of a plan to an IRA and that the exemption provides relief for prohibited transactions resulting from such advice.

The exemption requires that fiduciary advice providers maintain certain standards designed to ensure their investment recommendations reflect the best interest of plan and IRA investors. In addition, financial institutions and investment professionals relying on the exemption must:

- Acknowledge their fiduciary status in writing
- Disclose their services and material conflicts of interest

- Adhere to impartial conduct standards (as detailed further below) requiring they investigate and evaluate investments, provide advice and exercise sound judgment in the same way that knowledgeable and impartial professionals would (i.e., recommendations must be “prudent”)
- Adopt policies and procedures prudently designed to ensure compliance with the impartial conduct standards and to mitigate conflicts of interest that could otherwise cause violations of those standards
- Document and disclose the specific reasons any rollover recommendations are in the retirement investor’s best interest
- Conduct an annual retrospective compliance review

In addition, the exemption provides a 10-year look-back provision that precludes financial institutions and investment professionals from relying on the exemption for 10 years after conviction for specified crimes. Advisors will also be ineligible to rely on the exemption if they have engaged in systematic or intentional violation of the exemption’s conditions or provided materially misleading information to the DOL in relation to their conduct under the exemption.

The impartial conduct standards specifically require the following:

- Financial institutions and investment professionals must give advice that is in the best interest of the retirement investor. This best interest standard has two chief components: prudence and loyalty.
  - Under the prudence standard, the advice must meet a professional standard of care as specified in the text of the exemption.
  - Under the loyalty standard, advisors may not place their own interests ahead of the interests of the retirement investor or subordinate the retirement investor’s interests to their own.
- Advice providers must charge no more than reasonable compensation and comply with federal securities laws regarding “best execution.”
- Advisors may make no misleading statements about investment transactions and other relevant matters.

Effective dates

The current DOL rule became effective Feb. 16, 2021, and its requirements were to be complied with beginning Dec. 21, 2021. However, the DOL has recently announced that it would extend the enforcement relief period.

More specifically, for financial institutions that are working to comply with the impartial conduct standards, the DOL will not pursue prohibited transaction claims through Jan. 31, 2022. In addition, for the period Dec. 21, 2021, through June 30, 2022, investment advisors must adhere to the following requirements of the DOL fiduciary rule:

- Disclose their fiduciary status
- Provide a written description of services to be performed by the investment advisor, along with any material conflicts of interest the advisor may have
- Adopt and implement policies and procedures that ensure:
  - Compliance with the impartial conduct standards
  - Mitigation of any conflicts of interest
- Perform a retrospective review, at least annually, designed to assist in detecting and preventing violations of, and achieving compliance with, the impartial conduct standards and other requirements of the DOL fiduciary rule
- Maintain their eligibility
- Comply with applicable recordkeeping requirements

Regulation Best Interest and the SEC

In addition to a revised DOL rule, the SEC also issued its own version of a fiduciary rule during the Trump Administration. This rule includes several similarities and at least three differences versus the Obama-era DOL rule. The application of the SEC’s rule is broader than the DOL fiduciary rule, in that it applies to all securities transactions or strategies that a broker-dealer or associated person recommends to a retail customer, which generally includes ERISA plan and IRA rollovers. Among other things, the SEC’s rule creates a new standard for broker-dealers called the "Regulation Best Interest" (Reg BI) aimed primarily at policies and procedures dealing with mitigation of conflicts of interest, such as cases where one product would be recommended over another because of financial incentives to the broker-dealer.

Under this standard, the broker-dealer must disclose key facts about the customer relationship, including certain material conflicts of interest. However, this new standard does not impose the same fiduciary standards that apply to registered investment advisors (RIAs) about the provision of advice. Under the new standard, broker-dealers must exercise reasonable diligence, care, skill, and prudence to understand the product and have a reasonable basis to believe that the product and the proposed series of transactions are in the retail customer’s best interest.

The SEC's rule also creates a standardized customer relationship summary (CRS) form outlining the types of services to be provided, the legal standards applicable to each type and the accompanying fees. In addition, broker-dealers will not be able to call themselves "advisors" or "advisers" unless they have the requisite registration credentials. Furthermore, the SEC's rule creates new obligations for RIAs, most of which clarify judicial decisions issued in recent years.

However, the SEC's rule includes several important distinctions from the Obama-era DOL rule:

- The SEC's rule does not use the threat of lawsuits as an enforcement device.
- As noted above, a major component of the SEC's rule concerns procedures aimed at mitigating conflicts of interest. However, it does not necessarily avoid them.
- While the DOL's rule applies only to providing retirement advice, the SEC rule applies generally to all types of accounts, with some limited exceptions.

Regardless of how encouraging the adoption and implementation of Reg BI may seem on the surface, a recent report issued by the North American Securities Administrators Association paints a less positive picture. The report, issued Nov. 4, 2021, indicates that many broker-dealers have done little to change their operations since the implementation of Reg BI.

Conclusion

To date, the attempts by the DOL and SEC to impose a true fiduciary standard on advisors with respect to retirement plans, and more broadly to other types of investment advice, have fallen short. However, the push to make investment advice more understandable and transparent for clients continues. Time will tell whether future strides in this direction can happen under the current administration. ◆

Self-directed IRAs – American Eagle coins at home

In a case of first impression, the Tax Court held in *A. McNulty* that owners of self-directed IRAs that buy American Eagle coins must keep the coins in the hands of a custodian. Failure to do so means immediate and full taxation when the IRA owner takes delivery of the coins (157 TC —, No. 10, Dec. 61,950).

Before the *McNulty* decision, it was unclear whether IRA owners could keep these coins at home. On the one hand, there was the general rule that IRAs must have a custodian or trustee to hold any and all assets. The IRA owner could be a "conduit" for a check or stock certificate to a custodian. However, the IRA owner could not deposit the check, endorse the certificate or keep it in a drawer for safekeeping.

On the other hand, there was Code Sec. 408(m)(3), the provision that specifically addresses coins held by a self-directed IRA. This provision provides that, although self-directed IRAs cannot hold "collectibles," bullion and certain gold or silver coins issued by the Treasury Department, including American Eagle coins, do not count as collectibles, provided the bullion is in the physical possession of a trustee.

In the *McNulty* case, a husband and wife each established their own self-directed IRA through rollovers. They directed that the assets held in each IRA invest in a single-member limited liability company (LLC).

The wife directed the LLC in which her IRA invested to buy American Eagle coins, and she took physical possession of the coins. The IRS treated this transaction as a taxable distribution in the year she received physical custody of the coins.

The husband directed his IRA to invest in these kinds of coins and a condominium through his LLC. He conceded in litigation that he received taxable distributions from these transactions, but he contested understatement penalties for the failure to report the distributions.

Tax Court's opinion

According to the court, IRA owners cannot have unfettered command over the IRA assets without tax consequences. A qualified custodian or trustee must be responsible for the management and disposition of property held in a self-directed IRA. When coins or bullion are in the physical possession of IRA owners (in whatever capacity they may be acting), there is no independent oversight that could prevent them from invading their retirement funds.

The court took the view that no matter how one reads Code Sec. 408(m)(3), the trustee or custodian requirement is an essential element of qualifying as an IRA. Indeed, this requirement appears near the beginning of the main IRC section, Code Sec. 408(a), and governs all IRAs. A passage at the end of the last paragraph of the subsection that could be read to imply an exception to the custodian rule for coins does not change this fact.

Penalties

Despite the ambiguity in the law, the taxpayers had to pay a penalty for understatement of tax. The Tax Court acknowledged that in cases where the law is unsettled or debatable, it is not right to impose a penalty on taxpayers who made a reasonable attempt to obey. Relying on professional advice is a good excuse. In this case, however, the taxpayers never mentioned their self-directed IRA to their accountant who prepared the tax returns for the relevant years.

The taxpayers' research relied mostly on Check Book IRA's website and customer service phone conversations when setting up their self-directed IRAs. As far as the court was concerned, this amounted to no more than advertising.

The taxpayers also had a printout of part of the IRS website from 2019 explaining the collectibles rules found in Code Sec. 408(m)(3). Procedural issues precluded the use of the printout as evidence. However, in the court's view, the printout no more supported the taxpayers' position than Code Sec. 408(m)(3). Nowhere did it say, the court noted, that taxpayers can take physical custody of American Eagle coins held through the IRA's ownership of an LLC.

The taxpayers were relatively well-off and knowledgeable. They had liquidated nearly $750,000 from their existing qualified retirement accounts to invest in a questionable internet scheme without disclosing the transactions to their accountant.

Conclusion

The penalty might seem harsh, given that a cursory read of Code Sec. 408(m)(3) suggests coins do not have to be held in the physical custody of a trustee. However, if the Tax Court had held that reliance on the Check Book IRA website and customer service counted as an excuse, it would in effect be telling online tax services they could insulate customers from penalties by giving them misinformation. The court declined to make that invitation. ◆

Final regulations address foreign tax credit issues

The Treasury and IRS have issued final regulations affecting taxpayers that claim credits or deductions for foreign income taxes or foreign derived intangible income (FDII) (T.D. 9959).

The regulations finalize 2020 proposed regulations (REG-101657-20) and address:

- The disallowance of a foreign tax credit or deduction for foreign income taxes under Code Sec. 245A(d)
- The determination of oil and gas extraction income from domestic and foreign sources and of electronically supplied services under the Code Sec. 250 regulations
- The impact of the repeal of Code Sec. 902 on certain regulations issued under Code Sec. 367(b)
- The sourcing of inclusions under Code Secs. 951, 951A, and 1293
- The allocation and apportionment of interest deductions of certain regulated utilities
- A revision to the controlled foreign corporation (CFC) netting rule
- The allocation and apportionment of Code Sec. 818(f)(1) items of life insurance companies that are members of consolidated groups
- The allocation and apportionment of foreign income taxes, including taxes imposed with respect to disregarded payments
- The definitions of a foreign income tax and a tax in lieu of an income tax
- The allocation of liability for foreign income taxes in connection with certain mid-year transfers or reorganizations
- The foreign branch category rules in Reg. §1.904-4(f)
- The time at which credits for foreign income taxes can be claimed pursuant to Code Secs. 901(a) and 905(a)

Foreign tax credit

The final regulations address issues regarding the foreign tax credit, including the definition of a foreign tax credit for purposes of the creditability of foreign income taxes under Code Sec. 901 and Code Sec. 903. These issues include the jurisdictional nexus requirement, the net gain requirement, tax in lieu of income tax, separate levy determination and the amount of tax that is considered paid. The final regulations also address when the foreign tax credit may be claimed, including treatment of contested foreign income taxes.

> "The final regulations provide rules for determining whether one foreign levy is separate from another."

The jurisdictional nexus requirement in the proposed regulations is adopted and renamed the attribution requirement. The foreign tax law must require a sufficient nexus between the foreign country and the taxpayer's activities or investment of capital or other assets that give rise to the income being taxed. The foreign tax imposed on a nonresident must be based on the nonresident's activities in the foreign country (including its functions, assets and risks located in the foreign country) without considering the location of customers, users or similar destination-based criteria as a significant factor.

Under the final regulations, a tax in lieu of an income under Code Sec. 903 must also meet the jurisdictional nexus requirements.

To be creditable under current regulations, a foreign tax must reach net gain (i.e., meet realization, gross receipts and net income tests). Under these regulations, a gross basis tax may be creditable if the tax as applied does not result in taxing more than the taxpayer's profit. The IRS may request country-level or other aggregate data to analyze whether the tax reaches net gain. The tax is creditable or not creditable based on its application to all taxpayers rather than on a taxpayer-by-taxpayer basis.

Under the final regulations, applying the net gain requirements relies on the terms of the foreign tax law. For a foreign tax to be creditable, the tax must generally be levied on realized gross receipts (and certain deemed gross receipts) net of deductions for expenses. The use of data to demonstrate that an alternative base on which the tax is levied is in practice a gross receipts equivalent cannot be used to satisfy the gross receipts portion of the net gain requirement. Data-driven conclusions are used only for portions of the realization or cost recovery requirement.

The separate levy determination under the current and final regulations provides that whether a foreign levy is an income tax is determined independently for each separate levy. The final regulations provide rules for determining whether one foreign levy is separate from another.

Explicit rules are also provided for determining the effect of foreign law tax credits on the amount of tax a taxpayer is considered to pay or accrue.

The final regulations provide that contested taxes do not accrue until the contest is resolved. A taxpayer may, however, claim a provisional credit for the portion of taxes already remitted to the foreign government. The taxpayer must agree to notify the IRS when the contest concludes and not assert the statute of limitations as a defense against assessment of U.S. tax if the IRS determines the taxpayer failed to take appropriate action to get a refund. ◆

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Inside: Fiduciary rule for investment advice

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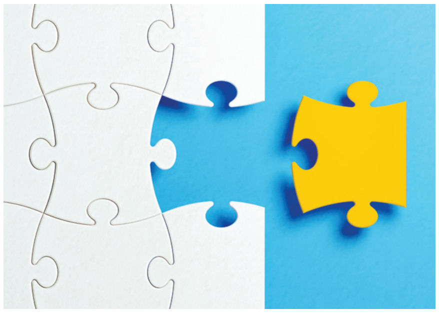

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(See inside)

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