THE Pension Digest

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Reasonable Interpretation Rule

A recent IRS Private Letter Ruling (PLR 9450042) has helped clarify a number of issues that the regulations on required distributions do not specifically address. Besides answering three specific questions, this letter ruling is important because the IRS states as policy that in the absence of final regulations, when the proposed regulation does not clearly address an issue, a taxpayer may use a "reasonable interpretation" of the proposed regulation and that the IRS will consider it acceptable.

In this particular case, the accountholder had an IRA with a value of about $1,300,000. He died in 1994. He had designated the spouse as beneficiary to 75% of the IRA and his brother as beneficiary to 25% of the IRA. The brother had died prior to 1994. The beneficiary form provided that if either the spouse or the brother predeceased the accountholder, that beneficiary's share would pass to the accountholder's estate. The accountholder's will (i.e. the accountholder's estate) named the spouse as executrix of the estate and provided that the residue of the accountholder's estate would pass 75% to the spouse and 25% to the brother. The will provided that if the brother did not survive the accountholder, that portion of the estate would pass to the spouse. In other words, the spouse would receive the entire residue of the estate. The result of this is that the spouse received the entire IRA although it passed through the estate.

The accountholder had attained age 70 1/2 and began required distribution in 1988 in accordance with the transition rules found in the regulations. The spouse now wished to treat the IRA as her own. Whether or not she could treat the entire IRA as her own is the first issue. The IRS stated that the general rule is that when there is a transfer of part of an IRA to an estate and from the estate to the surviving spouse, the spouse is treated as having received the IRA from a third party and not the deceased spouse. Thus the spouse cannot treat the IRA as his or her own. In this case, however, the IRS stated that if the estate is beneficiary to part of the IRA and the spouse is the sole executrix and beneficiary of the estate, the IRS will treat the proceeds which pass through the estate as having been acquired by the spouse from the decedent and not the estate. This means the spouse can treat the entire IRA, including the part that passed through the estate, as her own. She did treat it as her own in 1994.

The second issue — when must the spouse begin taking distributions after she had treated the IRA as her own? He had died in 1994 and he had not been paid his required minimum amount for 1994 prior to his death. The spouse had reached age 70 1/2 in 1985. Was she required to take a distribution for 1994 or would 1995 be the first year for a required minimum distribution? <u>The IRS stated that she was not required to take a distribution from the IRA until 1995.</u> They went on to say that the rollover from the decedent's IRA had to be considered as part of her account balance as of December 31, 1994, for purposes of determining her 1995 required distribution. The deadline for her first required distribution was December 31, 1995.

The third issue was how she would have to take distributions from the IRA. When she rolled the funds into her own IRA, she named her children as the IRA beneficiaries. The question was whether or not the children could be considered "designated beneficiary's" for required distribution purposes. The regulations really do not deal with this topic. The IRS said, in the absence of final regulations, issues such as this can be resolved using a "reasonable interpretation" of the proposed regulations. The IRS said they considered it reasonable to calculate minimum distributions in this case with joint life expectancy, using the children as designated beneficiaries. They said this would be permissible because the children were designated as beneficiaries prior to the spouse's required beginning date of December 31, 1995. They also stated that since the children were more than

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FDIC Insurance Coverage for SEPs and Inherited IRAs

The FDIC has issued one advisory opinion (FDIC 91-61) regarding SEPs and deposit insurance coverage. The rule is: Funds deposited in all IRAs (including a SEP) at one insured depository institution are added together and insured in the aggregate for a maximum of $100,000.

FDIC 91-61 as issued July 29, 1991 is set forth below:

I am writing in response to your letter regarding the deposit insurance coverage available for funds deposited in Individual Retirement Accounts. You ask if funds deposited in a SEP (simplified employee pension) would be aggregated with funds deposited in your regular IRA. Both the SEP and your regular IRA are maintained at the same FDIC-insured depository institution.

A SEP is treated as an IRA for deposit insurance purposes. All vested interests (excluding remainder interests) of any one person in a SEP and in a regular IRA are aggregated for purposes of determining deposit insurance coverage.

Under the FDIC's deposit insurance regulations, funds deposited in IRAs are insured separately from other types of deposit accounts held by the same depositor at the

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Also in this issue –

Estate — No Ability to Use Life-Distribution Rule in This Case

An estate which is an IRA beneficiary does not qualify to use the life-distribution rule when the IRA accountholder died prior to his or her required beginning date. This is also true for the person who is entitled to receive a distribution from the estate.

This may seem to be a very basic RMD rule, but the IRS recently issued a private letter ruling (9501044) which featured this result and we discuss it here to reemphasize this rule.

This situation is a good illustration that the designation of an IRA beneficiary should be reviewed for tax-planning purposes prior to death, because it is generally too late to save the tax situation (pay the minimum amount of tax) after the death has occurred.

The situation which existed in private letter ruling 9501044 is described below.

"A" established an IRA account and named his estate as the beneficiary of this IRA. "A" died before his required beginning date. "A" had never taken a distribution from this IRA.

Within his will, "A" had named his spouse "B" as the executrix of his estate. "A's" will transferred the residuary of his estate to a trust for "B's" benefit. This trust was to receive an amount of assets equal to the federal estate tax credit plus the state death tax credit less the value of various property passing outside of the will. This trust had three trustees, "B" was one of them. "B" was to receive from this trust as much principal and income as the trustee's deemed necessary for "B's" support.

"B" wanted to use the assets of the IRA to fund this trust and the co-trustees of the trust wanted to use the life-distribution rule, based on "B's" age, and have the inherited IRA make periodic distributions of the required minimum distribution amount to the trust.

"B's" advisors had probably reviewed prior IRS private letter rulings and knew that "B" was not entitled to treat this IRA as her own since she did not have total authority over the IRA under the will or the trust. Since "B" could not elect to treat "A's" IRA as her own, the next best tax result would be achieved if the IRA would make periodic distributions to the trust over a period of time equal to "B's" life expectancy. "B's" advisors asked the IRS if the life-distribution rule could be used or must the five-year rule be used?

The IRS ruled that the five-year rule must be used and that the life-distribution option was not available in this situation. Why? The IRS cited proposed regulation 1.401(a)(9)-1 Q&A D-2a for the position that only an individual can be designated an IRA beneficiary for RMD purposes. There is an exception for an irrevocable trust, but that exception will not apply for an estate. Since there was no person designated as a beneficiary, the five-year rule will apply and the life-distribution rule will not. Thus, the distribution will not be able to be made over "B's" life expectancy. The end result is that the IRS will certainly be paid a larger amount of taxes in the next five years than they otherwise would have been.

What Does It Mean to be an "Active Participant,"

and Why is it important to Know This?

This is the season when an IRA custodian/trustee will have IRA accountholders who made a contribution in 1994, or 1995 for 1994, come in with a desire to withdraw their contribution. Why? They have just visited their tax advisor and he or she has informed them that all or a portion of their previous 1994 contribution will not be deductible because the individual and/or spouse was an active participant in an employer-sponsored plan. And because most tax preparers don't like performing the special accounting tasks required for such nondeductible contributions, they recommend to your IRA accountholders that they withdraw such contributions. Most IRA accountholders will follow their advisor's recommendation.

Thus, your IRA accountholders now wish to withdraw their contribution (and the related earnings). This article is not about the rules which apply to withdrawing such contributions as that topic has been covered a number of times in this newsletter.

The purpose of this article is to again explain the conditions under which a person is considered to be an active participant for IRA purposes. Although it is not the job of the IRA custodian/trustee to make this determination, it will be helpful to you to have a basic understanding of the rules.

Be aware that a person can be an active participant in a pension plan for that pension plan's purposes, but not be an active participant for IRA tax-deduction purposes.

Many potential IRA accountholders/depositors are still confused as to who is eligible to make an IRA contribution and who is eligible to take a deduction for his or her IRA contribution.

A person is eligible to make an IRA contribution to the extent of the lesser of $2,000 or 100% of his or her compensation as long as the person has compensation and does not attain age 70 1/2 or older during the tax year for which the contribution is made.

A person who is eligible to make an IRA contribution is eligible to deduct the full contribution amount as long as he or she is ***not*** an active participant or their spouse, if married, is not an active participant. A single person with compensation of even $3,300,000(or more) is eligible to contribute $2,000 to his or her IRA as long as he or she is not an active participant.

A person who is an active participant may or may not be able to deduct all or a portion of his or her contribution. The adjusted gross income (AGI) limits apply as explained in the chart which follows.

CAN YOU TAKE AN IRA DEDUCTION?

This chart sums up whether you can take a full deduction, a partial deduction, or no deduction.

If Your Modified AGI* is		If you are covered by a retirement plan at work and your filing status is:			If you are not covered by a retirement plan at work and your filing status is:			
		• Single, or • Head of Household	• Married Filing Jointly (even if your spouse is not covered by a plan at work) • Qualifying Widow(er)	Married Filing Separately**	Married Filing Jointly (and your spouse is covered by a plan at work)	• Single, or • Head of Household	• Married Filing Jointly or Separately (and your spouse is not covered by a plan at work) • Qualifying Widow(er)	Married Filing Separately (even if your spouse is covered by a plan at work)***
At Least	But Less Than	You can take:	You can take:	You can take:	You can take:	You can take:	You can take:	You can take:
$0.01	$10,000.00	Full deduction	Full deduction	Partial deduction	Full deduction	Full deduction	Full deduction	Full deduction
$10,000.00	$25,000.01	Full deduction	Full deduction	No deduction	Full deduction	Full deduction	Full deduction	Full deduction
$25,000.01	$35,000.00	Partial deduction	Full deduction	No deduction	Full deduction	Full deduction	Full deduction	Full deduction
$35,000.00	$40,000.01	No deduction	Full deduction	No deduction	Full deduction	Full deduction	Full deduction	Full deduction
$40,000.01	$50,000.00	No deduction	Partial deduction	No deduction	Partial deduction	Full deduction	Full deduction	Full deduction
$50,000.00 or over		No deduction	No deduction	No deduction	No deduction	Full deduction	Full deduction	Full deduction

* Modified AGI (adjusted gross income) is: (1) for Form 1040A—the amount on line 14 increased by any excluded series EE bond interest shown on Form 8815, *Exclusion of Interest From Series EE U.S. Savings Bonds issued after 1989*, or (2) for Form 1040—the amount on line 31, figured without taking into account any IRA deduction or any foreign earned income exclusion and foreign housing exclusion (deduction), or any series EE bond interest exclusion from Form 8815.

** If you did not live with your spouse at any time during the year, your filing status is considered, for this purpose, as Single (therefore your IRA deduction is determined under the "Single" column).

*** You are entitled to the full deduction only if you did not live with your spouse at any time during the year. If you did live with your spouse during the year, you are, for this purpose, treated as though you are covered by a retirement plan at work (therefore, your IRA deduction is determined under the "Married Filing Separately" column in the "If You Are Covered by a Retirement Plan..." section of the chart).

Active Participant—*Continued from page 2*

Who is an active participant and how does a person know if he or she is an active participant?

An accountholder is an active participant if he or she participates in any of the following employer-maintained plans:

- Qualified pension, profit-sharing, stock-bonus, ESOP, 401(k) salary deferred plan, or qualified annuity plan.
- Simplified Employee Pension (SEP) plan.
- A plan established for its employees by the United States, a state or political subdivision thereof, or by an agency or instrumentality of any of the foregoing (other than an eligible state deferred-compensation plan (section 457 plan)).
- A 501(c)(18) trust (a certain type of tax-exempt trust created before June 25, 1959, that is funded only by employee contributions), if you made deductible contributions during the year.

An individual will be an active participant in a defined contribution plan if during the plan year ending with or within the individual's tax year there is allocated to the person's account any one of the following:

- Employer contributions,
- Forfeitures,
- Employee contributions.

Also, any type of salary deferral contribution under a 401(k) plan, salary reduction SEP plan, or tax-sheltered annuity (403(b)) will make an individual an active participant even if that deferral must be withdrawn because it is an excess deferral.

If an individual is eligible (meets minimum age and years of service requirements) to participate in his or her employer's defined benefit plan for the plan year that ends within the tax year, then the person is considered covered by the plan and is an active participant. This rule applies even if the individual declined to be covered by the plan, the individual did not make a required contribution, or the individual did not perform the minimum service required to accrue a benefit for the year.

A defined benefit plan is any plan that is not a defined contribution plan. Contributions to a defined benefit plan are based on a computation of what contributions are necessary to provide definite benefits to plan participants. Defined benefit plans include pension plans and annuity plans.

An individual who is married and files a joint return will be treated as an active participant if his or her spouse is an active participant. This is true whether the tax return is filed jointly or if a married person files separately. This change in the rules came about with the passage of the Technical and Miscellaneous Revenue Act (TAMRA) of 1988. Prior to TAMRA, it was possible to file a separate return and have one spouse not be treated as an active participant. Now, active participant status for one spouse generally means active participant status for both spouses, regardless of how they file income tax returns.

It is the responsibility of an individual's employer to inform the employee of his/her active participant status for the tax year using Form W-2. Form W-2 is the Wage and Tax Statement given to employees by January 31 after each taxable year. If the individual is an active participant for IRA purposes, then the employer will check the third box in box 15, entitled "Pension Plan." If the employee defers any compensation under a 401(k) or SEP salary-deferred plan, then the employer will check the seventh box in box 15, entitled "Deferred Compensation." If either or both boxes are checked, this means this individual is an active participant. Be aware employers do not always complete this section correctly.

An individual who is eligible to make salary deferrals under a 401(k), salary reduction SEP plan or 403(b) tax-sheltered annuity, but who elects not to, will not be an active participant for IRA purposes as long as there have been no other employer or employee contributions or forfeitures allocated.

In summary, it is not the IRA custodian's duty to determine whether or not a person is an active participant. But some knowledge of this subject may help you to reduce the amount of time you have to spend correcting such "excess/current-year contributions." If you do have to correct a contribution, we would recommend that you use CWF's Form #67, *Withdrawal of Current-Year Contributions*. A sample is enclosed.

a Control number 22222 | Void ☐ | For Official Use Only ▸ OMB No. 1545-0008

b Employer's identification number | 1 Wages, tips, other compensation | 2 Federal income tax withheld

c Employer's name, address, and ZIP code | 3 Social security wages | 4 Social security tax withheld | 5 Medicare wages and tips | 6 Medicare tax withheld | 7 Social security tips | 8 Allocated tips

d Employee's social security number | 9 Advance EIC payment | 10 Dependent care benefits

e Employee's name (first, middle initial, last) | 11 Nonqualified plans | 12 Benefits included in box 1 | 13 See Instrs. for box 13 | 14 Other

f Employee's address and ZIP code | 15 Statutory employee ☐ Deceased ☐ Pension plan ☐ Legal rep. ☐ 942 emp. ☐ Subtotal ☐ Deferred compensation ☐

16 State | Employer's state I.D. No. | 17 State wages, tips, etc. | 18 State income tax | 19 Locality name | 20 Local wages, tips, etc. | 21 Local income tax

Cat. No. 10134D — Department of the Treasury—Internal Revenue Service

Form **W-2** Wage and Tax Statement **1994**

For Paperwork Reduction Act Notice, see separate instructions.

An individual will not be an active participant merely because earnings are allocated to such individual's retirement plan account. Unlike the defined benefit plans, an individual who is a participant, but who is not entitled to share in the employer's contribution (including forfeitures) for the plan year ending with or within his or her tax year, because he or she does not have 1,000 hours of service or is not employed on the last day of the year, such individual will not be an active participant for IRA purposes.

If the plan contributions are purely discretionary (i.e. SEP plan or a discretionary profit sharing plan), and if there has not been an allocation by plan year-end of employer contributions, employee contributions or forfeitures, then such individual will not be an active participant for the taxable year in which such plan year ends. Rather, the individual will be an active participant for the taxable year during which the contribution is made. However, if contributions to a discretionary plan for two plan years are made in one calendar year, then the contribution for the later plan year are deemed to have been made in the next taxable year.

The IRS' summary on marital status is set forth below:

IRS Summary on Marital Status

Marital status. Generally you are considered covered by an employer retirement plan because your spouse is covered by one. To determine whether you are considered covered by an employer retirement plan for the tax year because of your spouse's coverage, you must wait until the last day of the year. This is because your filing status (whether you are considered married or single) for the year depends on your marital status on the last day of the tax year.

If you were married to two different spouses during the same year, you are considered married for the year, for this purpose, to the spouse to whom you were married at the end of the year.

If your spouse died during the year, and you file a joint return as the surviving spouse, coverage by an employer retirement plan for that year is determined as if your spouse were still alive.

If you are married filing a joint return. Both you and your spouse are considered covered by a plan if either of you is covered by a plan and you file a joint return.

If you are married filing a separate return and you are not covered by an employer retirement plan, but your spouse is, you are considered covered if you and your spouse lived together at any time during the year.

same institution. Consequently, funds deposited in all of an individual's IRAs (including SEPs) at one insured depository institution are added together and insured in the aggregate for a maximum of $100,000. Principal and interest earned are included when calculating insurance coverage. In the case of the accounts you listed (a SEP account and an IRA account), those accounts would be added together and the sum would be insured for a total of $100,000. Any amount of your combined SEP and IRA funds over $100,000 would be uninsured.

The FDIC has also issued at least three advisory opinions regarding insurance coverage after the original IRA accountholder has died. That is, what insurance coverage does the beneficiary have if he or she has their own IRA? Must the amount in the personal IRA be aggregated with the inherited IRA or are they insured separately?

The basic rule seems to be: an inherited account (John Doe as beneficiary of Mary Doe) will receive separate $100,000 insurance coverage; however, if a spouse elects to treat his or her deceased spouse's IRA as his or her own, then the personal and the inherited account (now personal since elected as own) will be limited to $100,000 of coverage.

Opinion FDIC 90-70 was issued November 28, 1990. It is set forth below:

This is in response to a letter dated August 9, 1990, written on your behalf by *** Savings Bank, which was recently forwarded to the Legal Division by the FDIC's Office of Consumer Affairs.

Your inquiry concerns whether the FDIC insures accounts separately when a spousal beneficiary rolls over a portion of funds from the deceased spouse's IRA into his or her own IRA at the same insured depository institution. The remaining balance in either account is less than $100,000, but the sum of both IRAs exceed $100,000.

Section 11(a)(3) of the Federal Deposit Insurance Act (12 U.S.C. § 1821(a)(3)) provides that IRAs held in time and savings deposits are insured "in the amount of $100,000 per account," separately from any other accounts held at the same insured depository institution. The term "per account" is defined as "the present vested and ascertainable interest of each beneficiary [*i.e.*, owner] under the plan, excluding any remainder interest ..."

For deposit insurance purposes, the individual who establishes an IRA is the owner (and beneficiary) of the deposit during his or her lifetime and is insured up to $100,000 for the total of all IRA funds he or she deposits in any given insured institution, separately from the insurance coverage afforded the same persons' non-IRA deposits at the same institution. When the individual who established the IRA dies, the succeeding beneficiaries previously designated become the vested beneficial owners of the IRA funds and are then separately insured up to $100,000 as to the IRA funds owned by each such beneficiary at the same depository institution.

If a beneficiary should choose to roll over part of a decedent's IRA into his or her own IRA then the two accounts would be aggregated for deposit insurance purposes and insured up to the $100,000 insurance limit since the beneficiary is the vested beneficial owner of both accounts.

Opinion FDIC 91-20 was issued March 21, 1991. It is set forth below:

I am writing in response to your letter dated March 1, 1991. In your letter you state that you own two Individual Retirement Accounts ("IRAs"), one in your name and one account established by your deceased husband of which you are the beneficiary. You indicate that the combined total of these two accounts exceeds $100,000. Your question is whether these two accounts are fully insured.

The rules governing deposit insurance coverage on individual retirement accounts provide that the interests of any one natural person in time and savings deposits in an insured depository institution shall be added together and insured up to $100,000 in the aggregate. 12 C.F.R. § 330.13(a). This insurance coverage would be separate from, and in addition to any other individual retirement accounts established by another individual on which you are named as beneficiary. The person who establishes an IRA account is the owner of the deposit during his or her lifetime and is insured up to $100,000 as to all IRA funds he or she deposits in time and savings accounts at any one insured bank, separately from the $100,000 limit applicable to such person's non-IRA deposits at the same bank. When the person who set up the IRA account dies, the beneficiaries previously designated by the deceased depositor become the vested beneficial owners of the IRA funds and are then separately insured up to $100,000 as to the IRA funds owned by each such beneficiary at the same bank. Therefore, the funds in your IRA account would be insured up to a maximum of $100,000. With regard to your deceased husband's individual retirement account of which you are the beneficiary, your interest in this account is insured up to $100,000, separately from the IRA established in your name in the same depository institution. If, however, you should elect to treat your interest in your husband's account as your own IRA for federal income tax purposes, then the funds in this account would be added to your IRA and insured in the aggregate.

Opinion FDIC 91-43 was issued May 14, 1991. It is set forth below:

This is in response to your letter of April 8, 1991, in which you request, on behalf of the ***, an interpretation of section 330.13 of the FDIC's deposit insurance regulations (12 C.F.R. 330.13) under the following circumstances.

You posit a situation where A and B have each established a separate Individual Retirement Account (IRA) in Bank X, and each account has a balance of $100,000. A dies having named B as beneficiary of A's IRA. You state that B has the following four options upon A's demise.

(1) B may withdraw the full amount of A's IRA. In such case, A's IRA would cease to exist.

(2) B may begin receiving installment payments from A's IRA over the appropriate period of time (which may be A's remaining life expectancy or B's life expectancy, for example). In such case, A's IRA would continue to exist until all amounts were distributed to B.

(3) If B is A's surviving spouse, B may roll over the funds into an IRA in B's name (either in Bank X or with another IRA trustee). The funds in A's IRA would then become part of an IRA belonging to B.

(4) If B is A's surviving spouse, B may treat the IRA as his or her own IRA. A's IRA would then become B's IRA.

It is your understanding that, with respect to option #1, the funds withdrawn from A's IRA would no longer be entitled to separate insurance coverage, but would instead be insured as B's single ownership funds if they remain deposited with Bank X. Your understanding is correct.

For options #3 and #4, you state that the funds, if left on deposit with Bank X, would be aggregated with any existing IRAs maintained by B at the same depository institution and insured up to $100,000 as B's IRA. Again, your understanding is correct.

Your primary concern appears to be option #2, and you suggest three possible interpretations of insurance coverage under this scenario. Your third interpretation is correct. As long as the two IRA accounts remain separate, one in A's name and the other in B's name, the FDIC would provide deposit insurance coverage for each account in the amount of up to $100,000 until A's IRA is depleted and ceases to exist. PD

Interpretation Rule—*Continued from page 1*

10 years younger than the spouse, the MDIB table would have to be used.

In summary, the IRS concluded that the spouse could treat the entire IRA as her own, including the portion payable to the decedent's estate. The spouse did not have to take her first distribution until December 31, 1995 and could use a joint life expectancy with the children as her designated beneficiaries. PD