THE Pension Digest

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Administrative Issues When an Estate or a Trust Is the Designated Beneficiary of an IRA and the IRA Owner Has Died

Various administrative and tax-reporting issues arise for the IRA custodian/trustee when the inheriting IRA beneficiary is an estate or a trust. The purpose of this article is to discuss these issues. As will be illustrated, what is best for your institution may not always be what your "new" customers want. Your new customers: are the personal representative of the estate, the trustee of the trust, the attorney representing the estate or trust, or the person(s) who is considered to be the owner of the revocable trust.

When a person dies, there are many rules and laws with which to comply, and many people confuse these various rules. For example, there are state probate laws, there are federal estate tax laws, there are federal income tax laws governing estates and trusts, and in many states there are state inheritance laws or similar laws.

A general observation is – some of your new customers will wish to simplify what they must do to comply with the above laws and rules by asking you to assume some of the work which they should do. To the extent possible, your institution will want to keep things simple by not following some of your new customers' special requests. Many times simple is best.

Discussion – When An Estate is the Beneficiary

To illustrate some of these issues, the situation of a Mr. Justin T. Chance will be considered. He established an IRA and he designated his estate as his beneficiary. He died on November 4, 1995. On December 19, 1995, his wife, Eileen S. Chance, as the executrix (or personal representative of the estate) withdrew the IRA account balance of $23,235.78 on behalf of the estate. This $23,235.78 was placed in the estate's checking account and then was distributed to the his daughter, Saundra S. Chance, as she was designated in his will as the person to receive the IRA account.

Your institution may well be presented with the following types of comments and requests by Eileen, the personal representative, or by the attorney assisting Eileen. Your institution will need to decide how you will respond to these requests and comments and if you will accommodate any of the special requests.

#1. "My attorney has told me that I don't need to obtain a special Tax Identification Number (TIN) for the estate."

#2. "I want you to make the check payable to my daughter and not the estate as it is she who is entitled to receive the funds under his will."

#3. "I want you to prepare the Form 1099-R in the name and social security number of my daughter because you issued the check to her."

Requirement for an Estate to Have TIN

Many people have the mistaken belief that an estate is required to obtain a TIN only if the estate will be required to file a federal estate tax return. A TIN is certainly needed for an estate if a federal estate tax return is required to be filed.

Most estates are not required to file a federal estate tax return since the fair market value of the estate, after being adjusted for lifetime gifts, is less than $600,000. If the estate owes the 15% excess accumulations tax, then an estate tax return must be filed even though the estate's value is less than $600,000. The requirement to file the federal estate tax return rests with the executor or the personal representative of the estate.

Although a TIN may not be needed because the federal estate tax return will not be filed, there are two other tax reasons which will require the personal representative or the attorney assisting the estate to obtain a TIN for the estate. The Form SS-4 is filed with the IRS to obtain a TIN.

A TIN is needed for most estates because most estates will be required to file a federal income tax return (Form 1041). The estate is a separate tax entity for federal income tax purposes. An estate with gross income of more than $600 must file the Form 1041 even if the estate is

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New Opportunity — The Medical Savings Account

As all of you are aware, the potential for greatly expanded IRAs and retirement plans under the current tax bill has been a major topic of this newsletter in recent months. It has also been a topic of great concern to financial institutions around the country. The potential explosion in IRA and retirement plan deposits has most people in the financial industry very excited. Somewhat lost in all of the discussion of "new" IRA and retirement plan rules has been a newly proposed type of savings account called the Medical Savings Account (MSA). This article will examine what this MSA is and what the rules that govern the account are all about under the most recent proposal.

The Benefits – A Tax Deduction

The proposed MSA is a brand new type of savings account explicitly linked with medical care expenses and individuals who have high-deductible medical care plans. It has been designed to encourage people who have medical plans that require a large out-of-pocket expenditure on their part to save funds in order to pay for the out-of-pocket expenditures. Within limits, the individual will receive a tax deduction for the amounts contributed to the MSA. Earnings on the funds held in the MSA are not subject to taxation.

The amount of the deduction is tiered depending on the type of health care coverage. The first tier limits the amount allowed as a deduction to an individual

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essentially a conduit and no tax is owing. That is, the estate must include as income the income which it receives, but then it is granted an off-setting deduction for the distributions it makes to the beneficiary(ies) who then must include the income in their personal income. The tax year of the estate may either be the calendar year or a fiscal year. The personal representative will make the tax year election. An estate must include as its income the income earned by the decedent's property after his or her death until the time of final distribution. In some cases, the distribution of funds from an IRA to the estate may be the only income realized by that estate (i.e. a small estate). Some executors and attorneys mistakenly believe that if they can convince the financial institution to make the distribution directly to the beneficiary of the estate, rather than to the estate, they can avoid having to file the Form 1041. This subject is discussed further below.

Some estates may not need to file an income tax return for the estate. Even so, a TIN will be needed because the IRA custodian/trustee needs a TIN to prepare the Form 1099-R, the form which reports distributions to the IRS and to the recipient. The cardinal IRS reporting rule is that a Form 1099-R must be prepared for the person, estate or trust who receives a distribution from an IRA, pension plan or annuity. In order to prepare the Form 1099-R, the recipient must have a TIN. Therefore, most financial institutions will not distribute funds to an estate until the estate furnishes its TIN. Many IRA plan agreements contain contractual terms which allow the IRA custodian to withhold distribution until the prospective recipient has furnished the IRA custodian/trustee with the information it needs to process the distribution, including the TIN.

In the situation of Justin T. Chance, who is the recipient? The estate, the spouse/executor (Eileen) or the daughter/estate beneficiary (Saundra)?

The estate should be the recipient as it is the estate which was the IRA's designated beneficiary. Thus, the IRA custodian/trustee must prepare the check and the Form 1099-R in the estate's name (e.g. Eileen Chance as personal representative of the estate of Justin T. Chance).

The IRA custodian/trustee is required by the federal income tax rules to furnish various reports, including Form 1099-R, to the IRS and to the recipient. Your institution is a third party reporting entity. As a third party reporting entity, your institution has the duty to report "gross" transactions, but it is not (in general) required to report the legal or tax ramifications of these transactions. Such explanations must be provided by the filer of any required return or the preparer of such return. Penalties apply if you fail to properly generate the Form 1099-R. The IRS can assess a penalty of $25 per day to a maximum of $15,000 for not preparing a Form 1099-R which was required to be prepared.

As in the Justin T. Chance situation, many times the personal representative (or the attorney) of the estate might like you to furnish the check (and the Form 1099-R) directly to the daughter (Saundra).

This might well be the case if the estate has no other income. There is no written authority which would allow an IRA custodian/trustee to explain to the IRS that it does not owe the penalty for failing to prepare the Form 1099-R for "Eileen Chance as the personal representative of the estate of Justin T. Chance" because it prepared one for Saundra Chance, the beneficiary of the estate. In essence the personal representative (or the attorney) has asked the IRA custodian/trustee to change the IRS reporting rules. Their purpose may be to simplify the reporting which the estate must do, but it does not simplify things for the IRA custodian/trustee.

An important concern for the IRA custodian who wishes to accommodate the personal representative is, how does the IRA custodian really know that it was the daughter who was entitled to be paid the IRA funds, and who is the party who should pay taxes? The IRA custodian/trustee may well assume contingent liabilities if it prepares tax forms as requested by the personal representative rather than as called for by the actual situation. Unfortunately, some people are not above seeking the help of a financial institution to accomplish some post-death tax planning which may or may not be authorized by the tax laws.

In summary, an IRA custodian/trustee should adopt very simple procedures when an estate has "inherited" an IRA and will be paid distributions. Most IRA owners who have designated their estate as their beneficiary have done so intentionally. An IRA custodian/trustee must deal with the personal representative of the estate who must be informed that a TIN will be needed by the estate before a distribution will be made. The check and the Form 1099-R should be issued to the personal representative of the estate. The IRA custodian/trustee should not grant special requests from the personal representative or the attorney that payment(s) be made to the beneficiary(ies) of the estate.

Discussion – When a Trust is the Beneficiary

More and more people are establishing revocable living trusts. Many IRA owners are designating these revocable trusts as their IRA beneficiary.

The trust which an IRA owner designates as his or her IRA beneficiary may or may not be a revocable trust. Some trusts are irrevocable trusts.

The administrative approach which an IRA custodian/trustee will wish to adopt will vary depending upon the type of trust (irrevocable versus revocable) and the type of trust which exists after the IRA owner dies (irrevocable versus revocable).

An irrevocable trust is a separate tax entity and is required to file an income tax return if it has any gross income or taxable income in excess of $600. This is true whether the trust was originally irrevocable or became irrevocable upon the death of the grantor who is also an IRA owner. Trusts for income tax purposes are classified as either simple or complex. A TIN will be needed for an irrevocable trust. The policies and procedures as discussed above for the estate situation apply to the irrevocable trust situation also.

What if the "inheriting" IRA is a revocable trust and continues to be a revocable trust?

A revocable trust is a type of grantor trust. A grantor trust is not treated as a separate tax entity for federal income tax purposes. The grantor of such a trust (one under which the grantor has retained specific powers) is treated under the income tax rules as being the owner of the income which is earned by the trust. Internal Revenue Code section 671 and the related regulation state that the income of the trust will be entirely taxed to the grantor (i.e. must be included on his or her own personal 1040 tax return) in the following situations:

1. There is a trust and the same person is both grantor and trustee (or co-trustee) and that person is treated as the owner of all of the assets of the trust, for the tax year, by application of section 676 (power to revoke); or

2. In the case of a trust having a husband and wife as the sole grantors, and one spouse is trustee or co-trustee with a third party, or both spouses are trustees or co-trustees with a third party, and one or both spouses are treated as owners of all of the assets of the trust for the tax year by application of section 676 (power to revoke) and a joint income tax return is filed.

A grantor of a such a trust (or a husband and wife in the case of the second situation) is required to furnish payors of income with his or her social security number. Regulation 301.6109-1 states that a grantor trust where all of the income is taxed to the grantor shall not obtain a TIN until such time as the income would not be taxed solely to the grantor or his or her spouse. Instead, the grantor must furnish his or her social security number to payors of income, and payors must report income as if paid to the grantor and not to the trust.

For example, a husband and wife created a joint revocable trust. He maintained an IRA and had designated this joint revocable trust as the beneficiary. He dies. The

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surviving spouse who is now the trustee of the trust is required to inform the IRA custodian that the trust is still a revocable trust and to furnish her social security number. A distribution to the trust/spouse would be made to her using her name and social security number. The trust, which is still a grantor trust, is considered to be owned by her for federal income tax purposes.

In summary, a TIN is required for an irrevocable trust. A revocable trust for which the income will be taxed solely to the grantor (or spouse) should not obtain a TIN until the income will not be taxed to the grantor or spouse as their personal income. It appears that the burden of determining when the trust should pay taxes, rather than the individuals, rests upon the individuals who created the trust. That is, the individuals must determine when the trust is no longer a grantor trust.

The procedure which an IRA custodian should adopt with respect to a revocable trust which has "inherited" an IRA is – ask to be furnished a written certification that the trust qualifies for the special reporting approach and that the name and social security number of the grantors of the trust will be used for all reporting purposes.

Overall Summary: An estate or trust which has "inherited" an IRA must have a TIN unless the trust is a revocable trust meeting the special conditions summarized above. The IRA custodian/trustee must deal with the estate's personal representative or the trust's trustee in their official capacities and not as individuals. In the case of a revocable trust, the IRA custodian will deal with the trustee of the trust as if there was no trust and will use the surviving spouse's name and social security number. PD

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for a tax year to the lesser of $2,000 or the annual deductible limit under a high-deductible health plan. The second tier applies to high-deductible health plans covering the individual, the individual's spouse and other dependents. The deduction is limited to the lesser of $4,000 or the aggregate annual deductible limit under the plan for all individuals who are covered.

If the individual's spouse is covered under a different high-deductible health plan, the deduction is limited to the first tier on an individual basis. This simply means that if each spouse is covered by a high-deductible plan, the deduction limit is the lesser of $2,000 or the annual deductible limit under the plan on an individual per-spouse basis. This rule could very well decrease the deductible amount of contributions that a married couple would qualify for, as is illustrated here. Husband A has a high-deductible plan that has a $1,500 individual limit. Wife B also has a high-deductible plan with a $5,000 limit. Since each spouse is in a different high-deductible plan, they must be looked at individually under the deduction limitation. The husband's deduction is limited to $1,500, and the wife's to $2,000. Their total deduction is then $3,500. If the husband was not a participant in a separate high-deductible plan, but instead was covered under the wife's plan, their deduction would be $4,000.

Employers may also choose to fund an MSA for employees. If an employer makes the MSA contributions, they are limited to the dollar figures discussed above. The employee does not include any employer MSA contributions in income. If the employer makes **any** MSA contribution on behalf of the employee, the employee is not eligible to make any deductible contribution.

Who Is Eligible for an MSA?

Individuals eligible to make a contribution to an MSA are those who are covered under a high-deductible health plan and are not covered under any other health plan which is not a high-deductible plan that provides coverage for any benefit also covered under the high-deductible plan.

A high-deductible health plan is one which has an annual deductible limit for each individual of not less than $1,500 and an annual limit on the aggregate amount of deductibles for all covered individuals of not less than $3,000.

As mentioned, insurance coverage in addition to coverage under the high-deductible plan will usually disqualify a person from eligibility for an MSA. Certain additional insurance will, however, be allowed. Coverage under Medicare supplement insurance, insurance where substantially all coverage relates to workmen's compensation, tort liabilities, and liabilities related to the ownership and use of property, insurance for a specified illness or disease, and insurance that pays a fixed amount per period for hospitalization will not render a person ineligible for an MSA.

Distributions

The purpose of the MSA account is to encourage people to save money to pay for medical expenses that are not covered by any health care plan. It makes sense, then, that there needs to be rules governing the distribution and use of these funds.

The MSA presents a fairly unique opportunity for people who qualify to use it. As discussed previously, contributions to the account are generally deductible by the individual. The unique nature of the account is on the distribution side. If a person takes a distribution from an MSA and uses it for "qualified medical expenses" that are not reimbursed by insurance, the distribution will not be subject to income tax. Qualified medical expenses are any medical expenses that would be deductible on an individual's tax return as a "miscellaneous deduction," except for the payment of insurance premiums. There are some exceptions to the prohibition on the use of these funds to pay insurance premiums. If the MSA distribution is used to pay premiums on long-term care insurance, for health care continuation coverage under any Federal law, or while the individual is receiving unemployment compensation, the distribution will not be subject to tax.

Distributions that are not for medical expenses will be included in the individual's income. They will also be subject to a 10% penalty unless they are made due to the attainment of age 59 1/2, death or disability.

The MSA accountholder will be allowed to name a beneficiary to the account. If the beneficiary at the time of death is the spouse, the MSA will be treated as if the spouse were the accountholder. If the beneficiary(ies) is a nonspouse, the MSA ceases being an MSA on the date of death, and the value of the account on that date is included in the nonspouse beneficiary's income for that year.

Rollover Rules

While a person could have an MSA account at more than one institution, for tax purposes, all MSA accounts a person has are treated as one. This becomes important when looking at the rollover rules for MSA accounts. Like IRAs, a person is allowed to take a distribution from the MSA and roll over to another MSA within 60 days. Also, like IRAs, this is limited to one time per 12-month period. A difference, though, is that if a person had MSAs at a number of different institutions and took a distribution from one to roll to another, none of the other MSAs could be rolled over for 12 months.

Document and Reporting Requirements

It is unclear at this time just exactly what the documentation requirements for establishing an MSA will be. What is clear is the fact that a written document will be required. The proposed legislation states that the MSA is a trust that is created by a written document with a financial institution serving as trustee. The document will have to specify that contributions be made in cash, that life insurance is not a permissible investment, that the assets of the MSA cannot be commingled, and that the account is nonforfeitable. Further docu-

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Promoting Nondeductible IRA Contributions

This article is primarily written for those financial institutions which offer self-directed IRAs.

When TRA 86 took away from many IRA owners the right to claim a tax deduction for their $2,000 contribution, many financial planners and accountants advised these IRA owners to not make a nondeductible IRA contribution. The reasoning: they could do better with other investments, such as with an annuity without having the accounting complexity associated with nondeductible IRA contributions.

Many IRA owners heeded this advice and quit making their annual $2,000 contributions. Remember that a person is eligible to contribute $2,000 to an IRA as long as he or she has compensation of at least $2,000 and as long as he or she does not attain age 70 1/2 or older during the tax year. The fact that a person participates in an employee-sponsored pension plan or makes elective deferrals to a 401(k) plan does not affect the amount he or she may contribute to the IRA.

With the way the stock market has performed the last few years, many IRA owners with self-directed IRAs and many people without any IRA may now be wishing that they had made nondeductible IRA contributions.

Consider the two examples set forth below.

Example #1. Assume that Wendy Barranger invested $2,000 in Class A shares of the Oppenheimer Main Street Income and Growth Fund on June 30, 1988. The 1989 year runs from July 1, 1988, to June 30, 1989, the 1990 year runs from July 1, 1989, to June 30, 1990, etc. The $2,000 would have grown or appreciated as follows. The total return at net asset value was calculated by Oppenheimer "assuming a hypothetical investment on the business day before the first day of the fiscal period, with all dividends and distributions reinvested in additional shares on the reinvestment day and redemption at the net asset value calculated on the last business day of the fiscal period and sales charges have not been reflected in the total returns."

Year	Beginning Value	Total Return at Net Asset Value	Ending Value
1989	$2,000.00	18.77%	$2,375.40
1990	2,375.40	9.07%	2,590.85
1991	2,590.85	10.60%	2,865.48
1992	2,865.48	39.48%	3,996.77
1993	3,996.77	46.38%	5,850.47
1994	5,850.47	14.34%	6,689.42
1995	6,689.42	20.52%	8,062.10

Most people would be very satisfied to have an IRA with a value of $8,062.10 after seven years as derived from an original nondeductible IRA contribution of $2,000. The $6,000 appreciation in value will go a long way towards convincing a person that the burden of accounting for nondeductible contributions is not that painful. Hopefully, this example and the next one illustrate the fact that because earnings are not presently taxed, the asset, over time, can become extremely valuable. That is, the earnings will not be taxed until the IRA owner starts to take distributions from the IRA. The pro rata formula must be used as a portion of any distribution is comprised of her nondeductible contributions (nontaxable) as well as earnings (taxable). Since earnings are not presently taxed, the account "compounds" faster than if there were present taxation of earnings.

Example #2. Assume that Tina Sanchez invested $2,000 in Class A shares of the Oppenheimer Main Street Income and Growth Fund each July 1 for the period of July 1, 1988, to June 30, 1995. Thus, there were seven contributions in all. The 1989 year runs from July 1, 1988, to June 30, 1989, the 1990 year runs from July 1, 1989, to June 30, 1990, etc.

The annual contributions from 1988-1994 of $2,000 would have grown or appreciated as follows.

Year	Beginning Value (July 1)	Total Return at Net Asset Value	Ending Value (June 30)
1989	$2,000.00	18.77%	$2,375.40
1990	4,375.40	9.07%	4,772.25
1991	6,772.25	10.60%	7,490.11
1992	9,490.11	39.48%	13,236.80
1993	15,236.80	46.38%	19,376.03
1994	21,376.03	14.34%	24,441.35
1995	26,441.35	20.52%	29,456.72

Again, many people would be very satisfied to have an IRA with a value of $29,456.72 after seven years as derived from nondeductible IRA contributions of $14,000. Obviously, past performance does not guarantee future performance, but the purpose of this article has been to illustrate that many people today might give more serious consideration to making nondeductible IRA contributions if they were again presented with the concept. PD

IRA and Pension Distributions at Fair Market Value

The distribution from an IRA or a pension plan can be comprised of assets other than cash. That is, stocks, bonds, real estate, etc. may be distributed. IRS rules require that these noncash assets be valued for Form 1099-R reporting purposes (i.e. for federal income tax purposes) at their fair market value.

This fair market value must be determine as of the time of distribution. Practically, this means the value as of the day of distribution, but it should be realized that it is the value as of the time of distribution which is required. The use of another value such as the prior month-end value does not comply with the rules.

Experience shows that the value of securities and other investments can change greatly within a few hours, as well as within a few days or weeks. The only rule which makes any sense from a tax logic standpoint is a rule which requires the use of the value as of the time of distribution.

Where is This Rule Found?

This rule is not written as expressly within the various regulations as one would expect. However, the above rule is derived from a reading of Code section 402 and 408 and the related regulations.

Regulation 1.402(a)-1(iii) reads as follows:

"Except as provided in paragraph (b) of this section, a distribution of property by a trust described in section 401(a) and exempt under section 501(a) shall be taken into account by the distributee at its fair market value."

In subsection (b) it is clearly stated that the value to be used is "the fair market value of such securities at the time of the distribution over ...."

Although an IRA custodian or pension plan trustee may like to take an easier approach and use an "older" value, the value which must be reported is the fair market value as of the time of distribution. PD

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mentation and disclosure requirements are just not known at this time. Collin W. Fritz and Associates, Ltd. will have MSA documents available when and if these accounts become reality.

Even more unclear at this time is what reporting requirements will accompany the MSA. The legislation simply states that the IRS may require whatever reports necessary to insurance compliance with the contribution and distribution rules for MSAs. It is our best guess that forms similar to the 5498 and 1099-R used for IRAs will be developed for the MSAs.

The MSA will present a new opportunity for savings deposits should it become reality. With the similarity to IRAs, your institution should be in a good position to offer this new type of account when and if the legislation passes. Collin W. Fritz and Associates, Ltd. will have the documents and materials you will need to offer to administer these accounts. Watch future issues of *The Pension Digest* for continuing developments with the Medical Savings Accounts. PD