THE Pension Digest

Published Since 1984 Collin W. Fritz and Associates, Inc., *"The Pension Specialists"* March, 1997

Medical Savings Accounts (MSAs) — Custodian Responsibility and Marketing

The creation of the new Medical Savings Account (MSA) has generated a great deal of interest on the part of many small employers. Eligibility for an MSA is limited to employees of small employers who participate in a high-deductible health care plan. Contributions are based on a percentage of the health care plan's annual deductible limit. Distributions from the MSA that are used for medical expenses that are not covered by insurance will not be subject to tax. Distributions used for nonmedical reasons will be taxable. These rules governing MSAs have caused some concern among potential MSA custodians and trustees. The most common questions we get from banks relating to MSAs is what the banks' responsibilities are for determining MSA eligibility, contribution amounts, and taxation of distributions. Recent IRS Notices and the release of the MSA reporting forms have clarified these issues.

A bank's responsibility in administering an MSA is perhaps even less complicated than what is faced with IRAs. To begin with, the issues of MSA eligibility and contributions will be examined. An MSA custodian or trustee is not responsible for determining whether or not an individual is eligible for an MSA. This determination will fall on the individual and to some extent the individual's employer. There is virtually no way an MSA custodian/trustee could determine when an individual does or does not meet the eligibility requirements for an MSA. As such, the determination will fall on the individual. The MSA forms we have designed clearly place this responsibility on the accountholder.

MSA contribution amount determination is again the responsibility of the individual. Again, it would be impossible for the custodian/trustee of an MSA to determine what contribution could be made to an MSA for an individual. The MSA custodian/trustee's responsibility with MSA contributions will be to report the amount of any MSA contributions. The new IRS Form 5498-MSA illustrates the fairly simple MSA contribution reporting an MSA custodian/trustee faces. It asks for the following information:

Box 1 asks for the total MSA contributions made for the year by the individual. This box does not include contributions made to an MSA by the individual's employer.

Box 2 asks for the total MSA contributions made in 1997 either by the employer or the individual.

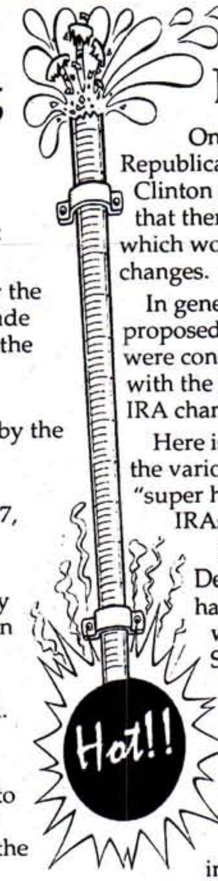
Box 3 asks for the total MSA contribution made in 1998, for 1997, either by the employer or the individual.

Box 4 asks for the amount of any rollover contribution to the MSA in 1997.

Box 5 asks for the December 31, 1997 fair market value of the MSA.

With these reporting requirements, the MSA custodian/trustee will only have to document, administer and report the amount of any contributions, the date made, and the source of the contributions. It will be critical that the custodian/trustee ascertain the source of the contribution. Is this coming from the individual, or from the individual's employer? Employer contributions to a person's MSA will only appear on the 5498-MSA in Boxes 2 or 3 and then again Box 5 as part of the fair market value. The source will also be important as the individual cannot contribute to the MSA in any year their employer does. Responsibility relating to rollover contributions is quite simple – it will be the individual's responsibility for compliance with the MSA rollover rules. We are strongly recommending that the MSA custodian/trustee get an MSA rollover form signed by the individual where the individual will certify compliance with the rules. To summarize, contribution responsibility for MSAs will be quite similar to that for IRAs. The custodian/trustee will need to ascertain

Continued on page 2



Possible IRA Legislation

One really does wonder if the Republicans, Democrats and President Clinton can get along long enough so that there will be a new tax bill enacted which would contain "major" IRA changes.

In general, the IRA changes being proposed are very similar to those which were considered in 1995 and 1996. And as with the last two years, the likelihood of IRA changes are very uncertain.

Here is a summary of the proposals by the various proponents as rated for being "super hot" to "cold" in their support of IRAs.

SUPER HOT. Senator Roth (R-Del.) and Senator Breaux (D-La.) have jointly introduced a bill which would be very favorable to IRAs. Senator Roth is chairman of the Senate Finance Committee; this committee has jurisdiction over all tax bills. He is a powerful ally, but he was not able to obtain the increase in the income limits the last two years. This proposal would increase the income limits for single filers from the current $35,000 to $50,000 in 1997, to $125,000 in 2000, and then there would be no limit thereafter. This proposal would increase the income limits for married filers from the current $50,000 to $65,000 in 1997, to $140,000 in 2000, and then there would be no limit thereafter. This

Continued on page 4

Also in this issue –

Published by Collin W. Fritz and Associates, Ltd.
Subscription Rate: $65 per year.

MSA—*Continued from page 1*

the source of the contribution, i.e. employee or employer, the amount of the contribution, the tax year of any regular MSA contribution, and the date made.

Perhaps the biggest concern most financial institutions had relating to MSAs was who is responsible for determining what a distribution is used for. In other words, is the distribution taxable or not? IRS Notice 96-53 makes the IRS' position very clear. Determination of whether or not the distribution is used for a qualified expense falls on the accountholder. The custodian/trustee has no responsibility for making a determination of whether the distribution was used for a qualifying medical expense. The distribution reporting requirements for MSAs clarify this further. The IRS has released a 1099-MSA to be used to report MSA distributions. It contains three boxes that need to be completed by the MSA custodian/trustee. they are explained here.

Box 1 - This box is used to report the gross amount of any MSA distribution.

Box 2 - This box is used to report the earnings distributed with any excess MSA contribution.

Box 3 - This box is used to report an MSA distribution code. There are five MSA distribution codes. Code 1 is a "normal MSA distribution," Code 2 is an "excess distribution," Code 3 is a "disability distribution," Code 4 is a "death distribution," and Code 5 is a "prohibited transaction distribution."

With these codes it is clear there is no responsibility for determining use of the distributions. If the distribution is not due to death, disability, excess withdrawal, or a prohibited transaction, it is reported as a normal distribution. In other words, the custodian/trustee does not have to determine its use. This point is further made by the lack of any "taxable distribution" box. All the custodian/trustee reports is the gross amount of the distribution. There is no requirement that the custodian/trustee determine whether or not any part of the distribution is taxable or for what it was used.

The last area of custodian/trustee reporting responsibility also appears to be fairly simple. By June 1, 1997, August 1, 1997, August 1, 1998, and August 1, 1999, MSA custodian/trustees will have to report to the IRS on a Form 8851 the following information:

- The number of MSAs that have been established at this institution.
- The name and taxpayer ID number of the individuals who have established these IRAs.
- The number of these individuals that were previously uninsured.

The last point, dealing with those individuals that were previously uninsured, should be handled by asking this question on the MSA plan agreement and/or on MSA contribution forms.

The reporting and administrative requirements an MSA custodian/trustee faces are very similar to IRAs. In many respects the requirements are even simpler than what a financial institution faces with IRAs. Responsibility for most of the tax issues an individual has with an MSA are the individual's and not the custodian/trustee's as can be seen in the previous discussion.

Marketing MSA accounts now is very important for institutions that are going to offer MSAs. As MSAs are in a "pilot phase" a financial institution will want to get as many MSAs established as soon as possible during this pilot time period. It

Continued on page 3

IRS Issues 1997 MSA Form 1099-MSA

0594 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code			OMB No. 1545-1517 **1997** Form **1099-MSA**	**Distributions From Medical Savings Accounts**
PAYER'S Federal identification number	RECIPIENT'S identification number	1 Gross distribution $	2 Earnings on excess contributions $	**Copy A** For **Internal Revenue Service Center**
RECIPIENT'S name		3 Distribution code		**File with Form 1096.**
Street address (including apt. no.)				For Paperwork Reduction Act Notice and instructions for completing this form, see the 1997 Instructions for Forms 1099, 1098, 5498, and W-2G.
City, state, and ZIP code				
Account number (optional)				

Form **1099-MSA** Cat. No. 23114L Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

Instructions to Recipient

Distributions from a medical savings account (MSA) are reported to recipients on Form 1099-MSA.

The payer is not required to compute the taxable amount of any distribution. An MSA distribution is not taxable if you used it to pay qualified medical expenses or you rolled it over to another MSA. However, see **Box 2** below. If you did not use the MSA distribution for qualified medical expenses or you did not roll it over, you must include the distribution in your income, and you may owe a 15% penalty. If the accountholder died during the year, see **Pub. 502,** Medical and Dental Expenses.

Box 1.— Shows the amount you received this year. The amount may have been a direct payment to the medical service provider or distributed to you. See the instructions for your income tax return for information about how to report this amount.

Box 2.—Shows the earnings on any excess contributions you withdrew by the due date of your income tax return. If you withdrew the excess, plus any earnings, by the due date of your income tax return, you must include the earnings in your income in the year you received the distribution even if you used it to pay qualified medical expenses. This amount is included in Box 1.

Box 3.—These codes identify the distribution you received:

1—Normal distribution
2—Excess contributions
3—Disability
4—Death
5—Prohibited transaction

Payers, Please Note—

Specific information needed to complete this form and other forms in the 1099 series is given in the **1997 Instructions for Forms 1099, 1098, 5498 and W-2G.** A chart in those instructions gives a quick guide to which form must be filed to report a particular payment. You can order those instructions and additional forms by calling 1-800-TAX-FORM (1-800-829-3676).

Furnish Copy B of this form to the recipient by February 2, 1998.

File Copy A of this form with the IRS by March 2, 1998. PD

IRS Issues 1997 MSA Form 8851

See the sample form enclosed with this newsletter.

Form 8851—A trustee of a medical savings account (MSA) must file Form 8851, Summary of Medical Savings Accounts, to report the number of MSAs established and other information. See Form 8851 for details. PD

MSA—*Continued from page 2*

would seem to us that there should be a two-fold marketing effort. To begin with, the financial institution should let its customers know that it offers MSAs.

Those financial institutions that are offering MSAs early on will see substantial activity due to the fact that many institutions have not yet decided whether or not to offer them, and others have decided that they won't. We have had comments from numerous individuals around the country that relate some difficulty in finding a financial institution that has or will have these available. This should make it easier for financial institutions that are offering MSAs to get these deposits. The trick will be to let people know you offer the MSA. This could be done through a statement mailing to existing customers, through print, radio, or TV media in your local markets. With the relative lack of MSA custodian/trustees, the later could prove quite effective.

We would also recommend a strong marketing effort be aimed at small employers. As eligibility for an MSA is limited to employees of employers with 50 or fewer employees, a concentrated effort should be made to aim marketing at this type of employer. The employer needs to be made aware of MSAs. Part of the eligibility requirement is participation in a "high-deductible health care plan." If the employer offers health insurance to its employees, it would have to fall under the parameters for a "high-deductible plan" in order for employees to have an MSA. Demonstrating the cost savings an employer will realize by using this type of high-deductible plan can go a long way towards getting the MSA deposit accounts. Additionally, demonstrating the tax benefits of an MSA for both the employer and the employee will make these attractive to many employers. In many banks, marketing towards employers can be a very targeted effort. In many cases, your personnel will know which customers are the owners of a small business or are self-employed. These are the people that need to be made aware of how MSAs work and of the fact that your institution offers them. Mailings, phone calls or personal visits to these people who are already bank customers should prove effective. This makes the marketing effort more focused and less expensive.

Tied to marketing to the small employer is an effort towards marketing to tax preparers, CPAs, attorneys, and insurance agents. When these tax professionals see the benefits of an MSA to their small employer clients, many will recommend the adoption of a high-deductible plan coupled with the MSAs for the employees. We are seeing a dramatic increase in the number of insurance people working with banks in this area. On a number of occasions we have had insurance agents who sell the high-deductible health plans call us to ask for the names of banks in their area who will offer the MSA deposit account. Working closely with these people will, in our opinion, dramatically increase your MSA deposits. Marketing to these people may be as simple as letting them know you offer MSAs. This can be done through a targeted mailing effort to these professions, through personal phone calls to these types of professionals in the bank's community, and possibly through a seminar aimed at these professionals. The key again is letting them know you have MSAs available. PD

IRS Issues 1997 MSA Form 5498-MSA and 8851

0527 ☐ VOID ☐ CORRECTED

TRUSTEE'S name, street address, city, state, and ZIP code		1 Employee MSA contributions made in 1997 and 1998 for 1997 $	OMB No. 1545-1518 1997	**Medical Savings Account Information**
		2 Total MSA contributions made in 1997 $	Form **5498-MSA**	
TRUSTEE'S Federal identification number	PARTICIPANT'S social security number	3 Total MSA contributions made in 1998 for 1997 $		**Copy A For Internal Revenue Service Center**
PARTICIPANT'S name		4 MSA rollover contributions (not included in boxes 1, 2, or 3) $	5 Fair market value of account $	**File with Form 1096.**
Street address (including apt. no.)				For Paperwork Reduction Act Notice and instructions for completing this form, see the **1997 Instructions for Forms 1099, 1098, 5498, and W-2G.**
City, state, and ZIP code				
Account number (optional)				

Form **5498-MSA** Cat. No. 23097L Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

Instructions to Participant

The information in boxes 1 through 5 is submitted to the Internal Revenue Service by the trustee of your medical savings account (MSA) to report regular or rollover contributions made to your MSA and the value of your MSA.

Generally, contributions you make to your MSA are deductible. However, if your employer makes a contribution to one of your MSAs, you cannot contribute to any MSA for that year. If your spouse's employer makes a contribution to your spouse's MSA, you cannot make a contribution to your MSA. If you did make a contribution to your MSA when an employer has contributed, you cannot deduct your contribution, and you will have an excess contribution.

Box 1. — The amount shown is the contribution you made in 1997 and through April 15, 1998, for 1997. You may be able to deduct this amount on your 1997 income tax return. See the instructions for your income tax return for information about how to deduct contributions. Employer contributions are shown on your Form W-2.

Note: *The information in boxes 2 and 3 is provided by the trustee for IRS use only.*

Box 2.—The amount shown is the total employer and employee contributions made in 1997 to your MSA.

Box 3.—The amount shown is the total contributions made in 1998 for 1997.

Box 4.—This is the amount of any rollover you made to this MSA in 1997 after a distribution from another MSA. See the instructions for your income tax return for information about how to report distributions and rollovers.

Box 5.—This is the fair market value of your account at the end of 1997.

The trustee of your MSA may provide other information about your MSA on this form.

You are not required to attach a copy of Form 5498-MSA to your income tax return. Keep this form for your records.

For more information about MSAs, see Pub. 502, Medical and Dental Expenses.

Trustees, Please Note—

Specific information needed to complete this form and forms in the 1099 series is given in the **1997 Instructions for Forms 1099, 1098, 5498, and W-2G**. You can order those instructions and additional forms by calling 1-800-TAX-FORM (1-800-829-3676).

Furnish Copy B of this form to the participant by June 1, 1998.

File Copy A of this form with the IRS by June 1, 1998. PD

✔✔✔ Check It Out ✔✔✔

Question: May the unrelated business income tax rules apply to self-directed IRAs?

✔ Answer. Yes. In general, Code sections 511-514 set forth the rules for unrelated business income tax. The general concept is that a tax preferred entity (IRA, nonprofit corporation, etc.) should pay tax if it is involved in a business or trade which is unrelated to the primary reason for its existence. The unrelated business tax is just that, a tax. It is not a disqualifying event. If an IRA takes on debt for some investment reason, the unrelated business income tax most likely will be owed. An IRA is generally required to pay income tax on its unrelated business taxable income to the extent such income exceeds $1,000 per year. The form to be filed is the Form 990-T.

Question: Is the mandatory withholding rate for IRAs 10% or 20%?

✔ Answer. The general rules for IRAs are that an IRA custodian must withhold 10% of the distribution amount unless the IRA accountholder instructs you to not have any amount withheld or he or she instructs to withhold more. The IRA accountholder could instruct you to withhold 20%, 30%, 50% or any percentage.

All distributions from a qualified plan which are eligible to be rolled over are subject to a mandatory 20% withholding rate. The fact that the distribution amount is less than $200 does not mean there is no duty to withhold at the rate of 20%.

Question: We have an IRA accountholder who made an excess contribution of $400 per year for tax years 1993, 1994 and 1995. She wants us to pay her the $1,200 plus the related income. She said she called the IRS and they told her to withdraw the $1,200 plus the related income. We called the IRS and they again told us that we should pay out the related income. Is there a requirement that an IRA accountholder must withdraw the related income when he or she withdraws an excess contribution after the due date? What should we tell her?

✔ Answer. There is no requirement for an IRA accountholder to withdraw any related income when he or she withdraws an excess contribution after the due date. The problem is this — the tax code has one set of rules when an excess contribution is withdrawn before the tax return for that year is due, and another set of rules when an excess contribution is withdrawn after the due date of that year's tax return. The rules are not the same. There is a requirement to withdraw the income if the withdrawal of the excess is "before" but not if it is "after" the deadline for filing the tax return. The pertinent portion of the Code section 408(d)(5) is set forth below:

(5) CERTAIN DISTRIBUTIONS OF EXCESS CONTRIBUTIONS AFTER DUE DATE FOR TAXABLE YEAR.

(A) IN GENERAL.—In the case of any individual, if the aggregate contributions (other than rollover contributions) paid for any taxable year to an individual retirement account or for an individual retirement annuity do not exceed the dollar amount in effect under section 219(b)(1)(A), paragraph (1) shall not apply to the distribution of any such contribution to the extent that such contribution exceeds the amount allowable as a deduction under section 219 for the taxable year for which the contribution was paid—

(i) if such distribution is received after the date described in paragraph (4),

(ii) but only to the extend that no deduction has been allowed under section 219 with respect to such excess contribution.

If employer contributions on behalf of the individual are paid for the taxable year to a simplified employee pension, the dollar limitation of the preceding sentence shall be increased by the lesser of the amount of such contributions or the dollar limitation in effect under section 415(c)(1)(A) for such taxable year.

(B) EXCESS ROLLOVER CONTRIBUTIONS ATTRIBUTABLE TO ERRONEOUS INFORMATION.—If—

(i) the taxpayer reasonably relies on information supplied pursuant to subtitle F for determining the amount of a rollover contribution, but

(ii) the information was erroneous,

subparagraph (A) shall be applied by increasing the dollar limit set forth therein by that portion of the excess contribution which was attributable to such information,

For purposes of this paragraph, the amount allowable as a deduction under section 219 shall be computed without regard to section 219(g).

Note: There is no indication that the related income must be withdrawn. We believe the reason is the person will have had to pay the 6% excise tax for having an excess, so there is no need to penalize this person a second time by requiring him or her to withdraw the related income. The 6% tax is a sufficient penalty.

Comment: The IRS is facing budgetary pressures and it is becoming more and more clear that the people who staff their consulting lines are not as well trained as they once were. This is unfortunate, but true.

If she chose to withdraw the related income, it would need to be included in income and subject to the 10% excise tax, if applicable. PD

The Pension Digest invites your questions and comments. Please address to "Check It Out," Collin W. Fritz & Associates, Ltd., P.O. Box 426, Brainerd, MN 56401.

Possible Legislation—*Continued from page 1*

bill would restore the law as it was from 1982-1986 — people would no longer be ineligible to deduct their contributions because they were active participants and their income was too high. This bill also contains the second type of IRA — no deduction, but distributions will not be included in income if certain rules are met. Two members of the House Ways and Means Committee have introduced a similar bill in the House. The two members are William Thomas (R-Cal.) and Richard Neal (D-Mass.).

HOT. President Clinton has contained within his 1998 fiscal budget a proposal which would, over a five- to six-year period, increase the adjusted gross income limits from $35,000 to $70,000 for single individuals, and from $50,000 to $100,000 for married individuals. This would mean more individuals would be eligible to deduct their $2,000 IRA contribution. President Clinton has also proposed that the 10% pre-59 1/2 tax would not apply to distributions used to cover post-secondary education expenses, unemployment expenses and first-time home purchasers.

COLD. Trent Lott (R-Miss.) is the Senate Majority Leader. His position is that increases in the income limits for IRAs will not be included in any final 1997 tax bill. He has stated that there are higher priorities: the $500 per child tax credit, a cut of at least 50% in the capital gains tax rate, and a reduction in federal estate taxes. Senator Lott believes the tax revenues lost by the IRA income limit changes would be too great and therefore he will not support such changes.

Summary

Time again will tell if there will be any tax law change which would restore the IRA deduction. At this time, a slight edge would be given that such a law change will be made. PD