THE Pension Digest

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IRS Grants Special Relief for Certain MSA/Health Plans

One of the eligibility requirements for an MSA is that the person must be covered under a high-deductible health plan. To qualify as a high-deductible health plan, there are two limitations which must be met: the annual deductible limitation and the annual out-of-pocket limitation. Both limits must be met to quality for the MSA.

A high-deductible health plan means a health plan:

"(i) in the case of self-only coverage, which has an annual deductible which is not less than $1,500 and not more than $2,250.

(ii) in the case of family coverage, which has an annual deductible which is not less than $3,000 and not more than $4,500, and

(iii) the annual out-of-pocket expenses required to be paid under the plan (other than for premiums) for covered benefits does not exceed —

(I) $3,000 for self-only coverage, and

(II) $5,500 for family coverage.

Section 220(c)(5) defines family coverage as coverage that is not self-only coverage."

Many people have had questions about how these limits apply to specific situations. The IRS has chosen to issue written guidance. The IRS has issued Rev. Rul. 97-20. It is set forth below. In this Rev. Rul. the IRS discusses two hypothetical situations and issues special relief.

One of the situations which has arisen with respect to some existing health insurance policies is that many "family" health insurance policies impose two annual deductible limits and not just one. There is a per family member limit and a per family limit. For example, the policy may impose a deductible limit of $1,500 on each family member and an overall family deductible limit of $4,000. Under such a policy, a family member who incurs expenses of $2,500 would be entitled to be reimbursed $1,000 because the individual deductible of $1,500 had been satisfied. The MSA rules do not permit this.

The IRS has chosen to grant special relief to people with such family policies. This special relief is temporary. There will come a time when the health policy will need to comply with the statutory requirements.

A health plan which is acquired and becomes effective before November 1, 1997, will not fail to be treated as a high-deductible health plan merely because the plan provides for individual deductibles of at least $1,500 and not in excess of $2,250. These are the same limits which apply for self-only coverage. This special relief is limited. In no event will it terminate before December 31, 1997, or extend past December 31, 1998.

When this special relief ends will depend upon whether or not the family health plan is renewable.

This special relief will apply until the first renewal date on or after December 31, 1997. A health plan that continues in force for an indeterminate period as long as premiums are paid is treated as a health plan that provides for renewals and each premium due date (determined without regard to any grace period) will be treated as a renewal date.

If the policy has a fixed term with no renewal provisions, then the special relief exists for the term of the plan, but not past December 31, 1998.

The complete text of Rev. Rul. 97-20 is set forth below.

Rev. Rul. 97-20

Issues

In the case of family coverage, what constitutes a "high-deductible health plan" for purposes of section 220(c)(2)(A) of the Code?

FACTS

Situation 1

Plan A is a health plan that provides for the payment of medical expenses. Taxpayer X and her family are covered by Plan A.

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Prohibited Transaction Concerns on Sale of a Financial Institution, a Subsidiary, or a Division of Assets

The Department of Labor (DOL) has recently issued a release (USDL 97-82). This notice puts financial institutions which act as trustees of qualified plans and IRAs on notice that there are prohibited transaction concerns when there is a sale of a financial institution, subsidiary or a division of assets.

ERISA requires a trustee to act solely in the interest of the plan, the participants and beneficiaries. Therefore, a financial institution which is a trustee must not exercise its discretion impermissibly in selecting a plan's investment manager or service provider.

The specific situation addressed by the DOL was as follows. A financial institution wished to sell a subsidiary which performed investment management services. This financial institution served as the trustee of numerous pension plans. In exchange for a higher sales price, the selling institution was willing to promise the buyer of the subsidiary that it would agree to retain the subsidiary as the investment manager for many of its pension plans. This contractual pledge of continued business by the trustee (who was the selling corporation) so that the selling corporation would receive a larger selling price was a prohibited transaction. The financial institu-

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Special Relief—*Continued from page 1*

Plan A provides for payment of covered medical expenses for all members of the family after the family's total covered medical expenses exceed $3,000 for the year. Plan A does not provide for payment of covered medical expenses until the family's total covered medical expenses exceed $3,000 for the year, regardless of which family member or members incur those covered expenses. Plan A limits out-of-pocket expenses to $5,000 for any year.

Situation 2

Plan B is a health plan that provides for the payment of medical expenses. Taxpayer Y and his family are covered by Plan B. Plan B provides for payment of covered medical expenses for all members of the family after the family has satisfied a family deductible of $3,000 for the year. Plan B also provides for payment of covered medical expenses of any member of the family after that family member has satisfied an individual deductible by incurring covered medical expenses for the year of at least $1,500. Plan B limits out-of-pocket expenses to $5,000 for any year.

Neither of the special rules regarding the definition of a high-deductible health plan applies to Plan A or B (see section 220(c)(2)(B)).

LAW

The Health Insurance Portability and Accountability Act of 1996, Pub. L. 104-191, added section 220 to the Code to permit eligible individuals to establish medical savings accounts (MSAs) under a pilot project beginning on January 1, 1997.

The section 220(c)(1) definition of an "eligible individual" includes, as one prerequisite for eligibility, the requirement that an individual be covered under a high-deductible health plan. Section 220(c)(2)(A) provides that "[t]he term 'high-deductible health plan' means a health plan —

(i) in the case of self-only coverage, which has an annual deductible which is not less than $1,500 and not more than $2,250,

(ii) in the case of family coverage, which has an annual deductible which is not less than $3,000 and not more than $4,500, and

(iii) the annual out-of-pocket expenses required to be paid under the plan (other than for premiums) for covered benefits does not exceed —

(I) $3,000 for self-only coverage, and

(II) $5,500 for family coverage."

Section 220(c)(5) defines family coverage as coverage that is not self-only coverage.

ANALYSIS AND HOLDING

Situation 1

Plan A provides coverage for Taxpayer X and other members of her family and is, therefore, family coverage within the meaning of section 220(c)(5). Because Plan A provides family coverage, Plan A is a high-deductible health plan only if, as required by section 220(c)(2)(A)(ii), it has an annual deductible that is not less than $3,000 and not more than $4,500. Plan A provides for the payment of covered medical expenses for Taxpayer X or her family members only after the family has incurred covered medical expenses during the year of $3,000. Accordingly, the deductible under Plan A is $3,000. Because Plan A has a deductible that is not less than $3,000 and is not more than $4,500, Plan A meets the requirement with respect to the minimum and maximum deductible for a high-deductible health plan under section 220(c)(2)(A)(ii). Because the annual out-of-pocket expenses required to be paid under Plan A can never exceed $5,000, which is less than $5,500, Plan A is a high-deductible health plan for purposes of section 220.

Situation 2

Plan B provides coverage for Taxpayer Y and other members of his family and is, therefore, family coverage within the meaning of section 220(c)(5). Plan B provides for the payment of covered medical expenses of any member of Taxpayer Y's family if the member has incurred covered medical expenses during the year in excess of $1,500, even if the family has not incurred covered medical expenses in excess of $3,000. For example, if Taxpayer Y incurred covered medical expenses of $2,000 in a year, Plan B would pay $500. Accordingly, depending on which family members incur the covered medical expenses, benefits are potentially available under Plan B even if the family's covered medical expenses do not exceed $3,000. Because Plan B provides family coverage with an annual deductible of less than $3,000, Plan B is not a high-deductible health plan as defined in section 220(c)(2).

CONCLUSION

In the case of family coverage, except as provided in section 220(c)(2)(B), a plan is a "high-deductible health plan" under section 220(c)(2)(A) only if, under the terms of the plan and without regard to which family member or members incur expenses:

(1) No amounts are payable until the family has incurred annual covered medical expenses in excess of $3,000,

(2) Amounts for covered benefits are always payable after the family has incurred annual covered medical expenses in excess of $4,500, and

(3) The annual out-of-pocket expenses required to be paid under the plan for covered benefits do not exceed $5,500.

APPLICATION OF SECTION 7805(b)

Section 7805(b) of the Code provides that the Secretary may prescribe the extent, if any, to which any ruling relating to the internal revenue laws shall be applied without retroactive effect.

Pursuant to section 7805(b), a health plan acquired before November 1, 1997 that provides family coverage that becomes effective before November 1, 1997 will not fail to be treated as a high-deductible health plan merely because the health plan provides for individual deductibles of at least $1,500 and not in excess of $2,250 (the permitted range of deductibles for a high-deductible health plan providing self-only coverage). The relief provided in the preceding sentence will apply until the first renewal date on or after December 31, 1997 (in the case of a health plan that provides for a renewal) or for the term of the health plan (in the case of a health plan that has a specified term and that does not provide for renewal). For purposes of this paragraph, a health plan that continues in force for an indeterminate period as long as premiums are paid and does not otherwise provide for renewal, will be treated as a health plan that provides for renewal and each premium due due date (determined without regard to any grace period) will be treated as a renewal date. In no event will the relief provided in this paragraph terminate before December 31, 1997 or extend beyond December 31, 1998.

Drafting Information

The principal author of this revenue ruling is Felix Zech of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). For further information regarding this revenue ruling, contact Mr. Zech at (202) 622-4606 (not a toll-free number). PD

Reporting/Filing Penalties for IRA and MSA Custodians

The Small Business Jobs Protection Act of 1996 (SBJPA) changed some of the penalties that apply when an IRA custodian/trustee fails to file correct information returns with the IRS or fails to furnish correct payee statements. The SBJPA created new penalties with respect to MSAs.

These law changes apply to forms required to be filed after December 31, 1996. Thus, those penalties apply to 1996 tax year forms required to be filed in 1997.

FORM 5498 (IRAS). The penalties/rules did not change. Code section 408(i) provides that the penalty for failure to timely file Form

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Reporting—*Continued from page 2*

5498 is $50 per return with no maximum, unless the failure is due to reasonable cause.

FORM 1099-R (IRAS). The penalties/rules were changed dramatically. Distributions are not reportable unless they aggregate $10 or more in any calendar year. And the penalties under Internal Revenue Code section 6721 and 6722 now apply. That is, the old penalty of $25 per day to a maximum of $15,000 no longer applies. A more detailed discussion of the penalties which apply to Form 1099-R under Code sections 6721 and 6722 is set forth below after a short summary of the penalties for the MSA forms.

FORM MSA-5498 AND 1099-MSA (MSAS). Code section 220(h) provides the penalty for failure to timely file Form 5498 is $50 per return with no maximum, unless the failure is due to reasonable cause.

Discussion of Penalties Under Code Section 6721 and Section 5722

Code section 6721 imposes the rules/penalties for when an IRA custodian/trustee fails to file a correct information return with the IRS by the required due date.

The penalty of Code section 6721 applies if an IRA custodian/trustee fails: (1) to file timely; (2) to include all information required to be shown on the return; (3) incorrect information is included; (4) a paper form is submitted when the IRA custodian/trustee was required to file on magnetic media; (5) a wrong TIN or no TIN is reported; or (6) paper forms are filed but they are not machine readable.

The amount of the penalty under Code section 6721 is based on when you file the correct information return and whether or not your financial institution qualifies as a small business. To qualify as a small business for this purpose, average annual gross receipts for the three most recent tax years ending before the calendar year in which the information returns were due are five million or less.

The penalty for failing to send the right information to the IRS is:

1. $15 per return if correctly filed within 30 days to a maximum of $25,000 per year for a small business or $75,000 for a non-small business;

2. $30 per return if correctly filed more than 30 days after the due date, but by August 1, to a maximum of $50,000 per year for a small business, or $150,000 for a non-small business.

3. $50 per return if filed after August 1 or if not filed, to a maximum of $100,000 per year for a small business, or $250,000 for a non-small business.

The penalty amount increases to $100 per return with no maximum penalty if the entity required to file intentionally disregards filing either the original or corrected returns.

In the following situations, the penalty amount otherwise owing will either not need to be paid or will be reduced:

1. If there is a reasonable cause and the errors were not due to willful neglect.

2. If the error or omission is considered to be inconsequential. To be inconsequential, even after the error or omission, the IRS must be able to process the return so that the information required to be reported on the return correlates with the payee's tax return. The following errors or omissions are never inconsequential: (A) those relating to the TIN, (B) those relating to the surname; and (C) any dollar amounts.

3. If you submit "corrected" returns by August 1 for a certain number of returns, then the penalty for filing incorrect returns (but not filing late) will not apply to the greater of 10 information returns or .005 of the total number of information returns you are required to file for the calendar year.

There is no forgiveness if you failed to file the original return. To gain this special treatment, three conditions must be met: (A) the original return was filed; (B) that original return was wrong either because you failed to include all required information or some of that information was wrong; and (C) a corrected return is filed by August 1.

Code section 6722 imposes the rules/penalties for when an IRA custodian/trustee fails to provide an IRA accountholder or beneficiary with a correct information return by the required due date.

The penalty of Code section 6722 applies if an IRA custodian/trustee fails: (1) to furnish the statement by January 31; (2) to include all information required to be shown on the return; or (3) incorrect information is included on the statement.

The amount of the penalty under Code section 6722 is NOT based on when you file the correct information return and whether or not your financial institution qualifies as a small business.

The penalty is $50 per statement, regardless of when the correct statement is furnished with a maximum of $100,000 per year. There is no reduction in the penalty for furnishing a corrected statement by August 1. The penalty amount increases to $100 per return with no maximum penalty if the entity required to file intentionally disregards filing either the original or corrected returns.

In the following situations, the penalty amount otherwise owing will either not need to be paid or will be reduced:

1. If there is a reasonable cause and the errors were not due to willful neglect.

2. If the error or omission is considered to be inconsequential. To be inconsequential, even after the error or omission, the recipient will be able to properly prepare his or her tax return. The following errors or omissions are never inconsequential: (A) those relating to a dollar amount; (B) a payee's address; (C) the use of the appropriate reporting form or qualifying substitute statement; and (D) whether the statement was furnished in person or by statement mailing when required.

Summary

New penalties/rules apply to IRA and MSA reporting forms to be filed in 1997 and subsequent years. Your institution must have procedures in place to make sure the returns are being prepared correctly and furnished to the IRS and your IRA accountholder/beneficiaries on a timely basis. It is more important than ever that corrections are completed as soon as possible.

Q&A
PROHIBITED TRANSACTIONS

We recently received two consulting calls that were concerned with prohibited transactions. Again, a prohibited transaction (PT) is a transaction which is defined in Code section 4975.

If an IRA is involved in a PT, then the IRA is deemed distributed on the first day of such year and thus becomes taxable. The amount of income tax which is owed can be very substantial. If a Qualified Plan (QP) is involved in a PT, then there will be an excise tax of either 10% or 100% assessed.

Question/Situation #1

An IRA custodian had an IRA accountholder with a self-directed IRA. This IRA accountholder had retained a registered investment advisor and estate planner. This advisor was going to render financial planning services with respect to her IRA and also with respect to her non-IRA investment and personal situation. She signed a service agreement and promised to pay $7,000 for these advisory services. She has now called you (i.e. the IRA custodian) because she wants to have her IRA pay $6,000 of the $7,000 fee. The service agreement does not expressly address the IRA funds. Are there prohibited transaction concerns?

Yes. For the following reasons, you should not agree with her request unless she would provide you with her attorney's opinion that this agreement would not result in a prohibited transaction — now or in the future.

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This is a "joined relationship" situation. A "joined relationship" is one which involves an IRA and the person for whom the IRA was established.

Code section 4975 sets forth the prohibited transaction rules. Very simplistically, the law does not permit an IRA accountholder to enjoy a benefit outside of his or her IRA because he or she maintains an IRA. The simple concept is — all earnings must go to the IRA. In the same fashion, expenses which are personal cannot be allocated to the IRA. There is a tax incentive for a person to allocate expenses to an IRA rather than pay them personally. By allocating such expenses to the IRA, the effect is very similar to that of being allowed a deduction. Most distributions from an IRA will be taxed. Thus, when an IRA pays an expense it has the result of reducing an amount that otherwise should be taxed.

The service agreement, as drafted, does not in any way attempt to define what services would be rendered to the IRA and what the fees would be. The contract simply says services will be rendered to her.

The IRA must pay only for the investment and distribution planning which is furnished to the IRA (on account of the IRA). There would be serious problems (a PT would occur) if an IRA accountholder had her IRA pay expenses which were "personal" expenses.

The IRA accountholder should speak with his or her own legal advisor.

It would be permissible to have two service agreements — one with respect to the IRA and one with respect to financial planning. The contracts should make clear that they are two separate contracts, and they are not dependent on each other. Whatever amount would be charged to the IRA should be supported by evidence that shows the IRA paid the proper fee and that part of the "personal" fee was not transferred to the IRA.

Question/Situation #2

An individual has assumed the position of Senior Vice President of Sales and Marketing for a computer software company. She wishes to buy corporate stock as follows: $40,000 will come from her personal fund, and $40,500 will come from her IRA. She will own approximately 1% of the corporate shares. She has signed a three-year employment contract.

This situation also presents a "combination" situation. That is, there is a combining of IRA funds and non-IRA funds to make an investment. Although it could be possible that there may also be a "tie" between the employment agreement and her desire or requirement to purchase the stock. There would be a PT whether or not there were these additional "ties."

Code section 4975 (c) defines what a prohibited transaction is. Under subsection (1)(D), a PT occurs when there is a direct or indirect transfer to, or use by or for the benefit of a disqualified person of the income or assets of the plan. Under (E) a PT occurs when a fiduciary deals with the income or assets of a plan in his own interest or for his own account.

Because she is self-directing her IRA, she is a fiduciary. Thus, she is a fiduciary and a disqualified person for that reason alone. There is no need to look at the percentage of ownership to see if she is a disqualified person under a different category.

It certainly appears that by using the IRA funds she is benefitting "outside of the IRA" as well as possibly benefitting the IRA. One may question whether the law should be written as it is, but as written, this proposed transaction would be a prohibited transaction under the DOL's current interpretation. The fact that she is a senior officer is another factor which shows that there is a great chance for a conflict of interest. PD

PT Concerns—*Continued from page 1*

tion had to pay a $1,800,000 settlement to resolve this situation.

The reason this ruling is mentioned in this newsletter is because there may well be prohibited transaction concerns with respect to other situations when the sale of IRA and pension accounts are involved in the sale of the institution itself, a subsidiary, a division, or assets of the institution.

For example, is it legally permissible for a financial institution to sell its pension plan and IRA accounts and to receive an express "profit"? The law is less than settled on this issue. A financial institution's counsel should certainly be aware of this issue when structuring the sales/purchase agreement. It may well be best that no dollar value be placed within the sale/purchase agreement on the pension or IRA accounts which are to be transferred. PD

✔✔ Check It Out

Question: Is there ever a time when the RMD elections made by a person who is older than 70 1/2 will not bind the beneficiary?

✔ Answer. Yes. The general rule is that an inheriting beneficiary of an IRA accountholder who establishes his or her 70 1/2 payout schedule must either continue that schedule or change the schedule by taking more than would have been required by the deceased accountholder's schedule.

The following factual situation illustrates an exception.

A prospective IRA customer (i.e. an IRA beneficiary) has come to you with the following situation. She is the beneficiary of her mother's IRA. The mother had established her IRA with a brokerage firm. Its value was approximately $240,000 on December 31, 1996. The mother had been born on September 24, 1925. Since she turned 70 1/2 in February of 1996, she had completed a form in March of 1996, establishing her payout schedule. For some reason she elected the single life expectancy/recalculation method. The mother died on December 30, 1996. This daughter wishes to transfer the $240,000 to your institution.

Will the daughter need to withdraw the $240,000 by December 31, 1997, because her mother had elected to use the single/recalculation method?

No, not in this situation. Even though the mother had made her elections and established her payout schedule after attaining age 70 1/2, she died before her required beginning date (April 1, 1997). Thus, the daughter beneficiary is not bound by the mother's election since it does not become binding until the end of the day on April 1, 1997.

The daughter/beneficiary is eligible to use either the five-year rule or the life-distribution rule to satisfy the RMD rules which apply to inherited IRAs. I expect she will wish to elect the life-distribution rule because of the large size of the IRA ($240,000).

Keep in mind that "inherited" IRAs may be transferred from one IRA custodian/trustee to another IRA custodian/trustee, but a rollover (payment to a beneficiary and a redeposit) is never permissible. PD

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