THE Pension Digest

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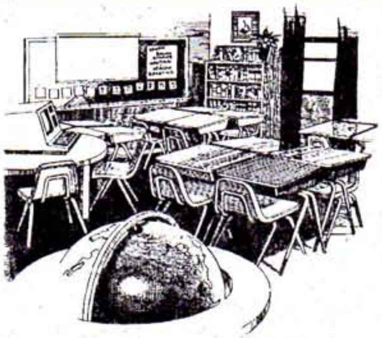
The Education IRA



On January 1, 1998 a new and unusual type of IRA will come into existence. It is called "The Education IRA." The Education IRA (EIRA) will provide a new type of savings tool whose purpose is to provide for the educational expenses of a beneficiary of the account. This article will address how the account works, the rules that govern contributions to and distributions from the account, and certain topics related to this IRA where further guidance from the IRS is needed.

This new type of IRA will result in new deposits for financial institutions. The Education IRA offers significant tax advantages that will make this account more attractive than many other types of savings vehicles. Many individuals in the past have saved for their children's education with normal savings vehicles or UGMA's (Uniform Gift to Minors Accounts). It would appear that a significant portion of this type of savings will shift to the Education IRA. We expect many individuals to utilize this new and unique savings opportunity.

INTRO TO THE EDUCATION IRA

An Education IRA is a trust or custodial account that is established for the purpose of paying the qualified higher educational expenses of the designated beneficiary of the account. An individual will be allowed to fund the account for the designated beneficiary up to certain levels, and distributions from the account that are used for qualified educational purposes will not be subject to income tax.

Custodian/Trustee Requirement

The Education IRA must have a trustee or custodian. The trustee/custodian can be any entity that qualifies to be an IRA trustee/custodian, i.e. banks, insurance companies, credit unions, savings banks, brokerage firms, etc.

Plan Document Requirement

The Code makes it very clear that a written plan document will be required to establish this new type of IRA. The document will be a trust or custodial document. At the current time it is not yet known whether the IRS will be issuing Education IRA plan documents similar to those they have issued for regular IRAs, i.e. the 5305 and 5305-A. It is our feeling that the IRS will issue a Model plan agreement for use with the Education IRA.

Title of Account

One of the most confusing issues at this point is determining exactly how these Education IRAs will be titled. The account is established by an accountholder for the benefit of a designated beneficiary. The question is, "in whose name is the account to be titled?"

It would appear to us at this time that the account would be titled in the following manner: First National Bank, Custodian for the John Smith's EIRA, FBO James Smith. In other words, the title will probably have to identify the accountholder and the beneficiary for whose benefit the EIRA is being established. We feel this will be the case due to the contribution rules that will be discussed below. Guidance from the IRS will be necessary in order to determine exactly how to title these accounts.

It does seem apparent that a separate Education IRA will have to be established for each beneficiary. An individual could not establish one Education IRA and contribute for multiple beneficiaries under that same document.

CONTRIBUTION RULES FOR THE EIRA

General Rules

In general, contributions of up to $500 a year per beneficiary under the age of 18 can be made to an Education IRA. Simply put, this means that if an individual had three children, the individual could contribute $500 to an Education IRA for each child. As such, there would be total contributions of $1,500 by the individual in the year. Again, a separate EIRA would be necessary for each beneficiary.

The $500 limit is a per beneficiary limitation. Simply put, this means that in one tax year, no beneficiary can receive more than $500 in total contributions to Education IRAs. The $500 limit is tied to the beneficiary and not the individual making the contribution.

1. Age Limit - Education IRA contributions cannot be made after the date the beneficiary attains age 18.

This rule presents an interesting situation. All other contributions hinge on what occurs in a particular tax year. The Code section dealing with this age limit seems to indicate that an Education IRA contribution can be made in the year the beneficiary attains age 18, as long as it is made prior to the actual day the beneficiary will reach that age.

2. Contributions must be made in cash.

3. No part of the Education IRA may be invested in life insurance.

4. The assets of the Education IRA may not be commingled with any other assets except in a common trust or investment fund.

5. Contribution Deadline - The new Code section pertaining to Education IRAs does not specify the contribution deadline. While the deadline is not specified, we would anticipate that it would be the same as for all other types of IRAs. This would be the deadline for filing individual federal tax returns, without extensions (i.e. April 15 of the following year).

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Income Limitations

As seen under the general contribution rules, the Education IRA contribution that can normally be made is $500 a year per beneficiary of an Education IRA. The contribution amount, however, will be phased out for individuals whose income exceeds certain levels. The levels where contributions are phased out are dependent on the individual's tax-filing status.

A single individual will begin to have an Education IRA contribution phased out at $95,000 of modified adjusted gross income (MAGI) and will lose the ability to make any contribution when their MAGI exceeds $110,000 in the year.

A married couple, filing a joint tax return, will begin to have an Education IRA contribution phased out at $150,000 of modified adjusted gross income and will lose the ability to make any contribution when their MAGI exceeds $160,000 in the year.

Tax Filing Status	Threshold Level	Phaseout Level
Single	$ 95,000	$110,000
Married Filing Joint Return	$150,000	$160,000

What this table means is that a single individual who earns less than $95,000 can contribute the full $500 amount to an Education IRA for each beneficiary of such account. The same is true for a married couple earning less than $150,000 and filing a joint return. While the new Code is not clear on this point, it does appear that married individuals who file separate tax returns may not contribute to an Education IRA.

A single individual who earns more than $110,000, and a married couple that earns more than $160,000, may not make any contribution to an Education IRA. Note that the income limitations apply to the individual who is making the contribution. The contribution limit of $500 per year applies to the beneficiary of the account.

Those individuals who fall between the threshold and phaseout levels must use a special formula to determine how much they can contribute to the Education IRA for a year. The formulas used for a single individual and a married couple filing a joint return are different. They are shown below.

Single Taxpayer Formula:
MAGI - $95,000/$15,000

Married Filing Joint Return:
MAGI - $150,000/$10,000

These formulas will provide a ratio that must be multiplied by the amount the individual would be eligible to contribute absent the income limitations or, in other words, $500. The result of this calculation is the amount by which the contribution must be reduced in order to determine what amount the person can contribute. Some examples are in order to demonstrate how these formulas will work.

Example 1 - George Bailey is a single taxpayer who earned $105,000 in 1998. He wishes to make a contribution to an Education IRA for each of his two children. How much can he contribute to an Education IRA for each child?

The formula to calculate George's Education IRA contribution is shown here.

Step 1	$105,000 - $95,000 / $15,000
Step 2	$10,000 / $15,000 = .666666667
Step 3	$500 X .6666666667 = $333.33
Step 4	$500 - $333.33 = $166.67

George could contribute up to $166.67 to an Education IRA for each child for the 1998 tax year.

Example 2 - John and Lori Child earned $154,000 in 1998 and file a joint tax return. They wish to make contributions to an Education IRA for their son. How much can they contribute to an Education IRA?

Step 1	$154,000 - $150,000 / $10,000
Step 2	$4,000 / $10,000 = .4
Step 3	$500 X .4 = $200
Step 4	$500 - $200 = $300

John and Lori could contribute up to $300 to an Education IRA for their son in 1998. Note that the contribution for their son is a total of $300. It is NOT $300 contributed by John and another $300 contributed by Lori. The total contribution for their son made by John and Lori cannot exceed $300.

Other Limitations

1. Multiple IRAs - The $500 limitation on contributions for each beneficiary cannot be circumvented by establishing multiple Education IRAs for the beneficiary and having different individuals make the contributions. Remember that this contribution limitation is tied to the beneficiary, not the actual contributor. No beneficiary can have more than $500 in contributions made to Education IRAs in one year on their behalf.

2. Other Education Programs - No Education IRA contribution can be made on behalf of a beneficiary in a year where any contribution is made to a qualified state tuition program on behalf of that beneficiary.

The term "qualified state tuition program" is defined in Internal Revenue Code Section 529. The applicable portion of this section is produced below.

> The term "qualified state tuition program" means a program established and maintained by a State or agency or instrumentality thereof—
>
> 529(b)(1)(A) under which a person–
>
> (i) may purchase tuition credits or certificates on behalf of a designated beneficiary which entitles the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary, or
>
> (ii) May make contributions to an account which is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account.

Contribution Reporting

At the current time there has not been any IRS announcement regarding the reporting requirements for contributions to Education IRAs. We anticipate that there will be a year-end fair market value statement requirement similar to that for other IRAs and that there will be a special 5498 for contribution and fair market value reporting to the IRS. It is also not yet clear who will have to receive any required IRS reports. While it is apparent that the IRS will receive some type of reports, it is not clear what reports will have to be provided to the contributor and what will have to be provided to the beneficiary of the Education IRA.

Other Tax Issues With Contributions

Contributions to an Education IRA on behalf of the beneficiary are considered to be completed gifts to that beneficiary. These contributions are eligible for the gift tax exclusion found in Code section 2503(b). Additionally, contributions to an Education IRA are excludable for purposes of the generation-skipping tax. This basically means that an individual could contribute to the EIRA of a grandchild without the imposition of the generation-skipping tax.

DISTRIBUTIONS

Distributions Excludable from Income

Distributions from an Education IRA will be excluded from income tax to the extent that the distributions do not exceed the qualified higher education expenses incurred by the beneficiary of the account in the year of the distribution.

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1. Qualified Educational Expenses Defined

Qualified educational expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution. Distributions used for these expenses will be excluded from income tax, regardless of whether or not the beneficiary is a full-time, half-time, or less than half-time student. Distributions will also be excludable, for students who are carrying at least one-half of the normal full-time course load, when used for the reasonable expense amounts incurred for room and board. Reasonable expense amounts for room and board are determined by the institution in calculating costs of attendance for federal financial aid programs. Qualified education expenses also include any purchase of tuition credits or any amount contributed to a state tuition program for the beneficiary.

Qualified education expenses do not include any elementary or secondary education expenses.

2. Eligible Educational Institutions Defined

An eligible education institution is generally any accredited college, university, junior college, community college or postsecondary vocational institution offering credit towards an associate, bachelor's, graduate or professional degree, or other recognized postsecondary credential. To be eligible, the educational institution must be eligible to participate in a Department of Education student aid program.

3. Adjustments to Education Expenses Eligible for Tax-free Distribution

The amount of educational expenses for which a distribution from an Education IRA can be used and not be subject to the tax, must be reduced by the amount of any qualified scholarship, educational assistance allowance, or payment that is excludable from the beneficiary's gross income.

4. Limitation on Exclusion

The exclusion from income tax for distribution from an Education IRA will not be available in any year in which a HOPE credit or Lifetime learning credit is claimed.

Non-Excludable Distributions

Distributions that are not used for the qualified education expenses of the beneficiary, or those that exceed the education expenses of the beneficiary, will be subject to income tax and a possible penalty.

1. Income Tax

As stated, distributions that are not used for qualified education expenses will be subject to income tax. Additionally, any portion of a distribution that exceeds the amount of the beneficiary's qualified education expenses for the year will also be subject to tax. Generally, however, it is not the entire distribution amount that will be taxable, but rather a portion of the distribution.

Any distribution from an Education IRA is treated as being made from both the contributions to the EIRA (always tax-free) and the earnings the account has experienced. It is the earnings in the account that the exclusion from income this account enjoys applies to. As such, if a distribution, or a portion of it, is subject to tax, it will be taxed on a pro rata basis. This pro rata determination is often a two-step process. The first step is to determine what portion of the distribution is attributable to contributions and what portion is attributable to earnings.

The amount of contributions deemed distributed is determined by multiplying the amount of the distribution by the ratio that the total amount of contributions bears to the total balance of the EIRA at the time the distribution is made. An example is in order.

Jill Wilson takes a $2,000 distribution from her Education IRA for non-educational purposes. At the time of the distribution there has been $7,000 contributed to the EIRA. The balance of the EIRA on the date of the distribution was $10,000. The formula to determine what portion of the distribution consists of contributions is shown here.

$2,000 X $7,000/$10,000

$2,000 X .7 = $1,400

In this example, $1,400 is treated as the distribution of contributions and as such is not subject to income tax. The remaining $600 will be subject to tax and to possible penalties.

The second step may or may not be necessary. It is only necessary when part of a distribution is used for education expenses and part is not. In that case, a portion of the distribution used for qualified education expenses is considered to be basis and a portion is attributable to earnings. The earnings portion used for education expenses is not taxable. The same holds true for the part of the distribution that was not used for qualified education expenses. A part of that consists of basis or contributions, and a part consists of earnings. This earnings portion will be taxable. The portion of the total earnings distributed that will not be taxable is based on the ratio that the qualified higher education expenses bears to the total amount of the distribution. An example follows.

Sue Morgan takes a $1,000 distribution from an Education IRA. This consists of $800 in contributions and $200 in earnings. She uses $600 of the distribution to pay education expenses. The portion of the $200 in earnings that is not taxable is calculated as shown here.

$800/1000 = .8

$200 X .8 = $160.00

As such, $160 of the excess portion of the distribution will not be taxable, and $40 will be.

UNANSWERED QUESTIONS - Do these pro rata calculations apply separately to each Education IRA of which the individual is the beneficiary, or are these calculations applied to all Education IRAs for the individual in aggregate? The answer is not yet known. Guidance is needed from the IRS. It is our best guess that the IRS will require that all the Education IRAs established for the beneficiary be aggregated.

2. Penalty Tax Issues

Any part of a distribution that is subject to tax because it was not used for qualified education expenses will also be subject to a 10% penalty tax. The only exceptions to this are listed below.

a. A distribution that is made to a beneficiary due to the death of the designated beneficiary of the Education IRA.

b. A distribution made to the designated beneficiary due to the permanent and total disability of that designated beneficiary.

c. A distribution made on account of a scholarship or allowance received by the accountholder to the extent the amount of the distribution does not exceed such scholarship or allowance.

d. A distribution of an excess contribution and earnings, on or before the tax filing deadline.

3. Tax or No Tax - A Choice

The new tax Code section creating the Education IRA very clearly states that the beneficiary of the EIRA can choose not to have the exclusion from income provisions apply to a distribution used for qualified education expenses in any year. In other words, the beneficiary could choose to pay tax on the distribution.

Why would they do this? This goes back to a rule mentioned earlier. A distribution from an EIRA cannot be excluded from income in a tax year where the HOPE credit or Lifetime learning credit is claimed. This rule for the EIRA seems to say that you can take distributions to pay ongoing expenses, and then decide at tax-filing time whether to exclude the distribution from income or use one of these credits.

Distribution Reporting

At this time none of the distribution reporting requirements for the Education IRA are known. We know there will be some sort of 1099-R reporting requirement. What is not known is whether or not there will be a special 1099-R (we anticipate one), and what

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information the IRS will ask the custodian/trustee to include on the form. Watch for these requirements.

ROLLOVERS

Rollover Transaction

A rollover can be made from one Education IRA to another, for the same designated beneficiary. The rollover must be completed within 60 days.

A rollover can also be made from one Education IRA for one designated beneficiary, to an Education IRA for a different designated beneficiary within 60 days with no tax consequence. In order for this to occur, the new designated beneficiary must be a "family member" of the prior designated beneficiary.

The following individuals are considered to be family members of the designated beneficiary.

1. A son or daughter of the taxpayer, or a descendant of either,
2. A stepson or stepdaughter of the taxpayer,
3. A brother, sister, stepbrother, or stepsister of the taxpayer,
4. The father or mother of the taxpayer, or an ancestor of either,
5. A stepfather or stepmother of the taxpayer,
6. A son or daughter of a brother or sister of the taxpayer,
7. A brother or sister of the father or mother of the taxpayer,
8. A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer.

In either type of rollover situation, the rule is that there can only be one Education IRA rollover per designated beneficiary in a 12-month period.

Redesignation of Account

The Code indicates that it is also possible to change the designated beneficiary, i.e. the person for whose benefit the EIRA is established, to another person. Again, the new designated beneficiary must be a family member of the prior designated beneficiary. If they are not, the change will result in a distribution and taxable income.

Question - Who can make this change, the contributor or the first designated beneficiary? The answer to this question is not yet clear. IRS guidance is needed.

OTHER EIRA ISSUES

Required Distributions

While the Code does not mention any time where distributions must be made from an EIRA, the Conference Committee Notes indicate that any funds remaining in an EIRA at the time the designated beneficiary attains age 30, will have to be distributed, and the earnings will be subject to tax. The Committee notes do indicate that the beneficiary could be changed prior to that time under the rules previously discussed in this section, and as such, distributions would not have to occur. It would appear that a technical correction to the Code is needed to address this issue.

Designated Beneficiary Designating a Beneficiary

While the heading to this section may appear to be a tongue twister, it is a real issue. The Code indicates that the designated beneficiary can designate a beneficiary to the account. The result of this designation and the tax implications differ depending on who the named beneficiary is. The Code states that the EIRA will be treated in the same manner as Medical Savings Accounts. The Medical Savings Account beneficiary rules are reproduced below.

220(f)(8) Treatment If Designated Beneficiary Is Spouse

If the accountholder's surviving spouse acquires such holder's interest in a Medical Savings Account by reason of being the designated beneficiary of such account at the death of the accountholder, such Medical Savings Account shall be treated as if the spouse were the accountholder.

220(f)(8)(B) Other Cases

220(f)(8)(B)(i) In General

If, by reason of the death of the accountholder, any person acquires the accountholder's interest in a Medical Savings Account in a case to which subparagraph (A) does not apply—

(I) such account shall cease to be a Medical Savings Account as of the date of death, and

(II) an amount equal to the fair market value of the assets in such account on such date shall be includible if such person is not the estate of such holder, in such person's gross income for the taxable year which includes such date, or if such person is the estate of such holder, in such holder's gross income for the last taxable year of such holder.

What this means is that if the spouse of the designated beneficiary is the named EIRA beneficiary, at the time of the designated beneficiary's death the rules state that the EIRA automatically becomes the EIRA of the spouse. If a nonspouse is the beneficiary, on the date of death, the EIRA ceases to be an EIRA and the fair market value on that date becomes taxable income to the nonspouse beneficiary in the year of death.

NOTE: These rules relating to the designated beneficiary naming a beneficiary present an interesting problem. The Code very clearly states that the rules discussed above are applicable to an EIRA. However, the Code also specifies some of the language provisions that must be contained in the trust/custodial EIRA plan agreement. One of those required provisions states that upon the death of the designated beneficiary, the funds must be distributed to the estate of the designated beneficiary within 30 days. This document requirement does not correspond to the Code section relating to the naming of a beneficiary by the designated beneficiary. What the requirements and options relating to this topic are is a very important issue the IRS will have to address.

Excess Contributions

An excess contribution to an EIRA can occur in two different situations. The first type of excess would occur if more than $500 was contributed to EIRAs for the same designated beneficiary for one tax year. The second type of excess would occur if any EIRA contribution was made on behalf of a designated beneficiary for the same year that any contribution was made to a qualified state tuition program.

In order to avoid penalties in an excess situation, the excess EIRA contribution and the related earnings must be withdrawn on or before the tax-filing deadline, including extensions. The excess will not be taxable. The earnings attributable to the excess contribution will be taxable income.

SUMMARY

There are many unanswered questions and issues surrounding the Education IRA. Reporting requirements, documents, and various tax issues all need to be addressed by the IRS.

The opportunities with the EIRA are great. This new type of IRA should generate new savings deposits for financial institutions. It is our feeling that these new accounts will generate a great deal of interest. As more information becomes available CWF will keep you informed as to any new requirements, clarifications, and all the forms and document issues. PD