THE Pension Digest

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Education IRAs

Beginning January 1, 1998, individuals were allowed to establish the new Education IRA. The only difficulty was that the IRS had not issued any Model Education IRA documents nor had they announced any document requirements. Later in January the IRS did issue Model Education IRA plan agreements, the 5305-E trust document and the 5305-EA custodial document. These documents contain a few surprises. We will discuss what the documents say and perhaps, most importantly, the completion of the document.

Both Model plans, the 5305-E and the 5305-EA, contain ten articles that are written by the IRS. The language is these articles may not be altered. The first surprise with the document, however, is that two of the articles, Article VI and Article VII contain options that the individual contributing to the account needs to complete. This will be discussed further in the section dealing with completion of the document. An optional article, Article XI, can be added to the document. Article XI, while not required, is strongly recommended. This is where a custodian/trustee can specify additional contractual provisions relating to the Education IRA.

Completion of the Education IRA Plan Agreement

When an Education IRA is established, a plan document must be completed and executed. Completion of an Education IRA document will be somewhat different from completing any other IRA plan agreement.

Certain information must be obtained from the depositor and other information must be provided to the depositor and other parties. This information is normally found in the application. With the Education IRA, parts of the plan agreement itself also need to be completed. The Education IRA application is unique in that information may need to be gathered for three individuals. They are the Depositor (the person making the contribution), the designated beneficiary (the person on whose behalf the contribution is being made), and the "responsible individual." The "responsible individual" is the parent or legal guardian of the designated beneficiary.

Application Completion

Information that needs to be completed on the application includes the name and social security number of the Depositor. While the IRS form does not require any

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Proposed Changes to RMD Rules for Trust as Beneficiary

The IRS has proposed two changes to the Required Minimum Distribution (RMD) rules as currently set forth in proposed regulation 1.401(a)(9).

The First Change. The prior rule provided that if a revocable trust was named as the designated beneficiary of an IRA that the life-expectancy factor to be used in the RMD calculation was required to be based upon the single life-expectancy factor of the IRA accountholder. The proposed rule permits the use of a joint life-expectancy factor (i.e. the accountholder and the "oldest" beneficiary of the revocable trust) provided the revocable trust becomes irrevocable upon the death of the accountholder.

Most "single" revocable trusts will meet this requirement. Most "dual" revocable trusts will not meet this requirement with respect to the first spouse to die. A dual revocable trust is created where both spouses contribute their property to one trust with both spouses serving as joint trustees. The trust normally stays a revocable trust even if one spouse dies, but will become irrevocable after the second spouse dies.

The Second Change. The IRS has created an alternative way to enable an IRA accountholder to certify who the beneficiaries of his or her trust are rather than having to furnish a copy of the trust instrument by the earlier of the required beginning date or the date of the accountholder's death. The obvious purpose of the requirement to furnish a copy of the trust instrument to the IRA custodian/trustee was to allow the custodian/trustee to determine who the beneficiaries were and how and when the funds were to be distributed. By definition, an irrevocable trust could not be changed or amended. With the possibility that a revocable trust may be amended, the IRA accountholder must now agree to provide a copy of any trust amendment within a reasonable period of time after the change.

An IRA accountholder must meet four requirements to qualify for the alternative method.

First, an IRA accountholder must provide a list of all of the beneficiaries of the trust (including the contingent and remain-

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derman beneficiaries) with an explanation as to when each would become entitled to receive any portion of the trust property.

Second, the IRA accountholder must certify in writing that the list is correct and complete, that the trust is valid under state law, or would be but for the fact that there is corpus; the trust is irrevocable under state law or will, by its terms, become irrevocable upon the death of the accountholder; and the beneficiaries of the trust who are beneficiaries of the IRA are identifiable.

Third, the IRA accountholder must agree to provide certifications to the extent any amendment changes any information previously certified.

Fourth, the IRA accountholder agrees to provide a copy of the trust instrument to the IRA custodian/trustee upon its demand.

This alternative certification method applies for required distributions commencing before death.

The requirements are slightly different for required distributions after the IRA accountholder has died. By the end of the ninth month beginning after the death of the IRA accountholder, the trustee of the trust which is the beneficiary must either provide a copy of the trust instrument or provide the list and the other certifications and requirements discussed above (including the requirement to furnish a copy of the trust instrument upon demand).

What happens if the certifications prove to be incorrect because they differ from what the trust instrument actually provides? There are two concerns—what minimum amount must be distributed from the plan to comply with the plan document, and how will the 50% excise tax be determined?

As long as the IRA custodian/trustee was reasonable to rely on the certification, then the IRA will not be disqualified. The concept of whether or not an IRA could be disqualified for noncompliance with the RMD rules is an unsettled legal issue, but in the right situation one can expect the IRS to present this argument. Once aware of the difference, the IRA custodian/trustee must apply the change in beneficiary rules; the change will apply for the year after the year of the discovery. Whether or not the 50% excise tax is owed will be determined by applying for each and every year based upon the actual terms of the trust instrument. Thus, the IRA accountholder bears the tax risk if his or her certifications are incorrect and the required distribution is less than what it actually should be.

Effective Date of New Rules

The regulation does not address whether or not this change is prospective or retroactive? Illustration—John Doe currently is 74 and he has been using a single life-expectancy factor because he had designated his revocable trust as his beneficiary. Under this trust he had named his three children as his beneficiaries. May he now start to use a joint factor rather than continuing the single factor he had been using? Normally, a proposed change to a regulation is treated as if it had been included in the initial proposal. Thus, the change is normally retroactive. Hopefully, the IRS will clarify this issue.

IRS Issues a Revised Form 5305A-SEP

In late December of 1997 the IRS issued a revised Form 5305A-SEP, Salary Reduction and other Elective Simplified Employee Pension—IRA Contribution Agreement.

As you remember, The Small Business Jobs Protection Act of 1996 made several changes to the laws affecting SEP plans, including SAR-SEPs. Because of these changes the IRS needed to revise its SEP model plan agreement forms. The primary changes were: prohibited the establishment of new SAR-SEP plans after December 31, 1996; repealed the family aggregation rules, and created a new definition of who is a highly-compensated employee. The family aggregation rules required the combining of compensation and elective deferrals for purposes of applying the special ADP test which exists for SAR-SEP plans. The deferral percentage for any highly-compensated employee may not be more than the average ADP for the eligible nonhighly compensated employees as multiplied by 1.25.

Be aware that even though the family aggregation rules have been repealed, the rules which require the application of the family attribution rules when determining if someone is a highly-compensated employee have not been repealed and must be applied.

In addition to some of the law changes, some of the "indexed" amounts have also changed and these changes are indicated in the revised form. The compensation limit for 1998 is $160,000—the same as it was for 1997. However,the elective deferral limit for 1998 is $10,000 whereas it was $9,500 for 1997.

The IRS' instructions state that an employer who wishes to continue to maintain a SAR-SEP by using the IRS model Form 5305A-SEP must adopt this new version by December 31, 1998.

1998 Tax Legislation?

One really does not know to what extent there will be additional tax legislation in 1998. It seems quite certain that there will be a technical corrections bill. But there are other rumblings in Congress about various IRA and pension issues and possibly even bigger tax reform.

Here is a brief summary of various proposals which may come before Congress in 1998.

Rep. Earl Pomeroy (D-ND) is intending to introduce a bill which would make permissible almost all of the types of rollovers which presently the law does not allow—rolling funds from a 457 plan to an IRA, a 403(b) plan or qualified plan; rolling funds from a 403(b) plan to a section 457 plan, rolling after-tax dollars from a QP plan to another QP plan and rolling true IRA funds (i.e. not a conduit IRA) into a QP plan or 403(b) plan, etc. The law would also allow the IRS to grant extensions of the 60-day requirement in certain hardship situations.

Senator Roth, the originator of the Roth IRA, is proposing a number of possible tax changes. He believes in increasing the contribution limit of $2,000 for the Roth IRA to an unspecified higher amount. He would like to expand the contribution limit for Education IRA accounts. He would like to see a reduction in the various marriage penalty taxes.

Senators Trent Lott (R-Miss) and Paul Coverdell (R-GA) are still promoting that the contribution limit for education accounts be expanded to $2,500, and that the use of these accounts be expanded to cover primary and secondary education. This is a somewhat controversial provision as some people are concerned that too many funds will go for private schools.

Richard Gephardt (D-MO.) is proposing much wider tax reform. He proposes a modified flat tax. His proposal would eliminate many deductions, including the deduction for employee contributions to pension plans. He would retain the deduction for mortgage interest and for employer-provided payment of health premiums.

Richard E. Neal (D-Mass) has introduced two bills—one would increase pension portability and the other would index the IRA contribution limit which has not been changed from $2,000 since 1981.

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address, phone number, or date of birth of the depositor, this may be valuable information and could be included on the application.

The application must also obtain the name, social security number, address, and date of birth of the designated beneficiary of the Education IRA.

The third party the custodian/trustee must gather information on is the "responsible individual." This is defined to be the parent or legal guardian of the designated beneficiary. The custodian/trustee must obtain the name and address of the responsible individual. This is the person who is ultimately responsible for the Education IRA that is being established.

Additionally on the application the custodian/trustee needs to provide their name, address, phone number, and the name of the Education IRA representative of the financial institution.

The application page needs to be signed and dated by the depositor and the custodian/trustee.

Plan Document Language and Completion

The articles found in the Model plans specify the rules that govern the Education IRA. We will examine each Article and discuss what it means.

Article I—This article relates to contributions to the Education IRA. It states that contributions must be in the form of cash and must be made prior to the date the designated beneficiary attains age 18. It also states that the custodian/trustee of this Education IRA can accept additional contributions from the depositor or from any other individual. This means that once an Education IRA is established for a child, a different depositor could contribute to that account. A new Education IRA document would not be required for a different depositor. **Caution:** If this is done, make sure to gather the same information for the new depositor that was gathered for the original depositor. As reporting requirements are not yet known, this is critical.

Article II—This article also relates to contributions. It states that contributions may not exceed $500 a year for a designated beneficiary. It also discusses the income limits on the depositor. It states that an unmarried individual can contribute up to the full $500 if their modified adjusted gross income is under $95,000 and that their contribution is phased out for modified adjusted gross income levels between $95,000 and $110,000. If their modified adjusted gross income exceeds $110,000, it says they cannot contribute to an Education IRA in that year. It states that married individuals who file a joint tax return can contribute up to the full $500 if their modified adjusted gross income is under $150,000 and that their contribution is phased out for modified adjusted gross income levels between $150,000 and $160,000. If their modified adjusted gross income exceeds $160,000, it says they cannot contribute to an Education IRA in that year. **Note:** This article indicates that a married individual who files a separate tax return is not eligible to contribute to an Education IRA. This appears to be contrary to what the Code states. The Code indicates that the $95,000 to $110,000 ranges apply to all individuals other than those who are married and filing a joint return.

Article III—This article discusses investments in the Education IRA. Like the traditional and Roth IRAs, it says that life insurance is not a permissible investment and that the assets of the account cannot be commingled with other assets except in a common trust or investment fund.

Article IV—The provisions in this article relate to when distributions must be made from the Education IRA. It says that upon the death of the designated beneficiary, the funds must be distributed to the estate of the designated beneficiary within 30 days of the date of death. It also states that the funds must be distributed within 30 days of the designated beneficiary's attainment of age 30.

Article V—This is an extremely important provision. It states that the depositor has the power to direct the custodian/trustee regarding investment of the account assets. It goes on to say that the responsible individual can change these directions and has the ability to control all future investments, administration of, and distributions from, the Education IRA. The thrust of this provision is that the responsible individual has ultimate control of this account. The unanswered question is, "Can this article be superseded in the optional Article XI or in a prototype Education IRA document?"

Unlike any other IRA plan agreement, the Education IRA documents require completion of parts of some of the actual Articles in the plan. Both Article VI and VII require the depositor to make choices. These choices answer some very pressing concerns that many individuals have had relating to the Education IRA since this new type of IRA was announced. CWF has these options on the application page of the Education IRA documents in order to facilitate the completion of these provisions.

Article VI—This article deals with the responsible individual. This provision allows the depositor to state that the "responsible individual," the parent or guardian of the beneficiary, will remain the responsible individual, and as such retain control of the account after the designated beneficiary reaches the age of majority. If this option is not marked, control of the account will pass to the designated beneficiary when that beneficiary reaches the age of majority; the designated beneficiary would then become the responsible individual.

Article VII—This provision allows the depositor to either permit or not permit the responsible individual to change the designated beneficiary of the Education IRA to another family member of the original designated beneficiary.

Article VIII—This article requires the depositor to furnish the custodian/trustee with all information necessary to complete any IRS required reports. It also places the responsibility on the custodian/trustee for providing these reports to the IRS and the responsible individual. It is silent on the issue of what these reports will be and whether or not any reports will be sent to the depositor and/or the designated beneficiary.

Article IX—This provision states that the rules in Articles I through IV are controlling and any additional language must be consistent with these provisions.

Article X—This is an amendment provision. It permits the Education IRA plan agreement to be amended when required to comply with changes in the law. It also allows other amendments with the consent of the depositor and the custodian.

Article XI—This is the optional article that a custodian/trustee can choose to add to the Model plan agreements. It is an important part of the document and should be considered a mandatory part of any Education IRA plan agreement. It is in this part of the document where a custodian/trustee can establish rules and procedures relating to the account that will serve to limit the liability of the custodian/trustee of the account.

Title of Account

The Education IRA is established by a depositor for the benefit of a designated beneficiary. The question is, "In whose name is the account to be titled?"

IRS contribution reporting will probably have to identify the depositor and the beneficiary for whose benefit the

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✔✔✔ Check It Out ✔✔✔

Question: Is there a need to withdraw a required distribution when "election to treat as own" does not occur until the second year (or any later year)?

An IRA accountholder died after his or her required beginning date. The beneficiary of this IRA was the surviving spouse. The required minimum distribution for the year of death had either been distributed prior to the death or the surviving spouse had been paid the required amount after the death but before December 31 of such year. It is now the following year and the surviving spouse wishes to treat the IRA as his or her own. Must the required distribution for the second year (or later year) be paid out before the inherited IRA funds may be "transferred" to the IRA of the surviving spouse?

✔ Answer and Discussion: The answer is "no," the amount required to be distributed under the schedule which the accountholder had established does not need to be distributed if the surviving spouse elects to treat their surviving spouse's IRA as his or her own.

There are two regulations which need to be considered in answering this question. First, there is regulation 1.408-2 as adopted on August 8, 1980, and there is proposed regulation 1.408-8 as released in July of 1997. The reason for the proposed regulation is that laws passed in 1982 and 1984 changed some of the required distribution rules. For example, these laws authorized the use of a joint life-expectancy factor even if the beneficiary was not the accountholder's spouse; these laws authorize the use of the recalculation method for redetermining the life-expectancy factor. These laws also took away the right of the nonspouse beneficiary to roll over or elect to "treat as own" the inherited IRA of a deceased accountholder.

The IRS has indicated many times that the portion of the 1980 regulation dealing with how and when a spouse elects to treat a deceased spouse's IRA is still the governing law.

The IRS has stated a number of times in private letter rulings and other informational letters that a surviving spouse who elects to treat an inherited IRA as his or her own in the same year as the year the spouse IRA accountholder died is not required to have paid the required distribution before transferring (i.e. treating as own) the funds to his or her own IRA.

The question is, "Does it make a difference if the surviving spouse waits until the next year or any later year before electing to treat it as his or her own?"

Internal Revenue Code regulation 1.408-2 sets forth many general rules regarding IRA accounts. This regulation was adopted on August 7, 1980.

The rules as written in Subsection (2) (b) (7) set forth the rules mandating distributions once the IRA accountholder has died. Subdivision (ii) sets forth the rules as to when and how a surviving spouse elects to treat a deceased spouse's IRA as his or her own.

Under regulation 1.408-2, a spouse elects to treat an inherited IRA as his or her own by performing any act of ownership which infers that the IRA is his or her own IRA (e.g. making current contributions, making a rollover contribution, designating new beneficiaries, etc.). In addition and more importantly, a surviving spouse is deemed to have elected to treat the deceased spouse's IRA as his or her own when he or she fails to take a required minimum distribution.

Presumably, the regulation was written as it was to prevent an inheriting beneficiary from having to pay the 50% excise tax for failing to take a required distribution from an inherited IRA. The 1980 regulation authorizes both spouse beneficiaries and nonspouse beneficiaries to treat (or be deemed to have treated) a deceased IRA accountholder's IRA as his or her own. The 1982 or 1984 law changes took away the right of a nonspouse beneficiary to roll over the funds (or elect to "treat" as own").

Once the surviving spouse treats (or is deemed as treating) the IRA as his or her own, the "afterdeath" rules no longer apply and the "before-death" rules now apply to the surviving spouse.

If the surviving spouse would intentionally or unintentionally not withdraw the distribution in the second year, then he or she is deemed to have treated it as his or her own as of December 31 of this second year. Because the IRA is now that of the surviving spouse, the 50% excise tax is not owed.

Additional Comment. Other consultants feel that because the proposed regulation does not expressly discuss the interplay of the "election" rules with the proposed regulation's payout rules, that the conservative thing to do is to pay out the required amount to the surviving spouse and transfer the remainder. 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.

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Education IRA is being established. The question that is unanswered is whether or not the depositor's name must appear in the title. For the current time it is our recommendation that both names and tax identification numbers be included in the title of this account. Guidance from the IRS relating to reporting will be necessary in order to determine exactly how to title these accounts.

Disclosure Requirements

The rules governing the Education IRA do require a disclosure be provided. A written disclosure discussing the rules relating to the Education IRA in a non-technical manner must be provided when the account is established. There appears to be no requirement that a financial projection of the account's growth be given. As with all IRAs, a disclosure of any penalties or fees connected to the account is required.

The written disclosure statement that is used can either be one drafted by a company like Collin W. Fritz and Associates, Ltd., or it could be a copy of the IRS Notice 97-60.

Who Must Receive the Documents?

A copy of the Education IRA plan agreement and disclosure statement must be provided to the depositor and the responsible individual. Additionally, the custodian/trustee must retain a copy of the executed document in its files. If the depositor and the responsible individual are not the same person, the custodian/trustee must provide copies to the responsible individual. Mailing copies of the documents to the responsible individual should suffice. PD