THE Pension Digest

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ALSO IN THIS ISSUE –

THE ABILITY OF IRA BENEFICIARIES TO NAME IRA BENEFICIARIES

The Wall Street Journal and other newspapers have written a number of articles making the general point that IRA beneficiaries were being harmed because the IRA plan agreement forms used by the IRA accountholder restricted the beneficiary's ability to defer distributions from the IRA for as long a time as the law would permit.

The purpose of this article is to discuss the following two subjects: (1) the subject of an IRA beneficiary being able to designate his or her own beneficiary, and (2) the subject of an estate being able to pass-through the right to the beneficiary of the estate the right to continue the schedule.

These are similar subjects, yet different.

Subject #1. What is the ability of a beneficiary to designate a beneficiary?

One of the newspaper articles stated that some IRA professionals have concluded that a beneficiary can designate a beneficiary, but other professionals have concluded that the law and the IRS guidance is less than clear on the subject.

We believe an IRA plan agreement can be written to allow a beneficiary to designate a beneficiary. There is a reason, however, why IRA plan documents are generally not written to allow a beneficiary to designate a beneficiary. The IRS has written its proposed required minimum distribution (RMD) regulation to contain Q&A E-5(f). It reads as follows:

> (f) *Designations by beneficiaries.* If the plan provides (or allows the employee to specify that, after the employee's death any person or persons have the discretion to change the beneficiaries of the employee, then, for purposes of determining the distribution period for both distributions before and after the employee's death, the employee will be treated as not having designated a beneficiary. However, such discretion will not be found to exist merely because the employee's surviving spouse may designate a beneficiary for distributions pursuant to section 401(a)(9)(B)(iv)(II)

We construe this provision to mean that if a beneficiary has the right to name a beneficiary AFTER THE IRA ACCOUNTHOLDER'S DEATH (which is when it normally would be done), then for RMD purposes a single life-expectancy factor must be used to calculate the RMD amount for the "70 1/2" calculation and if the accountholder dies before his or her required beginning date, then the life-distribution option is not available to any beneficiary (i.e. the five-year rule must be used).

Q&A E-5(f) is the reason why writers of an IRA plan agreement do NOT generally give the right to a beneficiary to name a beneficiary. The reason—some of the favorable options which allow a "stretched out" distribution schedule are lost if the beneficiary has the right to designate a beneficiary.

<u>Observation #1.</u> It appears that it would be possible for beneficiaries to designate their beneficiaries PRIOR to the accountholder's death. This seems somewhat strange since the accountholder has not yet died and the beneficiary's interest is subject to being divested. The beneficiary's designation would need to become irrevo-

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cable upon the death of the accountholder.

Having some ability for a beneficiary to designate a beneficiary is better than having no right. CWF is giving serious consideration to writing its IRA forms to allow a beneficiary to designate his or her beneficiary(ies) as long as such designation occurs before the accountholder dies. We most likely will elect to use an addendum approach because we believe many IRA custodians/trustees do not want to extend the payout schedule to a beneficiary of the beneficiary.

Observation #2. It should be possible for an inheriting beneficiary to designate a beneficiary if the inheriting beneficiary elects to use the five-year payout option. By definition, use of the five-year rule means the accountholder has died before his or her required beginning date. The IRA plan agreement would stipulate that this special right to designate a beneficiary would expire as of the end of the day on March 31 of the year following the year the IRA accountholder attains age 70 1/2. If this right did not expire and the accountholder attained his or her required beginning date, then the accountholder would have to use a single life-expectancy factor to calculate his or her RMD distributions.

Again, CWF is giving serious consideration to writing its IRA forms to give a beneficiary who is eligible and who elects the five-year option, the right to designate a beneficiary. Right now the CWF document only gives a spouse who has elected the life-distribution option the right to designate a beneficiary.

In summary, if a beneficiary is always given the right to designate a beneficiary(ies), this right will eliminate some of the favorable RMD options for the accountholder while he or she is alive and for the subsequent beneficiary(ies). This is the main reason why a beneficiary is not always given the right to designate a beneficiary under the IRA plan agreement.

Subject #2. Is it legally permissible for an estate to pass through to the beneficiary of the estate the right to continue the distribution schedule? If so, what administrative procedures should be used by the IRA custodian/trustee?

We admit the law is unsettled on this subject. We present our analysis, but we caveat our statements by saying any estate and any beneficiary of any estate must act on the advice of their legal advisor. CWF is giving serious consideration to changing our IRA plan agreements so that if an addendum would be executed by a beneficiary and his or her advisor, then the IRA custodian would acknowledge that an estate can pass-through the right to receive RMD distributions from an inherited IRA. The IRA plan agreement would be amended to allow for this addendum possibility.

Two examples will help illustrate Subject #2. *Example #l* shows that the distribution schedule continues if a living person is the beneficiary rather than an estate. *Example #2* addresses the estate situation.

Example #1. Peter is an IRA accountholder. He attained age 70 1/2 and 71 in 1994. His designated beneficiary was his spouse, Susan, age 63. He elected the nonrecalculation. method. The factor for 1994 was 24.0. Susan died in 1996. Peter then designated his daughter, Amy, as his primary beneficiary. Because nonrecalculation had been elected, Susan's death did not affect his RMD schedule. The factor for 1997 was 21.0. Peter died in 1998. Amy is required by the RMD rules to continue Peter's schedule or accelerate it. The factor to be used with respect to Amy for 1999 would be 19.0. Again, because nonrecalculation had been elected, Peter's death does not affect Amy's RMD calculation.

Example #2. Assume the same facts as in Example #1, but assume that it was Peter who died in 1996, and Susan died in 1998. Susan did not elect to treat Peter's IRA as her own. Peter's IRA form stated that upon the death of his beneficiary the remaining funds would be paid to the beneficiary's estate (i.e. Susan's estate). The IRA form did not require a lump-sum distribution. In her will, Susan designated that Amy would receive these inherited IRA funds. Susan allowed Amy to use any method of distribution as long as it complied with the law. Amy is currently earning $88,000 per year and she expects her income to increase over the next 10 years. Amy wishes to minimize the distributions from the inherited IRA to the extent the law permits.

Has Amy lost the right to receive IRA distributions over the next 19 years because the IRA plan agreement form requires distribution to be made to Susan's estate?

Does the fact that most estates must be "closed" within a certain time period require Amy to lose the right to receive distributions over the remaining 19 years?

We believe "no" is the answer to both of these questions. There is nothing under the RMD rules which requires an immediate payout of the entire balance to the estate. An estate is a pass-through tax entity. The estate tax rules contemplate that a decedent (and his or her estate) may well have the right to be paid a debt or other payments over a number of years.

For example, under the estate tax rules, IRA and other pension funds constitute Income with Respect to a Decedent (IRD) under the federal income tax laws. IRD is defined by Regulation as those amounts to which a decedent was entitled as gross income, but which were not properly includable in computing his or her taxable income for the year of death or for any previous tax year because of the method of accounting being used by the decedent (i.e. cash method of accounting). Code section 691.

The person or other taxable entity who acquires the right to receive IRD must include that amount in income for the taxable year when received. However, in the case of a charity, the IRD amount should not result in any taxation because of the charity's income tax exemption under Code section 501(a).

An estate's distribution of the right to receive IRD to:
(1) a residuary legatee of the estate or (2) the legatee of a specific bequest of the right to the IRD does not cause the estate to realize income. However, if an estate uses the right to receive IRD to fund a pecuniary bequest to a beneficiary, then this will cause the

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estate to recognize the income because it is using the IRD item to satisfy a known obligation or bequest.

IRD has the same character to the recipient as it would have had in the hands of the decedent if the decedent had lived (or a prior decedent, if applicable).

In addition to the recipient having to include the IRD in his or her income for income tax purposes, the estate must include the IRD in the federal estate for federal estate tax purposes. However, there is a deduction for income tax purposes for that portion of the federal estate tax which is paid because of the IRD. The recipient must claim this amount as an itemized deduction, but the 2% limit which applies to most miscellaneous deductions does not apply to this IRD deduction. A special rule applies if the IRD arises from a lump-sum distribution from a qualified plan so that there will be capital gain and/or 5/10 year averaging treatment, then the deduction is made against these amounts and not as a miscellaneous deduction. There is no deduction for the IRD associated estate taxes when the maximum marital deduction has been used so that no estate tax is due. When there is more than one recipient of IRD item(s), then this deduction must be allocated among the recipients and among different taxable years, if applicable.

The Tax Reporting Dilemma

There is no doubt that the simplest thing for an IRA custodian or trustee to do is to issue a distribution check to the estate and the Form 1099-R to the estate. The estate then can prepare reporting forms for its beneficiary(ies) if it makes reportable distributions. The real-life problem is the estate will be closed. The personal representative wants the IRA custodian to agree to prepare all future distribution reporting forms (i.e. the Form 1099-R and all future 5498 forms) in the name of "Amy as beneficiary of Susan as beneficiary of Peter's IRA." We believe the IRA custodian should feel comfortable doing so as long as there is a written opinion from the estate's attorney that the IRS rules and laws permit the IRA custodian to generate government reporting forms in the name of estate's beneficiary(ies) rather than in the name of the estate. We will also be checking with the IRS for their position on this issue. We will cover the IRS response in a subsequent newsletter.

Subject #3: Can an IRA custodian or trustee write its IRA plan document to require a pay-out to the beneficiary's estate and not allow the pass-through feature?

The answer is "yes." Such a plan document is not very customer/beneficiary friendly, but it can be written this way. One reason IRA plan agreements are written this way is for ease of administration purposes. This "simple" approach may work well for "retail/deposit" IRAs, but it does not work well for "Trust" IRAs.

Right now CWF's standard IRA plan agreements are written to require distribution to the beneficiary's estate. We are giving serious consideration to changing our forms.

A somewhat related issue is the question of whether or not the IRA plan agreement may be amended by the IRA custodian/trustee and the beneficiary (i.e. the estate) after the accountholder's death to expressly give the pass-through right. If the plan agreement authorizes such amendments, they should be permissible. The CWF IRA plan agreement has very broad amendment language.

In conclusion, we believe an IRA custodian/trustee should be willing to accept an opinion letter from an attorney notifying the IRA custodian/trustee that the estate had passed through the right to receive the IRA distributions to specific individuals. The IRA custodian/trustee then could change its records so that the future distributions would be reported in the name of the "new" beneficiaries. We will be checking with the IRS. ◆

FDIC ESTABLISHES POSITION ON INSURANCE COVERAGE FOR ROTH IRAs AND EDUCATION IRAs

The FDIC has finally issued its rules on deposit insurance coverage for Roth IRAs and Education IRAs. Roth IRAs and Education IRAs first became available as of January 1, 1998.

As is well known, the FDIC insurance rules are based upon the concept of "different rights and capacities." An individual is able to have insurance coverage in excess of the $100,000 limit because the FDIC rules allow separate (or multiple) insurance coverage for different types of deposits.

The FDIC has adopted the position or rule that deposits within a Roth IRA at an insured institution are treated the same as deposits within a traditional IRA. This means that these two types of deposits will be added together to determine whether the $100,000 limit which applies to aggregated IRA and other self-directed Keogh and pension deposits has been exceeded.

Somewhat surprisingly, the FDIC has adopted the rule that for FDIC insurance purposes, deposits within an Education IRA are NOT treated as IRA deposits. Rather, the FDIC has adopted the legal position that the Education IRA is to be treated as an IRREVOCABLE TRUST and not a traditional IRA for deposit insurance purposes because the FDIC has concluded that the law requires an Education IRA to be an irrevocable trust on behalf of the child (i.e. the designated beneficiary). The general practical result of the FDIC's new rule is that the deposits within an Education IRA will not be aggregated with traditional IRA deposits of the depositing grandparent or parent, but the trust interest of each trust beneficiary will be insured. Presumably, the $100,000 limit will be less of a concern in most situations because Education IRA deposits do not have to be aggregated with other IRA deposits.

Set forth below is a summary of the FDIC's coverage rules

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for IRAs/pensions and irrevocable trusts as taken from an FDIC brochure.

Irrevocable Trusts

3.33 How are irrevocable trust funds insured?

Irrevocable trusts are another legal ownership category. The interest of each beneficiary in an account established under an irrevocable trust is insured up to $100,000, separately from other accounts held by the grantor, trustee, or beneficiary, if all of the following requirements are met:

- The deposit account records of the depository institution must disclose the existence of the trust relationship.
- The interests of the beneficiaries must be ascertainable from the deposit account records of the depository institution or from the records of the trustee maintained in good faith and in the regular course of business.
- The value of each beneficiary's interest must be determinable according to FDIC regulations.
- The trust must be valid under state law.

Kinship is not a factor in determining coverage of irrevocable trusts.

In cases where the beneficiary has an ownership interest in more than one trust created by the same grantor, the beneficiary's interest in all accounts established under those trusts are added together and the sum is insured to a maximum of $100,000.

34. What if the beneficiaries or their interests in such a trust cannot be ascertained?

When the ownership interests of the beneficiary cannot be determined, insurance coverage for the entire trust is limited to a maximum of $100,000.

Retirement Accounts

3.35 How are funds deposited in Individual Retirement Accounts (IRAs) and Keoghs insured?

IRA and Keogh funds are separately insured from any non-retirement funds the depositor may have at an institution. But IRA and self-directed Keogh funds will be added together, and the combined total will be insured up to $100,000. IRA and self-directed Keogh funds will also be aggregated with certain other retirement funds: namely, those belonging to other self-directed retirement plans, and those belonging to so-called "457 Plan" accounts, if the deposits are eligible for pass-through insurance (see Question 37). The "457 Plans" are deferred compensation plans conforming to section 457 of the Internal Revenue Code that are established by state and local governments and nonprofit organizations. IRA and Keogh time deposits made before December 19, 1993, are insured separately from each other and from any other funds of the depositor. Such funds, however, become subject to the aggregation rules explained above when the deposits mature, roll over, or are renewed.

36. How are the new Roth IRA and Education IRA insured?

Although subject to different tax treatment under the Internal Revenue Code, the new Roth IRA is treated the same as a traditional IRA for deposit insurance purposes. So, if a depositor has both a Roth IRA and a traditional IRA at an insured depository institution, the funds in those accounts would be added together and insured as explained in Question 35. The new "Education IRA," however, is not considered an IRA for deposit insurance purposes. Because of the required features of the account, an Education IRA is treated, for deposit insurance purposes, as an irrevocable trust account. So, the FDIC insures an Education IRA under the rules for irrevocable trust accounts explained in Question 33 of this pamphlet. ◆

REMINDER—1999 IS LAST YEAR FOR FIVE-YEAR AVERAGING

The Small Business Jobs Protection Act of 1996 repealed five-year averaging effective for ALL distributions occurring after December 31, 1999. 1999 is the last year ANY taxpayer/QP participant will be eligible to elect to use the five-year averaging rule. This includes those taxpayers/QP participants who were grandfathered with respect to ten-year averaging. Since 1986, a qualifying QP participant/taxpayer (one who was age 50 as of 1-1-86) has had the flexibility to elect to use either ten-year averaging or five-year averaging. The concept was—the taxpayer would elect to use whichever method would result in the lowest amount of federal income taxes to be paid. Note that being age 50 as of 1-1-86, means the person was born on or before 1-1-36.

You may want to notify your qualified plan customers or clients of the fact that five-year averaging will no longer be available after 12-31-99. You may furnish a copy of this article to them.

The right to elect to use five-year averaging was created by the Tax Reform Act of 1986. Five-year averaging was created by Congress and the tax attorney's advising Congress because five-year averaging was viewed as being better than ten-year averaging for the reasons discussed below.

In order to be eligible for five-year averaging, a number of requirements must be met. In general, a participant of a qualified plan must be at least age 59 1/2 or older at the time of the distribution and must receive a lump-sum distribution. A person is limited to using a special averaging treatment only one time after 12-31-86. Five-year averaging has been available to those taxpayers born before 1936 and those born in 1936 or thereafter.

Congress, in 1986, was not ready to totally repeal ten-year averaging. They didn't want to bear the brunt of a taxpayer revolt as had been experienced in 1984 and 1985 with respect to certain changes in the social security program and withholding rules. Congress chose to do a partial repeal and to create two classes of taxpayers. The Tax Reform Act of 1986 repealed ten-year averaging (and a special capital gains treatment) for all taxpayers/QP participants who were not age 50 as of January 1, 1986. This class of taxpayers no longer could use 10-year averaging. In contrast, the class of taxpayers who were age 50 or older as of 1-1-86 were grandfathered and they continued to be eligible to elect ten-year averaging.

For some time, the tax experts who advise the tax committees of Congress had and have disliked any type of averaging concept with respect to lump-sum distributions from qualified pension plans. They have stated at least two reasons for their dislike.

The first reason was they thought the taxpayer was getting too good a deal (i.e. not paying as much in taxes as

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they should). Here is a simplified illustration of the tax effect of being able to elect ten-year averaging. A taxpayer receives a distribution of $150,000 from his or her pension plan. Without ten-year averaging, the taxpayer would add the $150,000 to his or her other income and have it taxed at the assumed marginal rate of 36%. Thus, $55,000 ($150,000 times 36%) would be paid with respect to the $150,000 distribution. With ten-year averaging, the taxpayer determines the tax amount owing with respect to the $150,000 as follows. He or she divides the $150,000 by 10, and then the tax rate and tax amount for the amount of $15,000 is determined. The tax rate to be used is the tax rate as existed in 1986. The tax rate on $15,000 in 1986 was 12%. $15,000 times 12% means the tax amount is $1,800. This $1,800 is then multiplied by 10 so the total amount owing is $18,000. By being able to use ten-year averaging, the person pays $37,000 ($55,000 -$18,000) less in federal income taxes. The concept for five-year averaging is the same except the tax rate to be used is the tax rate for the year of distribution and the "spread" is only five years and not ten. The fact that only five years is used and not ten has the practical consequence that the person may be in a higher marginal income tax bracket and thus more tax would be paid. Regardless of the fact that these funds had been accumulated for the important public policy of providing for retirement, the tax advisors did not like the relatively low rate of taxes being paid by these taxpayers.

The second reason was that the tax advisors viewed lump-sum distributions as contradicting the basic purpose of pension plans. They believed there was a good likelihood that people who received a lump-sum distribution would not retain the funds for retirement. They preferred to require the taxpayer to take periodic distributions from an IRA. These tax advisors understand well that if the averaging treatment is not available, then most individuals will be strongly induced (i.e. forced) by the higher marginal tax rates into rolling over his or her account balance to an IRA and then taking periodic/partial distributions from the IRA.

In summary, in 1996, Congress took one more step in restricting the use of any special averaging rules for lump-sum pension distributions. They repealed the right to use five-year averaging for all distributions occurring after 12-31-99. This means those people who were not age 50 as of 1-1-86 (not age 64 as of 1-1-2000) no longer will have any averaging rights. Those people who were age 50 as of 1-1-86 (age 64 or older as of 1-1-2000) will continue to be able to elect to use ten-year averaging if they meet the other requirements. Congress has chosen to continue to give special treatment to those people who were age 50 on 1-1-86.

All QP participants who are eligible to elect to use five-year averaging in 1999 will want to seriously consider, between now and December 31, 1999, whether or not they will elect to use five-year averaging in 1999. It will be too late to elect five-year averaging after December 31, 1999. One should not expect the IRS to grant any special relief if this deadline is missed. ◆

IRA ROLLOVERS AND THE DUTY OF CONSISTENCY

There is a term called "duty of consistency," which prevents a taxpayer from adopting a position for a particular year, and after the period of limitations has expired, adopting a contrary position that affects his or her tax liability for an open year.

In the case of the Estate of Hilda Ashman, Deceased, et al, v. Commissioner of Internal Revenue, United States Tax Court, Docket No. 15578-96, April 22, 1998, a decedent's estate was barred under the duty of consistency from denying that a timely rollover of a pension distribution had been made to an IRA, because the decedent's return for an earlier year had reported that the rollover was timely.

Hilda Ashman received a distribution from a qualified plan in 1990. More than 60 days after receipt, she made an IRA rollover of a portion of the distribution. She then proceeded to report the entire amount as nontaxable on her tax return for 1990, as she claimed that it was timely rolled over. In 1993, Hilda received two distributions from her IRA, but did not report these distributions as taxable income on her federal return.

Although the period for assessment of an income tax deficiency for taxable year l990 had expired, the IRS determined a deficiency in the federal income tax for 1993. The case was brought to court against Hilda's estate, as she was now deceased. The Ninth Circuit Appellate Court determined that the duty of consistency applied because: (1) the decedent reported the 1990 distribution as timely rolled over into an IRA; (2) the IRS relied on the representation; and (3) after the limitations period expired with respect to the decedent's 1990 return, the decedent claimed that the 1990 distribution was not timely rolled over, thereby qualifying the 1993 distribution as a nontaxable return of principal.

Perhaps another definition of "duty of consistency" could be "lying doesn't pay." ◆

CREDITORS AND SEP-IRAS

For the most part, the question whether traditional IRAs can be reached by creditors is a matter of state law. Most states provided limited protection from creditors for IRAs. Some states provide no protection.

Keep in mind that many times the creditor trying to reach a person's assets is a bankruptcy trustee after the individual has filed for bankruptcy.

The purpose of this article is to make the point that the law

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is not settled with respect to SEP-IRAs. A SEP-IRA plan with multiple participants most likely would be found to come under federal tax and pension law and all of the related SEP-IRAs would be protected from creditors. A SEP-IRA plan which covers only a self-employed person most likely will be found to not come under federal tax and pension law and would not be protected from creditors. Such was the result in CRS Steam, Inc. et. al, United States Bankruptcy Court, District of Massachusetts, Nos. 97-44296-JFQ and 97-44297-JFQ, February 11, 1998.

A debtor maintained a SEP plan that was created for him by his wholly owned company. He filed bankruptcy and claimed that the SEP could not be included in the bankruptcy because: 1) the SEP contained a spendthrift clause which would limit how the money was spent, and 2) the SEP was exempt under state law.

The court disagreed on both points. Because the debtor was the owner of the company that created the SEP, he was regarded as an employer under ERISA and not entitled to assert the rights that ERISA grants employees. Although the spendthrift clause was enforceable under state law, the debtor had a general power of appointment over the SEP. He could have required the custodian to distribute its entire balance to him at any time.

The court also held that the SEP was not exempt under state law. The exemption only applies to amounts deposited in the plan that are less than 7% of the total income of the debtor, within five years of the debtor's declaration of bankruptcy. Because the SEP exceeded the 7% limit, it was included in the bankruptcy action. ◆

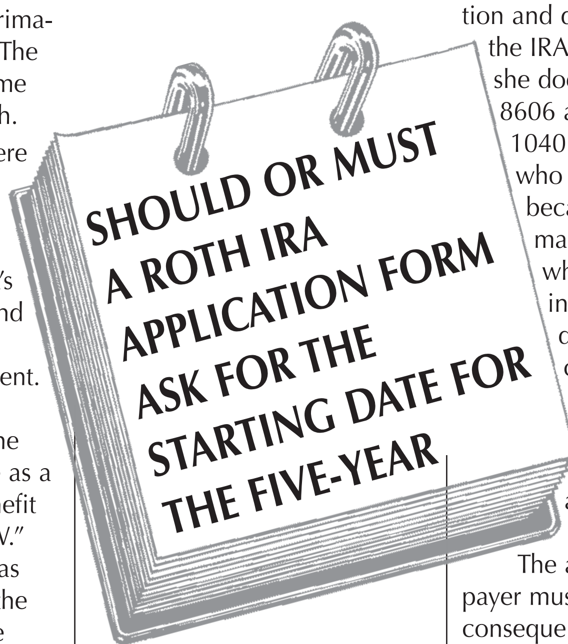
SPOUSE RULED BENEFICIARY OF IRA TRUST

An accountholder we will call "A" died, leaving his revocable living trust as the primary beneficiary of his IRA. The living trust, Trust D, became irrevocable upon A's death.

The assets of A's IRA were transferred into another IRA administered by the trustee of Trust D. This trustee was informed of A's beneficiary designation and had been provided with copies of the trust document. After the estate expenses were paid, Trust D held the balance of the trust estate as a residuary trust for the benefit of A's surviving spouse "W." This trust was referred to as the Marital Trust. W was the primary beneficiary of the Marital Trust, and was entitled to quarterly or more frequent distributions of all of the trust's income.

Upon W's death, the Marital Trust's remaining assets, if any, must be distributed to beneficiaries B and C, who are descendants of A and W, or to their then living descendants if B or C predeceases W.

In PLR 199912041, the IRS concluded that W should be treated as the designated beneficiary for purposes of determining the designated beneficiary with the shortest life expectancy determined at the time of D's death. Also, W is considered to be the designated beneficiary for purposes of the determining period over which distributions will be made from A's IRA to the Marital Trust. Last, distributions made to the Marital Trust over W's life, or over a period not extending beyond W's life expectancy, are in accordance with 401(a)(9)(B)(iii) as interpreted by Prop. Treas. Reg. 1.401(a)(9)-1, Question and Answer C-3(a). ◆



Our answer is "No." For the reasons discussed below, the IRA custodian does not need this information to perform its IRA duties, and requesting this information may give the accountholder the idea that the bank will assist in determining what portion of a distribution from a Roth IRA is taxable and what portion is not. Most banks do not want to assume this duty.

As you know, a distribution from a Roth IRA will be tax-free (i.e. any distribution will not be included in income) if certain requirements are met. One of those requirements is that a five-year holding requirement be met.

With respect to a traditional IRA, the IRS has long settled the issue that it is not the IRA custodian's job to determine what portion of a distribution is "taxable." Because of the "aggregation" rules (all IRAs, wherever located, are treated as one) and the "pro rata" distribution rule, it is the accountholder who is responsible to determine the tax consequence of any IRA contribution and distribution and not the IRA custodian. He or she does this on the Form 8606 and on the Form 1040. It is the taxpayer who is responsible because he or she is normally the only person who has all of the information needed to determine the tax consequences.

The law (and the IRS administratively) takes the same approach with respect to Roth IRAs. The accountholder/taxpayer must determine the tax consequences of his or her contributions and distributions. The Roth IRA custodian does NOT have this duty. The taxpayer handles these tasks by completing and filing the Form 8606 and Form 1040.

The IRS instructions for the 1998 and 1999 Form 1099-R are quite clear. For Roth IRAs, the Roth IRA custodian reports the gross distribution amount in box 1, but generally leaves box 2a (taxable amount) blank. That is, the Roth IRA custodian does NOT report a

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"taxable" amount. The IRS uses the term "generally" because in the return of an excess contribution situation the earnings are to be reported in box 2a. Otherwise, a taxable amount is not furnished by the Roth IRA custodian with respect to a distribution from a Roth IRA.

Also, note that in the instructions the IRS makes the following statement, "Use Code J to report (a Roth distribution) in box 7. You may also use Code 1, 2 or 4 if appropriate in box 7 with code J." The IRS does NOT want Code 7 to be used with Code J.

We, at Collin W. Fritz and Associates, Ltd. believe that a Roth IRA custodian will want to adopt the general administrative practice of inserting a "1J" in box 7 for those Roth IRA accountholders who have not yet attained age 59 1/2 or older at the time of the distribution from the Roth IRA.

As you know, Code 1 is used to report a distribution to a recipient who is not age 59 1/2 at the time of the distribution and no exception is known by the IRA custodian as to why the 10% additional tax does not apply. Code 2 is to be used if the IRA custodian is aware of an exception why the recipient, even though not 59 1/2, does not owe the 10% additional tax. The most common exception is the substantially equal periodic payment exception. There can be such payouts from Roth IRAs as well as traditional IRAs. An IRA custodian should insert "2J" for substantially equal periodic payment distributions being made from Roth IRAs as long as all of the applicable requirements have been met. A Roth IRA custodian must use Code "4J" to report distributions made to a Roth IRA beneficiary.

Question: *Must or should a Roth IRA custodian insert a code "2J" in box 7 if it knows that an accountholder who is not yet age 59 1/2 has met the five-year holding requirement with respect to a specific Roth conversion?*

Note that this is not a question of immediate concern since Roth IRAs have not yet existed for five years. The IRS will need to issue additional guidance. The current IRS instructions do not address this issue. Again, this is not that surprising since Roth IRAs are relatively new. Until the IRS addresses this question, our position is that a Code "2J" should not be used (i.e. still use "1J") even if an IRA custodian knows that the five-year rule has been met with respect to a specific conversion. *Why?* Because of the special distribution ordering rules, the Roth IRA custodian does not really know if the distribution, for tax purposes, came from the conversion. Only the accountholder/taxpayer will be able to determine this.

Additional Discussion

The IRS has written their instructions for the Form 1099-R to be consistent with the rules set forth in the final Roth IRA regulations. The applicable sections are set forth.

Q & A-2 provides that a taxpayer has only one five-year period for purposes of determining if the five-year requirement has been met to see if any portion of a distribution from a Roth IRA must be included in income.

Q & A-8 and 9 discuss the special rules to be used to determine the source of a distribution. Regular/annual contributions are deemed distributed first, then conversion contributions and then earnings on all types of contributions. When a person withdraws funds from his or her Roth IRA, that Roth IRA custodian has no idea if the distribution is taxable to any extent because the person may have a Roth IRA with other financial institutions and there is no knowledge as to the types of the various contributions in the various Roth IRAs.

Q & A-5 provides that for purposes of the 10% additional tax there is a separate five-year period for each conversion contribution. *Why?* Congress, the congressional tax staff and the IRS saw the possibility of many taxpayers taking advantage of the situation if there was only one five-year period.

An example will illustrate the rationale for this special rule. Alice M., age 46, maintains two traditional IRAs—one with a balance of $5,000 and one with a balance of $90,000. She converts the $5,000 in 1998. For whatever reason, Alice wants to wait to convert the $90,000 until 2003. If there was not a separate five-year requirement for each conversion, she could withdraw immediately in 2003 or later the $90,000 or any lesser amount from her Roth conversion IRA and she would not owe the 10% additional tax. The five-year requirement was met as of 12-31-2002 with respect to the $5,000 conversion. The policy makers thought that it was not right to allow a person to escape the 10% additional tax on a ""later" and/or "large" distribution/conversion just because the accountholder had converted a much smaller amount in an earlier year. Too good of a deal.

For the reasons discussed above, we do not believe it is necessary for a Roth IRA custodian to determine for each specific Roth IRA accountholder when his or her five-year period commences. This is a taxation issue and it is the responsibility of the accountholder/taxpayer and not the Roth IRA custodian. I see virtually no chance that the law will ever be changed so that a Roth IRA custodian would want or need to obtain this information.

If another forms vendor has forms which request the five-(5) year start date, they are doing so for reasons other than compliance reasons. Again, the Roth IRA custodian will not use this information for any governmental reporting requirements. We do not suggest a Roth IRA custodian gather this starting date because the accountholder may wrongly assume that the Roth IRA custodian will help with the tax calculations. ◆

WHO CAN MAKE IRA CONTRIBUTIONS?

With the advent of the Education IRA, it is clear that the law governing Education IRAs clearly contemplates that persons other than the accountholder are intended to make contributions. For example, grandparents and parents will

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IRA Contributions,
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make contributions on behalf of a grandchild or child.

Some people are now starting to ask the following types of questions. If I can make contributions to my child's Education IRA, then can I make such a contribution to my child's Roth IRA or traditional IRA? Can I make contributions to my mom's Roth or traditional IRA? Can I make contributions to my spouse's Roth or traditional IRA? Can I make contributions to my significant other's traditional or Roth IRA?

Our answer to each of the above questions is "no" unless the IRA accountholder has given the contributor a power of attorney authorizing that person to make contributions on his or her behalf, or the accountholder has consented in writing to these contributions. Note that there is no requirement that the contributor be a family member. However, such contributions by a parent on behalf of a minor child would presumably be permissible since the parent in this case is acting as the child's guardian and has the authority to do so.

The primary reason for our negative answer is that the IRA accountholder could well have adverse tax consequences arising from any unauthorized contribution since excess contributions could arise because either the eligibility or the contribution limit rules are not met by the person for whom the contribution is made.

The IRS has adopted the approach in its model IRA plan agreement forms and in its Publication 590 that there is a two-party relationship in an IRA—the depositor/accountholder and the IRA custodian/trustee. There is no indication in Publication 590 that a third party may make contributions. Note that the approach taken in the Model Form 5305-A is "the depositor whose name appears above is establishing an IRA under section 408(a) to provide for his or her retirement and for the support of his or her beneficiaries." That is, the IRS model form does not allow someone other than the depositor/accountholder to establish the IRA. However, the IRS has ruled that an employer may take such action (establish the IRA on behalf of the employee) in certain special SEP-IRA situations.

Might it be permissible under the law for a third party to execute a specially drafted IRA trust plan agreement wherein the contributor is not the person for whom the account is established? We believe this could be done. However, we have never seen any research materials which would indicate that the IRS has considered this question, nor ruled on it. We would strongly suggest that an IRS ruling letter be obtained on any IRA plan agreement allowing third-party contributions.

Additional Discussion

A traditional IRA is a special type of tax-preferred account. Code section 408 authorizes IRAs. An IRA is a trust or custodial account created for the benefit of an individual or his or her beneficiaries. There does not appear to be an express restriction in Code section 408(a) as to who may make the contribution on behalf of the accountholder.

This restriction, if any, currently comes from the IRA plan agreement. This agreement is between the depositor and the IRA custodian/trustee. An IRA custodian/trustee would be assuming a risk by accepting unauthorized contributions from a third party. For liability reasons, an IRA custodian should not accept IRA contributions from someone other than the IRA accountholder, for the basic reason that neither the plan document nor the accountholder has authorized such contributions. Unauthorized IRA contributions could cause the accountholder adverse tax consequences (i.e. excess contributions which are subject to an annual 6% excise tax).

The current reporting procedures illustrate the concern for an IRA custodian/trustee. The IRA custodian/trustee is not required to furnish the contribution information to the accountholder until May 31 of the following year. However, the taxpayer must generally file his or her federal income tax return and correct any excess contributions on or before April 15 of the following year. This means the accountholder could be notified of a third party's contribution after he or she needed to act to correct an excess contribution.

Code section 219 allows a tax deduction to the IRA accountholder in some situations. Code section 219 has two eligibility requirements - (1) the accountholder must have compensation and (2) the accountholder cannot attain age 70 1/2 or older during the year for which the contribution is made. And there is a $2,000 (in general) contribution limit which certainly could be exceeded if a third party has the right to make unconsented contributions in addition to the contributions made by the accountholder.

It is the accountholder who claims the tax deduction, if eligible. A third-party contributor will never be eligible to claim the deduction for contributions he or she makes for another person. An exception may exist for "spousal contributions," but even in this situation the approach of the law has changed. The law used to read that the compensated spouse would make a contribution for the noncompensated spouse, or the spouse with a minimal amount of compensation. The new approach of Internal Code section 219(c) is - the noncompensated spouse now makes the contribution for himself or herself after determining the compensation of his or her spouse and the amount of his or her IRA contributions. So, even in a spousal situation, it is required that a spouse be authorized to make the contribution on behalf of the other spouse.

In summary, under the current IRA plan agreement document, the IRA custodian/trustee owes its duties to the IRA accountholder and not a person who wishes to make a contribution on behalf of the accountholder. If the other person is not willing or able to get the IRA accountholder to consent or authorize the contribution, then the IRA custodian should not accept such a contribution from a third party, even if the third party is a family member. ◆