THE Pension Digest

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ALSO IN THIS ISSUE –

REVISITING THE SUBJECT: THE RMD CALCULATION IN THE YEAR A SURVIVING SPOUSE ELECTS TO TREAT DECEASED SPOUSE'S IRA AS OWN

For purposes of this article, we will assume the following situation. A husband and wife maintained their respective IRAs. Each spouse was over age 70 1/2. Each was the other's beneficiary. The husband died in 2000. The wife, as the surviving spouse, has made the decision to elect to treat the decedent's IRA as her own in 2000.

On 12/31/99, the account balance in the husband's IRA was $15,000,000. His 2000 RMD amount was $1,000,000 because the applicable joint life-expectancy factor was 15. (These numbers are used for illustrative purposes only.)

There are two considerations or questions concerning this situation:

1) Must the decedent's RMD amount of $1,000,000 be distributed to the decedent's estate before the surviving spouse can treat the decedent's IRA as her own?

2) Is the RMD amount of $1,000,000 required to be distributed by 12/31/00 to his surviving spouse who has chosen to treat the decedent's IRA as her own?

Obviously, there are serious tax consequences related to whether or not the $1,000,000 is required to be distributed in 2000. Most likely, the federal marginal tax rate of 39.6% would apply. $396,000 ($1,000,000 x 39.6%) would be owing with respect to such a distribution. As is well known, there is a 50% tax on excess accumulations for failing to withdraw a required distribution without having a reasonable excuse. Most surviving spouses would like to be able to skip taking this distribution, but only if they don't incur any tax problems and penalties.

The answer to question #1 is, "No." Upon the death of the IRA accountholder, any requirement to distribute the RMD to either him or his estate ends, as the fund now belong to the beneficiary. Therefore the RMD need not be distributed before this election/transfer takes place.

The answer to question #2 is also "No." Even though the spouse has chosen to treat the decedent's IRA as her own in 2000, it is our opinion that the spouse is not required to take a distribution on account of this account. The RMD calculation is always based on the previous year's 12/31 balance — in this case, it would be based upon the ending balance in the decedent's IRA as of 12/31/99. As of 12/31/99, the surviving spouse had no balance, as she did not own this IRA — it was her husband's. Therefore there is no distribution to be made.

There are two sources of authority for the above answers. First, Internal Revenue Code Regulation 1.408-2(b)(7) provides a special rule. An election (to treat as own) is considered to have been made "by default" if any amount required to be distributed is not distributed by the applicable deadline (i.e. normally December 31 of such year). An election is also deemed made if any additional amounts are contributed by a spouse to an inherited IRA. Thus, if the surviving spouse would intentionally or unintentionally fail to take the RMD amount for 2000 by 12/31/00, then the surviving spouse will be treated as having made the election. Note, in this situation, the spouse has not had to withdraw the required distribution. Therefore, the reasoning is: if the surviving spouse can wait until 12/31/00 to treat it as his or her own IRA and not be required to take a distribution, then the surviving spouse who makes this election earlier in the year should be able to have the same result— also not have to take a required distribution.

Second, the IRS wrote us a letter on November 1, 1991. This letter is set forth on page

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7. The IRS references regulation 1.408-8. The IRS' answer is clear—the balance as of December 31 of the last pre-election year (i.e. 1999) is used in the computation. As the IRS indicates, this may well be "zero." Thus, a distribution is not required for the year of election. Some may consider this position too good to be true and even wrong, because normally the IRS wishes to collect as much tax income as possible. We believe the IRS has truly adopted a "be kind to spouse rule." The IRS would probably not adopt the same approach today as they did in the 1970s, but they apparently feel that they are bound by their precedent.

In private letter ruling #9848042, the IRS clearly takes the approach that the surviving spouse is not required to take a distribution from the elected IRA in the year of his/her spouse's death. However, in the situation to which this private letter ruling pertained, it was stipulated to the IRS that the amount which would have been paid to the decedent, had he lived, was distributed to the surviving spouse. The IRS was not asked if this amount was required to be distributed. (The IRS will not answer a question it has not been asked.) The IRS needs to be asked the very pointed question, "Is any amount required to be distributed (either from the decedent's IRA or the spouse's elected IRA after she has elected to treat the decedent's IRA as her own) to anyone in the year in which a surviving spouse elects to treat a deceased spouse's IRA as her own?" If the IRS were to be asked, we expect the answer to be "No." However, we cannot guarantee that this would be the IRS response. Each entity must seek its own private letter ruling. CWF believes that the IRS possibly doesn't desire that the public be given a definite answer to this situation. When people err on the side of conservatism, they take the RMD in the year of death, and the IRS receives its tax revenue from the distribution sooner. ◆

REVISITING MSAs

Medical Savings Accounts (MSAs) are designed to encourage employees to save for medical expenses they may face. MSAs are available to self-employed individuals and employees of "small employers" (50 or less) who participate in "high-deductible health plans." They are also available to the spouses of the employees.

A high-deductible insurance plan must be sponsored by the employer in order for the individual to be eligible for an MSA. The high-deductible plan can be offered through a health maintenance organization (HMO) or through an employer-sponsored cafeteria plan. The employee is not eligible if they have additional health care coverage other than another high-deductible plan, or specialty coverage such as insurance for accidents, disability, dental or vision care, etc.

The 2000 limitations for the high-deductible plan are shown here:

<u>Individual Coverage</u> – The minimum deductible is $1,550 and the maximum is $2,350. The maximum out-of-pocket limitation is $3,100. (Out-of-pocket means the total of their deductibles: co-payments and other amounts the participant must pay for covered benefits, except premiums.)

<u>Family Coverage</u> – The minimum deductible is $3,100 and the maximum is $4,650. The maximum out-of-pocket limitation is $5,700.

An eligible individual will receive a tax deduction for the contribution that they make to an MSA. The contribution and deduction is limited to 65% of the annual deductible under the plan for a person with individual coverage, and 75% of the annual deductible under the plan for a person who has family coverage. These amounts must be prorated if the person did not participate in the high-deductible plan for the entire year. These amounts are further limited to the lesser of wages from the employer or net income if self-employed.

If the employer makes a contribution to the employee's MSA, the amount of the employer's contribution is not includible in income, nor is it subject to income tax withholding or other employment taxes. The employer will receive a tax deduction for the amount of the eligible contribution. If an employer makes a contribution for any employee, he must contribute the same amount or same percentage for all employees. Also, if the employer makes MSA contributions for its employees, the individual employees are not permitted to make any MSA contributions for themselves.

Earnings on MSA accounts are not included in income in the year earned.

Distributions can occur at any time. If the distribution is used for a medical expense that would qualify as a deductible item on an individual's 1040 Schedule A, it is considered a "qualified medical expense."

Distributions used for a purpose other than a qualified medical expense will be considered a nonqualified distribution and will be taxed. In addition, nonqualified distributions will be subject to a 15% penalty tax unless the distribution is made after age 65 or because of the accountholder's death or disability.

MSAs are currently considered a "test project," and the legislation creating them placed a limit of 750,000 MSA participants. Once this figure is reached, no more MSAs can be established until such time as the government decides to expand the program. At this time we remain below the estimated amount. No cut-off has been announced.

Form 8851 is used to furnish information about MSAs to Congress and to determine when the maximum number of MSAs allowed by law is reached. The form reports the total number of MSAs established for a particular time period, the total number of previously uninsured accountholders, the total number of excludable accountholders and the names and social security numbers of accountholders. The custodian/trustee filed this form by August 2, 1999, to cover the period from January 1 through June 30, 1999. There currently is no reporting requirement for January 1 through June 30, 2000.

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Revisiting MSAs,
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One of the tax advantages of MSAs is that there is no negative “use or lose” factor. If the funds are not fully used for qualified medical expenses, the funds will not necessarily be penalized. If the unused funds are not distributed until the accountholder attains the age of 65, has died, or becomes disabled, only tax will be assessed. There will be no additional penalty incurred. ◆

REMINDER REGARDING EMPLOYEE AFTER-TAX EMPLOYEE CONTRIBUTIONS—INELIGIBLE TO BE ROLLED OVER

A very common employer-sponsored retirement plan in the 1960s and 1970s was the thrift savings plan. The law at that time did not yet authorize 401(k) plans. The primary concept of such plans was: an employer would promise to match a certain portion of a participant’s after-tax employee contributions.

The law was then changed to authorize a participant to be able to make his or her elective deferral contributions to a 401(k) plan with before-tax dollars. Obviously, the 401(k) plan was much more attractive to both employers and employees after the law change, and most employers who sponsored a thrift savings plan converted them a long time ago into a 401(k) plan. However, such plans continue to hold employee after-tax employee contributions for many participants who now are in process of retiring.

The purpose of this article—to remind you, as the IRA custodian/trustee, that these after-tax employee contributions are not eligible to be rolled over or directly rolled over, and that some employers/qualified plan administrators forget this fact or do a poor job of informing a terminated participant of exactly what amount does not qualify to be rolled over. Admittedly, qualified plan administrators do a better job with after-tax employee contributions versus required distributions, but improvement many times is still needed.

The earnings on such contributions are eligible to be rolled over.

Set forth below is a typical explanation which is furnished to a terminating participant. We realize it is easy to criticize, but we would suggest the explanation does not explain the situation as simply or as well as it should be done.

“Employee after-tax contributions and earnings accounts may be withdrawn at any time. Payments requested during any given month will be paid on the 15th of the following month. Because these are after-tax contributions, taxes have already been paid on these funds. The earnings can be rolled into an IRA account or be rolled into another qualified plan which accepts direct rollovers. If the earnings are paid directly to you, federal income tax of 20% will be withheld from your check.

Listed below are the estimated balances in your Davis Retirement Plan.”

Note that the statement is not expressly made that the after-tax contributions are NOT eligible to be rolled over. The statement is made that “taxable benefits” may be rolled over. The reader of the statement is asked to reach the conclusion, “since after-tax contributions are not taxable, then I must not be able to roll them over.”

The participant is also required to determine what portion of the total balance is his or her after-tax contributions, since the total account balance is given and the amount of earnings, but not the amount of after-tax employee contributions. The participant must make the calculation—$8,513.04 less $2,960.23 equals $5,552.81, the amount of the after-tax contributions.

We would suggest that the qualified plan administrator also be informing the participant of the amount eligible to be rolled over. ◆

Typical Explanation – Davis Retirement Plan

401(k) Employee Contributions and Earnings - (All are Taxable)	$18,265.61
Employer After-Tax Contributions and Earnings - (Earnings of $2,960.23 are Taxable)	8,513.04
Company Contributions and Earnings at Vested Percentage — (All are Taxable)	14,601.48
Total Davis Retirement Account	$41,380.13

Preferred Explanation–Davis Retirement Plan

Amount Ineligible to Be Rolled Over	$ 5,552.81
Amount Eligible to Be Rolled Over	$35,827.32
Total Distribution Amount	$41,380.13

RELIEF FROM DISQUALIFICATION FOR PLAN ACCEPTING ROLLOVERS

The IRS has finally issued its final regulation (26 CFR 1.401(a)(31)-1) covering the situation: What happens if a qualified plan accepts a rollover or direct rollover which is not eligible to be rolled over?

The worst case scenario is that the accepting plan will be disqualified by the IRS. Obviously, this is a very harsh tax result for the plan and all participants of the plan. Generally, upon disqualification, plan participants must include their account balances in income, and such amounts are not eligible to be rolled over. If the participant is under age 59 1/2, the 10% additional tax of the Internal Revenue Code section 72(t) would apply unless an exception applied.

The IRS issued proposed regulations in 1996 to try to provide relieve for this situation. The IRS proposed the following two rules: (1) the plan would not be disqualified if the plan administrator was justified in reasonably concluding that the rollover was a valid rollover contribution and (2) upon determining that a rollover was actually an invalid rollover contribution, the plan must distribute the entire amount of the invalid rollover contribution plus earnings attributable thereto, to the participant within a reasonable period of time.

This seemed to be a reasonable rule. It was not good enough, though, for the industry of qualified plan administrators, because the IRS had created uncertainty by including within the proposed regulation a number of examples. It was the examples which caused the problems. All of the examples indicated that the plan administrator of the receiving plan was provided a letter by the participant from the plan administrator of the distributing plan stating that the distributing plan had received an IRS determination letter indicating the distributing plan was qualified under Code section 401(a). The qualified plan industry, the worry warts which they are, read this as requiring, in all cases, the issuance of an IRS determination letter. Many times such letters do not exist.

The final regulation clarifies that it is possible for the receiving plan administrator to reach a reasonable conclusion that a contribution is a valid rollover contribution without there being an IRS determination letter issued to the distributing plan. The IRS gave one example to illustrate one possible situation where reasonableness would be found: the plan administrator for the distributing plan furnishes a statement to the participant that in his or her opinion the plan is qualified and the distribution is eligible to be rolled over. The IRS states very clearly in the final regulation that other situations may also be found reasonable.

Set forth below are the IRS examples. In general, the receiving plan administrator must take reasonable steps to determine that a rollover contribution is eligible to be rolled over. That is, all the rules needed to have a valid rollover must be met. This applies to all plans involved in transactions, including conduit IRAs.

These rules are effective on April 21, 2000.

Example 1. (i) Employer X maintains for its employees Plan M, a profit sharing plan qualified under section 401(a). Plan M provides that any employee of Employer X may make a rollover contribution to Plan M. Employee A is an employee of Employer X, will not have attained age 70 1/2 by the end of the year, and has a vested account balance in Plan O (a plan maintained by Employee A's prior employer). Employee A elects a single sum distribution from Plan O and elects that it be paid to Plan M in a direct rollover.

(ii) Employee A provides the plan administrator of Plan M with a letter from the plan administrator of Plan O stating that Plan O has received a determination letter from the Commissioner indicating that Plan O is qualified.

(iii) Based upon such a letter, absent facts to the contrary, a plan administrator may reasonably conclude that Plan O is qualified and that the amount paid as a direct rollover is an eligible rollover distribution.

Example 2. (i) The facts are the same as Example 1, except that, instead of the letter provided in paragraph (ii) of Example 1, Employee A provides the plan administrator of Plan M with a letter from the plan administrator of Plan O representing that Plan O satisfies the requirements of section 401(a) (or representing that Plan O is intended to satisfy the requirements of section 401(a) and that the administrator of Plan O is not aware of any Plan O provision or operation that would result in the disqualification of Plan O).

(ii) Based upon such a letter, absent facts to the contrary, a plan administrator may reasonably conclude that Plan O is qualified and that the amount paid as a direct rollover is an eligible rollover distribution.

Example 3. (i) Same facts as Example 1, except that Employee A elects to receive the distribution from Plan O and wishes to make a rollover contribution described in section 402 rather than a direct rollover.

(ii) When making the rollover contribution, Employee A certifies that, to the best of Employee A's knowledge, Employee A is entitled to the distribution as an employee and not as a beneficiary, the distribution from Plan O to be contributed to Plan M is not one of a series of periodic payments, the distribution from Plan O was received by Employee A not more than 60 days before the date of the rollover contribution, and the entire amount of the rollover contribution would be includible in gross income if it were not being rolled over.

(iii) As support for these certifications, Employee A provides the plan administrator of Plan M with two statements from Plan O. The first is a letter from the plan administrator of Plan O, as described in Example 1, stating that Plan O has received a determination letter from the Commissioner indicating that Plan O is qualified. The second is the distribution statement that accompanied the distribution check. The distribution statement indicates that the distribution is being made by Plan O to Employee A, indicates the gross amount of the distribution, and indicates the amount withheld as Federal income tax. The amount withheld as Federal income tax is 20 percent of the gross amount of the distribution. Employee A contributes to Plan M an amount not greater than the gross amount of the distribution stated in the letter from Plan O and the contribution is made within 60 days of the date of the distribution statement from Plan O.

(iv) Based on the certifications and documentation provided by Employee A, absent facts to the contrary, a plan administrator may reasonably conclude that Plan O is qualified and that the distribution otherwise satisfies the requirements of section 402(c) for treatment as a rollover contribution.

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Relief From Disqualification, Continued from page 4

Example 4. (i) The facts are the same as in Example 3, except that, rather than contributing the distribution from Plan O to Plan M, Employee A contributes the distribution from Plan O to IRA P, an individual retirement account described in section 408(a). After the contribution of the distribution from Plan O to IRA P, but before the year in which Employee A attains age 70 1/2, Employee A requests a distribution from IRA P and decides to contribute it to Plan M as a rollover contribution. To make the rollover contribution, Employee A endorses the check received from IRA P as payable to Plan M.

(ii) In addition to providing the certifications described in Example 3 with respect to the distribution from Plan O, Employee A certifies that, to the best of Employee A's knowledge, the contribution to IRA P was not made more than 60 days after the date Employee A received the distribution from Plan O, no amount other than the distribution from Plan O has been contributed to IRA P, and the distribution from IRA P was received not more than 60 days earlier than the rollover contribution to Plan M.

(iii) As support for these certifications, in addition to the two statements from Plan O described in Example 3, Employee A provides copies of statements from IRA P. The statements indicate that the account is identified as an IRA, the account was established within 60 days of the date of the letter from Plan O informing Employee A that an amount had been distributed, and the opening balance in the IRA does not exceed the amount of the distribution described in the letter from Plan O. There is no indication in the statements that any additional contributions have been made to IRA P since the account was opened. The date on the check from IRA P is less than 60 days before the date that Employee A makes the contribution to Plan M.

(iv) Based on the certifications and documentation provided by Employee A, absent facts to the contrary, a plan administrator may reasonably conclude that Plan O is qualified and that the contribution by Employee A is a rollover contribution described in section 408(d)(3)(A)(ii) that satisfies the other requirements of section 408(d)(3) for treatment as a rollover contribution. ◆

PARTIES TO AN EDUCATION IRA

A frequently asked question about Education IRAs is, "May a person other than the initial depositor contribute to the Education IRA established for a certain child?" The answer is "Yes."

There are many people involved with an Education IRA: the child (designated beneficiary); the depositor, who is normally a parent, grandparent or family friend; the responsible individual, who is normally a parent; the inheriting designating beneficiary, who may also be a member of the family but who need not be; and the IRA custodian/trustee.

This article focuses on the rights and duties of these people. Our observations are set forth below after the IRS' definitions.

Definitions

Custodian—The custodian must be a bank or savings and loan association, as defined in section 408(n), or any person who has the approval of the IRS to act as custodian. Any person who may serve as a custodian of a traditional IRA may serve as the custodian of an Ed IRA.

Depositor—The depositor is the person who establishes the custodial account.

Designated Beneficiary—The designated beneficiary is the individual on whose behalf the custodial account has been established.

Family Member—Family members of the designated beneficiary include the spouse of the designated beneficiary. Family members also include a child, grandchild, sibling, parent, niece or nephew, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the designated beneficiary, and the spouse of any such individual.

Responsible Individual—The responsible individual, generally, is a parent or guardian of the designated beneficiary. However, under certain circumstances, the responsible individual may be the designated beneficiary.

The Observations:

Observation #1. It is the depositor and the custodian who are the primary signers of the IRS model form. The responsible individual does not sign it. The Education IRA comes into existence when signed by the depositor and the custodian/trustee.

Observation #2. Contributions after the first one may be made by the depositor or by any other individual.

Observation #3. There is a $500 contribution limit per designated beneficiary per calendar year. If a possible contributor has too large an MAGI (modified adjusted gross income), then he or she will not be eligible to make a contribution for a designated beneficiary.

Observation #4. The original depositor, the designated beneficiary, or other contributors do not need to have any "earned income" as with a traditional IRA or Roth IRA in order to be eligible to make a contribution to a person's Education IRA.

Observation #5. The depositor has the right to name the designated beneficiary for whom the Education IRA is established and to change this designation unless he or she transfers this right to the responsible individual. In Article VII, the IRS clearly provides for the depositor to define whether or not the responsible individual has the authority to change the designated beneficiary. If so, the new beneficiary must be a member of the designated beneficiary's family as described in section 529(e)(2).

An IRA custodian/trustee will want an administrative system which allows it to know who has the authority to change the designated beneficiary.

Observation #6. The depositor also has the right to name a successor designated beneficiary (i.e. being a named death beneficiary) in the situation where the designated beneficiary dies, unless he or she transfers this right to the responsible individual. An IRA custodian/trustee will want an administrative system which allows it to know who has the authority to change the inheriting designated beneficiary.

Observation #7. The depositor also has the right to designate the first responsible individual, but he or she is severely limited as to whom he or she can choose because only a parent or guardian of the designated beneficiary qualifies to be a responsible individual. There can be only be one responsible individual at any time.

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Parties to Education IRA,
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Observation #8. Articles V and VI of the IRS' Model Form 5305-EA define the other rights and duties of the depositor and the responsible individual and their successors. Most powers belong to the responsible individual, but additional provisions of the Ed IRA document could be written to reserve certain rights to the depositor rather than giving them to the responsible individual.

Investing. The depositor is responsible to invest the initial contribution. The responsible individual has the power to redirect the initial investment and the power to direct the investment of additional contributions. If the responsible individual fails to so instruct, the depositor's initial investment direction will govern all additional contributions until different instructions are received.

Distributions. The responsible individual also has the power to direct the custodian regarding distributions, administration, and management of the account unless a special provision has been added to the plan agreement reserving these powers for the depositor. There are two situations when the responsible individual does not determine when distributions take place. First, the custodian/trustee will distribute the Ed IRA's account balance directly to the designated beneficiary within 30 days of when the designated beneficiary attained age 30. Second, any balance to the credit of the deceased designated beneficiary shall be paid within 30 days of his or her death to the inheriting designated beneficiary, unless such inheriting designated beneficiary is a family member of the deceased designated beneficiary, who is under age 30 as of the date of death. In such case, this family member becomes the Education IRA's new designated beneficiary.

Successor Responsible Individual. The first responsible individual acquires the right to designate his or her successor. That is, neither the depositor nor the custodian has the right to designate a successor responsible individual. The responsible individual must designate his or her successor in writing and it must be witnessed. This successor does not need to be a parent or guardian of the designated beneficiary. However, if the responsible individual does not designate a successor, and if he or she dies or becomes incapacitated while the designated beneficiary is a minor, then the successor responsible individual shall be the other parent or successor guardian.

The depositor has the right to allow a designated beneficiary to become the responsible individual (i.e. revokes the authority initially granted to the responsible individual) when he or she attains the age of majority under state law.

The depositor also has the right to not authorize the designated beneficiary to become the responsible individual of his or her Education IRA when he or she attains the age of majority under state law. In this situation, the existing responsible individual continues to serve as the responsible individual until such time as all assets have been distributed. However, if the responsible individual dies or becomes incapacitated, then the designated beneficiary automatically becomes the responsible individual.

In the situation where the designated beneficiary has died and the Education IRA acquires a new designated beneficiary who is a family member under the age of majority, the parent or guardian of such new beneficiary shall automatically become the successor responsible. Note the IRS model form does not specify a method for selecting which parent.

Summary. An Education IRA can receive contributions from others in addition to those from the initial depositor. The depositor's right and duties are very limited unless he or she reserved the right to change the designated beneficiary and/or the inheriting designating beneficiary of the Education IRA. Most duties belong to the responsible individual who is a parent or guardian of the initial designated beneficiary. In some situations, there will be an automatic change in who the responsible individual is. For example, there is an automatic change in who the responsible individual is when the inheriting beneficiary is a family member of the deceased designated beneficiary and is not of the age of majority. A financial institution which serves as an Education IRA custodian should have the administrative capabilities to keep track of the above persons and their respective rights as summarized in this article. ◆

MISCELLANEOUS QUESTIONS ABOUT EDUCATION IRAs

Does the concept of carryback contributions (i.e. a contribution made on or before April 15 for the prior tax year) apply to Education IRAs?

No. Under current law the annual contribution limit is $500 per child. Whether or not this limit is exceeded is determined on a calendar-year basis. The deadline for making contributions for 1999 was December 31, 1999. The deadline for 2000 will be December 31, 2000.

Is it permissible for persons in addition to the original depositor to make contributions to an Education IRA?

Yes. Article I states subsequent contributions may be from the depositor, or from any other individual for the benefit of the designated beneficiary, provided the designated beneficiary has not attained the age of 18 as of the date such contributions are made.

Must the initial IRA depositor give the responsible individual the right to change the designated beneficiary?

No. Note that it is the depositor and the custodian who are the primary signers of the IRS model form. In Article VII the IRS clearly provides for the depositor to define whether or not the responsible individual has the authority to change the designated beneficiary. If so, the new beneficiary must be a member of the designated beneficiary's family as described in section 529(e)(2). ◆

Department of the Treasury
Internal Revenue Service
Washington, DC 20224

Person to Contact: Lawrence W. Heben
Telephone Number: (202) 535-5836
Refer Reply to: E:EP:R:10
Date: Nov 1 1991

Mr. James Carlson
Collin W. Fritz and Associates Ltd
PO Box 426
Brainerd, Minnesota 56401

Dear Mr. Carlson:

This is in response to your letter dated August 21, 1991, in which you seek information concerning minimum distributions from an individual retirement account (IRA).

Section 1.408-8 of the proposed regulations, Question and Answer A-4, in general, permits the surviving spouse of the owner of an IRA (irrespective of his/her age) to elect to treat the IRA as his/her IRA. Question and Answer A-4 further indicates how such an election is to be made, and provides that the effect of the election is to subject the surviving spouse's interest in the IRA to the distribution requirements of section 401(a)(9)(A) of the Code.

In general, distributions made from an electing surviving spouse's IRA are subject to the mandatory distribution rules of section 401(a)(9) and 408(a)(6) of the Code. Furthermore, distributions from the electing spouse's IRA must be made with reference to the required beginning date of the surviving spouse. Thus for example, an electing surviving spouse who is under age 70 1/2 need not begin receiving distributions from his/her IRA prior to his/her attaining age 70 1/2 even if the deceased IRA holder was over age 70 1/2 at the time of his/her death. Furthermore, calculating the amount of required distributions to an electing surviving spouse for a particular calendar year is done by referring to the attained age of the electing spouse in that calendar year (and the attained age of the electing spouse's designated beneficiary in that calendar year, if applicable).

In general, an electing surviving spouse may designate a beneficiary in order to comply with the requirements of section 401(a)(9)(A)(ii) of the Code.

Section 1.408-8 of the proposed regulations, Question and Answer A-5, provides that for purposes of determining the minimum required IRA distribution for a calendar year, the IRA account balance as of December 31 of the previous calendar year will be used.

In general, an electing surviving spouse's IRA, described in regulation section n1.408-8, Question and Answer A-4 (above), is treated as coming into existence in the calendar year in which the election is made. As of December 31 of the calendar year prior to the year of election, the IRA has no account balance and thus may be treated as having an account balance of "zero." If the surviving spouse is age 70 1/2 or older in the year he/she makes the election described above, his/her minimum required distribution for the year of election, if any, will be computed as of December 31 of the last pre-election year.

We believe that this general information will be of assistance to you. However, this is not a ruling and may not be relied upon as such.

Sincerely yours,

William B. Hulteng
Acting Chief, Employee Plans Rulings Branch

QA QUESTIONS AND ANSWERS

JOHN THOMAS IS AGE 73. HE HAS IRA #1 WHICH HAD A BALANCE OF $50,000 AS OF 1-1-00 WITH IRA CUSTODIAN #1. HIS REQUIRED DISTRIBUTION AMOUNT WITH RESPECT TO IRA #1 FOR 2000 IS $2,800. HE WISHES TO TRANSFER $20,000 TO AN IRA WITH US (IRA CUSTODIAN #2). MUST HE WITHDRAW HIS REQUIRED MINIMUM AMOUNT BEFORE HIS TRANSFER OCCURS?

No. The general rule is that a person must take his required minimum from the IRA which existed on January of that year. In John's case, this is IRA #1. Because he still has $30,000 in IRA #1, he will easily be able to comply with the rule that he needs to be paid his minimum of $2,800 from IRA #1. He may wait until 12-31-00 to take this payment. Leaving funds on deposit to pay the required minimum is one of the two main methods of complying with the rule that you cannot transfer a required distribution amount. The other method is to pay out this amount to the IRA accountholder.

SALLY HUSS PARTICIPATES IN HER EMPLOYER'S 401(k) PLAN. SHE HAS MODIFIED ADJUSTED GROSS INCOME OF $46,000 AND IS NOT MARRIED. HER ACCOUNTANT HAS TOLD HER SHE IS NOT ELIGIBLE TO CONTRIBUTE TO EITHER A TRADITIONAL IRA OR TO A ROTH IRA BECAUSE SHE IS COVERED BY THE 401(k) PLAN. IS THE ACCOUNTANT CORRECT?

No. Her accountant is wrong. Sally is eligible to contribute $2,000 to either a traditional IRA, Roth IRA, or both types. The combined contribution limit is $2,000. Many people mistakenly believe that because a person participates in a 401(k) plan that he or she cannot make a Roth IRA contribution. Participation in a 401(k) plan or any other pension plan has NO impact on Sally's or any other person's eligibility to make a contribution to a Roth IRA. Being an active participant, or your spouse being an active participant, only affects one's being able to claim a deduction for a contribution to a traditional IRA. Sally would be able to make a $2,000 nondeductible contribution to a traditional IRA, but she is not allowed to deduct this amount because her $46,000 is more than the phaseout amount for 2000—$43,000.

SAME SITUATION AS FOR QUESTION #2, EXCEPT SALLY'S MODIFIED ADJUSTED GROSS INCOME IS $174,000. HER ACCOUNTANT HAS TOLD HER SHE IS NOT ELIGIBLE TO CONTRIBUTE TO EITHER A TRADITIONAL IRA OR TO A ROTH IRA. IS THE ACCOUNTANT CORRECT?

This time the accountant is half right and half wrong. Sally is not eligible to make a Roth IRA contribution because her modified adjusted gross income exceeds the limit of $160,000. However, she is still eligible to make a $2,000 nondeductible IRA contribution to her traditional IRA.

WOULD THE ANSWERS TO QUESTIONS #2 AND #3 CHANGE IN ANY WAY IF SALLY PARTICIPATED IN HER EMPLOYER'S SIMPLE-IRA PLAN RATHER THAN A 401(K) PLAN?

No.

MARIA LEOPOLD DIRECTLY ROLLED OVER $30,000 FROM HER FORMER EMPLOYER'S 401(k) PLAN TO A CONDUIT IRA SHE ESTABLISHED WITH US IN JANUARY, 2000. HER NEW EMPLOYER HAS A 401(k) PLAN ALSO. SHE NOW WANTS TO DIRECTLY ROLL OVER THESE FUNDS TO THE NEW EMPLOYER'S 401(k) PLAN? YOU HAVE ASKED, "DOES THE ONE ROLLOVER PER YEAR" MAKE HER INELIGIBLE TO DO THIS ROLLOVER UNTIL NEXT YEAR?

No. The once per year rollover limitation rule only applies to distributions FROM IRAs. It does not apply to distributions from 401(k) plans and other qualified plans. If otherwise eligible, a person may roll over an unlimited number of distributions from a qualified plan.

OUR BANK HAS HAD A SEP FOR ITS EMPLOYEES SINCE 1987. THIS SEP WAS ESTABLISHED BY COMPLETING AND EXECUTING THE IRS MODEL FORM 5305-SEP. IN 1998 THE BANK STARTED A 401(k) PLAN. THE BANK, AS THE EMPLOYER, IS MAKING CONTRIBUTIONS TO BOTH PLANS. IN A RECENT SEMINAR WE WENT OVER THE FORM 5305-SEP IN SOME DETAIL. THE IRS CLEARLY WRITES IN THE INSTRUCTIONS FOR THIS FORM THAT AN EMPLOYER MAY NOT USE THE IRS FORM 5305-SEP TO ESTABLISH OR MAINTAIN A SEP IF IT CURRENTLY SPONSORS A QUALIFIED PLAN. DOES THE BANK HAVE A COMPLIANCE/TAX PROBLEM?

Yes. Your bank will want to talk with its attorney. We admit to not having ever seen how the IRS deals with this situation. The technical answer is that the contributions to the SEP have not qualified as SEP contributions. We expect the IRS would assess a reasonable monetary penalty and then allow these contributions to qualify as SEP contributions.

IS THE CONTRIBUTION DEADLINE FOR A FARMER TO MAKE HIS SEP CONTRIBUTION MARCH 1, 2000, OR APRIL 17, 2000?

Because April 15 falls on a Saturday, the deadline is April 17, 2000, plus extensions. Most farmers choose to file (and pay) on or before March 1 because they then are not required to comply with the estimated tax payment rules. ◆