THE Pension Digest

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ALSO IN THIS ISSUE –

TWO ALTERNATIVE METHODS TO CALCULATE RELATED INCOME FOR IRA CONTRIBUTIONS

The IRS recently issued Notice 2000-39. In it the IRS authorizes two new methods to calculate the related income for certain contributions, including excess contributions. In certain situations, the IRA rules allow an IRA accountholder to withdraw a contribution amount or to transfer it via a recharacterization as long as the related income is also withdrawn or transferred. These two new methods apply to any contributions made in 2000 or a later year. At this time these methods are an alternative and do not replace the current method set out in IRA Regulation 1.408-(c)(2)(ii). That is, an IRA accountholder, for the time being, will be able to select which method produces the best results. The IRS has said that there will come a time when they will settle on a mandatory method(s).

Why Methods?

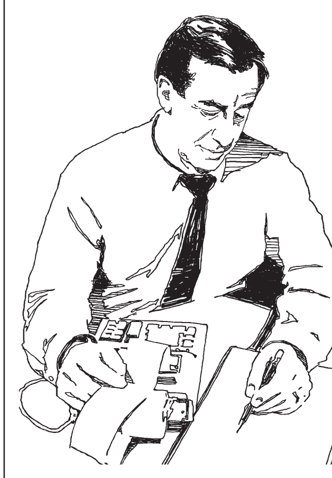
The IRS has proposed that the income calculation for an IRA recharacterization should be different from an IRA contribution which is withdrawn. With respect to annual contributions, the IRS has written the rule to adopt a last in, first out approach. This approach does not work for recharacterizations since the law gives the accountholder the right to choose which contributions will be recharacterized, if any.

Under Code section 408(d)(4), an IRA accountholder is given the special tax treatment that he or she is able to withdraw an IRA contribution and not have to include such distribution amount in his or her taxable income as long as three requirements are met: (1) no tax deduction was allowed for the contribution; (2) the withdrawal must be accomplished before the tax-filing deadline for the current tax year, including any extensions; and (3) the related income must be withdrawn. IRA Regulation 1.408-4(c)(2)(ii) sets forth the rules and procedures for calculating the related income. Under this method it was not possible to have negative income. Tax rules require an accountholder to include this income in his or her taxable income, and it will be subject to the pre-59 1/2 additional 10% tax unless an exception would apply. This method applies to contributions to traditional and Roth IRAs.

Under Code section 408(A)(d)(6), an IRA accountholder is given the special tax treatment that he or she is able to recharacterize an IRA contribution as long as three requirements are met: (1) no tax deduction was allowed for the contribution to the transferor plan; (2) the transfer must be accomplished before the tax-filing deadline for the current tax year, including any extensions; and (3) the related income must be transferred. The IRS, in writing the Roth IRA regulation, allowed that net income can be a negative amount.

Why the Need for New Methods?

The regulation's method requires that the income be determined from January 1 of the year the contribution was made, and not from the date of the contribution. Thus, it can be argued with some justification that income is overstated. In addition, net income could not be a negative amount under this method.



Continued on page 2

Alternative Methods, Continued from page 1

The New Method for Nonrecharacterized Contributions

The related income for a nonrecharacterized contribution would be a pro rata portion of the earnings accrued by an IRA during the period the IRA held the contribution. No longer will the IRS require earnings realized before the contribution was made to be withdrawn, but only during a computation period which is the period beginning immediately prior to when the particular contribution is made and ending immediately prior to the withdrawal of the contribution. The related income may now be a negative number.

Related Net Income (Loss) = Contribution to be Withdrawn X

(Adjusted Closing Balance - Adjusted Opening Balance)
Adjusted Opening Balance

The adjusted closing balance is the fair market value of the IRA immediately prior to the withdrawal of a particular contribution plus the amount of any distribution during the computation period.

The adjusted opening balance is the fair market value of the IRA immediately prior to the time the particular contribution is made plus the amount of any contributions during the computation period.

Obviously, a very important term is, "fair market value." The IRS has only partially defined this term. The IRS has stated the fair market value of an IRA asset at the beginning of the computation period which is not normally valued on a daily basis is deemed to be the most recent, regularly determined, fair market value of the asset, determined as of a date that coincides with or precedes the first day of the computation period. However, a recharacterized contribution is only taken into account for the period it is actually held in a particular IRA.

The IRS has created a last in, first out rule when a person has made multiple contributions to the same IRA. Also, if the individual has multiple IRAs, then the related income calculation is made only on the IRA designated by the individual, and the withdrawal must come from the IRA.

The IRS furnished the following two examples. We have modified the presentation of these examples:

Example #1. Taxpayer "A" contributes $1,600 to her IRA on 5-1-2000. Prior to this contribution the fair market value was $4,800. On 2-1-2001, Taxpayer "A" decides she wishes to withdraw $400 plus the related income. The IRA's fair market value is now $7,600. There were no other contributions or distributions. The formula to be used is:

Related Net Income (Loss) = Contribution to be Withdrawn X

(Adjusted Closing Balance - Adjusted Opening Balance)
Adjusted Opening Balance

Related Net Income (Loss) = $400 X ($7,600 - $6,400)
$6,400

Related Net Income (Loss) = $400 x .1875
Related Net Income (Loss) = $75.00

Example #2. Taxpayer "B" contributes $200 on the 15th of each month to her IRA in 2000 and 2001. Thus, she has an excess of $400 for 2000. Taxpayer "B" requests to withdraw this $400 for 2000 plus the related income, on 3-1-2001. The IRA's fair market value on 3-1-2001, is $16,000. The IRA's fair market value on 12-15-2000, is $12,000. The IRA's fair market value on 11-15-2001, is $11,000.

- Total Related Net Income = net income from 12-15-2000 contribution plus the net income from the 11-15-2000 contribution.

- Related Net Income for the 12-15 Contribution = Contribution to be Withdrawn X (Adjusted Closing Balance - Adjusted Opening Balance /Adjusted Opening Balance

  Related Net Income (Loss) = $200 X ($16,000 - $12,600)
  $12,600

- The $12,600 = $12,000 plus the three $200 contributions of 12-15, 1-15, and 2-1.

  Related Net Income (Loss) = $200 X .26984
  Related Net Income (Loss) = $54.00

- Related Net Income for the 11-15 Contribution = Contribution to be Withdrawn X (Adjusted Closing Balance - Adjusted Opening Balance /Adjusted Opening Balance

  Related Net Income (Loss) = $200 X ($16,000 - $11,800)
  $11,800

- The $11,800 = $11,000 plus the three $200 contributions of 11-15, 12-15, 1-15 and 2-1

  Related Net Income (Loss) = $200 x .3559
  Related Net Income (Loss) = $71.00
  Total Related Net Income (Loss) = $71 + $54 = $125
  Total Distribution Amount = $200 + $71 + $200 + $54 = $525

The New Method for Recharacterized Contributions

The related income for a recharacterized contribution would be a pro rata portion of the earnings accrued by an IRA during the period the IRA held the contribution.

The formula to be used is:

Related Net Income (Loss) = Contribution to be Withdrawn X

(Adjusted Closing Balance - Adjusted Opening Balance)
Adjusted Opening Balance

Continued on page 3

The Pension Digest

Alternative Methods,
Continued from page 2

The primary difference between recharacterizations and regular contributions is that in the case of multiple contributions to an IRA, the accountholder can choose by dollar amount (but not by specific assets acquired with those dollars) which contributions, or portions thereof, are to be recharacterized. Otherwise, the calculation rules are the same.

The IRS furnished two examples for calculating the related earnings for a recharacterized contribution, and we again have hopefully clarified these examples by making minor modifications.

Example #3. Taxpayer "C" makes a $160,000 conversion contribution to her Roth IRA on 3-1-2000. The fair market value of her Roth IRA as of 3-1-2000 was $80,000. She determines that she was ineligible to make this conversion contribution. She elects to recharacterize this contribution plus the related income (or loss) on 3-1-2001 when the fair market value is $225,000. There are no other contributions or distributions.

The formula to be used is:

$$\text{Related Net Income (Loss)} = \text{Contribution to be Withdrawn X} \frac{(\text{Adjusted Closing Balance - Adjusted Opening Balance})}{\text{Adjusted Opening Balance}}$$

$$\text{Related Net Income (Loss)} = \$160{,}000 \text{ X } \frac{(\$225{,}000 - \$240{,}000)}{\$240{,}000}$$

Related Net Income (Loss) = $160,000 x (-.0625)

Related Net Income (Loss) = ($-10,000)

Net Recharacterized Amount = $160,000 + (-$10,000) = $150,000

Example #4. Taxpayer "D" makes a $100,000 conversion contribution to her Roth IRA on 4-1-2000. She decides to invest such amount by buying $50,000 (100 shares) worth of ABC Corp. and $50,000 (100 shares) or XYZ Corp. On November 1, 2000, the 100 shares of ABC Corp are worth $40,000 and the 100 shares of XYZ Corp are worth $70,000. There has been a net gain of $10,000, since the ABC stock has decreased in value by $10,000 but the XYZ stock has increased in value by $20,000. Taxpayer D has the right to decide by dollar amount the contribution or portion thereof which is to be recharacterized. Under Notice 2000-39, she does not have the right to select the specific investment to be recharacterized. Regardless of the amount of the contribution recharacterized, the determination of that amount (and the net income allocable thereto) is not affected by whether the recharacterization is accomplished by the transfer of the shares of ABC Corp or of the shares of XYZ Corp.

For example, she may elect to recharacterize $50,000. The formula to be used is:

$$\text{Related Net Income (Loss)} = \text{Contribution to be Withdrawn X} \frac{(\text{Adjusted Closing Balance - Adjusted Opening Balance})}{\text{Adjusted Opening Balance}}$$

$$\text{Related Net Income (Loss)} = \$50{,}000 \text{ X } \frac{(\$110{,}000 - \$100{,}000)}{\$100{,}000}$$

Related Net Income (Loss) = $50,000 X .10

Related Net Income (Loss) = $5,000

Net Recharacterized Amount = $50,000 + $5,000 = $55,000

Taxpayer "D" must instruct that $55,000 be transferred from her Roth IRA to her traditional IRA. The $55,000 can be comprised of ABC Corp. stock, XYZ Corp. stock, or a combination thereof.

As another example, she may elect to recharacterize $40,000. The formula to be used is

$$\text{Related Net Income (Loss)} = \text{Contribution to be Withdrawn X} \frac{(\text{Adjusted Closing Balance - Adjusted Opening Balance})}{\text{Adjusted Opening Balance}}$$

$$\text{Related Net Income (Loss)} = \$40{,}000 \text{ X } \frac{(\$110{,}000 - \$100{,}000)}{\$100{,}000}$$

Related Net Income (Loss) = $40,000 X .10

Related Net Income (Loss) = $4,000

Net Recharacterized Amount = $40,000 + $4,000 = $44,000

Taxpayer "D" must instruct that $44,000 be transferred from her Roth IRA to her traditional IRA. The $44,000 can be comprised of ABC Corp stock, XYZ Corp stock, or a combination thereof.

Observe that the IRS examples do not illustrate a situation of multiple conversions.

Example #5. Taxpayer "E" makes a $60,000 conversion contribution to her Roth IRA on 4-1-2000. She also makes a $40,000 conversion contribution to her Roth IRA on 5-1-2000. She decides to invest such amounts by buying $60,000 (100 shares) worth of DEF Corp. and $40,000 (100 shares) of AAA Corp. On November 1, 2000, these 100 shares of DEF Corp are worth $90,000 and the 100 shares of AAA Corp. are worth $30,000.

Taxpayer E elects to recharacterize the $40,000 conversion contribution (and the related loss) made on 5-1-2000. The formula to be used is

$$\text{Related Net Income (Loss)} = \text{Contribution to be Withdrawn X} \frac{(\text{Adjusted Closing Balance - Adjusted Opening Balance})}{\text{Adjusted Opening Balance}}$$

$$\text{Related Net Income (Loss)} = \$40{,}000 \text{ X } \frac{(\$30{,}000 - \$40{,}000)}{\$40{,}000}$$

Continued on page 4

Alternative Methods, Continued from page 3

Related Net Income (Loss) = $40,000 X -.25

Related Net Income (Loss) = ($10,000)

Net Recharacterized Amount = $40,000 +(-$10,000) or $30,000

Summary. The IRS, for the time being, has authorized two additional methods to calculate the related income for certain IRA contributions. There is one new method for annual contributions and there is another method for recharacterizations. These two new methods apply to any contributions made in 2000 or a later year. At this time, these methods are an alternative and do not replace the current method set out in IRA Regulation 1.408-4(c)(2)(ii). For the time being an IRA accountholder will be able to select which method produces the best result. The IRS has said that there will come a time when they will settle on a mandatory method(s). IRA forms vendors will most certainly be making available new forms for these two alternatives.

Request for Comments

The Service and Treasury invite comments and suggestions concerning the new method described in this notice for calculating net income under §§ 408(d)(4) and 408A(d)(6) and also concerning the effective date for a rule that would establish the new method as the only method for calculating net income under §§ 408(c)(4) and 408A(d)(6). Any correspondence received will be evaluated, together with appropriate considerations relating to tax administration, to determine the scope of future guidance.

Comments can be submitted to CC:DOM:CORP:R (Notice 2000-39), Room 5226, Internal Revenue Service POB 7604, Ben Franklin Station, Washington DC 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 2000-39), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. All comments will be available for public inspection and copying.

CWF's Comments

We will be submitting the following comments to the IRS. We do not believe there needs to be or should be just one or two methods mandated for calculating the related earnings. The IRS' proposal serves the brokerage industry well and those accountholders with self-directed IRAs, but it does not service very well the customers of banks and credit unions with primarily time deposit IRAs. It appears the IRS wants to stay away from any method which looks at how the contribution to be withdrawn was specifically invested. The IRS apparently wants mandatory defined methods for ease of administrative purposes rather than for tax logic purposes. The calculation need not be made as difficult as the IRS proposes. If a person has invested his or her $2,000 contribution in an identifiable time deposit or savings account, then the earnings are readily determinable—the earnings realized by that deposit from the time of contribution to the time just prior to the withdrawal. The requirement that the earnings of all other time deposits under a specific IRA plan agreement be involved in the calculation is simply making too much work for IRA custodians. The IRS needs to be thinking about keeping it simple for bank and credit union IRA custodians rather than keeping it simple for the IRS or for IRA trustees that service self-directed IRAs. The IRS has adopted "any reasonable method applied on a consistent basis" for related income calculations for 401(k) plans and should adopt a similar rule for IRAs. ◆

THE SINGLE RECALCULATION SITUATION—TWO VERY INTERESTING (REVOLUTIONARY PLRs)

The following situation occurs fairly frequently. An IRA accountholder attained age 70½ on 5-2-95. He had named his two daughters as his primary beneficiaries.

Even though, for RMD calculation purposes, he was permitted to use a joint life expectancy, he nevertheless elected to establish a distribution schedule based on his singular life expectancy and the recalculation method.

Sometimes this election is expressly made, and other times it is deemed made. Apparently, a fair number of IRA custodians/trustees have written their IRA plan agreement to provide that an accountholder will be deemed to have elected a single recalculation distribution schedule unless he or she expressly instructs the custodian/trustee otherwise.

What happens with his IRA when he dies at age 75 on 9-20-00? Are his daughters required to close his IRA (now two inherited IRAs of the daughters) by 12-31-01, or are they eligible to have a payout over a longer period (i.e. one of their life expectancies)?

In Private Letter Rulings (PLRs) 200028040 (the letter to the first daughter) and 20028041 (the letter to the second daughter) the IRS concluded that each daughter would not be required to close our her respective inherited IRA by 12-31-01.

The IRS' analysis. The "at least as rapidly rule" of Code section 401(a)(9)(b)(i) and regulation 1.401(a)(9)-1, Question and Answer F-3A is not violated even though the father was having his IRA distributed to him over his single life expectancy. The IRS reasoned that the father <u>could have had his distribution over a joint schedule under the RMD calculation rules but he had chosen to withdraw more than was required.</u> The IRS thus concluded that the daughters would be eligible to use the oldest daughter's age to determine the post-death distributions even though the oldest daughter's age had not been used for the pre-death distributions.

The IRS also made another remarkable ruling with respect to the above situation. The

Continued on page 5

The Pension Digest

Single Recalculation Continued from page 4

father had had five (5) IRAs. Four of the IRAs contained a provision agreement which required that on the death of an accountholder who is receiving distributions over his life expectancy, his remaining IRA balance must be distributed no later than December 31 of the year following his death. One of the IRAs did not contain such a requirement. To solve the problem within four of the IRAs, the IRS found acceptable a proposal to transfer the funds from the four IRAs, with the immediate payout requirement to four new inherited IRAs which did not have such a requirement. In effect, the IRS has allowed a beneficiary to amend the IRA plan agreement after the death of the IRA accountholder. It appears that the IRS will allow such an amendment absent an express statement by the IRA accountholder that he would not permit such amendments.

One must wonder if the IRS will always be this nice, but these PLRs do provide a basis for other people in this same situation to argue that an immediate payout is NOT required. Tax benefits could be very substantial.

As you know, PLRs do not establish binding policy except with respect to the specific individual, but they do reflect the likely position which the IRS will adopt.

Presumably, all IRA form vendors will be revising their IRA plan agreement forms, if necessary, to make it clear that beneficiaries in the above situation will be able to achieve the same result.

Be sure to distinguish the above situation (i.e. the accountholder was eligible to use a joint distribution schedule but chose not to) from the situation where he is not eligible to use a joint schedule because he either did not name a beneficiary as of his required beginning date or he had designated a nonliving person other than a qualifying trust as his beneficiary. ◆

FDIC COVERAGE FOR MSAs

Medical Savings Accounts (MSAs) are a relatively new type of tax-preferred deposit account authorized by Code section 220 of the Internal Revenue Code. An MSA must be established in the United States by means of a written trust instrument and must be established exclusively for the purpose of paying the qualified medical expenses of the accountholder or other qualified beneficiaries. The primary purpose of an MSA is to accumulate funds to be used to pay the qualified medical expenses of the accountholder, his or her spouse, or other dependents. However, the intent is that funds remaining after an accountholder's death will go to his or her beneficiaries.

The FDIC has made the following statements regarding its $100,000 deposit insurance coverage. As is well know, insurance coverage is based upon the rule that there is separate insurance coverage for deposits held in different rights and capacities.

An MSA will generally be considered an individual-ownership account of the individual who establishes the MSA. This means that any funds in an MSA will be added to any funds this individual holds in his or her other individual ownership accounts at the same insured depository institution and be insured up to $100,000. However, it is possible that an individual's MSA will be entitled to separate insurance deposit coverage if the rules for a different right and capacity are satisfied.

As a Revocable Trust

An MSA may qualify as a revocable trust account under section 330.8 of the regulation and be entitled to $100,000 of coverage for this category of insurance coverage. To qualify for separate deposit insurance coverage, a revocable trust account must meet the following kinship and recordkeeping requirements: (1) the named beneficiary must be the accountholder's spouse, child, parent or sibling; (2) the accountholder's intentions that, upon his or her death, the funds belong to a named beneficiary must be manifested in the title of the deposit account using commonly accepted terms such as "in trust for," "as trustee for," or "payable on death" or the abbreviations for those terms, "ITF," "ATF," or "POD;" (3) the beneficiary must be specifically identified by name in the deposit account records of the depository institution; and (4) a qualified beneficiary, at the death of the last owner, must have a vested or non-contingent interest in the trust. Under the FDIC rules, the separate coverage for trusts will not apply if he or she names himself or herself as the beneficiary. The FDIC believes the failure to designate a beneficiary of an MSA is the same as naming himself or herself as the beneficiary.

As an Employee Benefit Plan

An MSA may also qualify as an employee benefit account under section 330.12 of the regulation and be entitled to $100,000 of coverage for this category of insurance. Among other things, section 330.12(a) provides "pass-through" deposit insurance coverage for "any deposits of an employee benefit plan." In general, pass-through coverage allows for an employee benefit plan's deposit to be insured in excess of $100,000 because each participant's pro rata share of the deposit is entitled to $100,000 of coverage.

An "employee benefit plan" means an "employee welfare plan" or an "employee pension benefit plan" or both.

An MSA is not an employee benefit plan because MSAs are not established for retirement purposes.

An MSA, however, could be established by an employer or an employee organization on behalf of an employee pursuant to an employee welfare plan and would be eligible for separate insurance as an account of an employee benefit plan. The term "employee welfare benefit plan" is defined as: "any plan, fund or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or both, to the extent that such plan, fund or program was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, (A) medical, surgical, or

Continued on page 6

FDIC Coverage
Continued from page 5

hospital care or benefits, or benefits in the event of sickness, accident, disability, death, or unemployment or vacation benefits..."

Summary

For FDIC insurance coverage purposes, an individual's MSA will usually be aggregated with his or her other individual-ownership accounts and will count towards the general $100,000 coverage limit. However, it is possible that an individual's MSA could be entitled to separate insurance deposit coverage under the trust coverage rules or the employee benefit plan rules. The FDIC believes its analysis applies equally to an MSA established by a self-employed individual—it could either be an individual ownership account, a trust account, or pursuant to an employee benefit plan. ◆

GOING, GOING, THE MSA DEADLINE

MSA's exist because of the Health Insurance Portablilty and Accountability Act of 1996 (HIPAA). HIPAA created a pilot program for MSAs to run from January 1, 1997 to the earlier of: the end of 2000 or whenever 750,000 MSAs had been established. The deadline is the end of 2000 as less than 75,000 MSAs have been established.

We do not expect a major rush to establish MSAs by year end, but, because of the grandfather rules (as discussed later) financial institutions will be receiving some questions from people who are eligible for MSAs but have put off making their decisions to have an MSA plan or an MSA. It is quite clear that the demand for MSAs has been hurt by the test nature of the program.

An MSA is a tax-exempt trust or custodial account with a financial institution where an individual can save money for future medical expenses. An MSA must be used in conjunction with a high-deductible health insurance plan.

Only certain employers are eligible. In general, an employer must either be a self-employed individual or a business which averaged 50 or fewer employees during either of the two preceding calendar years. There are special rules for companies which grow past 50 employees.

An employer may decide to make contributions to an MSA for its employees. An employer is allowed to deduct its contributions on the "employee benefits programs" line of its tax return for the year it makes its contribution. There are special rules governing deductibility and the amount of the contributions. An employee does does not pay taxes (withholding, employment, or income) on these employer contributions.

If an employer does not make contributions on behalf of its employees, then an individual may make his or her own contributions and deduct these amounts on his or her tax return without itemizing deductions as long as the contributions are within certain limits.

Who Is Grandfathered?

At the conclusion of the MSA test program, certain individuals and certain employers are grandfathered. That is, certain individuals and certain employers will be able to continue to maintain MSAs for years after 2000 even though all other individuals and employers will no longer be able to establish and fund MSAs.

Individuals with active MSAs and individuals of "participating employers" will be able to continue with their participation in their MSAs in the following situations. An individual will continue to be an eligible individual for any tax year after 2000 if such individual was an active participant for any year from 1997-2000, or first becomes an active participant for a tax year ending after 2000 by reason of coverage under a high-deductible health plan of an MSA participating employer.

There are two types of continued participation. The first allows the continued maintenance of the existing MSA balance, but future contributions are impermissible. The second allows additional contributions in 2001 and subsequent years into the MSA.

An employer is a participating employer if it makes contributions to the MSAs of its employees by December 31, 2000, or at least 20 percent of employees covered by a high deductible health insurance plan made MSA contributions of at least $100 in 2000.

What Happens to those Who Are Not Grandfathered?

Such individuals and employers are no longer eligible to establish MSAs and to make MSA contributions and will be eligible in the future only if a new law is enacted providing such right.

Set forth below is an additional discussion of MSAs in question and answer format.

What Is a Medical Savings Account (MSA)?

An MSA is a tax-exempt trust or custodial account established for the purpose of paying medical expenses in conjunction with a high-deductible health care plan. The MSA is established by and for the benefit of the individual and is "portable." This means that if the individual is an employee who later changes employers or leaves the work force, the MSA does not stay behind with the former employer but rather stays with the individual. MSAs are similar to IRAs in this regard. However, because MSAs differ from IRAs in some important respects, taxpayers cannot use an IRA as an MSA and cannot combine MSA and IRA funds in a single account. MSAs, in conjunction with high-deductible health care plans, can lower an employer's health care costs and give employees more control over where their own health care dollars are spent.

Who Is Eligible for an MSA?

Two types of individuals are eligible to establish an MSA: 1. an employee of a small employer that maintains an individual or family high-deductible health care plan covering that individual (employee or spouse); or 2. a self-employed person (or the spouse of that person) main-

Continued on page 7

The Pension Digest

The MSA Deadline

Continued from page 6

taining a family or individual high-deductible health care plan covering that individual (self-employed person or spouse).

Who Is Considered a "Small Employer" for MSA Purposes?

An employer is a "Small Employer" for a calendar year if the employer employed an average of 50 or fewer employees on business days during either one of the two preceding calendar years. Special rules apply to new employers, consolidated groups, and certain employers that have added employees. See Internal Revenue Code section 220(c)(4) for a detailed discussion of these special rules.

Can a Self-Employed Person Use an MSA?

Yes. If the self-employed individual meets the eligibility requirements, they can use an MSA.

What Is a "High-Deductible Health Care Plan" That Makes Someone Eligible for an MSA?

A high-deductible health care plan is a health plan that contains certain minimum and maximum dollar limitations on the annual deductible and out-of-pocket expenses listed under the plan. A health care plan that provides individual coverage will be considered a high-deductible plan if it has an annual deductible of at least $1,550 but not more than $2,300. A health care plan that provides family coverage will be considered a high-deductible plan if it has an annual deductible of at least $3,050 but no more than $4,600. Out-of-pocket expenses may not exceed $3,050 for individual coverage and $5,600 for family coverage. Out-of-pocket expenses include deductibles, copayments and other amounts the participant must pay for covered benefits, but do not include premiums.

Why Would an Employer Want to Use a High-Deductible Health Care Plan and MSAs?

High-deductible health care plans will have a much lower premium than traditional health care plans. An employer can significantly lower their health care costs with this type of plan.

Can a Health Maintenance Organization (HMO) Offer a High-Deductible Plan?

High-deductible health care plans can be offered by a variety of entities, including insurance companies and HMOs.

Can a Person Have Any Other Health Care Coverage and Still Be Eligible for an MSA?

An individual is not eligible for an MSA if they are covered under a health plan (whether as an individual, spouse or dependent) that is not a high-deductible plan (including being covered as a beneficiary under Medicare) as well as under a high-deductible plan.

An individual remains eligible for an MSA if, in addition to the high-deductible health care plan, the individual has coverage for accidents, disability, dental care, vision care, long-term care, insurance for a specified disease or illness, insurance that pays a fixed amount per day (or other period) of hospitalization, or insurance under which substantially all of the coverage relates to liabilities from workers' compensation laws, torts, or ownership or use of property (such as auto insurance).

Can I Utilize a High-Deductible Health Plan and MSAs Through a Cafeteria Plan?

A high-deductible health care policy can be offered through a cafeteria plan. The cafeteria plan is not permitted to provide for contributions to an MSA. Outside of the cafeteria plan, an employee will not be subject to taxation merely because the employee has a choice between employer contributions to an MSA and employer-provided accident or health coverage.

How Does an Eligible Individual Establish an MSA?

Beginning on January 1, 1997, an eligible individual can establish an MSA with a qualified MSA custodian or trustee. No permission or authorization from the Internal Revenue Service (IRS) is necessary. The individual will be required to complete a written MSA custodial or trust plan agreement.

How Does an Individual or Small Employer Sign Up for, or Enroll in, the MSA Pilot Project?

Neither individuals nor employers "sign up for" or "enroll" in the pilot program. The eligible individual or employer can proceed to arrange for the establishment of the MSA with a qualified custodian or trustee without permission from the IRS.

Who Can Make the MSA Contribution?

An accountholder who is an eligible employee of a small employer or the spouse of the employee may contribute to an MSA. Alternatively, the employer of the accountholder may contribute to the accountholder's or the spouse's MSA. If, however, an employer makes an MSA contribution on behalf of the accountholder or the accountholder's spouse, the accountholder may not contribute to any MSA for that year.

If contributions to the MSA are made by the employer, the contributions must satisfy a "comparability test." The employer satisfies this test if the employer contributes the same dollar amount to an MSA for each of their eligible employees, or contributes to the MSAs of each eligible employee the same percentage of each employee's annual deductible under the health care plan.

How Much Can Be Contributed to an MSA?

The amount which can be contributed depends upon whether or not the employer or the employee makes the contribution. The law states that only one or the other may make a contribution for a given year.

If the employee makes the contribution then, The maximum amount that can be contributed to an MSA for a tax year is a percentage of the high-deductible health care plan's annual deductible. If you have individual health care plan coverage, the contribution amount is limited to 65% of the annual deductible under the health care plan. For family coverage, your con-

Continued on page 8

The MSA Deadline
Continued from page 7

tribution amount is limited to 75% of the annual deductible under the health care plan. The same annual contribution limit applies whether the contribution is made by you or your employer.

The annual contribution amount must be prorated by the number of months you participate in the high-deductible health care plan as of the first day of each month. For example, if your family began coverage participation in a high-deductible plan on May 1 of the year, the contribution amount for the year would be calculated as follows: ((Health Care Plan Deductible X 75%)X 7/12). Even though the contribution amount is based on monthly prorating, the total contribution can be made at any time up to your tax-filing deadline, excluding extensions.

If an employer makes the contribution, then it must make comparable contributions to all comparable participating employees' MSAs. An employer's contributions are comparable if they ar either: the same amount ,or the same percentage of the annual deductible limits under the high deductible health plan covering the employee. Comparable participating employees are those who are covered by the high deductible health plan and are eligible to establish an MSA, have the same category of coverage (either self-only or family coverage) and have the same category of employment (either part-time or full-time).

What Is the Tax Treatment of MSA Contributions?

When the accountholder makes an eligible contribution to the MSA, the amount of the contribution made by the accountholder is deductible from the accountholder's adjusted gross income. The accountholder does not have to itemize deductions to claim this deduction. The tax deduction may not exceed the accountholder's compensation attributable to the employer that sponsors the high-deductible health care plan that covers the accountholder. For a self-employed individual, the amount of the deduction may not exceed the individual's earned income from the trade or business with respect to which the high-deductible health care plan has been established. Any person who may be claimed as a dependent on another taxpayer's return may not claim a deduction for a Medical Savings Account contribution.

When an employer makes an MSA contribution to the accountholder's MSA, the amount of the employer's contribution is not includable in the income of the accountholder. The contribution amount is not subject to withholding for income tax or other employment tax purposes. The employer will receive a tax deduction for the amount of the eligible MSA contribution.

Will Earnings in the MSA Be Taxed?

Earnings on the funds in an MSA are not taxable prior to distribution. For more information, see the discussion on the taxation of distributions.

What Is the Deadline for Making an MSA Contribution?

The deadline for contributions to an MSA is the time prescribed by law for filing individual income tax returns, excluding extensions. Normally this is April 15. Like an IRA, contributions to an MSA can be made for the prior year up until April 15 of the next year.

When Can an MSA Distribution Occur?

An individual can receive a distribution from their MSA at any time.

How Will an MSA Distribution Be Taxed?

A distribution from an MSA that is used for medical expenses not covered by insurance will generally not be included in the accountholder's gross income. Distributions that are used for nonmedical purposes will be included in gross income and may be subject to an excise tax. A 15% excise tax will apply to any distributions made for nonmedical purposes prior to the accountholder's death, disability, or attainment of age 65.

What "Medical Expenses" Qualify for Tax-Free Distributions?

Medical expenses for MSA purposes are defined in Code section 213. They generally include any medical expense that could qualify as a medical expense itemized deduction on the tax return. Note: If a distribution is made from an MSA for medical expenses, those medical expenses do not qualify to be itemized as a deduction on the individual's tax return. These would include expenses related to the diagnosis, cure, mitigation, treatment or prevention of disease, and transportation to and from a medical care facility for such medical care. "Medical expenses" do not include insurance premiums other than premiums for long-term care insurance, premiums on a health plan during any period of continuation coverage required by Federal law, or premiums on a health plan during a period in which the individual is receiving unemployment benefits under any Federal or State law.

Who Is Responsible for Determining if the Distribution Was Used Exclusively for Qualifying Medical Expenses?

It is the sole responsibility of the accountholder to determine the purpose and tax effect of any distribution from the MSA. The custodian of the MSA is not required to determine whether MSA distributions are used for medical or nonmedical purposes.◆