THE Pension Digest

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ALSO IN THIS ISSUE –

Collin W. Fritz and Associates, Inc., *"The Pension Specialists"*

Qualified Tuition Program

We are well aware of the Coverdell Education Savings Account to provide for a child's education, but are there other programs available?

Yes, and one such program is the Qualified Tuition Program (QTP) (formerly called Qualified State Tuition Program — QSTP). We have been asked by some of our customers if a financial institution should be involved in offering these programs and how it would go about doing so. First, we will explain the program, and then we will discuss a financial institution's role. **Note:** These plans are also known as "529" plans, because of the IRS Code section on which they are based.

Excerpts from IRA Publication 970:

Important Changes for 2002

Beginning in 2002, what were formerly known as qualified state tuition programs have been renamed and can be established and maintained by educational institutions.

Name change. Qualified state tuition programs (QSTPs) are renamed qualified tuition programs (QTPs).

Distributions from state-maintained QTPs. A distribution from a QTP established and maintained by a state (or an agency or instrumentality of the state) can be excluded from income if the amount distributed is used for higher education. For more information, see *Are Distributions Taxable* later.

QTPs maintained by educational institutions. Beginning in 2002, you can make contributions to a QTP established and maintained by one or more eligible educational institutions. Any earnings distributed before January 1, 2004, will be taxable. For more information, see *What is a Qualified State Tuition Program*, later.

Rollovers of QTPs to same beneficiary. Amounts in a QTP can be rolled over, tax free, to another QTP set up for the same beneficiary. However, the rollover of credits or other amounts from one QTP to another QTP for the benefit of the same beneficiary cannot apply to more than one transfer within any 12-month period for the same beneficiary.

Definition of family members. For purposes of rollovers and changes of designated beneficiaries, the definition of family members is expanded to include first cousins of the beneficiary. For more information, see *Can You Transfer Amounts or Change Beneficiaries,* later.

Qualified expenses. Calculation of the amount that is considered reasonable for room and board expenses has been changed. You must contact the educational institution for their qualified room and board costs. For more information, see *Qualified higher education expenses,* later.

Special needs beneficiaries. The definition of *qualified higher education expenses* has been expanded to include expenses of a special needs beneficiary that are necessary in connection with that person's enrollment or attendance at an eligible institution. For more information, see *Qualified higher education expenses*, later.

Coordination with Coverdell ESAs. You can make contributions to Coverdell ESAs and QTPs in the same year for the same beneficiary. For more information, see the *Caution*, later.

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Introduction
Certain states and, beginning in 2002, educational institutions, may maintain programs that allow you to either prepay a student's tuition or contribute to an account established for paying a student's qualified higher education expenses (defined later). If you prepay tuition, the student (beneficiary) will be entitled to a waiver or a payment of qualified higher education expenses. You cannot deduct either payments or contributions to a QTP. For information on a specific QTP, you will need to contact the state agency or educational institution that established and maintains it.

For 2001, no tax is due on earnings based on the prepayments or contributions unless the earnings were distributed. The student pays tax on the earnings if they were were distributed. Because payments and contributions were not deducted, any tax due on them has already been paid. Therefore, if amounts were distributed from the program, tax is due only on the part of the distribution that represents earnings on the payments or contributions. See *Are Distributions Taxable*, later, for more information.

Note. Even if a QTP is used to finance a student's higher education, the student or the student's parents still may be eligible to claim either the Hope credit or the lifetime learning credit.

What Is a Qualified State Tuition Program?
A qualified state tuition program (QSTP) is a program set up to allow you to either prepay a student's tuition or contribute to an account established for paying a student's ***qualified higher education expenses*** at an ***eligible educational institution.*** Prior to 2002, a QSTP could only be established and maintained by a state or an agency or instrumentality of the state. Beginning in 2002 QTPs (formerly called QSTPs) can also be established and maintained by educational institutions. The program must meet certain requirements. Your state government or the educational institution in which you are interested can tell you whether or not they participate in a QTP.

Qualified higher education expenses. For 2001, these are the tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution (defined below).

In 2001, they also include the reasonable costs of room and board for a ***beneficiary*** who is at least a half-time student. The cost of room and board is generally considered reasonable if it is not more than either:
1) The school's posted room and board charge, or
2) $2,500 per year for students living off-campus and not at home.

Note: Calculation of the amount that is considered reasonable for room and board expenses has been changed beginning in 2002. You must contact the educational institution for qualified room and board costs.

For 2002, the definition of qualified higher education expenses has been expanded to include expenses of a special needs beneficiary that are necessary for that person's enrollment or attendance at an eligible institution.

Beneficiary: The beneficiary is generally the student (or future student) for whom the QTP is intended to provide benefits. The beneficiary can be changed after participation in the QTP begins. If a state or local government or certain tax-exempt organizations purchase an interest in a QTP as part of a scholarship program, the beneficiary is the person who receives the interest as a scholarship.

Eligible educational institution. This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

How Much Can You Contribute?
Contributions to a QTP on behalf of any beneficiary cannot be more than the amount necessary to provide for the qualified higher education expenses of the beneficiary.

Caution! For 2001, no contributions could be made to a Coverdell ESA (formerly known as an education IRA) on behalf of a beneficiary if any amount was contributed during 2001 to a QTP on behalf of the same beneficiary. Any amount contributed to the Coverdell ESA must be treated as an excess contribution to the Coverdell ESA.

Are Distributions Taxable?
The part of a distribution representing the amount paid or contributed to a tuition plan does not have to be included in income. This is a return of the investment in the plan.

Generally, **for 2001,** the beneficiary must include in income any earnings distributed from a QSTP. The beneficiary does not have to include in income any return of the investment in the plan.

Generally, **for 2002**, the beneficiary does not have to include in income any earnings distributed from a QTP established and maintained by a state (or an agency or instrumentality of the state) if the earnings are used for higher education. However, the beneficiary must include in income any earnings distributed from a QTP if the plan was established and maintained by one or more educational institutions. The beneficiary does not have to include in income any return of the investment in the plan.

Determining earnings and return of investment. If you received a distribution in 2001, how you determine the part

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of the distribution that is earnings and the part that is a return of investment in the plan depends on whether.

1) Contributions were made to an account established to meet the qualified higher education expenses of a designated beneficiary, or
2) Tuition credits or certificates were purchased that entitle a designated beneficiary to the waiver of payment of his or her qualified higher education expenses.

In-kind distributions. Any in-kind distribution (such as a waiver of tuition) furnished to a designated beneficiary under a QTP is considered a distribution to the beneficiary.

Distributions From Account

If contributions were made to an account established to meet the qualified higher education expenses of a beneficiary, you determine the part of any distribution that is earnings by:

1) Dividing the amount of the distribution by the account balance as of the end of the year (including all amounts distributed during the year), and then
2) Multiplying the result of (1) by the earnings in the account as of the end of the year (including all earnings distributed during the year).

The remaining portion of the distribution is a tax-free return of investment.

Example: In 1996, your parents opened a college savings account with a QTP on your behalf. Your parents contributed $18,000 to the account, including processing fees. On December 31, 2001, the balance in the account is $24,000 (including amounts distributed in 2001).

In 2001, you enrolled at a 4-year university. The QTP made distributions on your behalf to the university in August for the fall semester, and in December for the spring semester. Tuition for full-time attendance at the university is $6,600 for the academic year. The only expense covered by the QTP distributions was tuition.

You figure the part of the distributions that is earnings by:

1) Dividing the amount of the distributions ($6,600) by the account balance as of the end of the year ($24,000, which includes all amounts distributed during the year), and then
2) Multiplying the result (.275) by the earnings in the account as of the end of the year ($6,000, which includes all earnings distributed during the year).

The earnings are $1,650. This is illustrated in *Worksheet 8-1* which follows.

Worksheet 8-1

Earnings Part of Distributions from Account

1. Distributions in 2001	________
2. Account balance as of 12/31/01	________
3. Divide line 1 by line 2	________
4. Earnings as of 12/31/01	________
5. Multiply line 3 by line 4	________

This is the part of the 2001 distributions that is earnings.

Distributions Related to Credits or Certificates

If tuition credits or certificates were purchased that entitle the beneficiary to the waiver or payment of qualified higher education expenses, the part of any distribution that is earnings is the value, at the time of distribution, of the credits, hours, or other units of education distributed minus the return of investment portion of the distribution. The value of the credits, hours or other units of education may be based on the tuition received or the cash distributed.

You determine the return of investment portion of the distribution by:

1) Dividing the investment in the account at the end of the year in which the distribution is made (including any return of investment made during the year) by the number of credits, hours, or other units of education in the account at the end of the calendar year (including all credits, hours, or other units of education distributed during the calendar year) and then
2) Multiplying the result of (1) by the number of credits, hours, or other units of education distributed during the current calendar year.

Example: In 1996, your parents opened a QTP account on your behalf. Through the account, they purchased eight units of education equivalent to eight semesters of tuition for full-time attendance at a public 4-year university covered by the QTP. They contributed $16,000 ($2,000 for each unit) that included payment of processing fees.

In 2001, you enrolled at the university. The QTP made distributions on your behalf to the university in August for the fall semester and in December of the spring semester. Tuition for full-time attendance at the university is $5,200 for the academic year. The only expense covered by the QTP distributions was tuition.

To figure the earnings part of the distribution, you must figure the return of investment portion and subtract that amount from the current value of the distributed units.

Worksheet 8-2

Earnings Part of Distributions Related to Credits or Certificates

1. Current value of 2 units distributed in 2001	$ 5,200
2. Investment in the account as of 12/31/01	16,000
3. Number of units in account as of 12/31/01	8
4. Divide line 2 by line 3 This is the per-unit investment	2,000
5. Number of units distributed in 2001	2
6. Multiply line 4 by line 5 This is the investment portion of the 2001 distributions	4,000
7. Subtract line 6 from line 1	$1,200

This is the part of the 2001 distributions that is earnings

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You figure the part of the distributions that is a return of your parents' investment in the account at the end of the year in which the distribution is made ($16,000 — which includes any return of investment made during the year) by the number of credits, hours, or other units of education in the account at the end of the calendar year (8— which includes all credits, hours, or other units of education distributed during the calendar year), and then

2) Multiplying the result of (1) by the number of credits, hours, or other units of education distributed during the current calendar year (2).

You then subtract the result of (2) above from the current value of the distributed units. (This is illustrated in *Worksheet 8-2* above.)

Penalty on Refund of Earnings

Generally, distributions must be used to pay the qualified higher education expenses (defined earlier) of the beneficiary.

Penalty. There is a penalty on any refund of earnings in 2001 that does not meet ***at least one*** of the following conditions.

1) The refunded earnings are used to pay qualified higher educational expenses of the beneficiary.
2) The refund of earnings is made because of the death or disability of the beneficiary.
3) The refund of earnings is made because the beneficiary received a scholarship, a veterans educations assistance allowance, or another nontaxable payment (other than a gift, bequest, or inheritance) for educational expenses. This only applies to the part of the refund that is not more than the scholarship, allowance, or other payment.

Can You Transfer Amounts or Change Beneficiaries?

Amounts can be transferred to other QTPs and beneficiaries can be changed.

Amounts in a QTP can be transferred tax free to the QTP of another beneficiary. The transfer must be completed within 60 days of the distribution and the other beneficiary must be a family member (as defined later) of the beneficiary from whose program the transfer is made.

Starting in 2002, amounts in a QTP of one beneficiary can be transferred tax free to another QTP for the same beneficiary. However, the transfer (rollover) of credits or other amounts from one QTP to another QTP for the benefit of the same beneficiary cannot apply to more than one transfer within any 12-month period for the same beneficiary.

The beneficiary of a QTP can be changed. However, the new beneficiary must be the existing beneficiary's spouse or one of the family members listed below.

Family members. If the beneficiary does not use the amount in the QTP, the amounts can be transferred tax free to the beneficiary's spouse or any of the following other members of the beneficiary's family.

1) Son or daughter or descendant of son or daughter.
2) Stepson or stepdaughter.
3) Brother, sister, stepbrother, or stepsister.
4) Father or mother or ancestor of either.
5) Stepfather or stepmother.
6) Son or daughter of a brother or sister.
7) Brother or sister of father or mother.
8) The spouse of any individual listed above.

Beginning in 2002, for purposes of tax-free transfers (rollovers) and changes of designated beneficiaries, the definition of family members is expanded to include first cousins of the beneficiary.

Summary.

The rules governing this program are found in IRS Publication 970. This program is designed to allow an individual to either prepay a student's tuition or contribute to an account established for paying a student's qualified higher education expenses at an eligible educational institution. Prior to 2002, QTPs could only be established and maintained by a state or an agency or instrumentality of the state. Beginning in 2002, QTPs can also be established and maintained by educational institutions..

There is no tax deduction for the contribution, and, in 2001, any earnings distributed are considered taxable (earnings are not taxed until distributed). In 2002, earnings which are distributed from a QTP established and maintained by a state do not have to be included in income. However, if the plan was established and maintained by one or more educational institutions, the earnings must be included in income.

When these programs had to be established by the state, the state controlled all investments and would choose the financial institution which would manage the investments. Now that educational institutions can establish and maintain these accounts, CWF would assume a college will affiliate with one or more financial institutions which will manage the funds.

How can your institution become involved in offering this program?

On your own, it does not appear that your institution can sponsor these accounts. You would have to check with the educational institutions near you to see if they are allowed to set up these accounts, and then you would have to affiliate with such educational institution to allow your bank to be an investment choice made available for a certain college or university.

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Sample RMD Letters for 2003 distributions

As you are aware, the IRS has finalized the new RMD rules, and these rules, as finalized, must be used to calculate 2003 distributions. Your customers may not understand why these new rules must be used, or the impact the new rules will have concerning their account. Financial institutions will want their customers to understand the new rules so that they may make informed decisions concerning their IRA account. One effect of the new rules is that generally an accountholder's RMD will be less when calculated under the new rules than under the old rules. Below we discuss what is required of a financial institution under the new rules, and we then provide two sample letters to explain the rules to your customers.

Required Reporting to the IRA Accountholder
Beginning with RMDs for 2003, a financial institution is required to prepare a statement and provide it to the IRA accountholder by January 31, 2003. This statement can be furnished in two ways.

Alternative #1 —
The IRA custodian/trustee furnishes the IRA accountholder with a statement of the amount of the RMD and the date* by which such amount must be distributed.

Alternative #2 —
The IRA custodian/trustee provides a statement to the IRA accountholder that (1) informs the IRA accountholder that an RMD is required for the calendar year, and the date* by which such amount must be distributed, and (2) includes an offer to furnish the IRA accountholder, upon request, with the amount of the distribution.

The statement can be provided to the IRA accountholder in conjunction with the required fair market value statement of the IRA (as of December 31 of the prior year). The statement could also be provided in a separate notice, if desired.

Under both alternatives, the statement must also inform the IRA accountholder that the trustee will be reporting to the IRS, beginning with the required minimum distributions for calendar year 2004, that the IRA accountholder is required to receive a required minimum distribution for the calendar year. This information must appear on the 2003 statement, even though the requirement to report this information to the IRS does not go into effect until the 2004 distribution year. This information will, of course be required for all subsequent years, also.

Another consideration of which an IRA custodian/trustee must be aware is the payment instruction of the IRA accountholder (CWF for #64). As mentioned above, an RMD calculated under the new rules is generally less than an RMD calculated under the old rules. If your customers have chosen to be paid just their RMD amount each year, they may or may not want to continue that election under the new rules, when their distribution could be considerably less. If the customer has instructed the bank to pay them a certain dollar amount each year, they may or may not want to continue that election. It would be wise for your institution to inform your customers of the implications of the new rules on their RMD, and provide a form such as CWF's Form #64, in case they wish to change the amount of their yearly distribution. Just as under the old rules, an IRA accountholder can always request to be distributed an amount greater than their RMD.

You may also encounter accountholders who will tell you to just keep calculating their RMD as you have been. Technically there is nothing wrong with continuing to do this, as long as the result is greater than or equal to the RMD as calculated under the new rules. However, because the old rules are so complicated (that's why the IRS enacted the new, simplified rules), there is no reason for a financial institution to burden themselves with such cumbersome calculations. An easy solution would be to have the accountholder fill out a new instruction form and merely list a dollar amount (which, of course, must be equal to or greater than their RMD for any given year).

We have prepared two sample letters which explain these new rules to your accountholders. One is for those already in distribution, and one is for those accountholders who will turn 70 1/2 in 2003. You may use the language in these letters as you desire.

*The date by which a distribution must be taken is 12/31/03, if it is the second or later distribution year (meaning the accountholder attained age 70 1/2 in a year prior to 2003), and 4/1/04, if the accountholder attains age 70 1/2 in 2003.

2003 RMD letter to accountholder who attains age 70 1/2 in 2003

Dear Accountholder:

The IRS now requires that by 1/31/03, financial institutions must notify all IRA accountholders who will attain age 70 1/2 this year, that they are required to take a minimum distribution from their IRA account. Because you will attain the age 70 1/2 in 2003, we are notifying you that you must take a required minimum distribution (RMD). The deadline for taking this distribution is 4/1/04. As you may or may not be aware, the IRS has finalized new RMD rules; these rules mandate a new method for calculating RMDs, and the bank is required to use this new method for 2003 and subsequent years. This new method will normally result in your yearly RMD being less than it would have been under the old rules (note: you are always allowed to be distributed an amount greater than your RMD). We have calculated your 2003 RMD to be ____________________.

We have enclosed CWF Form #64, "Periodic Payment Instruction for Accountholders 70 1/2 and Older." Please fill out this form and return it to the bank to instruct us how and when you wish to be paid your required minimum amount. If you have questions and would like help filling out the form, just call the bank to make an appointment, and we would be happy to help you.

Be advised that although we must calculate the RMD amount for each IRA which you hold with our institution, you do not have to withdraw an RMD from each IRA. There is an alternative method available under which you may take your total RMD amount from any combination of IRAs, or from just one IRA. However, our institution will require that you notify us if you wish to use this alternative method.

Beginning with RMDs for 2004, the IRS is requiring financial institutions to report to the IRS when an individual is required to receive an RMD. This reporting will be done for each IRA which you hold with our institution.

Because we know the new RMD rules can be confusing, we have enclosed a brochure* which we hope will help you understand these new rules.

Please call us if you have any questions.

Sincerely,

Anytown Bank

** Your institution may order CWF's brochure #107 by calling our sales dept. at 1-800-346-3961.*

2003 RMD letter to accountholder who is already in distribution

Dear Accountholder:

We have calculated your 2003 Required Minimum Distribution (RMD) to be ___________________. Because you have attained age 70 1/2 in a year prior to 2003, the deadline for taking this distribution is 12/31/03. As you may or may not be aware, the IRS has finalized new RMD rules; these rules mandate a new method for calculating RMDs, and the bank is required to use this new method for 2003 and subsequent years. This new method will normally result in your yearly RMD being less than had been required under the old rules (however, you are always allowed to be distributed an amount greater than your RMD). Also, if you have set up a distribution schedule under which at least an amount equal to your RMD is withdrawn each year, there is no need to change such schedule unless you desire to.

Be advised that although we must calculate the RMD amount for each IRA which you hold with our institution, you do not have to withdraw an RMD from each IRA. There is an alternative method available under which you may take your total RMD amount from any combination of IRAs, or from just one IRA. However, our institution will require that you notify us if you wish to use this alternative method.

Beginning with RMDs for 2004, the IRS is requiring financial institutions to report to the IRS when an individual is required to receive an RMD. This reporting will be done for each IRA which you hold with our institution.

Because your RMD as calculated under the new rules may be less than was calculated under the old rules, we want to be certain we are executing your payment instructions correctly. Your current payment election is:

☐ Pay me only my required minimum distribution

☐ Pay me $_____________________

We have enclosed a change of instruction form for you to fill out and return to us if you wish to change your current instruction. Please be aware that the amount you desire to have distributed must be equal to or greater than the RMD amount as calculated under the new rules.

Because we know the new RMD rules can be confusing, we have enclosed a brochure* which we hope will help you understand these new rules.

Please call us if you have any questions.

Sincerely,

Anytown Bank

** Your institution may order CWF's brochure #107 by calling our sales dept. at 1-800-346-3961.*

Substitute
FORM W-4P
Department of the Treasury (IRS)

Periodic Payment Instruction for Accountholders 70½ and Older

OMB NO. 1545-0415

Custodian/Trustee Information

Name ____
Attn: ______________________________ Phone ____________________
Address ____
City, State, Zip____

Accountholder Information

Name ____
Home Address ____
City ______________________________ County _____________________
State _________ Zip ________________ Date of Birth _________________
Phone: Home (________) ____
SSN _________________________________ Plan No. ____________________

Accountholder's Instruction to Custodian/Trustee

I hereby instruct you, by the option completed and selected, to distribute my IRA funds to me in equal or substantially equal periodic payments over the period specified. I can choose any option as long as the annual distribution equals or exceeds the amount required by the required minimum distribution (RMD) rules. Alternatively, I may select (4) to instruct you that I am using the alternate method.

☐ 1. I request you to pay me an annual amount which shall equal the amount of my Required Minimum Distribution (RMD) with respect to this IRA.
☐ 2. I request you to pay me an annual amount equal to $______________ or the amount which equals my required minimum distribution amount, whichever is greater. You shall pay this amount to me over a period of __________ years.
☐ 3. I request you to pay me an amount equal to the interest to be paid to the account during the next year, or the amount which equals my required minimum distribution amount, whichever is greater. You shall pay this amount to me over a period of __________ years.
☐ 4. I elect to use the alternative method (as summarized on the reverse side) and therefore I will not be taking a distribution from the IRA referenced above, but I will be taking it from another IRA which I maintain. This instruction shall govern the current year and all subsequent years until I notify you otherwise.
☐ 5. Other: ____

Purpose of Form

The IRA accountholder uses this form to establish a periodic payment schedule that complies with the requirements of section 408(a)(6) and the proposed regulation 1.408-8. This form is designed to be used by those IRA accountholders who will attain age 70 1/2 or older during the current year.

Format of Payment

Commencing on ___________________ and each ☐ annual ☐ monthly ☐ quarterly or ☐ semi-annual anniversary, you shall pay the pro rata portion of the annual amount. This periodic payment will initially be: $___________________.

I instruct you to make payments to:

☐ Me directly by mail to:
  ☐ the address given above; or
  ☐ ___________________________________
☐ My regular savings account or share account #___________________
☐ My checking account #___________________
☐ Other/Special Instruction ___________________
____

Special Conditions: The above method of distribution will terminate once all the funds are distributed. I hereby certify that the annual amount indicated above will equal or exceed my required minimum distribution amount for that year. I reserve the right to modify this distribution schedule at any time as long as such revised schedule will comply with the required minimum distribution rules.

Substitute
FORM W-4P
Department of the Treasury (IRS)

Withholding Certificate for IRA Pension or Annuity Payments

OMB NO. 1545-0415

The instructions to this substitute Form W-4P are on the reverse side, as well as additional discussion of special withdrawal topics. Select #1, #2, or #2 and #3.

1. ☐ I elect NOT to have income tax withheld from this IRA distribution.
2. ☐ I elect to have income tax withheld from this IRA distribution equal to 10% of the amount withdrawn.
3. ☐ I want the following additional amount withheld from each IRA payment. $______________

When signing the withholding certification, I signify that I understand that the initial distribution is subject to federal income tax withholding unless I elect to not have it apply. I also understand that my initial instruction will stay in effect until I change it, and that this distribution may have income tax consequences; therefore I should consult a tax advisor as necessary. If I do not have sufficient income tax withheld, then I realize that I may have to pay additional tax penalties under the withholding and estimated tax payment rules. I am aware that whatever portion of this distribution is a required minimum distribution is not eligible to be rolled over.

_______________________________________ _______________________________________
Signature of IRA Accountholder Date Custodian/Trustee (Payer) Date

IRA #64 (1/02) White — Custodian/Trustee Yellow — Accountholder