THE Pension Digest

January 2003
Published Since 1984

ALSO IN THIS ISSUE –

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

2002 PUBLICATION 590

The IRS has issued the 2002 version of Publication 590. For those of you who have CWF's IRA Procedures Manual, you will be receiving a copy shortly. In addition, copies may be printed from the IRS web site, and you may also order additional copies from CWF.

Publication 590 (Individual Retirement Arrangements (IRAs)) is written by the IRS for the taxpayer. It is an excellent reference tool. Many times it is the easiest way to convince someone that what you did, as the IRA custodian, was correct.

As with the prior versions, the IRS discusses the important changes for the two "current" tax years—2002 and 2003. EGTRRA was passed in June of 2001. Most of the IRA changes were discussed in the 2001 version of Publication 590. However, the IRS did choose to clarify some things which they wrote last year.

Here are the items we found of interest in the 2002 version of Publication 590.

1. Statement of required minimum distribution. If a minimum distribution is required from the accountholder's IRA for 2003, the trustee, custodian or issuer that held the IRA at the end of 2002 must either report the amount of the required minimum distribution to the accountholder, or offer to calculate it for the accountholder. The report is due January 31, 2003. It can be provided with the year-end fair market value statement that you normally provide each year. No report is required for section 403(b) contracts (generally tax-sheltered annuities) or for IRAs of owners who have died.

2. The new Form 8880 is set forth. It handles the determination of the credit for qualified retirement savings contributions, including IRA contributions.

3. The new rules which apply with respect to changing methods for substantially equal periodic payment calculations are summarized.

4. Sets forth the modified AGI limits for 2003. $60M-$70M for married filing jointly; $40M-$50M for single or head of household, and $0-$10M for married filing a separate return.

5. Deemed IRAs are new for 2003. If a separate account is set up within an employer plan, then either traditional and/or Roth IRA contributions may be made to the plan.

6. An IRA beneficiary who is subject to closing out the IRA by the end of the fifth year may elect the life-distribution rule if the election is made on or before December 31, 2003.

7. The new rules which govern a spouse's right to elect to treat their deceased spouse's IRA as their own IRA are discussed, as is the surviving spouse's right to roll over a distribution into his or her own IRA. A surviving spouse can roll over a distribution into his or her own IRA as long as the distribution is not an RMD, even if the spouse is not the sole beneficiary of the deceased IRA accountholder.

8. Before a qualified plan may make a distribution to a participant, the plan

Continued on page 2

WHAT TO DO—2002 RMD DUE 12/31/02 BUT NOT DISTRIBUTED UNTIL 2003

Somehow your institution missed distributing the RMD amount to one or more IRA accountholders. What is the remedy for this situation?

As you are aware, the penalty for not taking a distribution when required to do so is 50% of the amount which was required to be distributed but was not. This is an extremely harsh penalty. The only way to possibly avoid the severe penalty of a missed distribution would be to write a "reasonable" explanation to the IRS and ask that they waive the 50% excise tax. The IRS may well waive the

Continued on page 8

2002 Publication 590
Continued from page 1

administrator must furnish a written explanation of the rollover rules and treatment. It is made clear that this requirement does not apply to an IRA custodian/trustee

9. Tax treatment of a rollover from a traditional IRA to an eligible retirement plan other than IRA. If a person receives a distribution from his or her IRA, the part of the distribution you may roll over is considered to come first from amounts other than after-tax contributions in any person's traditional IRAs. It must be this way, since the accountholder may not roll over IRA basis into a qualified plan.

10. The need for conduit IRAs still exists. EGTRRA did not eliminate conduit IRAs.

11. With respect to certain transfers incident to a divorce, both spouses will be required to file the Form 8606 if the transfer includes "basis."

12. The RMD for the year in which an IRA owners dies is figured as if the owner lived for the entire year. That is, a beneficiary calculation is first made for the year after the year the IRA owners dies.

13. In calculating the RMD for a given year, marital status is determined as of January 1 of each year. Divorce or death after January 1 is disregarded until the next year unless you divorce during the year and change your beneficiary designation.

14. Separate accounts with separate beneficiaries can be set up at any time, either before or after the owner's required beginning date. If separate accounts with separate beneficiaries are set up, the separate accounts are not combined for required minimum distribution purposes until the year after the separate accounts are established, or the date of death, if later. As a general rule, the required minimum distribution rules separately apply to each account. However, the distribution period for an account is separately determined (disregarding beneficiaries of the other account(s)) only if the account was set up by the end of the year following the year of the owner's death.

15. Conversion income must be taken into account when computing other AGI-based phaseouts and taxable income. A taxpayer disregards conversion income only for purposes of figuring a person's modified AGI for Roth IRA purposes.

16. The election to recharacterize a contribution can be made by the executor, administrator, or other person responsible for filing the decedent's final income tax return.

17. The basis of property distributed from a Roth IRA is its fair market value (FMV) on the date of distribution, whether or not the distribution is a qualified distribution.

18. Recognizing losses on traditional IRA investments. If a person has a loss on his traditional IRA investment, a person can recognize the loss on his income tax return, but only when all the amounts in the person's traditional IRA accounts have been distributed to him and the total distributions are less than his unrecovered basis, if any. His basis is the total amount of the nondeductible contributions in his traditional IRAs. He claims the loss as a miscellaneous itemized deduction, subject to the 2%-of-adjusted-gross income limit that applies to certain miscellaneous itemized deductions on Schedule A, Form 1040.

19. Recognizing losses on Roth IRA investments. If a person has a loss on his Roth IRA investment, a person can recognize the loss on his income tax return, but only when all the amounts in the person's Roth IRA accounts have been distributed to him and the total distributions are less than his unrecovered basis. His basis is the total amount of the contributions to his Roth IRAs. He claims the loss as a miscellaneous itemized deduction, subject to the 2%-of-adjusted-gross income limit that applies to certain miscellaneous itemized deductions on Schedule A, Form 1040.

20. If a Roth IRA owners dies and his or her spouse is the sole beneficiary, then he or she can either delay distributions until the decedent would have reached age 70½ or treat the Roth IRA as his or her own Roth IRA.

21. A new rate table was devised to determine the deduction limit for a self-employed person.

EFFECT OF TRUST BEING DESIGNATED AS THE BENEFICIARY OF AN IRA

For RMD purposes, the general rule is that a designated beneficiary must be an individual who is designated as a beneficiary under the IRA. A trust is not such an individual. An estate, church college, foundation, etc is not such an individual. If the IRA accountholder designates an entity other than an individual to be his or her designated beneficiary, then, for RMD purposes, the IRA accountholder is treated as not having a designated beneficiary. This is true even if the IRA accountholder has designated individuals as his or her designated beneficiary along with this other entity. For example, if an IRA accountholder designates his wife to receive 50% of his IRA and his church to receive the other 50%, then this person will be considered to not have designated a beneficiary for RMD purposes. This will have practical consequences only after the IRA accountholder has died, as he or she is required to use the Uniform Lifetime Table regardless of who or what is the beneficiary, except when the spouse is the sole beneficiary and is more than 10 years younger.

There is, however, a special rule for certain revocable and irrevocable trusts. There is no special rule for an estate. The special rule is that the beneficiary(ies) of a trust will be treated as the beneficiary(ies) of the IRA for calculating the applicable distribution period in the RMD calculation, if the following requirements are met:

1. The trust is a valid trust under state law, or would be but for the fact that there is no corpus.

Continued on page 3

The Pension Digest

Effect of Trust Being Designated as Beneficiary, Continued from page 2

2. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the IRA accountholder.

3. The beneficiaries of the trust who are beneficiaries with respect to the IRA are identifiable from the trust instrument.

4. The required documentation has been provided to the IRA custodian or trustee. The documentation to be provided depends upon whether the required distributions are occurring before the IRA accountholder has died or after the accountholder has died.

A. There are two ways to meet the documentation requirement when an RMD must be paid to the accountholder before his or her death.

(1) The IRA accountholder provides the IRA custodian with a copy of the trust instrument and agrees to provide a copy of any amendment to the trust to the IRA custodian within a reasonable time.

(2) The IRA accountholder provides the IRA custodian with the following:

a. A list of all the beneficiaries of the trust. This must include all contingent and remainderman beneficiaries with a description of the conditions of their entitlement so that it can be ascertained that the spouse is entitled to be treated as the sole beneficiary for RMD purposes.

b. A certification that the list is correct and complete and that the first three trust requirements discussed above have been met.

c. An acknowledgment that he or she will provide corrected certifications within a reasonable time if there is any amendment to the trust instrument.

d. An acknowledgment that he or she will provide a copy of the trust instrument when requested by the IRA custodian.

B. There are also two ways to meet the documentation requirement when an RMD must be paid to a beneficiary after the accountholder has died. This requirement must be met by October 31 of the year after the year the accountholder died.

(1) The trustee of the trust provides the IRA custodian with a copy of the trust instrument for the trust that is the designated IRA beneficiary as of the IRA accountholder's date of death.

(2) The trustee of the trust provides the IRA custodian with the following:

a. A final list of all the beneficiaries of the trust as of September of the year following the year of the accountholder's death. This list must include all contingent and remainderman beneficiaries with a description of the conditions of their entitlement;

b. A certification that the list is correct and complete and that the first three trust requirements discussed above have been met; and

c. An acknowledgment that he or she will provide a copy of the trust instrument when requested by the IRA custodian.

Effect on the RMD Calculation When a Qualifying Trust Is the Beneficiary While the IRA Accountholder is Alive

The effect is minimal under the 2002 RMD rules because the accountholder is almost always permitted to use the Uniform Lifetime Table to calculate the RMD amount. The only exception is that the joint life-expectancy tables are used when the spouse is the sole beneficiary and is more than 10 years younger. Most trusts will not have the spouse as the sole beneficiary. In this case, the Uniform Lifetime Table is used. When the spouse is the sole beneficiary of the trust, the trust documentation rules will need to be met in order to substantiate that the spouse is the sole beneficiary of the trust and is more than 10 years younger.

Effect on the RMD Calculation When a Qualifying Trust Is the Beneficiary After the IRA Accountholder has Died

Once the IRA accountholder dies, the required distribution rules will apply to a designated beneficiary, including a trust beneficiary. The rules which apply depend upon whether or not the accountholder died before or on or after his or her required beginning date, whether the beneficiary is an individual and whether or not the beneficiary is the accountholder's spouse who is the sole beneficiary. The IRA accountholder's designated beneficiaries are determined based on the beneficiaries designated as of the date of his or her death who remain beneficiaries as of September 30 of the year following the calendar year of his or her death.

Situation #1: The Trust Has a Spouse Beneficiary Who Is the Sole Beneficiary, and the Accountholder Dies Before the Required Beginning Date.

The look-through rule means the spouse is the measuring life. The life-distribution rule, based on the age of the spouse, will apply, unless the five-year rule is elected by the trust. Distributions are not required to commence until December 31 of the year the accountholder would have attained age 70½. For each calendar year after the accountholder's death up through the year of the spouse beneficiary's death, the applicable distribution period is determined by determining the age of the spouse and then determining the distribution period from the Single Life Table. For each calendar year after the spouse beneficiary's death, the applicable distribution period is determined from the Single Life Table by using the spouse beneficiary's age in the year he or she dies and adjusting such period by reducing by one for each calendar year that elapses after the spouse beneficiary dies.

A special rule applies if the spouse beneficiary dies before payments commence to him or her. In this case, the life-distribution rule or the five-year rule will be applied as if the

Continued on page 6

New Form 8880 - Credit for IRA/Elective Deferrals

The IRS has recently issued a new Form 8880, Credit for Qualified Retirement Savings Contributions. The form and the instructions are set forth. The value of the form and instructions is that the form clearly discusses who may claim the credit, who may not claim the credit and how distributions of the account-holder (and spouse, if any) impact the credit to be claimed.

A "credit" is much more valuable than a tax deduction. A credit is a dollar-for-dollar reduction in a person's tax liability. The value of a tax deduction depends upon the marginal tax rate which applies to the taxpayer(12%, 14%, 27%, etc).

Remember that the purpose of the credit is to intentionally give taxpayers with lower to moderate MAGIs the right to receive TWO (not one) tax benefits for the same IRA contribution or elective deferral to a 401(k) plan, SIMPLE plan, 403(b) plan, governmental 457 plan or SAR-SEP. The person who makes these contributions may receive two tax benefits—the credit and the tax deduction for the contribution to the traditional IRA or possible tax-free treatment for the earnings arising from the Roth IRA contribution.

The credit is determined by applying a percentage rate of 10%, 20% or 50% to a contribution amount. The law limits the contribution amount which can be

Continued on page 5

Form **8880**
Department of the Treasury
Internal Revenue Service

Credit for Qualified Retirement Savings Contributions

▶ **Attach to Form 1040 or Form 1040A.**

OMB No. 1545-1805
2002
Attachment Sequence No. **129**

Name(s) shown on return | **Your social security number**

CAUTION

You **cannot** claim this credit if any of the following apply.

- The amount on Form 1040, line 36, or Form 1040A, line 22, is more than $25,000 ($37,500 if head of household, $50,000 if married filing jointly).
- You were born after January 1, 1985.
- You are claimed as a dependent on someone's (such as your parent's) 2002 tax return.
- You were a **student** in 2002 (see instructions).

		(a) You	(b) Your spouse
1	Traditional and Roth IRA contributions for 2002. **Do not** include rollover contributions	1	
2	Elective deferrals to a 401(k) or other qualified employer plan, voluntary employee contributions, and 501(c)(18) plan contributions for 2002 (see instructions)	2	
3	Add lines 1 and 2	3	
4	Certain distributions received **after** 1999 and **before** the due date (including extensions) of your 2002 tax return (see instructions). If married filing jointly, include **both** spouses' amounts in **both** columns. See instructions for an exception	4	
5	Subtract line 4 from line 3. If zero or less, enter -0-	5	
6	In each column, enter the **smaller** of line 5 or $2,000	6	

7 Add the amounts on line 6. If zero, **stop**; you cannot claim the credit . . . 7

8 Enter the amount from Form 1040, line 36*, or Form 1040A, line 22 . . . 8

9 Enter the applicable decimal amount shown below:

If line 8 is—		And your filing status is—		
Over—	But not over—	Married filing jointly	Head of household	Single, Married filing separately, or Qualifying widow(er)
		Enter on line 9—		
---	$15,000	.5	.5	.5
$15,000	$16,250	.5	.5	.2
$16,250	$22,500	.5	.5	.1
$22,500	$24,375	.5	.2	.1
$24,375	$25,000	.5	.1	.1
$25,000	$30,000	.5	.1	.0
$30,000	$32,500	.2	.1	.0
$32,500	$37,500	.1	.1	.0
$37,500	$50,000	.1	.0	.0
$50,000	---	.0	.0	.0

9 X .

Note: *If line 9 is zero, **stop**; you cannot claim the credit.*

10 Multiply line 7 by line 9 . . . 10

11 Enter the amount from Form 1040, line 44, or Form 1040A, line 28 . . . 11

12 Enter the total of your credits from Form 1040, lines 45 through 48, or Form 1040A, lines 29 through 31 . . . 12

13 Subtract line 12 from line 11. If zero, **stop**; you cannot take the credit . . . 13

14 **Credit for qualified retirement savings contributions.** Enter the **smaller** of line 10 or line 13 here and on Form 1040, line 49, or Form 1040A, line 32 . . . 14

*See Pub. 590 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 33394D Form **8880** (2002)

The Pension Digest

New Form 8880, Continued from page 4

considered to $2,000. This means the credit can range from $200 - $1,000 per taxpayer. Some married couples will be entitled to claim a credit of $2,000. The credit for a couple is calculated on the same Form 8880.

In order to prevent a person from making a contribution, claiming the credit and then soon thereafter taking a distribution, the law imposes a two-year look-back rule. The taxpayer must reduce his or her current-year contribution by the amount of certain distributions received during the two years preceding the current year and during the current year. Since the current year is 2002, then any distributions from 2000-2002 will be subtracted from the contributions made for 2002. To a certain degree the rule seems unfair, since the person obviously did not know that his or her distribution from January 1, 2000, to June 7, 2001, (passage of EGTRRA) would penalize him or her with respect to the credit. The IRS has limited the impact of this rule by subtracting the distributions from the total contribution amount and not the $2,000 contribution limit. See lines 1-5 of the form. For example, a person (age 54 with MAGI of $13,000) who contributed $3,500 to her traditional IRA and then withdrew $1,500 would still be entitled to claim a credit of $1,000, since the limit is determined by subtracting $1,500 from $3,500 and not from the $2,000 limit.

You do have some customers (or potential customers) who would benefit if you would tell them about the existence of this credit. CWF brochure #108 may be used. We realize many bankers are conservative, but this is a situation where it would be in the best interest of some individuals to borrow the funds to allow them to make the IRA contribution or the 401(k) elective deferral, so that they can claim the credit. Certainly, not everyone should borrow money for this purpose, but some should.

This credit exists only for five years (i.e. until December 31, 2006) unless the law would be extended.

Note the marriage penalty rule which requires a taxpayer to not only reduce his or her contributions by the amount of distributions which he or she received, but also for distributions received by his or her spouse. This rule does not apply if the couple did not file a joint return for the year the distribution was received.

Form 8880 (2002)

Section references are to the Internal Revenue Code.

General Instructions

Purpose of Form

Use Form 8880 to figure the amount, if any, of your retirement savings contributions credit.

TIP This credit may be claimed in addition to any IRA deduction claimed on Form 1040, line 24, or Form 1040A, line 17.

Definitions

Student

You were a student if during any 5 months of 2002 you:

- Were enrolled as a full-time student at a school or
- Took a full-time, on-farm training course given by a school or a state, county, or local government agency.

A **school** includes technical, trade, and mechanical schools. It does not include on-the-job training courses, correspondence schools, or night schools.

Who May Claim the Credit

You may be able to claim the retirement savings contributions credit if you, or your spouse if filing jointly, made:

- Contributions (other than rollover contributions) to a traditional or Roth IRA,
- Elective deferrals to a 401(k), 403(b), governmental 457, SEP, or SIMPLE plan,
- Voluntary employee contributions to a qualified retirement plan (as defined in section 4974(c)), or
- Contributions to a 501(c)(18) plan.

You **cannot** claim the credit if **any** of the following apply.

- The amount on Form 1040, line 36, or Form 1040A, line 22, is more than $25,000 ($37,500 if head of household, $50,000 if married filing jointly).
- You were born after January 1, 1985.
- You are claimed as a dependent on someone's (such as your parent's) 2002 tax return.
- You were a student (defined above).

Specific Instructions

Column (b)

Complete column **(b)** only if you are filing a joint return.

Line 2

Include on line 2 any of the following amounts.

- Elective deferrals to a 401(k), 403(b), governmental 457, SEP, or SIMPLE plan.
- Voluntary employee contributions to a qualified retirement plan (as defined in section 4974(c)).
- Contributions to a 501(c)(18) plan.

These amounts may be shown in box 12 of your Form(s) W-2 for 2002.

Page **2**

Line 4

Enter the total amount of distributions you, and your spouse if filing jointly, received **after** 1999 and **before** the due date of your 2002 return (including extensions) from any of the following types of plans.

- Traditional or Roth IRAs.
- 401(k), 403(b), governmental 457, 501(c)(18), SEP, or SIMPLE plans.
- Qualified retirement plans (as defined in section 4974(c)).

Do not include any:

- Distributions not taxable as the result of a rollover or a trustee-to-trustee transfer.
- Distributions from your IRA (other than a Roth IRA) rolled over to your Roth IRA.
- Loans from a qualified employer plan treated as a distribution.
- Distributions of excess contributions or deferrals (and income allocable to such contributions or deferrals).
- Distributions of contributions made during a tax year and returned (with any income allocable to such contributions) on or before the due date (including extensions) for that tax year.
- Distributions of dividends paid on stock held by an employee stock ownership plan under section 404(k).

If you and your spouse are filing jointly, include **both** spouses' amounts in **both** columns.

Exception. Do not include your spouse's distributions with yours when entering an amount on line 4 if you and your spouse did not file a joint return for the year the distribution was received.

Example. You received a distribution of $5,000 from a qualified retirement plan in 2002. Your spouse received a distribution of $2,000 from a Roth IRA in 2000. You and your spouse file a joint return in 2002, but did not file a joint return in 2000. You would include $5,000 in column **(a)** and $7,000 in column **(b)**.

Line 7

Add the amounts from line 6 columns **(a)** and **(b),** and enter the total.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Recordkeeping,** 19 min.; **Learning about the law or the form,** 9 min.; **Preparing the form,** 29 min.; **Copying, assembling, and sending the form to the IRS,** 20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the Instructions for Form 1040 or Form 1040A.

Effect of Trust Being Designated as Beneficiary, Continued from page 3

spouse beneficiary had been the IRA accountholder. That is, the spouse's beneficiary will become the measuring life.

Be aware that a spouse who is the sole beneficiary of the trust does not have the right to treat the deceased spouse's IRA as his or her own. This is true even if the spouse has an unlimited right to withdraw from the trust. Question: Will a spouse who receives a distribution from the trust be able to roll over the distribution? CWF does not think the spouse has the rollover right, and that private letter rulings which pre-date the 2002 RMD regulation are no longer valid.

Situation #2: The Trust Has Either Nonspouse Beneficiaries and/or a Spouse Beneficiary Who Is NOT the Sole Beneficiary and the accountholder Dies Before the Required Beginning Date.

The life-distribution rule will again be used unless the trust would elect to use the five-year rule. The oldest beneficiary of the trust will normally be the measuring life. The separate account rules do not apply to beneficiaries of a trust with respect to the trust's interest in the accountholder's benefit. For each calendar year after the IRA accountholder's death, the applicable distribution period is initially determined from the Single Life Table by using the beneficiary's age in the year after the accountholder's death and then, for subsequent years, adjusting such factor by reducing by one for each calendar year that elapses after the accountholder dies. This distribution period will continue and will not be modified by the death of the beneficiary who is the measuring life.

The measuring life will be the accountholder and not the beneficiary, if the beneficiary is older than the accountholder. The applicable distribution period for distributions to the trust for years after the accountholder's death is based on the accountholder's age and life expectancy as determined as of December 31 of the year the accountholder dies. For subsequent years, the original factor is reduced by one for each elapsed year.

Situation #3: The Trust Has No Designated Beneficiary and the Accountholder Dies Before the Required Beginning Date.

Remember the rule that the IRA accountholder is treated as not having a designated beneficiary when there is a designation of an entity other than an individual. In this situation, the life-distribution rule is not an option. The five-year rule will apply.

Situation #4: The Trust Has a Spouse Beneficiary Who Is the Sole Beneficiary and the Accountholder Dies On or After the Required Beginning Date.

The life-distribution rule based on the age of the spouse will apply. For each calendar year after the accountholder's death up through the year of the spouse beneficiary's death, the applicable distribution period is generally determined by using the age of the spouse and then determining the distribution period from the Single Life Table. For each calendar year after the spouse beneficiary's death, the applicable distribution period is determined from the Single Life Table by using the spouse beneficiary's age in the year he or she dies and adjusting such period by reducing by one for each calendar year that elapses after the spouse beneficiary dies.

The measuring life will be the accountholder and not the spouse beneficiary, if the spouse beneficiary is older than the accountholder. The applicable distribution period for distributions to the trust for years after the accountholder's death is based on the accountholder's age and life expectancy as determined as of December 31 of the year the accountholder dies. For subsequent years, the original factor is reduced by one for each elapsed year.

Again, a spouse who is the sole beneficiary of the trust does not have the right to treat the deceased spouse's IRA as his or her own.

Situation #5: The Trust Has Either Nonspouse Beneficiaries and/or a Spouse Beneficiary Who Is NOT the Sole Beneficiary. and the Accountholder Dies On or After the Required Beginning Date.

The life-distribution rule will be used. The oldest beneficiary will be the measuring life. The separate account rules do not apply to beneficiaries of a trust with respect to the trust's interest in the accountholder's benefit. For each calendar year after the IRA accountholder's death, the applicable distribution period is initially determined from the Single Life Table by using the beneficiary's age in the year after the accountholder's death and then, for subsequent years, adjusting such factor by reducing by one for each calendar year that elapses after the accountholder dies. This distribution period will continue and will not be modified by the death of the beneficiary who is the measuring life.

Situation #6: The Trust Has No Designated Beneficiary and the Accountholder Dies On or After the Required Beginning Date.

Again, the IRA accountholder is treated as not having a designated beneficiary when there is a designation of a person or entity other than an individual. The applicable distribution period for distributions to the trust for years after the accountholder's death is based on the accountholder's age and life expectancy as determined as of December 31 of the year the accountholder dies. For subsequent years, the original factor is reduced by one for each elapsed year.

Special Rules

Special Rule #1. A revocable trust will not fail to be a trust for RMD purposes merely because the trust elects to be treated as an estate under section 645, as long as the trust continues to be a trust under state law.

Special Rule #2. If the accountholder died before the adoption of the 2002 RMD rules, most likely the documentation rules would not have been satisfied. If the deadline for furnishing documentation is before October 31, 2003, then a special rule permits the documentation to be furnished to the IRA trustee on or before October 31, 2003.

Continued on page 7

The Pension Digest

Effect of Trust Being Designated as Beneficiary, Continued from page 6

Special Rule #3. The rules governing contingent beneficiaries and successor beneficiaries.

The general rule is that a contingent beneficiary will not be considered to be a designated beneficiary for purposes of determining which designated beneficiary has the shortest life expectancy and whether a person other than an individual is designated as the beneficiary so that the IRA accountholder would be treated as not having designated a beneficiary. However, if the person, as a successor beneficiary, has any right (including a contingent right) beyond being a mere potential successor to the interest of one of the IRA accountholder's beneficiaries upon that beneficiary's death, then such beneficiary will need to be considered in determining the beneficiary with the shortest life expectancy and whether only individuals are beneficiaries.

For example, the IRA accountholder designates two beneficiaries. John Doe, age 65, is to receive all of the income from the IRA while he lives, and then, after his death, a second beneficiary (Jane Roe, age 49) is entitled to the principal of the IRA. Since John Doe has the shortest life expectancy, he will be the measuring life for RMD purposes.

If the person who is the measuring life for the trust dies during the period between the IRA accountholder's date of death and September 30 of the year following his or her death, that person continues to be treated as the designated beneficiary for purposes of determining the distribution period rather than other beneficiaries of the trust.

If the spouse is treated as the sole beneficiary of the trust and dies before distributions to such spouse have begun (i.e. December 31 of the year the accountholder would have attained age 70½), then the oldest beneficiary of the trust will be the measuring life for purposes of applying the RMD rules.

Examples from the regulation. Note that CWF has modified the examples to illustrate the fact that there is an IRA rather than a pension plan.

#1. John Doe maintains an IRA. He died in 2005 at the age of 55. He is survived by his spouse, Jane Doe, age 50. John named a testamentary trust (Trust P) established under his will to be the beneficiary of all amounts payable from the IRA after his death. Trust P was irrevocable and was a valid trust under the laws of his domicile. The trustee of Trust P provided a copy of Trust P and a list of the trust beneficiaries by October 31 of the year following his death (i.e. 2006). The IRA was included in John's gross estate under Code section 2039.

Under the terms of Trust P, all trust income is payable annually to Jane, and no one has the power to appoint Trust P principal to any person other than Jane. Jane has the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to the income earned by Trust P during the calendar year and to distribute that amount, through Trust P, to Jane. John's children, who are all younger than Jane, are the sole remainder beneficiaries of Trust P. No other person has a beneficial interest in Trust P. The IRA contains no prohibition on withdrawal from the IRA of amounts in excess of the annual RMD.

John died before his required beginning date. In accordance with the terms of the IRA, the trustee of Trust P elects to use the life-distribution rule to take annual distributions over a distribution period equal to Jane's life expectancy.

If Jane exercises the withdrawal power, the trustee of Trust P must withdraw from the IRA and have paid to Trust P, the greater of the amount of income earned in the IRA during the calendar year or the RMD amount for such calendar year. This is true, even if under the terms of Trust P and state law, Jane is only entitled to the income earned by the IRA (along with any other trust income). Because some amounts distributed from the IRA to Trust P may be accumulate in Trust P during Jane's lifetime for the benefit of John's children, as remaindermen beneficiaries of Trust P, even though access to those amounts are delayed until after Jane's death, the children must be considered as beneficiaries in determining the applicable distribution period. Jane is not the sole designated beneficiary of John's IRA. However, she is the beneficiary with the shortest life expectancy, and thus, her life expectancy is used to determine the distribution period. Because she is not the sole beneficiary, the annual distribution from the IRA to Trust P must begin no later than the end of the calendar year immediately following the calendar year of John's death.

#2. The facts are the same as the prior example except that the testamentary trust provides that all amounts distributed from the IRA to the trustee of Trust P while Jane is alive will be paid directly to Jane upon receipt by the trustee. Jane is now considered to be the sole beneficiary of Trust P's interest in the IRA because no amounts distributed from the IRA are accumulated in Trust P for the benefit of the children or any other beneficiary. Therefore, the children are mere potential successors to Jane's interest in the IRA. Because of the fact that Jane is the sole beneficiary of Trust P's interest in the IRA, the annual required minimum distributions from the IRA must begin no later than the end of the calendar year in which John would have attained age 70½ rather than the calendar year immediately following the calendar year of John's death.

Use of Trusts—Planning Technique

Trusts are commonly used for estate-planning purposes as discussed below.

A decedent's estate is given a 100% (i.e. unlimited) deduction for any property which is "passed" (i.e. given or transferred) to his or her surviving spouse. There are, of course, requirements to be met to receive this favorable tax treatment. They are:

1. There must be a surviving spouse;

2. The property is being transferred from the decedent to the surviving spouse;

3. The property being transferred must be included in the decedent's spouse's gross estate;

Continued on page 8

Effect of Trust Being Designated as Beneficiary, Continued from page 7

4. The surviving spouse must be a U.S. citizen except to the extent the property passes to a Qualified Domestic Trust.

5. The transfer must not pass in the form of a nondeductible terminable interest.

The general marital deduction serves only to defer when the estate tax will be paid. The estate of the first-to-die spouse will not pay an estate tax. However, estate taxes will be paid in the estate of the second spouse to die.

A decedent's estate is also given a 100% (i.e. unlimited) deduction if there is a properly designated marital deduction trust such as a QTIP trust, estate/general power of appointment trust, or estate trust which has been designated as the beneficiary.

Special rules allow certain types of trusts to be set up so that they can "benefit" the surviving spouse, yet there will be a marital deduction available for such property in the first-to-die spouse's estate and then such property will not have to be included in the second-to-die spouse's estate.

One of these trusts is called the qualified terminable interest trust (QTIP). Many times IRA accountholders designate a QTIP trust as the beneficiary of their IRA.

In order for the property of a trust to qualify as a QTIP, the property must pass or transfer from the decedent; the surviving spouse must have a "qualifying income interest for life," and an election under these rules applies. A "qualifying income interest for life" exists if (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or the right to use the property during the spouse's life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

With respect to the requirement to distribute income annually to the surviving spouse, the governing regulation requires that either the assets in the trust must actually be income producing, or the surviving spouse must have the right to demand that the trustee convert unproductive assets to productive assets or distribute other assets, equal in value, to the income that would have been produced by the unproductive assets, if they were productive. In fact, the IRS has ruled that if IRAs are part of the assets of the QTIP, then the IRA must pay out to the QTIP at least annually, the income earned by the IRA assets, and such income must be distributed by the QTIP to the spouse.

Obviously, a spouse beneficiary who is paid funds from the deceased spouse's IRA will have to include such property in his or her estate, regardless if he or she rolls them over to another IRA, but the unlimited marital deduction should apply.

The optimum marital deduction plan for a married couple generally involves establishing a non-marital trust (normally called a credit-shelter trust) and a marital trust. The non-marital trust is funded with assets worth $675,000 (i.e. the amount equivalent to the unified credit). The balance is allocated to a marital trust for the benefit of the surviving spouse.

What to Do—2002 RMD Due 12/31/02, Continued from page 1

penalty; however, we can never guarantee what the IRS will do. The explanation will need to include a statement to the effect that as soon as the mistake was discovered, steps were taken to correct it.

The usual procedure to follow when an RMD has not been timely distributed is to file Form 5329 along with the individual's tax return, detailing the missed distribution and enclosing a check for the 50% excise tax. However, CWF believes it is permissible to fill out the 5329, not send a check, and send a letter of explanation requesting that the IRS waive the penalty tax.

CWF has drafted two sample letters, one from the bank (assuming it was the bank's mistake) to the customer (to be included with the customer's tax return), and one from the customer to the IRS.

Bank to Customer:

In the process of checking our customers' Forms 1099-R, we discovered that we did not have a 1099-R for your IRA. We apologize, as we certainly do not usually make such a mistake. We realize that this can result in harsh tax consequences for you, and we authorize you to provide this letter of explanation to the IRS. As soon as we found the error (the first week of 2003), we contacted you, and mailed you the required amount.

Customer to IRS:

Due a bank oversight, I missed taking the 2002 required distribution from my IRA. Please see the enclosed letter from the bank discussing the oversight. The bank issued my RMD as soon as the mistake was discovered.

Also, I am aware of the 50% excise tax on RMDs that were not distributed when required. I am also aware that the usual process is to pay the 50% excise tax with IRS Form 5329 and then file for a refund. I have completed IRS Form 5329, but have not attached a check. I respectfully request that, because of this oversight, the 50% excise tax on the missed distribution be waived.

Thank you in advance for your consideration.