The Pension Digest

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ALSO IN THIS ISSUE –

Inherited IRA Reminder—

A nonspouse IRA beneficiary has no rollover rights with respect to the inherited IRA!

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

New HSA Laws—Effective January 1, 2007

If you are a fan of HSAs, recent law changes will make HSAs much more attractive for 2007 and subsequent years than they have been for 2004-2006.

President Bush signed the Tax Relief and Health Care Act of 2006 on December 20, 2006. The purpose of this tax law was to extend various tax provisions which had expired and for other purposes. One of those other purposes was to revise the HSA rules. The new HSA rules are generally effective for tax years beginning after December 31, 2006. Some of the new rules are effective as of the date of enactment (December 20, 2006).

Repeal of the Annual Deductible Limitation on HSA Contributions

A person covered by an HDHP (for HSA purposes), with single coverage, with an annual deductible of at least $1,100, will be able to contribute $2,850, regardless of the amount of the deductible. Under the rules applying for 2004-2006, the maximum contribution amount was the lesser of the annual deductible amount or the annual contribution limit. The annual contribution limit for 2006 is $2,700, and will be $2,850 for 2007. **Example:** Sara, age 31, is covered under an HDHP (single coverage), and the plan has an annual deductible limit of $1,200. The maximum contribution for 2006 is $1,200, but it will be $2,850 for 2007.

A person covered by an HDHP (for HSA purposes), with family coverage, with an annual deductible of at least $2,200, will be able to contribute $5,650, regardless of the amount of the deductible. Under the rules applying for 2004-2006, the maximum contribution amount was the lesser of the annual deductible amount or the annual contribution limit. The annual contribution limit for 2006 is $5,450, and will be $5,650 for 2007. **Example:** Maria, age 42, is covered under an HDHP (family coverage), and the plan has an annual deductible limit of $2,200. Her maximum contribution for 2006 is $2,200, but it will be $5,650 for 2007.

CWF Comment. Many individuals who, under the old rules, would not have had an interest in maintaining an HSA will now want to contribute to their HSAs. Under the old laws, the only way to contribute larger amounts was to have a higher annual deductible. Under the old rules, a person with single coverage who wanted to make a $2,700 contribution had to put up with a $2,700 annual deductible. Many individuals did not want such high deductibles. Individuals who are willing to accept relatively low annual deductible limits ($1,100 for single coverage and $2,200 for family coverage) will now be able to make substantial contributions to their HSAs.

One Lifetime Tax-Free Transfer from a Traditional IRA or Roth IRA to an HSA

An individual with funds in a traditional IRA will generally pay income tax on the amount he or she withdraws. A person who is eligible to make an HSA

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contribution, who has funds within a traditional IRA (and in limited cases a Roth IRA) may make a special election once during their lifetime to transfer a certain amount from their traditional IRA to their HSA. This type of special transfer is called a qualified HSA funding distribution. Such an election, once made, is irrevocable. The amount transferred in such a direct trustee-to-trustee transfer will be excluded from the taxpayer's income. However, as with the new charitable distribution rules, this tax-free treatment only applies to the extent that the IRA distribution would be taxable. This means that nontaxable IRA basis may not be transferred to an HSA. Funds within SEP-IRAs and SIMPLE-IRAs are ineligible for this special election.

The amount to be excluded is limited. It shall not exceed the annual contribution limit for single or family coverage, as applicable, as based on the HDHP coverage as of the time of the special transfer, or, in some cases, the amount of an earlier qualified HSA funding distribution. Thus, the maximum amount eligible for this special transfer for 2007 will be $2,850 for single coverage and $5,650 for family coverage. The statutory law does not expressly discuss how this limit will apply to spouses. It may be that both spouses will be able to transfer the amount of $5,650, if they would have such amount within their traditional IRA. The IRS will need to issue guidance.

The law does allow a person who has taken a qualified HSA funding distribution while covered under a single HDHP and who subsequently is covered by a family HDHP during that same year, to elect to make an additional qualified HSA funding distribution.

This one-time transfer rule allows a person to change funds which would be taxable (money distributed from an IRA) to funds which will escape taxation if they are withdrawn from the HSA and used to pay qualified medical expenses. People will wish to take advantage of this new special rule. There is no time limit as to when a person must make this special election. Presumably, it could be done 15-30 years from now. Even so, the sooner one does it, the sooner one could take a tax-free distribution.

Caution — Once the IRA funds are contributed to the HSA, there is no authority or provision in the law to recontribute the funds to the IRA. However, if the recontribution took place within the standard 60-day rollover period, it would be permissible. Also, because of the tax penalties, an individual will want to be certain they will be covered by the HDHP for the forthcoming 12-month period. If this is not a certainty, the individual should not perform the rollover.

There is a recapture rule if someone makes this special type of transfer and then ends their coverage under an HDHP before a one-year time period has expired.

The testing period starts with the month in which the qualified HSA funding contribution is contributed to the HSA and ends on the last day of the 12th month following such month. A person who made the special transfer on March 10, 2007, will have to maintain the HDHP coverage through March 31, 2008.

If, at any time during the testing period, the individual is no longer an eligible individual, then he or she will be penalized as follows. The individual will have to add to their income all contributions which had been excluded from income. This is required for the first month they become ineligible. The tax they owe will depend on what marginal tax rate applies. They will also owe an additional 10% tax. For example, if Jon Doe must include in his income the amount of $3,000 and he is in the 15% tax bracket, then he will owe $450 in taxes plus an additional $300 (10% of the $3,000).

Although there is no discussion in the statute, it is assumed that the ineligible amount must be withdrawn from the HSA. The IRS will have to provide further guidance on this issue.

One Lifetime Transfer/Rollover from an FSA and/or HRA Termination to an HSA

An individual with funds in an FSA (cafeteria plan) and/or a health reimbursement arrangement (HRA), in some cases may "lose" the benefit of certain elective deferral contributions because of the "use it or lose it rules." The new law allows employers who sponsor such plans to amend such plans to authorize the transfer or rollover of any unused funds to an HSA. Presumably, this would be done at the instruction of the individuals. This type of special transfer is called a "qualified HSA distribution." Note that different terms are used if the money comes from an FSA/HRA versus an IRA.

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The amount eligible to be so transferred must meet the following two requirements:

1. It cannot exceed the lesser of: the balance in the arrangement as of September 21, 2006, or the balance as of the date of the distribution/transfer and

2. The employer must contribute this amount directly to an employee's HSA before January 1, 2012.

The amount transferred in such a direct payment will be treated as a rollover contribution described in section 223(f)(5).

Code section 4980G, in general, provides for a 35% excise tax if an employer violates the comparability rules set forth in Code section 4980G. The comparability rules will NOT apply to qualified HSA distributions as long as, in the case of a qualified HSA distribution to any employee covered under an HDHP of the employer, this distribution option is made available to any such employee.

Caution — Once the FSA or HRA funds are contributed to the HSA, there is no authority or provision in the law to recontribute the funds to the the FSA or HRA. Also, because of the tax penalties, an individual will want to be certain they will be covered by the HDHP for the forthcoming 12-month period. If this is not a certainty, the individual should not perform the rollover.

As with the special one-time contribution to an HSA from an IRA, there is a recapture rule if someone makes this special type of transfer and then ends their coverage under an HDHP before a one-year time period has expired. The testing period starts with the month in which the qualified HSA funding contribution is contributed to the HSA and ends on the last day of the 12th month following such month. The time period for this recapture rule is the same as it was for the one-time contribution to an HSA from an IRA. A person who made the special transfer on March 10, 2007, will have to maintain the HDHP coverage through March 31, 2008.

If, at any time during the testing period, the individual is no longer an eligible individual, then he or she will be penalized as follows. The individual will have to add to their income the amount of the purported special rollover contribution/transfer. This is required for the first month they become ineligible. The tax they owe will depend on what marginal tax rate applies. They will also owe an additional 10% tax. For example, if Jon Doe must include in his income the amount of $3,000 and he is in the 15% tax bracket, then he will owe $450 in taxes plus an additional $300 (10% of the $3,000).

Although there is no discussion in the statute, it is assumed that the ineligible amount must be withdrawn from the FSA or HRA. The IRS will have to provide further guidance on this issue.

This new law applies to distributions on or after the date of enactment (December 20, 2006).

Limited Relief During FSA Grace Periods

In September of 2005, the IRS issued Notice 2005-42; the IRS authorized an employer who sponsors a cafeteria plan, to adopt a grace period for such plan. Prior to this Notice, the use-it-or-lose it rule applied with no exception. The effect of the grace period is that an individual who incurs expenses for a qualified benefit during the grace period will be allowed to have the cafeteria plan pay for those expenses using funds in the appropriate account as of the end of the year. That is, the funds which otherwise would have been lost, since they had not been used by plan-year end, can still be used, and not lost, if done so during the grace period. The grace period was limited to being 2½ months or less.

In Notice 2005-86 (December 2005) the IRS discussed how these new grace period rules impacted a person's eligibility for an HSA. In general, the result was — the individual became ineligible to contribute to an HSA until he or she was no longer covered by the grace period. It did not matter that the individual had no balance which carried over. The fact that the plan provided for the grace period was enough to make a person ineligible for an HSA during the grace period.

The new law authorizes that FSA coverage during a grace period may be disregarded in determining whether or not a person is an eligible individual for HSA purposes. This new rule applies for tax years commencing after December 31, 2006.

The new law eliminates this result in two situations. First, an individual who has a balance of 0.00 at the

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end of such plan year will now be eligible for the HSA. Secondly, an individual who makes the special distribution/rollover/transfer described above, in an amount equal to the remaining balance, pursuant to IRS rules, will now also be eligible.

This law is effective on the date of enactment (December 20, 2006).

In Some Situations the Contribution Limit Will not Be Reduced for Part-Year Coverage, but in Other Situations It Will Still Be Reduced for Part-Year Coverage

Under the 2004-2006 laws, the annual contribution is actually the sum of the monthly limitations for those months a person was an eligible individual. In general, an eligible individual is a person who is covered by a qualifying HDHP on the first day of a month.

For those individuals who were covered under the HDHP for only one or two months, their allowed contribution amount was severely limited. For example, a person who is an eligible individual for only one month, (January or December) is only allowed to contribute 1/12 of the permissible contribution amount.

The law change for 2007 and subsequent years is that an individual who is an eligible individual for the last month of the taxable year (generally December) will be allowed to make the full year's contribution amount. Note, however, this **only applies if a person is an eligible individual in December.** A person who is an eligible individual during the period of January 1 to November, April to October or February to August, must pro-rate the contribution amount.

An individual who is an eligible individual for December is treated as having been an eligible individual for the entire year (for each month) and as having been covered for the entire year by the HDHP which covers them in December.

Note, there is a recapture rule if someone makes this special type of contribution and then ends their coverage under an HDHP before a one-year period has expired.

The testing period starts with the last month of the taxable year for which the special contribution is made and ends with December 31 of the following year. In general, this testing period will be the following calendar year. This assumes that the tax year is the calendar year. A person who is initially covered under an HDHP as of December 1, 2006, will have a testing period of January 1, 2007, to December 31, 2007.

We have seen some commentators state that an individual would have to maintain the HDHP for a full year beginning in the month the HSA begins. We do not read the statutory law in this fashion. Even if a person would start their HSA on September 1, 2007, the testing period would be January 1, 2008, to December 31, 2008.

If, at any time during the testing period, the individual is no longer an eligible individual, then he or she will be penalized as follows. The individual will have to add to their income all contributions to the HSA which were able to be made only because of this special rule. The tax they owe will depend on what marginal tax rate applies. They will also owe an additional 10% tax. For example, if Jon Doe must include in his income the amount of $3,000, and he is in the 15% tax bracket, then he will owe $450 in taxes plus an additional $300 (10% of the $3,000).

Note that the 1/12 pro-rata rule is not repealed in all situations.

An Exception Is Created to the Requirement for Employers to Make Comparable HSA Contributions so that the Employer Can Contribute More for Lower-Paid Employees

The IRS issued its final regulation setting forth the comparability rules in July of 2006. In general, these regulations require an employer to make contributions of the same dollar amount to all HSA eligible employees with similar coverage (single or family) and similar work status (full or part time). An employer will now be able to make larger contributions for lower-paid employees, since it is now permissible to exclude the highly-compensated employees. A highly-compensated employee, for this purpose, for 2007, is the same as for pension purposes; an employee who owns 5% or more of the employer, or an employee earning $100,000 or more.

Change in Effective Date and Announcement Date of Cost-of-Living Adjustments

In October of each year, the IRS announces next year's tax limits. The IRS normally issues a news

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release setting forth all of the revised amounts and limits. On October 18, 2006, the IRS issued News Release No. IR-2006-162; it reported the 2007 adjusted amounts and limits.

With respect to HSAs, the amounts adjusted are: the maximum contribution amount, the minimum annual deductible, and the maximum out-of-pocket limit.

Most employers use November and December to have their employees enroll for the upcoming year. Announcing the new limits in October does not give much time for HSA custodians, IRA custodians, pension administrators, etc. to communicate the new limits, prepare new enrollment forms and allow for planning.

To be fair to the IRS it is not the IRS' fault. The IRS is simply implementing the tax laws as written.

With respect to HSAs, the law has now been specifically changed to set up a different period for determining the adjusted amounts for HSAs each year.

Under the new tax law, the Secretary of the Treasury (i.e. the IRS) is required to announce the new limits for the following year by June 1. For example, the limit for 2008 will need to be announced by June 1, 2007.

The earlier announcement will give everyone (individuals, insurance companies, HSA custodians, etc.) involved with HSAs more time to implement these new amounts. ◆

Who Is Considered a "Reservist" Under the Pension Protection Act (PPA) of 2006?

Under the Pension Protection Act, members of a "reserve component" are allowed to make penalty-free IRA withdrawals, meaning the 10% additional tax is not owing, if the individual is younger than age 59½. Financial institutions will want to be aware of the definition of "reservist," in order to properly handle the newly allowed distributions from, and recontributions to, the IRAs/pension accounts of such reservists.

The IRS definition of reservist is: an individual who was a member of a reserve component who was ordered or called to active duty for a period in excess of 179 days or for an indefinite period.

In Code section 101 of Title 37, the term "reserve component" is defined to mean:

- the Army National Guard of the United States;
- the Army Reserve;
- the Naval Reserve;
- the Marine Corps Reserve;
- the Air National Guard of the United States;
- the Air Force Reserve;
- the Coast Guard Reserve;
- the Reserve Corps of the Public Health Service

Under Section 827 of the Pension Protection Act, a "qualified reservist distribution" is defined as follows:

"Qualified Reservist Distribution — For purposes of this subparagraph, the term "qualified reservist distribution" means any distribution to an individual if:— (1) such distribution is from an individual retirement plan, or from amounts attributable to employer contributions made pursuant to elective deferrals as described in subparagraph (A) or (C) of section 402(g)(3) or section 501(c)(18)(D)(iii), (2) such individual was (by reason of being a member of a reserve component as defined...) ordered or called to active duty for a period in excess of 179 days or for an indefinite period, and (3) such distribution is made during the period beginning on the date of such order or call and ending at the close of the active-duty period."

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This Section continues concerning repayment of the qualified reservist distribution as follows:

"Amount Distributed May Be Repaid— any individual who receives a qualified reservist distribution may, at any time during the 2-year period beginning on the day after the end of the active duty period, make one or more contributions to an individual retirement plan of such individual in an aggregate amount not to exceed the amount of such distribution. The dollar limitation otherwise applicable to contributions to individual retirement plans shall not apply to any contribution made pursuant to the preceding sentence. No deduction shall be allowed for any contribution pursuant to this clause." ◆

Retirement Plans FAQs Relating to Waivers of the 60-Day Rollover Requirement

(From the IRS, US Department of the Treasury)

These frequently asked questions and answers are provided for general information only and should not be cited as any type of legal authority. They are designed to provide the user with information required to respond to general inquiries. Due to the uniqueness and complexities of Federal tax law, it is imperative to ensure a full understanding of the specific question presented, and to perform the requisite research to ensure a correct response is provided.

1. Are there any automatic waivers of the 60-day rollover period? The 60-day rollover requirement is waived automatically only if all of the following apply:

- The financial institution receives the funds on your behalf before the end of the 60-day rollover period.
- You followed all the procedures set by the financial institution for depositing the funds into an eligible retirement plan within the 60-day period (including giving instructions to deposit the funds into an eligible retirement plan).
- The funds are not deposited into an eligible retirement plan within the 60-day rollover period solely because of an error on the part of the financial institution.
- The funds are deposited into an eligible retirement plan within 1 year from the beginning of the 60-day rollover period.
- It would have been a valid rollover if the financial institution had deposited the funds as instructed.

If you do not qualify for an automatic waiver, you can apply to the Service for a waiver of the 60-day rollover requirement.

2. How do I obtain a waiver of the 60-day rollover requirement? To obtain a waiver, a request for a ruling must be made pursuant to Revenue Procedure 2003-16, 2003-1 C.B. 359. Furthermore, every request for extension of the 60-day rollover period must be accompanied by the appropriate user fee (See Revenue Procedures 2006-4 and 2006-8 published in Internal Revenue Bulletin 2006-1 (January 3, 2006)).

3. How does IRS (Service) determine whether to grant a waiver? In determining whether to grant a waiver, the Service will consider all relevant facts and circumstances, including:

- whether errors were made by the financial institution (other than those described under automatic waiver, above),
- whether you were unable to complete the rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error,
- whether you used the amount distributed (for example, in the case of payment by check, whether you cashed the check), and
- how much time has passed since the date of distribution.

4. Which taxpayers are eligible to request extensions of the 60-day rollover period? Only an individual initially eligible to roll over the distribution concerning which the extension is requested is eligible to request an extension of the 60-day rollover period. Thus, only IRA owners, plan participants and surviving spouses treated as distributees or payees of the distributions are eligible to roll over funds distributed from an IRA or a plan. As a general rule, a non-spouse beneficiary of an IRA holder or a qualified plan participant is not eligible to roll over a distribution received from either a plan or an IRA even if a distribution is made without the consent of the non-spouse beneficiary. Thus, a non-spouse beneficiary will not receive an extension of the 60-day rollover period.

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5. What information is required to be submitted to obtain a waiver? Revenue Procedure 2006-4, Appendix A contains a sample letter ruling request format. Appendix B contains a checklist of information which should be submitted with ruling requests made under the revenue procedure. The following additional information should be supplied when making a request for an extension:

a. Either the full name of the qualified retirement plan and the name of the employer which sponsors the plan, or the full name of the IRA holder and the name of the trustee/custodian of the IRA making the distribution;

b. If the request is being made on behalf of a surviving spouse (beneficiary) of an IRA holder or plan participant, a copy of the beneficiary designation and a copy of the death certificate;

c. If an IRA, the account number;

d. The amount(s) of the distribution(s);

e. The date(s) the distribution(s) was/were made;

f. The amount of federal and/or state taxes, if any, withheld from the distribution;

g. A statement as to why the distribution(s) was/were made. The statement should indicate what was intended to be done with the distribution at the time of receipt, and should contain a description of what was actually done with the distribution including the name of the financial institution where the distribution was deposited, if applicable;

h. A detailed explanation as to why the 60-day rollover requirement was not met, such as:

• A description of any medical problems of the taxpayer and how the problems caused the failure to meet the 60-day requirement;

• A description of an erroneous information from, or mistake by, a financial institution. If the erroneous information was in writing, copies of the correspondence must accompany the ruling request,

• Descriptions of any other event(s) or causes that prevented the completion of the rollover within 60 days.

Note: If the request for extension is based on erroneous advice/information, an explanation as to how the information affected the taxpayer's ability to complete the rollover within the requisite 60-day period.

i. All documentation relevant to the hardship being claimed which prevented the timely completion of the rollover, including doctors' statements or bills regarding any mental or medical impairment, copies of any correspondence to or from the doctor(s) and medical institutions, and copies of completed financial or institutional forms;

j. Evidence that the distributed funds have not been used (e.g., copies of bank statements, etc.);

k. State the name of the qualified retirement plan or IRA trustee/custodian where you intend to deposit the funds which are the subject matter of the ruling request if the request is approved;

l. State whether the individual on whose behalf the request for extension was made is 70½ or older. (If so, some of the funds distributed may be ineligible for rollover treatment because they are required to be distributed under the minimum required distribution rules of sections 408(a)(6) or 401(a)(9) — the individual may need to check with the holder of the IRA or plan administrator on this);

m. If this waiver request involves an IRA to IRA rollover, state whether the one rollover per year rule of section 408(d)(3)(B) of the Internal Revenue Code applies to the distribution which is the subject matter of the extension request.

n. A signed and dated perjury statement as follows:

"Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts relating to the request and such facts are true, correct and complete."

o. The request for extension should state how long an extension is needed to make the rollover (a request may be made for an extension of a period not exceeding 60 days as measured from the date of issuance of the letter ruling granting the waiver of the 60-day rollover period).

p. Powers of Attorney: If the taxpayer's request for extension is submitted by an authorized representative, then a Form 2848, Power of Attorney and Declaration of Representative, must be submitted with the request.

6. How does the Service process requests for extension? The Service will process requests for

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extension of the 60-day rollover period in the order received. However, requests that do not include the appropriate user fee and/or that do not comply with the procedural requirements described above will be returned to the requester without any action.

7. Is a request for extension subject to disclosure? The text of certain letter rulings is open to public inspection. The Service makes deletions before it is made available for inspection. To help the Service make any necessary deletions, a request for a letter ruling must be accompanied by a statement indicating the deletions desired ("deletions statement"). A taxpayer who wants only names, addresses and identifying numbers to be deleted should state this in the deletions statement.

8. Where do I send the request for a waiver? The information described above should be submitted to the Service as a ruling request, and accompanied by the appropriate user fee. It should be sent to the following address: Internal Revenue Service, Attention: EP Letter Rulings, P.O. Box 27063, McPherson Station, Washington, DC 20038 ◆

H & R Block Case Dismissed in Court

In the March 2006 Pension Digest, we published an article concerning a law suit by New York State against H & R Block, for fraudulent marketing of their "Express IRA." This month, the court has dismissed the case because H & R Block is a Missouri holding company, and New York State has no jurisdiction over the company. The fact that H & R Block is the parent company of direct and indirect subsidiaries providing tax and investment services in New York, is insufficient to establish jurisdiction over the parent company. The actual New York subsidiaries offering the alleged fraudulent IRA were not mentioned in the complaint.

Mr. Eliot Spitzer, then attorney general of New York, is now the governor-elect of New York. As attorney general, he is the one who brought the charges against H & R Block. The Attorney General's office initiated the investigation in 2005, after having received the information from a Block employee.

It would not be surprising if Mr. Spitzer appealed the court's decision, as the dismissal included a "replead" clause. To replead, it must be shown that H & R Block, Inc. is present in New York through a subsidiary, and it must also be shown that there was unlawful conduct attributable to H & R Block Financial Advisors.

Mr. Spitzer's complaint details the experiences of many New York customers who invested a minimal amount in the Express IRA; touted by H & R Block as a sound investment. However, because H & R Block's tax preparers are not licensed to sell securities, the Express IRAs have only one investment option — an insured money-market account which pays very little interest. One example in the complaint detailed an individual who invested $300, and in four years earned less than $12 of interest. H & R Block's fees for the account totaled $45. It is alleged that H & R Block did not provide adequate disclosure of its fees.

Some employees of H & R Block refused to sell the Express IRA and even commented to the management that clients would lose money because of the fees involved. The fees are: a $15 set-up fee, a $15 re-contribution fee, and a $10 yearly maintenance fee. Coupled with the low interest the account pays, 85% of investors in the Express IRA lost money.

It must also be considered that the Saver's Credit was most likely available to most investors in the Express IRA, thereby saving them one half of their investment in federal income taxes, to a maximum of $1,000 (on a $2,000 contribution) if their income was under $30,000 (for a joint return). Therefore, in the $300 example above, if the individual was married and filed a joint return, with modified adjusted gross income of less than $30,000, the couple would realize a $150 savings on federal income tax.

CWF finds it interesting that not only do fiduciaries have to be prepared for IRS and bank regulators scrutinizing day-to-day operations, apparently they must be prepared for the attorney general to intervene, if he/she has sufficient evidence of fraudulent activity. The judge in this case also pointed out that during the years in question, the interest on basically any investment was quite low. Yet that fact does not excuse H & R Block for not providing an accurate disclosure of its fees.

If the case is appealed, CWF will keep you informed via this newsletter. ◆