# The Pension Digest

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## ALSO IN THIS ISSUE –




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




## IRS Authorizes an IRA Rollover by Personal Representative—PLR 200742027

An IRA accountholder had withdrawn money from this IRA in 2004. That same day he become seriously ill. He died 27 days later in 2004 at the age of 63 without having completed the roll over. There was clear evidence that he had intended to roll over this distribution since he had taken other distributions in 2004 from other IRAs and rolled over such amounts. In December of 2005, the personal representative of his estate asked the IRS to waive the 60 day requirement and to allow the roll over into an IRA which would be a beneficiary or inherited IRA.

The IRS did so in PLR 200742027. A long time ago the IRS had adopted the approach that making a rollover contribution was a personal tax right and ended upon a person's death. The IRS does not discuss this rule in this PLR. Rather, the IRS was willing to start from the position that the personal representative under state law may have the authority to establish an IRA and make a roll over contribution to it. The IRS has the authority to waive the 60 day requirement if the inability to complete the rollover within the 60 day period was due to the accountholder's death. The personal representative furnished information and documentation supporting the statement that the rollover was not completed because of the accountholder's death. Consequently, the IRS


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## What is meant by the term, "Custodial IRA"?

**There are two general meanings to this term.**

One term is used when the IRA funds are on the "retail" side of the financial institution. The other term is used when the IRA funds are on the "trust" side of the institution.

Collin W. Fritz and Associates, Ltd. has three basic IRA forms to establish a traditional IRA, and three basic forms to establish a Roth IRA.

Serious problems may well arise if the personnel of an IRA custodian/trustee do not understand which forms are the proper forms to be used to establish an IRA.

If you have a question, you should ask your forms vendor for assistance.

**A Custodial IRA Form.** This form defines the permissible investments as being the savings accounts on time deposits as offered by the financial institution serving as the IRA custodian. This form is to be used by a financial institution that does not want to serve as a formal trustee or does not have the legal authority to act as a trustee. Many banks, savings and loans, or credit unions have the authority to only act as an IRA custodian. This form restricts the investments which may be purchased by (and for) the IRA accountholder to savings accounts and time deposits which are offered by that financial institution. This form does not authorize the investment in a CD of


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**IRS Authorizes a Personal Rollover, Continued from page 1**

ruled that the personal representative was granted a period of 60 days from the issuance of this PLR to make a rollover contribution equal to or less than the amount distributed. The IRS makes clear that there is no authority to roll over any "interest" which would have been earned or was earned while the funds were not in an IRA.

The IRS also states that for purposes of the required distribution rules that this beneficiary or inherited IRA is treated as not having designated a beneficiary. The estate (or the beneficiaries of the estate) will need to comply with the five year rule as he died before his required beginning time. The life distribution rule is inapplicable. ◆

## One HSA, or Two HSAs, When There Are Employer Contributions

We understand that many married couples would prefer to have only one HSA. A primary reason may be to save on fees.

The subject of whether a husband and wife should both maintain an HSA is certainly a hot HSA topic right now. The topic becomes more complicated when an employer will be making contributions.

There will be times when the only way for a married couple to maximize the HSA tax benefit is for each spouse to have his or her own HSA. There are other times when a couple will be able to have the same contribution/tax deduction even though only one of them maintains an HSA.

There are HSA rules which support, in some situations, the right of a married couple to have their HSA contributions made to just one HSA. Code section 223(b)(5) authorizes this action. This section does not apply to most employer contributions as Code section 223(b) sets forth the limitations applying to contributions qualifying to be deducted. Employer contributions, if comparable, are generally excluded from the income of the employee and are not subject to the deductibility rules.

The IRS discussed the comparability rules in Notice 2004-50 and then the IRS also adopted a final regulation (2006) setting forth detailed comparability rules. Nowhere in any of the IRS discussion has the IRS said that the contributions required to be made by an employer to an employee to satisfy the comparability rules may be made to the HSA of the employee's spouse rather than the HSA of the employee.

We believe the IRS has adopted the position that the comparability rules are separate and distinct from the rules of Code section 223(b)(5) which allow spouses to divide the annual HSA contribution in any way that they want, including allocating nothing to one spouse when one spouse has family HDHP coverage.

An employer may wish to review Q&A 8 of the final regulation wherein the IRS ruled that in a certain situation the employer is not required to contribute to the HSAs of both employee-spouses. In other cases, the employer "is required to contribute to the HSAs of both employee-spouses. Again, note there is no discussion that both contributions can be made to one of the employee-spouse's HSA.

**Review of General HSA Rules**

The IRS has adopted the rule that any person or entity may make an HSA contribution on behalf of an eligible individual. No reason or test must be met to make the contribution. Therefore, an employer could make such a contribution into the HSA of a spouse of an employee. But such a contribution would be subject to the "deduction" rules rather than the exclusion of income rules.

The type of health plan coverage applying to the HSA owner determines the amount which may be contributed to an HSA. There is one contribution limit if there is single coverage, and there is one contribution limit if there is family coverage.

A catch-up contribution with respect to a person may only be made to that person's HSA. A person's HSA catchup contribution cannot be made to their spouse's HSA.

Q&A 81 of Notice 2004-50 discusses an employer's responsibility when it makes a contribution to an HSA established by one of its employees. The employer is responsible to determine what type of health plans cover the employee so that a determination can be made as to whether the employee may make an HSA contribution and the employee's age. The employer may rely on the employee's representation as to his or

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**One HSA, or Two HSAs, Continued from page 2**

her date of birth. Note that there is no requirement for an employer to determine whether the employee has single or family coverage.

The IRS has made it clear that it is primarily the duty of the HSA owner to determine if excess contributions have been made to his or her HSA. Again, this depends on whether or not the person has single or family HDHP coverage.

The HSA plan agreement does not require the HSA custodian to know or monitor whether the person has single or family coverage. The HSA plan agreement in Article I states that the HSA custodian will not accept any contributions for an HSA account owner that exceeds the maximum annual amount for family coverage plus the catch-up contribution. Any amount less than those amounts is permissible.

Set forth below are three different situations where the married couple, if possible might consent to maintain only one HSA. The general rule is this is impermissible.

**Situation #1.** A husband and wife both work for the same school district and each spouse has single health plan coverage. The school district will be making HSA contributions on behalf of comparable employees. If possible, this couple would like to maintain only one HSA.

The general rule is that a person is not required to establish an HSA. There is a major exception. In order to satisfy the comparability rules, an employer can require an employee to establish an HSA. And the comparability rules require each spouse to have his or her own HSA.

**Situation #2.** A husband and wife both work for the same school district. The couple has a child and the wife and the child will be covered under a family policy. The husband will still be covered under a single policy. If possible, they would like to maintain only one HSA.

We believe the comparability rules do not permit this. If a comparable contribution must be made for both employee-spouses, such contributions must be made to each spouse's respective HSA.

**Situation #3.** Same facts as situation #2 except assume that there are two unrelated employers. One employer employs the husband, and another employer employs the wife. Again, if possible, they would like to maintain only one HSA.

The same analysis as set forth for situation #2 applies to this situation also.

**Conclusion.** We believe the comparability rules require an employer making comparable contributions to the HSA of the employee and not the HSA of the spouse of the employee. There is no authority to make such contributions to the HSA of a spouse, even if that spouse is employed by the same employer. Certainly, not if there are different employers.

However, an employer can also make non-comparable contributions to the HSA of an employee. Such a contribution would be considered to be income for federal income, social security and medicare tax purposes and would be subject to the "deduction" rules rather than the exclusion of income rules. The tax result is not as clear if the employer would make a non-comparable HSA contribution to the HSA of a spouse of an employee. We believe the IRS would argue this contribution amount would also be "income" to the recipient (or the spouse of the recipient). However, one can imagine that in some situations (truly gratuitous situations) the making of an HSA contribution on behalf of a person should not result in income for that person. ◆

## How Does an IRA Custodian/Trustee Administratively Treat a Proposed SEPP Schedule Including a COLA?

Code section 72 provides that the 10% additional tax will not apply to an IRA accountholder who withdraws funds from his or her IRA, even though younger than age 59½, if the distribution is part of a substantially equal periodic payment schedule. There appears to be a number of IRA practitioners who believe that it is no longer permissible to include a COLA provision in a Substantially Equal Periodic Payment (SEPP) schedule.

Collin W. Fritz and Associates, Ltd. disagrees with this position. We believe it is permissible to have a SEPP formula with a COLA. We are unaware of any

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**Proposed SEPP Payment Schedule, Continued from page 3**

express written statement by the IRS that a person may not include a COLA in a SEPP formula. The IRA accountholder should be informed that adopting such a formula (unless a PLR has been obtained) is not as safe as using one of the three safe harbor formulas and that there are tax risks associated with a non safe harbor SEPP.

Does an IRA custodian/trustee have to decide if CWF, Vanguard, Wolters Kluwer or the IRA accountholder is correct on this tax question?

We at CWF don't think so. The IRS does not normally require the IRA custodian/trustee to make tax determinations. The IRS requires the IRA accountholder to make such determinations. We believe this general rule applies to the SEPP situation. Therefore, the IRA custodian may use the reporting code "2" to report any such distribution on the Form 1099-R as long as the IRA accountholder or his or her tax advisor has certified that the proposed schedule qualifies as a SEPP. If the IRS ever states in writing that the Code "2" can only be used if the IRA accountholder has elected to use one of the safe harbor methods in Revenue Ruling 2002-62, then we would suggest that such guidance be followed. At this point, the IRS has not said this and we don't think the IRS will.

**Additional Discussion**

1. The Internal Revenue Code uses the term substantially equal periodic payment, but does not define it. The 10% additional does not apply if the distribution is a SEPP.

2. The IRS gave written guidance on SEPPs when it discussed this subject in Notice 89- 25. The IRS said that a party could use any one of three methods and such methods were safe harbor methods. That is, the IRS could not argue that such a schedule did not qualify as a SEPP. The law provides for the imposition of some tax penalties if the schedule is modified before the law permits. After issuing Notice 89-25 the IRS did receive some PLR requests asking is a particular formula could qualify as a SEPP even though the formula contained a COLA. In a number of cases the IRS rules that a formula with a COLA would qualify as a SEPP.

3. In 2002 the IRS issued Revenue Ruling. 2002-62. The purpose of the Revenue Ruling was to update or modify the rules applying to SEPPs. Under the rules as written, any change in the SEPP formula would generally result in the tax penalties associated to changing the schedule. In general, it is now permissible for any party who has established a SEPP to now switch to the RMD method and the taxes penalties will not be assessed for modifying the schedule.

4. Revenue Ruling 2002-62 again provides for 3 safe harbor methods. If payments are made in accordance with one of the three methods the payments, then the payments are considered to be substantially equal periodic payments. There is also discussion of the subject of modifying the SEPP and the IRS defines certain situations when various recapture taxes will apply and when they won't. There is no express discussion in this revenue ruling of the topic of COLAs. I am unaware of any Private Letter ruling issued after Rev. Rul. 2002-62 concluding that a proposed formula containing a COLA did not qualify as a SEPP solely because it contained a COLA.

A Revenue Ruling binds each and every person acting for the IRS. The taxpayer can cite the Revenue Ruling as authority so that the IRS (and any employee of the IRS) cannot put forth an argument inconsistent with the Revenue Ruling. However, the IRS cannot cite as legal authority the position set forth in the Revenue Ruling. It is simply an opinion. It is not a regulation. Most courts will not give much authoritative status to a Revenue Ruling.

5. The IRS has made clear that a formula may qualify as a SEPP even though it is not one of the safe harbor formulas. The IRS has said that they will simply have to review it and then decide if it qualifies. The review can occur because the taxpayer requests a private letter ruling or upon an audit by the IRS. If the IRS would rule that a formula does not qualify as a SEPP, then the individual would have to decide if it was worthwhile to appeal the IRS ruling to the proper tax court.

The fact that the annual amount to be distributed each year under a formula changes (e.g. because there is a COLA) does not mean that the formula cannot qualify as a SEPP. The annual amount distributed under the RMD formula changes each year. In the later years the amount distributed annually changes

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**Proposed SEPP Payment Schedule, Continued from page 4**

dramatically. One can expect that the IRS will argue that a formula allowing for larger distributions in the first few years versus later years will not qualify. This is not what a COLA does.

6. We at CWF do not agree with Vanguard or WK/BS that the lack of expressly authorizing a formula with a COLA in Rev Rul 2002-62 means that a person can no longer use a formula with a COLA. The IRS has never said this in writing.

7. In order for a formula containing a COLA to qualify as a SEPP, the COLA must be included in the formula from day one. CWF will be adding some additional language to our forms to state our understandings. There is no doubt the most conservative approach is to adopt a safe harbor formula. But is it up to the IRA accountholder to make this decision. ◆

## Administrative Complexities if Multiple IRA Accountholders have Cross-Named Each Other as Beneficiaries

An IRA custodian called CWF with a situation similar to the following. There were four Doe brothers: John (68), David (66), Mark (65), and Paul (62). Each brother had his own IRA with the following balances:

| | | | |
|---|---|---|---|
| 1. | John | $50,000 | As of December 31, 2007 |
| 2. | David | $60,000 | As of September 15, 2007 |
| 3. | Mark | $45,000 | As of March 10, 2007 |
| 4. | Paul | $25,000 | As of December 31, 2007 |

Each brother had named his 3 brothers as the beneficiaries of his IRA, each brother to share equally. Mark died on March 10, 2007, and David died on September 15, 2007. No distributions were taken in 2007.

The general rule is that a nonspouse beneficiary is required to commence distribution over his life expectancy commencing on or before December 31 of the following year. The life expectancy of the applicable brother beneficiary would be used.

**Administratively, what will an IRA custodian need to do with respect to each brother?**

Note that John, David, and Paul each acquired $15,000 (1/3 x $45,000) from Mark's IRA on March 10, 2007. On David's death, John nd Paul will each receive 50% or $30,000 with respect to David's IRA, and John and Paul will also each receive $7,500 (50% of $15,000) with respect to the $15,000 (plus earnings) which David had acquired with respect to Mark's IRA.

**What needs to happen?**

1. Mark. He had one IRA. The IRA custodian will need to prepare a final FMV statement and a final 2007 Form 5498 with respect to Mark's IRA. The IRA custodian may either furnish the fair market value as of March 10, 2007, with the amount of $45,000, or use the amount of $0.00 along with a special note stating that the IRA custodian will furnish the fair market value as of the date of death to the personal representative of Mark's estate upon request.

2. David. He had two IRAs. David had his own IRA. For a short time he also had an inherited IRA, "David as beneficiary of Mark's IRA." With respect to this IRA he had named John and Paul to be his beneficiaries.

A. With respect to David's own IRA, the IRA custodian will need to prepare a final FMV statement and a final 2007 Form 5498. The IRA custodian may either furnish the fair market value as of September 15, 2007, with the amount of $60,000, or use the amount of $0.00 along with a special note stating that the IRA custodian will furnish the fair market value as of the date of death to the personal representative of Mark's estate upon request.

B. With respect to the inherited IRA associated with Mark, upon David's death, this IRA has now been transferred to John and Paul. Although the IRS has not addressed this, the IRA custodian will likely need to prepare a final FMV statement and a final 2007 Form 5498 for this inherited IRA. The IRA custodian may either furnish the fair market value as of David's date of death ($15,000 plus interest earned from March 10, 2007 to September 15, 2007) or use the amount of $0.00 along with a special note stating that the IRA custodian will furnish the fair market value as of the date of death to the personal representative of David's estate upon request.

3. John. He has four (4) IRAs.

A. He has his own IRA (John Doe) with a balance of $50,000. He will need to be furnished a FMV

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**Administrative Complexities, Continued from page 5**

statement and/or a 2007 Form 5498 according to the standard IRS rules.

B. He now has a beneficiary IRA, “John Doe as beneficiary of Mark Doe’s IRA.” The balance as of December 31, 2007, will need to be reported. This is $15,000 plus the interest earned from March 10, 2007, to December 31. He will need to be furnished a FMV statement and/or a 2007 Form 5498 for this inherited IRA according to the standard IRS rules. Unless he would elect the 5-year rule, he will need to commence distribution over his life expectancy commencing in 2008.

C. He now has a beneficiary or inherited IRA ”John Doe as beneficiary of David Doe’s IRA.” The balance as of December 31, 2007, will need to be reported. This is $30,000 plus the interest earned from September 15, 2007, to December 31. He will need to be furnished a FMV statement and/or a 2007 Form 5498 for this inherited IRA according to the standard IRS rules. Unless he would elect the 5-year rule, he will need to commence distribution over his life expectancy commencing in 2008.

D. He now has a beneficiary or inherited IRA, “John Doe as beneficiary of David as beneficiary of Mark’s IRA.” The balance as of December 31 will need to be reported. This will be the balance of $7,500 (50% of $15,000) and the earnings since the date of Mark’s death. He will need to be furnished a FMV statement and/or a 2007 Form 5498 for this inherited IRA according to the standard IRS rules. Unless he would elect the 5-year rule, he will need to commence distribution in 2008. However, the divisor for this IRA will be determined using the age of the original beneficiary (David) and not the age of John who is the “second” beneficiary to acquire the IRA.

4. <u>Paul. Paul also has 4 IRAs as follows</u>. They would be similar to the ones which John has.

A. He has his own IRA (Paul Doe) with a balance of $25,000. He will need to be furnished a FMV statement and/or a 2007 Form 5498 according to the standard IRS rules.

B. He now has a beneficiary IRA, “Paul Doe as beneficiary of Mark Doe’s IRA.” The balance as of December 31, 2007, will need to be reported. This is $15,000 plus the interest earned from March 10, 2007, to December 31. He will need to be furnished a FMV statement and/or a 2007 Form 5498 for this inherited IRA according to the standard IRS rules. Unless he would elect the 5-year rule, he will need to commence distribution in 2008 over his life expectancy.

C. He now has a beneficiary or inherited IRA, “Paul Doe as beneficiary of David Doe’s IRA.” The balance as of December 31, 2007, will need to be reported. This is $30,000 plus the interest earned from September 15, 2007, to December 31. He will need to be furnished a FMV statement and/or a 2007 Form 5498 for this inherited IRA according to the standard IRS rules. Unless he would elect the 5-year rule, he will need to commence distribution in 2008 over his life expectancy.

D. He now has a beneficiary or inherited IRA, “Paul Doe as beneficiary of David, as beneficiary of Mark’s IRA.” This will be the balance of $7,500 (50% of $15,000) and the earnings since the date of Mark’s death. He will need to be furnished a FMV statement and/or a 2007 Form 5498 for this inherited IRA according to the standard IRS rules. Unless he would elect the 5-year rule, he will need to commence distribution in 2008. However, the divisor for this IRA will be determined using the age of the original beneficiary (David) and not the age of Paul. This is why there needs to be a separate inherited IRA. ◆

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## State Court Designated Beneficiary <u>Not</u> Designated Beneficiary for RMD Purposes

IRAs are great for deferring federal income taxation. When an IRA accountholder dies after his required beginning date without having designated a beneficiary the remaining distribution period will be based on the age of the decedent and will many times be much shorter than if a beneficiary had been designated. For example, the beneficiary may only have 5-10 years to take the required distributions rather than a possible 30-40 year period for a beneficiary in the 30-40 year range. The tax deferral benefits of the IRA are drastically reduced as the taxpayer beneficiary must include larger amounts in income over a shorter time period. The IRS has released a private letter ruling, 200742026, wherein the IRS rejected the request that the life expectancy of a daughter should be used rather than the age of the deceased IRA accountholder in calculating the required distributions to be passed to the daughter or the trust.

Factual Situation. John Doe maintained an IRA. He died in 2004 when he was age 78. His wife had predeceased him in 2004. His sole surviving heir was his daughter, Anita. She was born in 1985. In 1997 John had designated Anita as his primary IRA beneficiary and his wife as his contingent IRA beneficiary. In 2003 John had changed his beneficiary designation. He had designated his wife as his primary beneficiary, but he did not name a contingent beneficiary. The effect was that his daughter was no longer his IRA beneficiary. Supposedly, the IRA custodian had mailed John another form to change his beneficiary after his wife had died so that his daughter would again be the designated beneficiary. But he did not complete it prior to his death. His will provided all of his tangible personal property, including his IRA was to go to his trust. The RMD for 2005 was calculated based on John's age. However, in 2006, an attorney for the trust went into state court and received a state court order that the IRA beneficiary form was to be amended to show the daughter as the beneficiary.

<u>The IRS ruled the order of the state court had no effect for purposes of the required distribution rules.</u> The facts clearly show that he died with his estate being the designated beneficiary. The RMD regulation provides in this situation that the required distribution is based on the age of the decedent and not any later named beneficiary, even if ordered by a state court. ◆

## There is no Such Thing as a Family HSA

An HSA is a special tax-favored account, established by and between a financial institution, serving as the HSA custodian/trustee, and an individual. An HSA is an individual account. There is no such thing as a joint or family HSA. It is true that an HSA account owner may withdraw funds from their HSA and use such funds to pay the medical expenses of their spouse, if any, or for any other dependent. It is also true that the HSA account owner can grant a power of attorney to their spouse or another person to act on their behalf. These actions do not change the fact that the HSA is an individual account. Nor does the fact that a person may be covered by a "family" HDHP impact whether the HSA is an individual account or not. We believe the better approach is to never describe an HSA as being a family HSA. This can only lead to confusion.

The IRS has taken the position that once a contribution is made to a person's HSA, those funds belong to that person. There is no authority in the tax code to move funds in one spouse's HSA to the HSA of the other spouse. Any purported transfer or rollover from one spouse's HSA to the other spouse's HSA would be invalid and would constitute an excess contribution. The HSA laws do provide that a spouse beneficiary becomes the HSA account owner upon the death of their spouse. ◆

# ROLLOVER CHART

| ROLL FROM \ ROLL TO | IRA | SEP-IRA | SIMPLE IRA | Roth IRA | 457(b) | 403(b) | Qualified Plan | Designated Roth Account |
|---|---|---|---|---|---|---|---|---|
| IRA | YES | YES | NO | YES, must include in income. | YES, must have separate accounts. | YES | YES | NO |
| SEP-IRA | YES | YES | NO | YES, must include in income. | YES, must have separate accounts. | YES | YES | NO |
| SIMPLE IRA | YES, after two years. | YES, after two years. | YES | YES, after two years. Must include in income. | YES, after two years. Must have separate accounts. | YES, after two years. | YES, after two years. | NO |
| Roth IRA | NO | NO | NO | YES | NO | NO | NO | NO |
| 457(b) | YES | YES | NO | YES, after 12/31/07. Must include in income. | YES | YES | YES | NO |
| 403(b) | YES | YES | NO | YES, after 12/31/07. Must include in income. | YES, must have separate accounts. | YES | YES | NO |
| Qualified Plan | YES | YES | NO | YES, after 12/31/07. Must include in income. | YES, must have separate accounts. | YES | YES | NO |
| Designated Roth Account | NO | NO | NO | YES | NO | NO | NO | YES, if a direct trustee to trustee transfer. |

**For more information regarding retirement plans and rollovers, please visit www.irs.gov/ep.**
**This chart was prepared by the IRS**

### What is meant by the term, "Custodial IRA"?
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another financial institution, or the purchase of mutual funds, the purchase of an EE bond, or an I-bond. CWF has assigned Form #40 to this custodial form.

**A Custodial Self-Directed IRA Form.** This form defines various investments as being permissible IRA investments. Most often this will be defined as mutual funds, U.S. Bonds or similar investments. This form is also to be used by a financial institution that does not want to serve as a formal trustee or does not have the legal authority to act as a trustee. Most banks, savings and loans, or credit unions have the authority to act as an IRA custodian of self-directed IRA accounts. Two requirements must be met by the financial institution. First, it must keep appropriate accounting records. Secondly, it must render no investment advice. This is the form to be used if the IRA accountholder wishes to invest in the CD of another financial institution, to purchase mutual funds, or to purchase an EE bond, or an I-bond. CWF has assigned Form #42 to this custodial self-directed form.

**A Trust IRA Form.** The financial institution must have the authority to serve as a trustee of IRAs and non-IRAs. In many trust situations, the individual who establishes the IRA is hiring the financial institution to gain the benefit of its investment skills. This is called a "managed" account. The trustee will be primarily liable for the investment decisions. In other cases, the individual will want to take a more direct role in making the investment decisions. By doing so, he or she will become primarily responsible for the investment decisions. The trustee will be following the direction of the individual. It's role is "custodial" versus "managing". It is a type of self-directed IRA, but the self-direction is being done within the trust IRA. ◆