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ALSO IN THIS ISSUE –

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

Warning – Don't Move Inherited IRA Funds to the Estate Checking Account Too Quickly

The cardinal rule for administering inherited IRAs is that they cannot be rolled over. They may be transferred.

Many times family members of a deceased IRA accountholder think it is important to move all of the decedent's funds and assets into an estate account, including IRA funds. And in some cases, bank employees who do not work with IRAs on a regular basis may also think it is important to move all of the deceased funds into an estate account, including IRA funds. It makes the distribution process easier.

The problem is - if funds are moved from the IRA to the estate account, the funds are no longer IRA funds. The distribution is includable in income. And there is no tax law authorizing such a distribution to be rolled over to undo the distribution. An attempted roll over of a nonqualifying amount is an excess contribution and is subject to the annual 6% excise tax.

It is important for a financial institution to understand these inherited IRA rules as illustrated by the following situation.

A good customer came to a financial institution seeking help. She had been designated as the beneficiary of her aunt's IRA. She was 1 of 3 beneficiaries. This beneficiary was age 58. Her share of the inherited IRA was $90,000. She asked her financial institution if she could somehow transfer these funds to this financial institution. The financial institution had her establish an inherited IRA and had her complete a transfer of inherited IRA form.

Set forth below is CWF's communication on this topic.

A woman has established an inherited IRA with your financial institution. She was the designated beneficiary of her aunt's IRA. The aunt had established her IRA with a financial institution located in the state of Alabama. Recently, this woman's share of the IRA was wired to your financial institution as the IRA custodian of the inherited IRA. The titling of the payment made very clear that the funds were to be deposited into an inherited IRA for this woman. The inherited IRA would be titled, First State Bank as IRA custodian for Jane Doe (name of woman) as beneficiary of Aunt Doe's (name of decedent) IRA.

A representative of the Alabama financial institution indicated that it would be preparing a 2009 Form 1099-R to report the "IRA distribution" and would be inserting the reason code "4" in box 7. The "4" would indicate the distribution was to a beneficiary and was made on account of the death of the IRA accountholder.

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For the reasons discussed below, the Alabama financial institution should not prepare a 2009 Form 1099-R. A Form 1099-R is to be prepared when there has been a "reportable" distribution.

Since these funds were "transferred" from the decedent's IRA (now an inherited IRA) to the beneficiary's inherited IRA with your financial institution, there has been no reportable distribution.

The IRS instructions for Form 1099-R are clear: Do not report a transfer between IRA custodians that involves no payment of distribution of funds to the participant or other recipient. There is no special rule making the transfer of inherited IRA funds reportable when the transfer of "regular" IRA funds is not reported.

The IRS instructions note that a recharacterized distribution, a Roth conversion distribution and a direct rollover distribution from a qualified plan (and certain other employer plans) do need to be reported.

CWF understands the funds with the Alabama financial institution were IRA funds. These funds were "transferred" to Iowa. They were not a recharacterized distribution, a Roth conversion distribution or a direct rollover distribution.

Also see page 11 of the IRS instructions. A code "4" is to be used when there has been an actual or a "reportable" distribution to a decedent's beneficiary, including an estate or trust. CWF understands that such a distribution did not occur.

CWF acknowledges the numerous laws governing rollovers, direct rollovers and transfers has become very complex these past few years. The law is very clear, however, that a nonspouse beneficiary cannot rollover or directly rollover inherited IRA funds. Any actual or deemed distribution to a person would require that person to include the distributed amount in his or her income.

The law is also clear that IRA funds cannot be directly rolled over from one IRA to another IRA or from one inherited IRA to another inherited IRA. The law defines a direct rollover as being the movement of funds from an employer plan to an IRA or vice versa. The law does NOT define a direct rollover as occurring when funds move from one IRA to another IRA.

CWF believes the Alabama financial institution could be assessed a fine for preparing an incorrect 2009 Form 1099-R if it would prepare such a form.

In summary, the movement of the IRA funds from the Alabama financial institution to your financial institution was done as a transfer. The Alabama financial institution should not prepare a Form 1099-R to report the "transferred" funds and we understand that the Alabama financial institution has reached the same conclusion. Likewise, your financial institution will not report this transfer contribution when you prepare the 2009 Form 5498 for this inherited IRA. ◆

Transferring of a Credit Union's Inherited IRA

Factual Background. The IRA accountholder was Jane Doe. She was a client of the bank, but she did not have her IRA account with the bank. She had it with a credit union. Jane Doe did execute a revocable trust in 1993 and she restated it in April of 2008. Her non-IRA deposit accounts with the bank have been titled, "Jane Doe, trustee, first restatement of the Jane Doe revocable inter vivos trust u/a/d September 20, 1993." Jane Doe died in early 2008. The successor trustee, John Doe, has had the title changed to, John Doe, successor trustee, first restatement of the Jane Doe revocable inter vivos trust u/a/d September 20, 1993." John Doe also asked if the inherited IRA with the credit union could be transferred to the the bank.

Credit unions have administrative problems with inherited IRAs because many times the inheriting IRA beneficiaries do not qualify to be a member of the credit union.

A nonspouse beneficiary (including a trust) has no legal right to roll over funds from one inherited IRA to a second inherited IRA. However, such funds can move via a tax-free non-reportable transfer. The general rule is that the two IRA custodians

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need to agree that the inherited IRA funds will be transferred from the inherited IRA at the credit union to an inherited IRA with the bank. The bank should certify to the credit union that it understands the IRA is an inherited IRA and that there will be compliance with the RMD rules applying to an inherited IRA with a trust as the beneficiary.

The trust is not required to take a lump sum distribution. The trustee on behalf of the trust could elect to take a distribution over a certain number of years. The rule is, if the trust is a qualifying trust, then the age of the oldest beneficiary (and the Single Life table) is used to determine the pay-out period.

It appears there may be a couple of issues needing to be resolved before such a transfer could or should take place.

A possible problem – it appears the IRA was retitled at the credit union and the titling at the credit union appears to be the same titling used for other non-IRA accounts. That is, the IRA title shows the IRA accountholder as being the Jane Doe Trust rather than Jane Doe. Such a change should not have been made. See page 8 for an article on this topic.

A determination will need to be made that the trust was designated by Jane Doe to be the IRA beneficiary and that the credit union is willing to transfer to the bank the inherited IRA with the trust being the inheriting beneficiary. ◆

Interesting Inherited IRA Situation

Mr. John Alsop maintained an IRA with First State Bank. He died on June 25, 2008. He had designated his three sons (Mark, Abe and Brett) to be his primary beneficiaries, each to receive a 1/3 share.

The IRA custodian was sent a letter by Ms. Attorney of the firm, Attorney & Attorney, LLP. She instructed First State Bank that the IRA be closed and that a check be sent to her for the full amount. This was pursuant to an authorization from one of his sons, Mark Alsop. She indicated the law firm would be taking its fee from these funds.

The bank cannot disburse the IRA funds to the law firm. An IRA is a non-estate asset. Unless Ms. Attorney can furnish some additional authority, the IRA funds should not have been included in the assets comprising the Affidavit of Heirship.

An IRA is a special tax-preferred revocable trust created primarily under federal income tax laws. The trust contains provisions whereby the IRA accountholder designated his three (3) sons as his beneficiaries to receive the IRA funds after his death.

Once an IRA accountholder dies, as a matter of law (and the IRA plan document) there are generally three inherited IRAs established. One for each son. Each son will need to instruct the bank, as the IRA custodian, how he will comply with the required distribution rules applying to beneficiaries. Each beneficiary will need to furnish his instruction.

Mark Alsop is certainly able to take a 100% distribution of his share, but he has no authority with respect to the two inherited IRAs of his brothers. The two other brothers will have to provide the IRA custodian with their instructions as to how and when they will withdraw their funds from their inherited IRAs. ◆

Should HSAs be Added to Internet Banking Accounts?

Financial institutions are starting to consider whether they should add HSA accounts to other accounts on their banking site allowing a person to move funds from his or her HSA account to their standard checking account or vice versa. Such a change will benefit your customers by giving them more flexibility.

The IRS has made clear that the HSA account owner is responsible to properly report the tax consequences of his/her HSA contributions and HSA distributions. This is done by completing and filing Form 8889. See IRS Notice 2004-50.

HSA Contributions and Contribution Reporting.

Most HSA accounts are comprised of a checking account, a savings account, a money market account, a time deposit account or a combination of these accounts.

An individual who has both a regular checking account along with an HSA will appreciate being able to make their HSA contribution(s) by moving funds from his or her checking account to his or her HSA. The individual is responsible to report these contributions on Form 8889. The HSA custodian will be required to report these contributions on Form 5498-SA. The HSA account agreement will need to authorize the making of these additional contributions. Most HSA plan agreements have been written to provide that an HSA annual contribution will be treated as made for the year in which the contribution is made unless he or she notifies the HSA custodian in writing that the contribution is made for the prior year. A rollover contribution is always made for the current year.

The HSA custodian does have the duty to make sure the aggregate total of a person's HSA contributions for the current year does not exceed the limit applying to a person who has family HDHP coverage. This is the limit to be monitored even when a person has single HDHP coverage. The family limit is $5,950, if the HSA account owner will not be age 55 by December 31, 2009 and $6,950 if the HSA account owner will be age 55 or older as of December 31, 2009.

Technically, the HSA custodian is not to allow a person's contributions to exceed these amounts. It would be great if your software would NOT allow these limits to be exceeded. The next best approach, is to run an HSA contribution report every month so that you can determine if these limits have been exceeded. If so, the excess contributions, as adjusted for earnings or losses, will need to be paid out to the HSA owner as soon as possible.

HSA Distributions and Distribution Reporting.

An individual who has both a regular checking account along with an HSA will appreciate being able to withdraw funds from their HSA (s) by moving funds into their checking account. The individual is again responsible to report these distributions on Form 8889. The HSA custodian will be required to report these distributions on Form 1099-SA.

Most HSA plan agreements have been written to provide that for reporting purposes, a withdrawal of HSA funds will be reported as a "normal" HSA distribution unless the individual informs the HSA custodian in writing that a different reason applies (e.g. excess contribution, death of HSA account owner; disability, prohibited transaction, etc.). The HSA custodian will be required to aggregate all HSA distributions for a given year. If the financial institution is informed that an HSA distribution was a non-normal HSA distribution, it will need to change the transaction code.

CWF suggests furnishing a special HSA notice. A sample is set forth on the next page. ◆

Special Notice to HSA Account Owners

We are pleased to inform you that you may now add your HSA account to your other web bank account(s). You may then move funds from one account to one or more of your other accounts. Your HSA could either be the source or the recipient of the moved funds.

We want to emphasize that once you withdraw funds from your HSA or make contributions to your HSA that you will only be able to change or undo your transaction in very limited situations. Almost always you will have to live with the tax consequences associated with your contribution or distribution.

For example, moving funds into your HSA from your checking account will be a reportable contribution. Unlike with IRAs, there is no special rule allowing you to withdraw your current year HSA contribution for any reason. If your HSA contribution was an excess contribution, then you are authorized to withdraw such funds using the special rules applying to the withdrawal of an excess contribution. Similarly, withdrawing funds from your HSA will be a reportable distribution and you will not be able to return such funds to the HSA unless you were eligible to rollover such funds or the distribution qualified as a mistaken distribution for HSA purposes. Again, it is your responsibility to determine and explain the tax consequences of all of your contributions and distributions.

With respect to making contributions, you may only make an annual HSA contribution and the contribution must be for the current calendar year. You are not permitted to make rollover contributions as we need you to provide us with a rollover certification form. You are responsible to know that your current contribution along with any prior contributions on your behalf for the year do not exceed your permissible contribution amount as based on your single HDHP coverage or your family HDHP coverage. For 2009, a person with single HDHP may contribute a maximum of $3,000 if he or she is under age 55 as of December 31, 2009 and may contribute $4,000 if age 55 or older. For 2009, a person with family HDHP may contribute a maximum of $5,950 if he or she is under age 55 as of December 31, 2009 and may contribute $6,950 if age 55 or older.

With respect to making HSA distributions, any distribution you make must qualify as a normal HSA distribution for IRS reporting purposes. You will need to come into the bank if you are withdrawing an excess contribution or making any other special type of distribution. ◆

Thoughts on the Withholding Notice Requirements for 2009 and 2010

There may be no required distributions for 2009, but many IRA accountholders still want to receive their periodic IRA distributions. When there are distributions, there are withholding rules to be complied with.

A summary of these withholding rules are set forth at the end of this article.

Each IRA custodian will need to adopt its own procedures for complying with the withholding reminder notice rules. Here are CWF's thoughts on these rules. In general, we would suggest sending the withholding reminder notices closer to the time when the accountholders will be taking their distributions rather than sending the notice as early as possible. There is general belief that an IRA custodian must always furnish the withholding notice at least 30 days in advance of a scheduled periodic distribution. There is no tax law or regulation requiring a minimum of 30 days notice. The IRA custodian is required to furnish "reasonable notice" so an accountholder is able to change his/her previously furnished withholding instruction. In many cases, furnishing 10-14 days notice should be reasonable notice. Always furnishing 30 days notice is more conservative than necessary. There are times when it is permissible to furnish less than 30 days notice. For example, an IRA custodian is being

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more conservative than necessary when it adopts the rule of furnishing the notice on the first day of the current month for all distributions taking place the following month. There are two main goals with respect to the requirement that an IRA custodian (or any other payer) furnish the withholding notices.

1. Inform the individual that he or she may incur tax penalties if he or she does not have sufficient withholding or make estimated tax payments with respect to their income, including the income arising from IRA distributions.

2. Inform an individual that he or she can change their previous withholding instruction. That is, if a person previously instructed to not have any withholding with respect to an IRA distribution, he or she may now instruct to have withholding or vice versa.

Some IRA custodians adopt the approach of furnishing the withholding notice as early as permitted under the regulation. CWF suggests considering a different approach - furnish the notice closer to when the individual is to take the actual distribution.

Set forth are some proposed mailing dates for furnishing the reminder withholding notices for 2010 periodic distributions under the assumption that there would be a separate mailing of the withholding notice. An IRA custodian may certainly adopt its "own" dates.

1. December 1, 2009.
   A. Mail to anyone scheduled to receive monthly or quarter distributions in 2010, and
   B. Mail to anyone scheduled to receive his or her 2010 annual distribution or the first of their biannual distributions for 2010 from January 1 to May 31.

   Note: The first day of the month is used. However, we think the day could be in the range of the first to the fifteenth of the month and the reasonable requirement would normally be met.

2. April 15 – Mail to anyone with an annual or biannual distribution from June 1 to September 30.

3. September 15 – Mail to anyone with an annual or biannual distribution from October 1 to December 31.

Set forth below are proposed mailing dates for 2010 periodic distributions under the assumption that the withholding notice would be combined with other mailings. A combination mailing could realize some cost savings.

Combined Mailing Approach:
1. January 10-15.
   A. The substitute W-4P would be sent with the FMV statement and the RMD notice as applicable. It would go to:
      1. Anyone scheduled to receive monthly or quarterly distributions in 2010, and
      2. Anyone scheduled to receive his or her 2010 annual distribution or the first of their biannual distributions for 2010 from January 1 to May 31.

Note: The IRA custodian should control it so that the distributions being made in January are being made after January 19. If necessary, have each accountholder sign new instruction forms.

2. May 15 – Anyone with an annual or biannual distribution from June 1 to September 30. Could be sent with the 5498 mailing, if applicable.

3. September 15 – Anyone with an annual or biannual distribution from October 1 to December 31.

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Summary of the Withholding Reminder Notice Rules For Periodic Distributions.

An IRA custodian is required each year to furnish a "reminder" withholding notice form. Normally, an IRA custodian will furnish a substitute Form W-4P. This rule is similar to the rule requiring an employer each year to furnish a Form W-4 so that the employees may change their withholding instructions. Recipients of IRA distributions must also be given the chance to change their previously furnished IRA withholding instructions.

An IRA accountholder only needs to complete the form and return it if he or she wishes to change their previous instruction. The IRA custodian needs to be able to prove it furnished or mailed this form on a timely basis. The IRS may assess a $10.00 fine per failure to furnish the proper notice.

If a person's payment schedule provides for more than 3 distributions per year (e.g. monthly or quarterly), then he or she needs to be sent only one notice to cover all distributions for the year of 2010.

If a person is scheduled to receive 1 or 2 distributions during this year, then the IRA custodian will send this notice for each distribution. The reason 2 notices must be sent is because a special withholding rule does not allow the IRA custodian to send the notice more than 6 months in advance of the distribution when less than 4 distributions are scheduled during the year. ◆

Reminder – No Covering of NSF Checks

The covering of NSF checks/debit cards for HSAs by the HSA custodian has been a "problem" issue since the inception of HSAs. The position of CWF has always been - the bank cannot cover an NSF check/debit card because the covering is a short term loan which is a prohibited transaction.

We at CWF have hoped the IRS would create a de-minimis rule allowing a certain amount of "covering." At this point, the IRS has not done so. It is really Congress which needs to amend the statute to create an exception for certain HSA debit card transactions.

The IRS' formal position as set forth in Notice 2008-59 is that a loan by an HSA custodian is a prohibited transaction. Code section 4975 defines any loan between the HSA custodian and the HSA as being a prohibited transaction.

The most conservative approach for an HSA custodian is to not offer debit cards to HSA account owners. However, employers and employees like the convenience of debit cards. They expect they will be available. Some possible planning considerations are discussed later.

The occurrence of a PT generally means the HSA is disqualified. One might think that the tax consequences associated with having an HSA with a negative or low balance being disqualified would not cause major tax issues or problems. Since the value of the account is minimal, the tax consequences should be minimal. However, this is not necessarily the case. Code section 4975 provides the rule that when a PT occurs with respect to an IRA or HSA during a year, the account is considered distributed as of January 1 of that year. This <u>retroactive</u> feature means a PT could in many situations create a real tax nightmare. Example. An HSA account owner has $10,000 is her HSA as of 1-1-09. She is age 51. She goes into a hospital in March of 2009 and incurs medical expenses of $9,800. She withdraws $9,800 from her HSA to pay these expenses In July of 2009, she goes to her pharmacy for a prescription. She uses her debit card to pay for her subscription. She is short in her checking/debit card account by $8.49 but the amount is still paid. Under Code section 4975, the $10,000 is treated as distributed from the HSA as of 1-1-09. Since it was not used for medical purposes, the $10,000 must be included in her income and she must also pay a penalty tax of $1,000 (10% of the $10,000) since she is not age 65. These taxes will be owed even though there is no longer any funds in her HSA. This result is overly harsh, and the law should be changed so this tax consequences does not result. Although HSAs and IRAs

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are similar in many ways, there are some fundamental differences which need to be recognized and the law changed when appropriate. The retroactive disqualification may be appropriate for an IRA PT, but this approach does not work for HSAs which have many transactions taking place during the year.

Possible Planning Techniques.

1. An employer could deposit funds into an account to cover NSF checks of its HSA account owners/employees. A formal written procedure/contract would be adopted. Further research would need to be done with respect to the tax issues. A determination would need to be made if the employer would be allowed to treat the withdrawals from this special account as an administrative expenses and that there would be no reportable income to any employee. Rules could be set so that the same employees would not misuse the covering of a NSF debit card situation. After a certain number of NSF situations, the employee would lose his or her right to the debit card option. An employer would want to make sure that this special account was assisting all employees equally.

2. The HSA custodian would offer the debit card approach only if the HSA account owner also maintained an HSA savings or MMD account with a certain minimum balance at all times to be used to cover NSF situations. Under this approach, there are two accounts comprising the HSA and these accounts will be aggregated for IRS reporting purposes. ◆

Revocable Trusts and the Naming of IRA Accounts

There will be times when an individual who has recently established a revocable trust will come into your financial institution and instruct to change the titling for all of his or her accounts, including the IRA accounts. The individual wants the "owner" of these accounts to be his or her revocable trust.

The name or titling of the IRA cannot be changed to show the trust as the owner of the IRA. IRAs must be established on behalf of an individual. The individual may certainly designate his or her revocable trust as the IRA beneficiary. An IRA is itself a revocable trust, albeit a tax-preferred revocable trust.

There is no right answer whether a person should designate his or her trust as the IRA beneficiary versus expressly naming individuals or entities as his or her beneficiaries. This author, in general, prefers naming individuals as the IRA beneficiaries versus a trust because the separate accounting rule will apply and each individual will then have his or own RMD calculation using his or her date of birth. If the trust is named as the beneficiary, then there is just one RMD calculation using the age of the oldest beneficiary.

However, there are special RMD tax rules which can cause tax problems in some situations when a trust is named as the beneficiary. One such rule states that if a non-living person (church, estate, college, etc.) is a designated beneficiary of the trust along with individuals, then the life distribution/stretch-out rule is unavailable to calculate the annual required distribution amount for an inherited IRA.

A trust which has multiple beneficiaries, including a nonliving person, is ineligible to use the life distribution rule and a much faster pay-out will normally be required. The payment period will be the five-year rule if the IRA accountholder died prior to his or her required beginning date (April 1 of the year following the year when the accountholder attained or would have attained age 70½). If the accountholder died on or after his or her required beginning date, then the payment period will be based on the age of the deceased accountholder. This will normally be a shorter period than the distribution period based on the age of the oldest living beneficiary of the trust. ◆