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STATE OF MINNESOTA

DEPARTMENT OF REVENUE

IN THE MATTER OF THE PROPOSED ADOPTION OF RULES OF THE DEPARTMENT OF REVENUE GOVERNING THE INCOME TAX DEDUCTION FOR CONTRIBUTIONS TO AN INDIVIDUAL HOUSING ACCOUNT

STATEMENT OF NEED AND REASONABLENESS

This document is intended as a verbatim affirmative presentation of the facts necessary to establish the statutory authority, need for and reasonableness of the proposed new rules. It is prepared pursuant to Minn. Stat. 15.0412, Subd. 4h and 9 MCAR Section 2.104.

A Notice of Intent to Solicit Outside Opinion regarding the proposed rule was published in the State Register on April 21, 1980. The proposed rule was submitted for comment to those people and organizations that requested it, to the members of the Commissioner's Advisory Committee, to various legislative staff persons and to various financial institutions and banking associations. Suggestions and comments that were received have been duly considered.

Minn. Stat. 290.52 grants the Commissioner of Revenue statutory authority to promulgate rules concerning the income tax laws. Moreover, Laws 1980, Chapter 512, Section 5 grants additional authority to the Commissioner to promulgate rules regarding the reporting requirements imposed on the trustee of an individual housing account.

Individual housing accounts are authorized by Laws 1980, Chapter 512. Section 5 of the law adds subdivision 30 to Minn. Stat. 290.09, and is referred to as the Young Family Housing Act. For purposes of this Statement of Need, Minn. Stat. 290.09, Subd. 30 will be referred to simply as "the Act."

Rule 13 MCAR Section 1.6016 - Individual Housing Accounts

Statement of Need and Reasonableness

A. Definitions.

1. The term "IHA" is used simply as an abbreviation.

2. The term "participant" is used as a concise way to refer to the individual for whose benefit the IHA was established. Including the requirement that the individual be a "natural person" makes it clear that artificial persons, such as corporations, trusts, estates and the like cannot be participants.

3. The term "deposit" is used in place of the statutory term "contribution." Both terms mean the same, yet "deposit" is more descriptive of the action being described and is more familiar and more easily understandable to the ordinary person.

4. The term "withdrawal" is used in place of the statutory term "distribution" for the same reason expressed in the preceding paragraph.

5. The definition of "principal residence" contains three elements. First, it must be a dwelling unit. Second, the participant must actually live in the unit. Third, the participant must have the intention to make the unit a "fixed abode."

   This definition is needed to assure that the IHA is used for the purpose intended by the legislature, i.e., to purchase the participant's first principal residence. The first two requirements are obvious and inherent in the common meaning of the noun "residence." The third requirement explains the adjective "principal."

If the third element of the definition was not adopted, an individual could easily circumvent the legislative intent and use the IHA program to help finance the purchase of a vacation home or income property. The definition plugs these loopholes by requiring some degree of permanence in the use of a dwelling unit as a residence. Simply moving into a dwelling unit for a day or two will not suffice.

This definition is consistent with the closely analagous definitions of "resident" in Minn. Stat. 290.01, Subd. 7 and Income Tax Rule 2001(7).

The requirement that the dwelling unit be located in Minnesota is taken from the Act. It is repeated in the rule for purposes of continuity and emphasis. If many of the requirements regarding the residence are included in the rule, it is almost misleading to leave out other requirements.

The rule adopts a liberal interpretation of what structures may qualify as a residence, allowing any type of dwelling unit which the participant will actually own or have an ownership interest in and in which the participant will actually reside.

If the building contains more than one dwelling unit, each unit is a separate residence. Only the participant's own principal residence can qualify and the rule so states.

And it seems quite reasonable to provide that if a building is divided into a residential area and a business area, only the residential area will qualify for the special IHA benefits.

There is no requirement in the Act that the participant purchase the residence in his or her own name, individually. Therefore, the rule provides that it is permissible to purchase the residence with others in various types of co-ownership. The rule goes on to provide a very logical corollary--that it will qualify as a residence only to the extent of the participant's ownership interest therein. This is best illustrated by a simple example. If three individuals purchase a residence in joint tenancy at a total cost of $30,000, each individual will be treated as owning one-third of the residence. Therefore, one-third of the purchase price is attributable to each. The IHA holder cannot use more than $10,000 (1/3 of $30,000) out of the IHA for the residence, because that is the extent of the participant's ownership interest.

Any excess in the account over $10,000 cannot be used for the residence and will be treated as a withdrawal not used for the purchase of a first principal residence so that it will be included in gross income and subject to the 10 percent additional tax.

There is ambiguity in the statutory phrase "first purchase of a principal residence in Minnesota," found in clause (c)(1) of the Act. Does it mean the first purchase in Minnesota (of a principal residence)? Or the first purchase of a principal residence (which also must be located in Minnesota)? The ambiguity can be cleared

up by looking at a similar phrase in clause (a) of the Act. There the legislature used the phrase "the purchase of his first principal residence." The requirement that it be in Minnesota is not present. Looking at the two phrases together leads one to the conclusion that the legislature intended the IHA program to benefit an individual in the purchase of his first principal residence. If he owns a residence (or owned one in the past) outside of Minnesota, he is still precluded from the IHA benefits. The language "in Minnesota" is simply an additional requirement--that the residence for which the IHA benefits are applicable be located in Minnesota. This is the interpretation adopted in the rule. Thus, a person who owns (or owned) a residence in another state or country is not eligible for the IHA benefits, even though he seeks to purchase his first principal residence in Minnesota. To hold otherwise would unfairly discriminate in favor of individuals who owned residences outside of Minnesota, a doubtful legislative intent.

B. General Requirements.

1. Part B makes it clear that the IHA must be a trust account for the exclusive benefit of one individual participant. If the participant is married, the account must be established for the joint benefit of the participant and his or her spouse. Although these provisions paraphrase the statute, they are necessary for emphasis, clarity and continuity.

2. Since an IHA may be used only for the purchase of a first principal residence that is located in Minnesota (see the explanation of this requirement in Part A.5, above), it is reasonable to prohibit an individual who already owns or did own a residence from

establishing an IHA. For purposes of clarity, it is necessary to again emphasize the previous rule that the residence must be the first residence ever owned by the participant (anywhere) and that it be located in Minnesota.

3. Since an individual may deposit more than he may deduct, there is no necessity of having more than one account. Moreover, an individual may "transfer" the account to another bank. If more than one account at a time was permitted, the reporting requirements would be extremely difficult for the banks and it would also be much more difficult for the participant to compute the proper deductions and taxes. It would likely produce many complaints, calls for help in preparing returns and audit adjustments. The rule takes a liberal position and allows an individual who had an IHA, but which was terminated, to establish another IHA. There is no express prohibition of this in the statute, although it is arguable under the 10 year rule.
4. If the trustee has a duty, statutorily or by this rule, it is reasonable to include that duty in the trust agreement. That way the trustee is agreeing with the participant to perform those duties. This may give the grantor a cause of action against the trustee for failure to perform those duties, which is quite reasonable, especially if the trustee's failure to perform a duty results in the loss of a tax benefit for the participant.

It should be noted, however, that neither the rule nor this statement of need takes a position with respect to any potential liability on the part of the trustee or the participant. Such matters are best left to the parties involved.

The specific duties will be discussed in a subsequent part of this statement of need.

5. a. The idea for a disclosure statement was taken from the IRS rules applicable to Individual Retirement Accounts. The authority for this requirement is clause (e) of the Act, which requires the trustee to make reports regarding the account to the individual for whom the account is maintained with respect to contributions, deductions and other matters, as the Commissioner may require under rules. The disclosure statement deals with "contributions" and "distributions" by requiring a report to the participant that explains the tax consequences thereof. "Other matters" are also covered by the disclosure statement. Almost identical statutory language provided the authority for the federal rule. See IRC Sec. 408(i) and IRS Reg. 1.408-1(d)(4).

The disclosure statement is needed and reasonable as a consumer protection device. The statement will, hopefully, protect individual taxpayers from overzealous financial institutions who, in the interest of competition, stress only the potential benefits of the IHA program without mentioning the drawbacks and pitfalls, thereby not presenting a balanced picture. It must be remembered that the Young Family Housing Act is not only a very new, but also a very complicated statute. The average unsophisticated taxpayer is not likely to be familiar with it.

The need and reasonableness of each required item of the disclosure statement is as follows:

(1) Informing the potential participant of the ineligibility of individuals who own or have owned a residence will prevent a person from establishing an IHA if the person is not eligible. If an ineligible person opened an IHA, not only would he get no tax deduction, but he would be stuck with the 10 percent additional tax upon withdrawal.

(2) It is certainly reasonable to make the taxpayer aware of the limitations, both on deductions and on deposits. These limitations limit the benefits available under the IHA program. Only if a person is aware of these limits can he properly evaluate the advantages and disadvantages of participating in the IHA program.

(3) Probably the most severe limitation on the IHA program is the tax treatment of a withdrawal that is not used for the purchase of the participant's first principal residence that is located in Minnesota. It is vital to clearly explain the tax consequences in this situation so that the potential participant can make an informed decision on whether to participate.

(4) It is important to let a participant know that he must use the account within 10 years for the purchase of his first principal residence in Minnesota. If he waits too long to buy the residence, he will incur severe tax consequences.

(5) Corresponding with (3), above, is the 10 percent additional tax that is due when a withdrawal is not used

for the purchase of the first principal residence in Minnesota. It is important to make it very clear that the 10 percent additional tax is in addition to the regular tax liability that will result from including a withdrawal in gross income in the tax year of the withdrawal.

(6) Another trap for the unwary is the six percent additional tax imposed on deposits in excess of $2,500 during a taxable year or in excess of $10,000 for all taxable years. In order that a participant does not fall into this trap unknowingly, the disclosure statement clearly points it out.

(7) A participant should be aware that he may transfer the IHA to another trustee. Yet it is doubtful that the trustee would voluntarily inform him of this opportunity, since the trustee would have an economic interest in keeping the business himself. Therefore, the disclosure is required.

(8) The disclosure statement would lose much of its value if read only after the IHA was established. Therefore, the rule gives the participant seven days to read the disclosure statement before the IHA is final. The participant should be made aware of this revocation period and so the disclosure is included.

(9) Since it is the participant's responsibility to assure that the financial institution is authorized by law to act as trustee of IHAs, it is essential that this is disclosed to the participant.

(10) Likewise, since it is the participant's responsibility to assure that the trustee abides by all applicable laws and rules, it is essential that the trustee agree to do so and disclose this agreement.

(11) There can be little question of the need for and reasonableness of a disclosure that the participant has the sole responsibility to assure that the trustee is qualified and authorized and that the account itself is according to the laws and rules. In the absence of such a disclosure, it is likely that the participant would think that he could rely on the trustee's representations.

(12) The final disclosure reveals to the participant the consequences of a failure to carry out the responsibility mentioned in (11), above. Only when the participant considers the consequences can he properly evaluate the responsibility.

5. b. The penalty is provided by statute, clause (e) of the Act, whenever the trustee fails to furnish a report required by that provision. It is reasonable to treat a statement that does not substantially comply as not being furnished at all. Otherwise, it would be simply too easy to circumvent the disclosure statement requirement. Yet requiring only "substantial" compliance assures that the penalty will not be imposed arbitrarily or capriciously whenever the "i's" are not dotted or "t's" not crossed. A statement that is false or misleading certainly does not achieve the desired purpose and should at least be treated as not in "substantial compliance."

6. State chartered financial institutions are required to obtain approval to act as the trustee of IHAs from the Minnesota

Commissioner of Banks. See Minn. Stat. Sections 48.159, Subd. 2, 50.157, Subd. 2, 51A.21, Subd. 16a, and 52.136. National banks, federal savings and loan associations and federal credit unions, under federal law, cannot be regulated by state agencies. Therefore, the federal institutions are not required to obtain the approval of the Minnesota Commissioner of Banks.

7. The purpose of the statutory provision requiring a trustee to actively make residential real estate mortgage loans in Minnesota is not entirely clear. Two purposes come to mind. First, the fact that the program is designed to aid individuals with the purchase of a home makes it likely that the provision was intended to aid the individual in obtaining financing by making money available at the same financial institution in which the individual has his IHA. A secondary purpose may be to make it at least possible that the money taken in by the financial institution as deposits to IHAs is pumped back into real estate mortgage loans. If an institution makes no such loans, it is impossible for the IHA deposits taken in to go into real estate mortgage loans.

   It is in view of these two purposes that the rule provides that the financial institution must originate real estate mortgage loans. Only if the institution originates such loans can it be said that the statutory provision aids the individual in obtaining financing.

   The rule next addresses the problem of determining which institutions are actively making (originating) residential real estate

mortgage loans in Minnesota. The rule attempts to make a reasonable, yet liberal, distinction between those financial institutions and credit unions that make residential real estate mortgage loans in Minnesota and those that do not. An institution will not be disqualified merely because it makes only a few such loans. Nor will it be disqualified solely because of poor market conditions--something beyond its control. Rather, the rule seeks to focus solely on the institution's actual lending policy, which is the most reasonable approach.

The authority to require a taxpayer to submit evidence to substantiate any tax deduction or exemption is contained in Minn. Stats. 290.46 and 290.56.

8. Rather than requiring every participant in the IHA program to submit to the Commissioner of Revenue copies of the trust agreement and disclosure statement, the rule takes a much less onerous approach. The participant must submit the documents only when requested to do so by the Commissioner. Such a request will occur only when there is some question raised concerning those instruments.

The statute allows an income tax deduction only for contributions to an individual housing account which meets the requirements of the statute. If either the trustee or the account does not meet the statutory requirements, no deductions are allowable. Placing the burden of proof on a participant to prove that he is entitled to a deduction is in accordance with many court decisions. See, for example, Northern National Gas Company v. Commissioner of

Revenue, 312 Minnesota 177, 251 NW 2d 125 (1977).

C. Duties of Trustee.

1. a. Since the IHA deduction is allowed only for cash paid to the account, under clause (a), it is reasonable to require that the trustee accept only deposits of cash. It does not appear from the statute that the legislature intended that contributions of other types of assets be allowed, e.g., stocks, bonds, partnership interests, etc.

1. b. Since the trust agreement must contain a provision that the contributions will not be accepted for a taxable year in excess of $2,500 or in excess of $10,000 for all taxable years, it is reasonable for the Commissioner to prohibit the trustee from so doing.

1. c. The Young Family Housing Act was obviously designed to aid a person or a young family who seeks to purchase his or her first home. A person who already owns a home cannot, by statute, use an IHA for the purchase of a first residence, Therefore, he should be prohibited from establishing an IHA. The most practical way to accomplish this is to prohibit the trustee from accepting deposits from an individual who already owns a home. It is reasonable because the rule only requires the trustee to ask a depositor whether he owns a home. The trustee is not required to verify the answer.

1. d. The rule paraphrases the statutory requirement that the account shall be distributed to the participant within 10 years after the first deposit. This is done for the purposes of introduction as well as continuity. The rule allows the trustee to simply transfer the amount in the IHA into a

different, non-IHA account, rather than requiring the actual receipt of the distribution by the participant. This eliminates the problem of locating and making actual delivery of the money from the account to the participant on the very last day. Yet the rule makes it clear that such a distribution, since it is not used for a first residence, will be so treated, i.e., the trustee must withhold tax and the participant must include it in income and pay the additional 10 percent tax.

1. e. The rule clarifies the confusing language of clause (b)(5) of the Act regarding withholding and the exceptions thereto. It also spells out how the trustee is to handle withholding where only part of a withdrawal is used for a first residence.

Requiring withholding on the part of a withdrawal not used for a first residence is consistent with the statute and prevents a participant from circumventing the withholding requirements by using only a small part of the IHA for a first residence and the rest for tax deferral or other reasons.

1. f. The authority, need and reasonableness of the disclosure statement are discussed at Part B.5.a, above. Requiring the statement seven days prior to the establishment of an account is a reasonable consumer protection, allowing the consumer a limited period of time to read the statement and seek opinions of others, whether family, friends or professionals. It is a requirement similar to the "cooling off" periods provided by modern consumer legislation. The seven day period is the same period allowed by the IRS for individual retirement accounts. See IRS Reg. 1.408-1(d)(4)(ii)(A)(1).

An option is allowed the trustee. If the trust agreement provides that the trust does not become final and does not constitute an IHA for seven days following execution of the agreement, during which period the agreement is revocable, then the disclosure statement may be furnished at the time that the agreement is signed. This will also give the prospective participant seven days to read the statement and decide whether an IHA is best for him. This procedure is more practical than requiring a disclosure statement seven days prior to execution of the trust agreement because it does not necessitate the prospective participant making another trip to the financial institution seven days later to sign the agreement. He can, in effect, open the account with only one trip to the financial institution even though it won't be effective for seven days, during which time he has a "cooling off period."

If, during the "cooling off period," the prospective participant decides to revoke the agreement and not establish the IHA, the 10 percent additional tax will not be applicable because the IHA was never established. Therefore, the revocation does not constitute a withdrawal from an IHA that is not used for a first principal residence in Minnesota. This is also discussed at Part F.6 of the rule and the corresponding section of this statement of need.

It is reasonable to require that the trustee furnish a copy of the governing instrument to the participant. Every party

to a binding legal commitment should have a copy of the governing legal document.

1\. g. Following the rationale for the disclosure statement, the rule requires a similar disclosure for amendments to the trust agreement or to the statute or rules. The disclosure seems even more justified in the case of an amendment because the amendment may have been made with no knowledge of it on the part of the participant.

1\. h. It is reasonable, by rule, to impose a duty on the trustee that, by statute, the trustee must agree to perform (since it must be part of the trust agreement). Therefore, the rule prescribes that the trustee may invest trust assets only in savings or time deposits fully insured by a state or federal agency. See clause (b)(3) of the Act. By negative inference, the trustee may not invest in other types of assets, such as stocks, bonds, notes, debentures, mutual funds or otherwise. The rule requires that the savings or time deposits in which the trustee invests trust assets be the trustee's own accounts or certificates. This requirement is based on a recommendation from Northwest Bancorporation, in order to allow a national bank which does not have trust powers to act as trustee. See Exhibit A. Moreover, Minn. Stat. 48.159 has a similar restriction for Individual Retirement Accounts (IRAs).

1\. i. The statutory language allowing commingling of funds for investment purposes is paraphrased for purposes of clarity and continuity.

2. a. The reporting requirements are authorized by clause (e) of the Act. February 28 is a reasonable date for the reports because not only does it allow two months for the trustee to prepare the reports but it also is the same date that the federal Form 1099 information return is due. Moreover, it is a longer period of time than exists for individual retirement account reports, which must be filed within 30 days after the close of the individual's taxable year. See Proposed IRS Rule 1.408-1(d).

The necessity and reasonableness of the identification data is obvious. The reports would be worthless if we did not know who filed them and the taxpayer to whom they pertained.

The date the account was established is needed to determine the date that the account terminates. The account can only last 10 years. If within that time a first principal residence in Minnesota is not purchased, the IHA terminates and the entire amount in the IHA is subject to both regular Minnesota income tax and the 10 percent additional tax.

The verification form for amounts used for a first principal residence is needed to determine whether a taxpayer is entitled to exempt from income withdrawals that are used for a first principal residence. It also verifies that the trustee was not required to withhold tax on the withdrawal.

The forms verifying death or disability are required to establish those facts which exempt the amounts withdrawn from additional tax or withholding.

The date and amount of each deposit is required to determine the amount of the deduction allowable for the particular tax year in light of the $1,500 limitation and the six-month deposit limitation. The information is also necessary to determine the amount, if any, of additional tax for excess contributions (deposits in excess of $2,500 during any taxable year).

The date and amount of each withdrawal is needed to determine the amount, if any, of additional tax for withdrawals not used for a first principal residence. It is also used to determine the amount that may be exempt because it was used for a first principal residence.

The amount of interest paid is necessary in order to determine the amount of the allowable deduction for interest earned on an IHA.

It must be emphasized that although the Commissioner needs all of the above information in order to audit the participant, it is even more important that the participant receive the information, since it is essential in order to compute his tax liability and prepare his return.

Two copies are to be furnished to the participant, allowing the participant to file one with his tax return, much like a Wage and Tax Statement, Form W-2, and keep one for his records.

2. b. The requirement that the trustee verify that a withdrawal is used for a first principal residence in Minnesota is authorized by clause (b)(5) of the Act. The requirement that the trustee report this verification information to the Commissioner is authorized by clause (e) of the Act.

The specific information requested on the verification form is needed in order for the Commissioner to audit the participant's return and to assure that the withdrawal was in fact used for the purchase of a first principal residence in Minnesota. Certain of the requested information is obviously necessary and reasonable to the accomplishment of this purpose, specifically: location and description of property being purchased, name and address of person or entity from whom the property is being purchased, amount withdrawn from the account during the taxable year, and portion of the amount withdrawn which will be used to purchase the first principal residence. Justification for requesting the other items of information is as follows: the name of the realtor, closing company, etc. will help in determining or verifying any of the other information. The type of ownership anticipated is necessary to determine or verify whether the entire amount withdrawn is exempt from tax because it is used for a first residence or whether a portion of the amount is not used for a first residence. For example, if $10,000 is withdrawn from the IHA and the down payment on the residence is $10,000, it does not necessarily follow that the whole $10,000 withdrawal is exempt from tax. If the residence is being purchased in joint tenancy, one-half ownership by the participant and one-half

ownership by a third party, only one-half of the $10,000 down payment is attributable to the participant's portion, so that only one-half of the $10,000 withdrawal is exempt from tax.

The total purchase price and the amount to be financed also help to determine or verify the amount of the down payment and the portion of the withdrawal that is exempt. Closing costs are considered used exclusively for the first residence, and so, must be determined. The closing date is asked for to verify the completion of the sale. If the closing date was long after the withdrawal date, it would raise some suspicions which would require further investigation. The name of the person or entity from whom the withdrawal was made payable is requested to verify the statutory requirement that it be made so payable and also, generally, to verify the legitimacy and completion of the purchase.

Allowing the trustee to wait on filing this verification form until the time for filing the annual information return is a benefit to the trustee in that he doesn't have to go to the trouble of sending in the report until the end of the year when he is sending in other reports anyway.

3. With respect to the withholding requirements, the rule begins by paraphrasing the statutory requirements found in clause (b)(5) of the Act. This is necessary to make the statutory requirements clear and understandable. The statutory language is very confusing.

The rule provides that the trustee is personally liable for the withheld tax. Although this is not expressly provided in the statute, it nevertheless follows under general trust law. As a "trustee," the financial institution has many specific duties which it must perform, including the withholding of tax. The duties arise not only from statute but also from the trust agreement. When a trustee fails to perform these duties, he is absolutely liable. Consequently, the trustee is personally liable for the amount of any tax required to be withheld.

There is a further reason for holding the trustee personally liable for withheld tax where the trustee actually withheld the tax but did not pay it over to the Commissioner of Revenue. This further liability arises under the doctrine of constructive trust. The amounts withheld from a withdrawal are not the property of the trustee. Rather, the amounts actually withheld are the property of the participant. The trustee is only to send those amounts to the Commissioner of Revenue to be applied against the participant's tax liability. If he does not do so and instead converts the property to his own use, he is violating that constructive trust. The trustee is personally liable for the amount so converted.

4. The penalties in the rule are expressly authorized by clause (e) of the Act. The rule makes it clear just when these penalties will be imposed.

D. Deduction for Contributions to an IHA.

1. The statutory language limiting the deduction to $1,500 per year and $10,000 for all years is paraphrased in the rule for the sake of continuity and clarity.

2. The statutory language is somewhat ambiguous on whether the deduction limitation of $1,500 applies only to contributions (deposits) to the account or whether it includes interest accrued on the account. The Department has also received a number of inquiries on this point. The rule again takes a liberal approach and provides that the limitation applies only to the contributions to the account. In other words, there are really two deductions allowed by the IHA provisions, a $1,500 deduction for contributions and a deduction for interest which has accrued on the account. Support for this interpretation can be found in the last paragraph of clause (a) of the Act, where the $10,000 deduction limitation is made applicable only to "amounts paid in cash." The amounts paid in cash are the contributions and not the accrued interest. Since the $10,000 deduction limitation is applicable only to contributions and not to accrued interest, the $1,500 deduction limitation should be interpreted in a similar manner.

   Since the trustee is prohibited from accepting contributions in excess of $2,500 for a taxable year or in excess of $10,000 for all taxable years by clause (b)(1) of the Act, it is reasonable to prohibit the deduction of interest accrued on such "prohibited" contributions.

3. A basic principle of arithmetic is that you cannot subtract more than you have. Thus, it is reasonable to prohibit the deduction under the IHA provisions of amounts which have already been deducted or excluded under some other provision of law. It is only common sense.

4. The rule makes it clear that the prohibitions contained in Minn. Stat. 290.10(9) and (10) apply to individual housing accounts. In other words, the deduction for interest expense is prohibited where the interest expense is from a loan which was deposited in an IHA in order to get the IHA deduction.
5. The six month deposit requirement is prescribed by clause (a) of the Act, and is paraphrased in the rule for purposes of clarity and continuity.

The statute specifically provides that "any amount deposited less than six months before the close of the taxpayer's taxable year may be taken as a deduction only for the next succeeding taxable year." The rule provides that such an amount that is deducted in the succeeding year counts against the $1,500 maximum deduction limitation for that succeeding year, rather than for the year in which the deposit was made. This is a reasonable interpretation because it is the deduction that is limited to $1,500 per year, not the contribution. So the limitation should apply in the year that the deduction is claimed rather than the year that the deposit is made. On the other hand, the year that the deposit is made controls the contribution limitation of $2,500 per tax year.

For example, for a calendar year taxpayer, if $3,000 is deposited August 1, 1985 and another $3,000 is deposited May 1, 1986, and both amounts remain on deposit until at least December 31, 1986, the participant would get no deduction in 1985 because the $3,000

was not on deposit for at least six months by the close of the 1985 taxable year. Since the $3,000 exceeds the $2,500 limitation on deposits, there is a six percent excess contribution penalty due in 1985 on the excess of $500. In 1986, the participant is entitled to a deduction of $1,500, which is the maximum deduction allowed for a taxable year. Again, there is an excess contribution in 1986 of $500, since the maximum contribution permitted in a taxable year is $2,500. The six percent excess contribution penalty, however, applies on $1,000 in 1986, which is the excess contributions of $500 in 1986 and $500 in 1985 (since the 1985 excess contribution remained in the account in 1986).

The rule also points out that while there is a six month deposit requirement in order to get a deduction for a deposit, there is no such requirement with respect to the deduction for interest accruing on an IHA. This is done because great confusion already exists on this point and more confusion can be expected. The confusion results from the unusual statutory scheme which, in a sense, creates two different taxable years for the two different IHA deductions, i.e., contributions, which are deductible for a calendar year taxpayer in the current taxable year if made between July 1 of the preceding taxable year and June 30 of the current taxable year (and remain on deposit for at least six months), and interest, which is deductible in the current taxable year if it accrued in the current taxable year.

E. Exemption From Tax For Distributions Used For a First Residence.

1. Once again the rule seeks to obtain a greater degree of clarity and continuity by reorganizing and rewording the provisions of the Act.

2. The rule seeks a reasonable and practical interpretation of the phrase "used exclusively in connection with the first purchase of a principal residence," found in clause (c)(1) of the Act. In addition to amounts actually spent for the residence itself, the rule permits amounts to be spent for the land upon which the residence sits and for the expenses incurred in acquiring the residence, such as closing costs, sales commissions, etc. The items listed in the rule are only meant as examples. Other items may qualify if it can be shown that they are directly related to the first purchase of a principal residence.

Items which are deductible under some other provision of law, for example, interest, which is deductible under Minn. Stat. 290.09, Subd. 3, are excluded from the meaning of the term in order to prevent the taxpayer from getting a double deduction. After all, if an item has already been removed from a taxpayer's taxable income, how can it be removed again?

"Points" are included within the term under the rationale that they are a cost of acquiring the property. However, if the points are deductible as interest, they do not qualify since it would cause a double deduction. The "points" that are deductible as interest are those paid as a bonus or premium to get a mortgage loan, often termed a "loan processing fee," which are paid for the forebearance of money and not for services rendered. IRS Rev. Rul. 69-188, 1969-1 C.B. 54; IRS Rev. Rul. 69-582, 1969-2 C.B. 29. If the "points" are paid for services rendered and not for the forebearance of money, as a service charge or a

"loan origination fee," the "points" are not deductible as interest. IRS Rev. Rul. 67-297, 1967-2 C.B. 87.

As previously stated, the items must be for the residence itself or directly related to the acquisition of the residence. Payments for maintenance or repairs of the residence are neither for the residence itself nor directly related to the acquisition of the residence. Therefore, repairs and maintenance are not allowed. Similarly, furnishings are not allowed.

It does not seem reasonable to limit the IHA program to the purchase of existing homes. There is nothing to indicate that an individual who builds his home should not have the benefits of the program. Therefore, the rule expressly allows both the cost of labor and material to qualify.

The same rationale applies to the purchase of an existing house which the participant will remodel and make his principal residence.

The rule provides that in order to qualify as an amount "used exclusively in connection with the first purchase of a principal residence," the amount withdrawn must be made payable to the person or entity from whom the property is being purchased. Thus, in order to claim the exemption for a withdrawal, it must be made so payable. This provision is based on the statutory requirement that the trust agreement contain a provision that, subject to certain exceptions, the trustee will either withhold tax or make the withdrawal payable to the mortgagor, construction

contractor, or other vendor of the property purchased. See clause (b)(5) of the Act. Since the trust agreement is equally binding on the trustee and the participant, it is reasonable to require, by rule, that the participant have any withdrawal made so payable.

The rule takes a liberal position and allows a withdrawal to be made payable jointly with such person or entity and the participant.

When a participant uses money withdrawn from an IHA for earnest money in connection with the purchase of his first principal residence, it is treated as "used exclusively in connection with the first purchase of a principal residence," even if the deal falls through and no purchase results. However, if the earnest money is not forfeited but returned to the participant, then the participant must redeposit the money in the IHA. This is a reasonable and practical interpretation. If the money was forfeited, it nevertheless was used in the attempt to purchase the participant's first principal residence. If the money was not forfeited but immediately redeposited in the IHA, it seems unreasonable to penalize the participant for his attempt, when no other use was made of the money.

In accordance with this treatment, the rule expressly provides that the trustee is not required to withhold tax on a withdrawal that the participant verifies will be used as earnest money in connection with the purchase of the participant's first principal residence.

3. The statutory framework gives a tax benefit when a withdrawal from an IHA is used for the purchase of a first principal residence. It would be a tremendous administrative burden to trace the amount withdrawn from one transaction to another until it is ultimately used for the first purchase of a principal residence. Therefore, it is provided in the rule that the amount be used for a principal residence within a reasonable time after the withdrawal and that the withdrawal shall not be used for any other purpose in the interim. This seems to be in keeping with the statutory framework, especially the requirement that the withdrawal be made payable to the seller of the property, which evidences a legislative intent along similar lines.
4. An IHA may be used only to purchase a first principal residence for the particular participant of that IHA. It cannot be used to purchase a residence for someone else. Although the statute does provide this, the rule does so with more clarity and emphasis.
5. This provision of the rule expresses a concept similar to that explained in Part D.3, above. The other provision dealt with double deductions, while this provision deals with double exemptions.
6. This provision makes it clear that even though the residence was purchased with tax free dollars, the basis of the residence need not be adjusted. In other words, the IHA provisions create a permanent exemption, rather than merely a deferral of tax.
7. This provision makes it clear that when a withdrawal is used for the first purchase of a principal residence, it is not only exempt from income tax, but it is also not included in computing

the low income alternative tax, etc. The rationale is that there is no provision in the law which specifically includes these amounts for computing the particular items.

8. The authority for this provision is found in clause (e) of the Act. Justification for the verification form was discussed above. The closing statement contains much of the information required on the verification form. In case that the verification form looks suspicious or that there are other matters that need investigation, the Commissioner may request additional information.

F. Tax Treatment of Distributions Not Used For a First Principal Residence.

1. The rule seeks to simplify and clarify the difficult and complex language of the statute. Consequently, much paraphrase of the statute is used. The first paragraph represents the general rule that withdrawals not used for a first principal residence are includible in gross income and subject to the 10 percent additional tax.

2. The second paragraph is an exception to the general rule. This provision of the rule rewords the statutory language found in the third paragraph of clause (c) of the Act.

3. The exception contained in paragraph 3 is taken from clause (d) of the Act.

4. The rule makes it clear that whenever an amount is required to be included in gross income because it was not used for a first principal residence, it is ordinary income to the participant. It cannot be treated as a capital gain.

The rule provides that the 10 percent additional tax is not to be offset by any nonrefundable tax credits. It seems quite

apparent that the legislature intended the 10 percent additional tax to constitute a penalty for not using the withdrawal in the intended manner. To allow a penalty to be offset by any excess nonrefundable credits destroys the effect of the penalty.

5. The 10 percent additional tax is only applicable when a withdrawal is required to be included in gross income. The withdrawal of an excess contribution is not required to be included in gross income if the withdrawal was made within the time for filing an income tax return for the taxable year in which the excess contribution was made. This is found in clause (c)(2) of the Act.
6. If the trust agreement so provided, the agreement does not take effect and the IHA is not established for seven days after the date of the trust agreement. The purpose for allowing such a "revocation period" is explained earlier at Parts B.5 and C.1.f. During the seven day period, the prospective participant may revoke the agreement and receive back his money without the 10 percent additional tax and without the trustee withholding any tax. This is so because the penalty and withholding provisions apply only to withdrawals from an IHA. Not until after the seven day period does the arrangement constitute an IHA.
7. The trustee is required by clause (b)(4) of the Act to distribute the entire amount in the IHA to the participant within 10 years after the date of the first contribution to the account. There is nothing in the statute that would exempt this distribution from the requirement that it be included in gross income and subject to the 10 percent additional tax. Moreover, it would seem that it should be subject to such treatment since the

account was not used for the purchase of a first principal residence, which was the objective of the statute, yet the participant was allowed tax deductions with respect to the account.

G. Excess Contributions.

1. The first paragraph is a paraphrase of the statutory requirements regarding "excess contributions" and is made for purposes of introduction, clarity and continuity.
2. The second paragraph makes it clear in what taxable year the six percent additional tax is due. It also clarifies and emphasizes that this additional tax is due in <u>each</u> taxable year that an excess contribution remains in the account, not just in the taxable year in which the excess contribution was made. This interpretation is based on the language in the second paragraph of clause (f) of the Act where it is said that there "is imposed for each taxable year, a tax not to exceed six percent . . . ."
3. Excess contributions are defined in clause (f) of the Act as "the amount by which the amount contributed for the taxable year to the account exceeds the amount allowable as a contribution under clause (b)(1) for the taxable year." Since clause (b)(1) provides that the amount allowable as a contribution is any amount that does not exceed $2,500 during a taxable year or that does not exceed $10,000 for all taxable years, the rule so states. The second sentence of clause (f) of the Act excepts from the definition of excess contributions any contribution which was distributed out of an individual housing account to which clause (c)(2) applies. The rule incorporates the provisions of clause (c)(2) and provides that an amount shall not be considered an excess contribution if it, plus the interest earned

on it, is withdrawn from the account by the date that the tax return is due for the taxable year in which it was made. The rule also points out that even though in such circumstances the interest withdrawn is not includible in gross income under the IHA provisions, it is still subject to tax under other provisions. Unlike the interest, the withdrawn contribution was probably already taxed. The rule provides, however, that to the extent the contribution was not already taxed, it must be included in gross income.

4. This paragraph points out the statutory provisions found at clause (c)(3) of the Act.
5. It is reasonable to assume that if there are excess contributions in the account and the individual withdraws an amount from the account, that he would intend to withdraw the excess contribution. After all, by reducing the amount of excess contributions, he is reducing the amount of additional tax that he would have to pay. The rule adopts such an assumption.
6. There is no express provision in the statute to allow an excess contribution made in one taxable year from being used as a deductible contribution in a subsequent taxable year. On the other hand, there is no express provision prohibiting such treatment. It seems reasonable, however, that if an individual makes an excess contribution in one taxable year and in the next taxable year does not contribute enough to utilize the maximum deduction allowed, the individual should be allowed to reduce the amount of his excess contributions in the account and use it as a deductible contribution. After all, he could do so indirectly, by withdrawing the excess contribution before

the close of the taxable year and redepositing it in the IHA. On the other hand, it would be going too far to allow the taxpayer to carry the excess contribution back to a preceding year. The preceding taxable year is already closed and the taxpayer obviously could not meet the six month deposit requirement. See clause (a) of the Act.

H. Special Rules.

1. Disability or death. For purposes of clarity and continuity the rule points out that a participant who is disabled is not subject to the 10 percent additional tax for not using an IHA for the purchase of a first principal residence. This exception to the 10 percent additional tax is found in the middle of clause (d) of the Act. In order not to mislead people, it is pointed out in the rule that even though a disabled participant is not subject to the 10 percent additional tax, any withdrawal from an IHA is still includible in the participant's gross income for the year of the withdrawal under the same rules as for any other participant. There is also no exception to the six percent additional tax on excess contributions for a disabled participant and the rule so provides.

   Clause (d) of the Act provides that "an individual shall not be considered to be disabled unless he furnishes proof of the disability in the form and manner as the commissioner of revenue may require." It is upon this basis that the rule requires a disabled participant to furnish a signed declaration of disability to the trustee at the time of a withdrawal. The items required in the disability statement are taken from the definition of the term

"disabled" in Minn. Stat. 290A.03, Subd. 10, which is also the definition for IHAs, since it is incorporated by reference in clause (d) of the Act.

Only upon audit when there is some question whether the participant's disability is within the meaning of Minn. Stat. 290A.03, Subd. 10 will the participant have to produce any further information about the disability. This is certainly more reasonable and less onerous than requiring every participant claiming disability to furnish all of the detailed information.

The rule repeats the statutory requirements that upon the death of a participant, the amount in the account shall be payable to the estate of the participant. This is done for purposes of introduction, emphasis and continuity. The statute provides an exception only to the 10 percent additional tax where the participant has died. The rule emphasizes this and states that upon the death of the participant, the amount in the account is still includible in gross income. The rule makes it clear that it must be included in the decedent's final income tax return, rather than on the estate's fiduciary return. The statute is silent on this point but the rule's position is reasonable in light of the statutory scheme. The deduction was allowed only to help save for a first residence. Since the taxpayer died, the purpose for the deduction is lost. It cannot be used for a residence, which is the only time a withdrawal is not included in income. And it was the decedent that got the deduction so it should be the decedent's final return that includes the income. Moreover, since

the income does not accrue after the participant's death, it is not proper to include the income in the fiduciary return.

The statute provides an exception where the account was held jointly by the decedent and a spouse of the decedent. In such a case the account shall remain as the individual housing account of the surviving spouse and does not become payable to the estate of the deceased participant. Since the statute provides that the account shall continue as an IHA for the benefit of the surviving spouse, all of the limitations and restrictions contained in the law are still applicable to the surviving spouse. The rule so provides.

It would be very difficult to determine, administratively, whether or not a particular withdrawal was "attributable" to the death of a participant. Consequently, the rule takes a liberal position and provides that any withdrawal made within 60 days after the death is automatically attributable to the death. This seems to be more than reasonable since even after the 60 days a particular withdrawal could still be shown to be attributable to a death.

2. The concept of a "transfer" of an IHA to a different financial institution is similar to the concept of a "rollover" with respect to Individual Retirement Accounts (IRAs). The term "transfer" was used, rather than the term "rollover" in order to distinguish a transfer from a rollover, since the rules and restrictions are somewhat different.

The primary difference is that a "rollover" of an IRA is paid directly to the participant, while a transfer of an IHA must be

made payable to the transferee institution. Moreover, a rollover need not be paid into another IRA for 60 days thereafter, while an IHA must be promptly transferred to the new account and not used for any other purpose in the interim. See IRC Sec. 408(d)(3) and IRS Proposed Reg. 1.408-1(b)(2).

The stricter requirements for IHA transfers arise from the fact that transfers of IHAs are not expressly authorized by statute (although they are also not expressly prohibited). The rule seeks to allow as much freedom with respect to the IHA as it can within the framework of the statutory provisions. However, there is no 60 day period authorized by the statute, as there is for IRAs. And use of an IHA for any purpose other than the purchase of a first principal residence subjects the participant to both tax and penalty. Therefore, the additional restrictions on transfers of IHAs are essential if transfers are to be allowed at all.

It seems reasonable to allow an individual to transfer his account from one institution to another as long as he continues to meet all of the statutory requirements regarding the IHA. And since he is merely transferring the account from one institution to another, it seems reasonable to treat it as such and not treat it as a withdrawal or deposit. The transfer provisions apply only when the IHA is transferred from one financial institution to another, i.e., when the trustee is changed. If the IHA is only transferred within one institution, e.g., transferred from one branch to another branch, there will be no tax consequences since the trustee remains the same. The transfer provisions in the

rule, in effect, treat the transfer as a mere substitution of trustees. It is for this reason that the transfer is treated as not being a withdrawal from the first account and a deposit in the second account. It is also for this reason that the participant is required to transfer the entire amount in the first IHA and to close and terminate that account.

Obviously, if the amount to be transferred is used for any purpose while it is being transferred, it cannot be considered a mere substitution of trustees. Then it must be treated as an actual "withdrawal" and subject to the consequences thereof.

Since both accounts are IHAs, both of them must meet all of the requirements of the rule. A participant should not be able to get around the 10 year limit on the life of an IHA by simply transferring it. Therefore, the rule provides that the receiving account shall terminate 10 years from the date that the original IHA account was established. The trustee of the receiving account will probably not know the date that the original account was established. Therefore, the rule provides that the trust agreement covering the receiving account shall provide that that account will terminate 10 years from the date that the original account was established. This will force the participant to tell the new trustee that it is a transfer and the date that it must terminate. The new trustee must then terminate the account on such date and so notify the participant.

Since the transfer is not treated as a withdrawal, the transferor trustee is not subject to the withholding requirements. The rule so provides as long as the transferor trustee receives notice of the transfer from the participant. To assure that the account is actually transferred and the transfer provisions are not used merely to circumvent the withholding requirement, the rule provides that the original trustee must make the instrument of payment payable to the new trustee.

The requirement that the participant furnish to the trustee a written declaration of his intention to transfer an IHA gives the trustee protection from the withholding requirements. Since the trustee is personally liable for any tax required to be withheld, obviously the trustee would be reluctant to honor an oral request. The requirement that the trustee file the statement within 10 days with the Commissioner of Revenue allows the Commissioner to closely monitor such transfers.

3. The rule provides that an individual who is not a resident of Minnesota may establish an IHA in Minnesota. This is based on an implication from Section 6 of the Act, which provides that withdrawals and penalties from an IHA are assignable to Minnesota even though the participant is not a resident of Minnesota. The rule also paraphrases Section 6 of the Act in order to avoid any misunderstandings and because Section 6 is codified in a different part of Chapter 290, specifically, Minn. Stat. 290.17, Subd. 2(5).
4. Married Individuals. For married individuals, clause (b) of the Act requires an IHA to be for the exclusive benefit of the individual and his spouse jointly. Part D.6 of the rule provides

that married individuals are allowed no more than one $1,500 maximum deduction between them.

A question immediately arises on the treatment to be accorded to two individuals who each have their own IHA and who marry.

It seems clear that prior to the marriage, each individual may deduct up to $1,500 for any taxable year and up to $10,000 in total for all taxable years. It also seems clear that after the marriage the two married individuals do not each get to deduct up to the $1,500 and $10,000 limitations, but rather, the married couple as a unit, is allowed only one deduction up to the $1,500 and $10,000 limitations, to divide between them. This interpretation is reasonable because prior to the marriage, the treatment is consistent with the treatment accorded other non-married individuals; after the marriage, the treatment is consistent with the treatment accorded other married individuals.

In the taxable year of the marriage, the couple is allowed only one deduction not to exceed the $1,500 and $10,000 limitations, even if each individual had deposited $1,500 in his or her own IHA prior to the marriage. This is because both the deduction and the marital status is determined as of the close of the taxable year. The date of the deposit is relevant only as to whether the six month deposit requirement has been met.

There is a more difficult problem with respect to the $10,000 maximum limitations on the total deductions that may be claimed

and total contributions that may be made for all taxable years. What treatment should be accorded to two married individuals who each had an IHA prior to marriage with respect to which they had contributed and deducted a combined total of more than $10,000 prior to the year of the marriage, even though neither of them had individually exceeded the $10,000 maximum limitations?

To be consistent with the treatment accorded other married individuals, the couple should not be allowed to contribute any more to the IHA after the marriage. But should the marriage, itself, apart from any contributions in the year of the marriage or thereafter, result in the application of the six percent additional tax for excess contributions, since the total contributions to the account exceed the $10,000 maximum allowed to a married couple?

The Department did not feel that the penalty should be applicable, and the rule so provides. The basis for our position is that at the time the contributions were made (or more correctly, at the end of the taxable year in which the contributions were made), they were allowable contributions. Therefore, in subsequent years they remain allowable contributions. The marriage itself, does not render a contribution made in a prior year an excess contribution.

Since there is a 10 year limitation on the existence of an IHA, and after the marriage the two individual accounts are treated as one joint account, it must terminate 10 years from the date

of the first deposit to account first established. The rule so provides.

The trustee is required to terminate an IHA upon expiration of the 10 year limitation. Yet for two participants who marry and whose individual accounts are treated as one joint account, the trustee will only know the date that the account he is administering was established. In the situation being discussed, the trustee will probably not even know of the marriage, much less whether the spouse's account was established before the account the trustee is administering. In order to protect a trustee in this situation, the rule provides that the treatment of the accounts of two participants who marry as one joint account shall extend only to the participants themselves. The trustee may continue to administer the two accounts as if the individuals had not married.

5. Termination of the Account. The obvious legislative intent of the IHA program is to assist individuals or married couples in saving for the purchase of their first principal residence. Once the participant owns his own residence, the purpose of the program is lost. Consequently, the rule provides that an IHA shall terminate whenever it is used to purchase the participant's first principal residence. This is consistent with the prohibition on the establishment of an IHA by an individual who owns (or did own) his own residence.

The rule summarizes and clarifies the treatment of an IHA upon the expiration of the 10 year limitation on its existence. These

provisions have been previously discussed at Parts C.1.d, C.1.e, and F.7.

6. Marriage Dissolution Transfers. The general treatment of marriage dissolution transfers is provided in clause (c)(4) of the Act. The rule paraphrases the statutory provision for purposes of introduction and clarity. The rule then provides that the limitations and restrictions on the IHA apply to the transferee as if he or she had made all prior deposits and withdrawals. This seems to be the legislative intent, since it did not provide a different treatment for the money in the account that is transferred. There is certainly nothing in the Act to indicate that a former spouse that receives an IHA as part of a marriage dissolution should have higher deduction or contribution limitations than anyone else or that the IHA should last longer than 10 years.

I. Exhibits.

The requirements for the written trust agreement are provided in Part B.4 of the rule. The requirements for the written disclosure statement are provided in Part B.5 of the rule. The exhibits in Part I. of the rule are meant only as examples of particular documents which are in compliance with the rule. There is no requirement that the particular documents provided in the exhibits actually be used to set up an IHA. The financial institution and a prospective participant may use other trust agreements or disclosure statements as long as the documents meet the requirements of this rule.

Use of the prototypes provided in the rule does have an advantage. The prototypes will be treated as being in compliance with the requirements of the rule. By using the prototypes, the trustee need

not worry that trust agreement or disclosure statement will be found deficient in some respect which could cause the participant to lose the deductions provided in the Act. The trustee may so assure the participant.

The trustee may add provisions to the prototype trust agreement or disclosure statement as long as the added provisions are not in conflict with any provisions of the prototypes or in conflict with any provisions of the rule or the statute.

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EXHIBIT A

NORTHWEST BANCORPORATION
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Minneapolis, Minnesota 55480
612/372 8123

December 12, 1980

Mr. Gary Mesna
Attorney
Income Tax Division
Minnesota Department of Revenue
Centennial Office Building
St. Paul, Minnesota 55145

Dear Mr. Mesna:

RE: Draft Rules for Individual Housing Accounts

We have reviewed the draft rules forwarded to us for comment. We have some concerns about the general statuatory framework, which may be beyond the scope of the rules, but will take this opportunity to comment on those matters as well as the draft rules themselves.

Our first concern is the requirement that a contribution must be made six months prior to year end in order to be deductible in that year. Bank records are kept on an annual basis. This requirement will cause a great deal of hand posting and manual recordkeeping. Reporting requirements placed on the trustee will be unduly burdensome and expensive as a result of this requirement. Shifting part of the reporting onus to the taxpayer would greatly ease the trustee's burden and expense. It would not be unduly burdensome for the taxpayer to maintain records of the dates and amounts of contributions and to report this information to the state. The trustee could provide the taxpayer with the amount of interest earned in the calendar year and the amount in the account at the end of the calendar year. Present systems would not have to be modified to provide such reports.

The statute permits a trustee to commingle funds held in IHA accounts for purposes of investment. The regulation permits commingling in a common trust fund or common investment fund. The only authority for commingling investments by a bank trustee in a common trust fund is that contained in Regulation 9, §9.18 of the Comptroller of the Currency. Minnesota Statutes §48.84 incorporates the applicable regulation for national banks (Regulation 9) as the governing rule for commingling of investments by state banks and trust companies. Both the IHA regulation and statute limit investments to certificates of deposit or savings or time deposits. Regulation 9, §9.18 specifically prohibits investment in a bank trustee's own accounts. Income tax and securities law questions would also be raised by common trust fund investments not

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complying with Regulation 9. See §584 of the Internal Revenue Code, §3(a)(2) of the Securities Act of 1933 and Minnesota statutes §290.281 sub.1 and §80A.15(j). We recommend that commingling in a common trust fund not be permitted.

Since the investment provisions do not limit a trustee to investments in its own savings deposits, there is a question of whether a national bank which does not have trust powers can act as trustee. We have raised this question with the Regional Office of the Comptroller of the Currency but do not anticipate an answer before year end. We recommend that the regulations specifically limit a trustee's investment authority to its own savings deposits and not to savings deposits generally. Minnesota statutes §48.159 covering IRA accounts has such restriction.

The proposed rule requires that the trustee prepare a rather intricate disclosure which must include the tax consequences of this type of account. The statue does not require a disclosure statement. We, therefore, question the requirement that the trustee prepare a detailed disclosure not required by the statute. The draft rule contains over 15 pages of technical explanation. We would suggest that the taxpayer be provided with a copy of the rule in its final form in lieu of a disclosure or that the state prepare a standard disclosure of the tax consequences, both state and federal, of the account.

The rule provides that the trustee will not accept deposits to an IHA from an individual who currently owns or formerly owned a principal residence. We believe that this provision should be amended to authorize the trustee to rely upon the certification of the taxpayer that he or she does not presently own or has not owned a principal residence. The rule as proposed would require the trustee to make some type of inquiry which we believe is unwarranted. The onus should be put on the taxpayer, the person with knowledge.

The statute is silent on the question of fees or compensation. A bank will incur considerable expense in acting as an IHA trustee. We suggest that the rule and the trust agreement specifically provide that the trustee be entitled to reasonable compensation for its services. See Minnesota Statutes §48.80 covering trustees and trust companies generally.

The rules use the term "beneficiary" and the proposed trust agreement uses "grantor." Grantor more accurately describes the relationship. We would recommend that grantor be used throughout the rules in place of beneficiary.

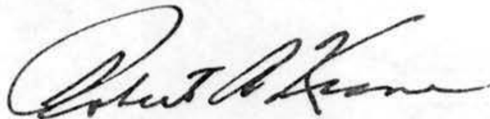
In our opinion, the prototype trust agreement should be revised to accomplish the changes and comments outlined above. We would recommend that Article II be completely redrafted to put the onus on the taxpayer to state that he or she does not now and has not owned a principal residence. The recommended change in reporting requirements would likewise necessitate modifications in the trust agreement. The taxpayer should also acknowledge the contribution limitations and agree to abide by them.

1980

We are in the process of developing a trust agreement for use by our banks and will forward a copy to you under separate cover.

We appreciate the opportunity to comment on these draft rules and sincerely hope that the rules can be modified and amended to greatly simplify the reporting requirements for trustees.

Sincerely,



Robert A. Krane
Executive Vice President

RAK:meb