THE Pension Digest

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SEP Prototypes –

Should Your Bank Sponsor One? Must They Be Amended For TRA 86?

Should your bank sponsor a SEP prototype? The answer is an unequivocal "yes." SEPs provide your business customers with a needed and much-desired service, which can result in significant deposits activity.

As summarized in last month's newsletter, the IRS Model Form 5305-SEP is usable by many employers. But there are certain employers who cannot use the IRS Model Form, or prefer not to. They are:

1. an employer who currently maintains any other qualified plan;

2. an employer who now or who has ever maintained a defined benefit plan;

3. an employer who is part of a controlled group, an affiliated service group or one who leases employees;

4. an employer who wishes to establish the plan on a tax year basis rather than a calendar year basis; and

5. an employer who wishes to use an integrated contribution/allocation formula.

Thus, by offering a SEP prototype your institution can service those businesses which are not eligible to use the IRS Model form, or do not want to.

Tax Year Situation

A business customer has a fiscal tax year of May 1, 1989 to April 30, 1990. The business customer is a corporation so it must file its tax return within 2-1/2 months, or by July 15, 1990 unless it receives an extension. This business customer (Sally West has a small business with 14 employees) comes to you on July 1, 1990 and indicates she would like to establish a SEP. She and the 14 employees have compensation of $300,000 for the period of May 1, 1989 to April 30, 1990. Sally West wants to contribute the maximum, which is 15% of the $300,000, or $45,000. She, of course, wants to take a tax deduction for the tax year ending April 30, 1990.

If your institution had a SEP prototype, you could accommodate her. That is, this business could makes its $45,000 contribution and deduct this contribution amount for the tax year ending April 30, 1990. Why? With the right plan document, the contribution is based on compensation earned during the fiscal year.

However, if the only form you had was the IRS Model Form 5305-SEP, the contribution must be based on the compensation paid for a calendar year period. In this situation, it is too late to make a contribution for the 1989 calendar year, and it is too early for the 1990 calendar year.

An institution should seriously consider sponsoring a SEP prototype so that it can effectively service its business customers who have a fiscal tax year.

Integration Situation

The owner of a small business will usually want to integrate its plan. Why? Because a larger percentage of the contribution can be allocated to the owner under an integrated formula than under a nonintegrated formula. There is no doubt that the integrated allocation formula is complex, but that is what accountants are paid for. And the increased contribution amount for the business owner will usually outweigh the cost of having the integration allocation calculated. The value of integration is explained in an article elsewhere in this newsletter.

Amendment Requirement

The IRS has not formally stated that SEP prototypes with pre-TRA 86 favorable opinion letters need to be resubmitted for new letters. Based on recent actions by the IRS and after discussions with an IRS employee, we believe the IRS will soon announce a deadline for when SEP prototypes must be rewritten and resubmitted for new favorable TRA 86 opinion letters.

The IRS very recently issued a revised Form 5306-SEP (Approval of Prototype Simplified Employee Pension–SEP). The print date is February, 1990. The IRS also drafted in November of 1989 new LRM's

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(Language Required Modifications) for SEP's.

Without wanting to unfairly criticize the IRS, the subject (amending SEP prototypes) illustrates the lack of clear communication that can arise between the agency and the pension industry. No doubt the IRS has been very busy with processing the qualified plan prototype filings, but the IRS apparently has been accepting amended and restated SEP prototype filings since November of 1989. This fact has not been communicated very well to the pension industry.

Thus, your institution may now file with the IRS its revised SEP prototype. We would recommend doing so even though the IRS has not yet issued a formal deadline. If you are serviced by a prototype mass submitter (e.g. Collin W. Fritz and Associates, Ltd.) they should be contacting you in the near future if they have not already done so. Since the IRS has increased the user filing fees for mass submitter prototypes from $50 to $100 effective October 1, 1990, your institution will want to file its revised SEP prototype before then.

Cost of Prototypes

Costs, of course, vary depending upon who the SEP prototype vendor is. But unlike Qualified Plan prototypes, there should not be an extreme difference in the cost of SEP prototypes among the various vendors since there simply isn't that much that can vary within the SEP prototype documents. This author feels that a SEP prototype should sell in the range of $350 or less. If a financial institution adopts a mass submitter's prototype, the IRS filing fee will be $50 as long as the filing is on or before September 30, 1990. Collin W. Fritz and Associates, Ltd. for a limited time is offering a SEP prototype for an initial fee of $125 plus an annual fee of $100. This offer expires May 15, 1990. PD

Why an Integrated Plan?

Integration allows an "extra" contribution to be allocated to highly compensated employees, which many times are the owners of small businesses. This extra contribution for the highly compensated means that the other employees receive a lesser contribution. The rationale for permitting integration is that it partially reverses the discrimination which occurs under social security, since social security discriminates in favor of non-highly compensated employees. Even so, the trend in the past 4-5 years has been to reduce the "extra" which is permitted to go to highly compensated individuals under private pension plans.

The concept of integration is that a contribution percentage applies to income equal to or less than the specified " integration level" and a higher percentage applies to a participant's income in excess of the integration level. For example, a typical plan contribution formula may provide that a 5% contribution will be given for compensation up to $20,000 and a 9.3% contribution will be given for compensation in excess of $20,000.

The old rules allowed a 5.7% spread between the lower percentage and the excess percentage. Thus, it was permissible under the old rules to have an excess-only plan. For example, the plan contribution formula would be: to contribute 5.7% of compensation in excess of $20,000. Those earning less than $20,000 did not receive an allocation.

The new rules did away with excess-only plans. Actually, the new rules limit the permissible spread in two ways. First, the excess percentage (disparity rate) may not exceed the base percentage by more than the lesser of: (1) the base percentage or (2) 5.7% (under indexing rules this figure may be larger once the old age portion of the OASDI rate exceeds the 5.7%). Secondly, the IRS requires under the new qualified prototype plan LRM's (Language Required Modifications) that the 5.7% be reduced to 4.3% or 5.4% when the integration level is set less than the FICA taxable wage base. This disparity rate calculation is discussed in more detail on the next page.

An owner of a small business will want an integrated plan because a larger contribution will be allocated on his or her behalf. The larger contribution potential makes up for the complexity and cost of the integration calculation.

Example: The St. Paul Dental Clinic, Ltd. has six employees with $300,000 of compensation for 1989. The clinic has elected to contribute the maximum deductible amount of $45,000 (15% of $300,000).

If the plan is nonintegrated the allocation would be as follows:

Employee	Total Compensation	Total Allocation	Percentage
Sara Phillips	$125,000	$18,750	15%
David Bollin	95,000	14,250	15%
Beth Long	35,000	5,250	15%
Paula Wright	17,000	2,550	15%
Mark Flaherty	15,000	2,250	15%
Maggie Waters	13,000	1,950	15%
Total	$300,000	$45,000	N/A

If the plan were integrated under the old rules, the allocation would be as follows:

Employee	Total Compensation	Total Allocation	Percentage
Sara Phillips	$125,000	$20,104	16.08%
David Bollin	95,000	15,005	15.79%
Beth Long	35,000	4,808	13.74%
Paula Wright	17,000	1,920	11.25%
Mark Flaherty	15,000	1,695	11.29%
Maggie Waters	13,000	1,468	11.29%
Total	$300,000	$45,000	N/A

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A Non-IRA Trust as an IRA Beneficiary

In a recent IRS Private Letter Ruling, the Internal Revenue Service clarified some of the issues that arise when IRA payments are made from a trust to the trust beneficiaries.

In the situation the IRS examined, an individual had established a valid IRA with a bank. At a later date, this individual established a non-IRA trust with the same bank as trustee. This non-IRA trust was designated as beneficiary of the IRA, and it had two beneficiaries, both children of the IRA accountholder.

The accountholder had not yet begun to take distributions from the IRA account when he died. Upon death, the entire IRA was paid to the non-IRA trust. Within a year, one of the beneficiaries elected to begin receiving distributions from the trust, based on their own life expectancy. The question the IRS examined was: "were the distributions from the non-IRA trust subject to the 10% penalty for premature distributions from a qualified retirement plan?" Their answer was that the distributions were not subject to the 10% penalty.

The IRS stated that in order for them to arrive at this conclusion, a number of requirements had to be met. The first requirement dealt with the non-IRA trust itself. The IRS said that it had to meet the requirements of proposed regulation 1.401(a)(9)-1. Among other things, this meant the trust had to be irrevocable and valid under state law. The IRS found this to be true in this case.

Secondly, the distributions from the trust had to meet the minimum distribution requirements for IRA beneficiaries set out in the same proposed regulation. One of the options a non-spouse beneficiary has for distributions where the accountholder dies prior to reaching age 70-1/2, is to take distributions based on their own life expectancy. The beneficiary must elect this option and begin to receive distributions by December 31 of the year following the accountholder's death. In this case, the beneficiary chose to take distributions under this method.

Since the distribution chosen by the beneficiary satisfied the proposed regulation, the IRS stated that this was a distribution they viewed as being to an IRA beneficiary. This was the case even though the distribution was actually coming from the trust and not the IRA itself. The distribution was also one being made as a result of the death of an IRA accountholder. Distributions due to death are not subject to the 10% premature distribution penalty. In this case, no penalty was owed.

The interesting question the IRS did not answer was "who owed income tax on the distributions that were made. " In this case, two distributions really appear to have occurred. The first was the distribution from the IRA to the trust. The second was a distribution from the trust to the trust beneficiary. Who owed tax? This question was not answered in the PLR. The implication, however, is that the distribution to the trust was not taxable. Distributions from the trust to the beneficiary are typically taxable.

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If the plan is integrated under the new rules, the allocation would be as follows:

Employee	Total Compensation	Total Allocation	Percentage
Sara Phillips	$125,000	$19,771	15.82%
David Bollin	95,000	14,820	15.60%
Beth Long	35,000	4,917	14.05%
Paula Wright	17,000	2,075	12.21%
Mark Flaherty	15,000	1,831	12.21%
Maggie Waters	13,000	1,586	12.21%
Total	$300,000	$45,000	N/A

Note that Sara Phillips and David Bollin receive smaller allocations under the new rules than under the old rules. Even so, Sara Phillips and David Bollin are better off (and the others worse off under the new integration rules versus nonintegration) to the extent indicated in the chart below:

Employee		
Sara Phillips	+	$1021
David Bollin	+	$ 570
Beth Long	-	$ 333
Paula Wright	-	$ 475
Mark Flaherty	-	$ 419
Maggie Waters	-	$ 364
Total		-0-

Disparity Rate Calculation

The 4.3% or 5.4% limits are derived from the following language which will be found in prototypes. The maximum disparity rate is based on the specific integration level. If the Integration Level:

is more than	but not more than	then the appli-able percentage is
$0	X*	5.7%
X* of TWB	80% of TWB	4.3%
80% of TWB	Y**	5.4%

*X = the greater of $10,000 or 20% of the TWB.

For 1989 X = $10,000. For 1990 X = $10,260.

**Y = any amount more than 80% of the TWB but less than 100% of the TWB.

For 1989, 80% of TWB = $38,400. For 1990, 80% of TWB = $41,040.

TWB for 1989 = $48,000.

TWB for 1990 = $51,300.

IN SUMMARY, most people in the position of Sara Phillips would like to have the opportunity to adopt an "integrated" plan, whether it be a QP/Keogh plan or a SEP plan. Your institution should have prototypes which will meet this "integration" need.

Post 70-1/2 Rollovers by Surviving Spouses

What must be done in order for a surviving spouse to roll over a distribution from a Qualified Plan to her own IRA; specifically, in a case where the accountholder was older than 70-1/2? In a recent private letter ruling (PLR#9005071) the IRS gave some guidance for making this transaction.

A surviving spouse, in this case, asked the IRS if they could roll over a distribution from the decedent's retirement plan into their own IRA, and thus avoid immediate taxation of the distribution. The retirement plan was qualified under section 401(a) of the Internal Revenue Code. Additionally, the distribution to the surviving spouse was to be a "qualified total distribution." This meant that the entire remaining account balance of the decedent was to be paid to the surviving spouse within one taxable year. The IRS said that this distribution of the entire account could be rolled to the spouse's own IRA as long as certain requirements were met.

1. The IRS said that if the surviving spouse received the distribution in the same calendar year as the decedent's death, the spouse could roll over and exclude from income, the amount of the distribution less the amount of any required minimum distribution for the year that had not yet been made. Essentially this means that the surviving spouse would have to take the minimum distribution for the deceased in the year of death. The remainder of the account could then be rolled into the spouse's own IRA.

2. When the surviving spouse receives the distribution in the calendar year following the year of the decedent's death, the entire distribution could be rolled into the spouse's own IRA so long as the decedent had received the minimum distribution in the prior year. This rollover would also result in the spouse being able to exclude this minimum distribution from income for the time being.

3. As with all rollovers, the IRS stated that the rollover would have to take place within 60 days of the spouse's receipt of the funds.

The IRS also stated that once the rollover had occurred, section 401(a)(9)(A) would govern the spouse's IRA, and not section 401(a)(9)(B). This means that the spouse would not be required to begin minimum distributions from this IRA until they reached their own required beginning date. PD

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Question: A customer comes to you on a Monday and wishes to rollover an IRA contribution. The 60 day period ended on the preceding Saturday or Sunday. Is the person still eligible to do the rollover?

✔ The IRS may well argue that the rollover could not be made. Internal Revenue Code Section 7503 provides that when a tax deadline ends on a Saturday, Sunday or legal holiday, the deadline is extended until the next business day. Even so, the IRS has generally limited this rule to the filing of the income tax return.

The law is not settled. Any customer in this situation should seek professional advice and should hold the IRA trustee harmless if it (trustee) accepts such a rollover contribution.

Question: Should the bank as custodian/trustee of Keogh plans still prepare the Schedule P which is an attachment to the form 5500EZ?

✔ For the 1989 Form 5500EZ (to be filed on or before 7-31-90) the IRS has changed the rule so that a filing is not necessary when the plan (or the combination of plans when more than one plan is sponsored) has assets of less than $100,000. The rule has always been that the Schedule P could not be filed separately—that is it must be filed with the Form 5500EZ. That rule is unchanged.

Since many Keogh accountholders will no longer file the Form 5500EZ, the IRS will need to address how this affects the purpose of filing the Schedule P (i.e. to start the running of the statute of limitations). The IRS has not yet addressed this question. Until the IRS does, a custodian/trustee should continue to prepare and furnish the Schedule P to its customers. The custodian/trustee should also prepare this form if it does not know whether its customer has a plan(s) at another financial institution(s).

Question: I am a participant in the bank's profit sharing plan. I am not married. The bank did not make a plan contribution for 1988 and also will not make an employer contribution for 1989. This was permissible since the plan authorizes the employer to make contributions at its discretion. I did not make any employee contributions and I was allocated no forfeitures. The W-2 form which the employer prepared indicated that I am a participant in a "pension plan." Am I an active participant for 1989 IRA purposes so that some or all of my IRA contribution will be nondeductible?

✔ Notwithstanding the W-2 Form, you are NOT an active participant for IRA purposes. Everyone makes mistakes, including employers. The intent of the law change in 1986 was that a person should lose the ability to take a tax deduction for an IRA contribution only if contributions are made (or required to be made) for that year. If not, then one should be able to deduct the IRA contribution.

If the plan contributions are purely discretionary and if there has not been an allocation of employer contributions, employee contributions or forfeitures, then such an individual is not an active participant for IRA purposes.

If you or your customer ever has a question about whether or not a person is an active participant for IRA purposes, IRS Notice 87-16 should be reviewed. PD

The Pension Digest invites your questions and comments.
Please address to "Check It Out," Collin W. Fritz & Associates, Ltd., P.O. Box 426, Brainerd, MN 56401.