THE Pension Digest

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401(k): Advantages For Employer *and* Employee Boost Popularity

Like so many things, pension plans experience cycles of popularity. A perfect example is the 401(k), an employer-sponsored plan to which both employer and employee may contribute.

Though first authorized in 1978, the 401(k)'s popularity has experienced its greatest growth in the last 5-7 years. The period from 1983 to 1988 saw a quadrupling of the number of workers whose employer offered a 401(k) plan, reaching almost 30 million eligible employees. Financial institutions able to capitalize on this trend through effective marketing, may realize substantial benefits in greater profitability of their retirement plan business.

Why this phenomenal growth? The 401(k) offers both advantages to the employer, and relief from the restrictive deduction rules of IRAs. From an employer perspective, the 401(k) is less costly than the more traditional "defined benefit" plan, with its locked-in benefits and contributions. In a typical 401(k) plan, the employer matches between one-half and the full amount that its employees contribute, up to 6% of the worker's salary. However, the employer—as in a standard profit sharing plan—retains the discretionary freedom to contribute an amount based on the profitability of the company.

From an employee standpoint, the 401(k) is attractive for several reasons. First—depending on their employer's plan—it may allow them to make a tax-deductible contribution of as much as $7,979 in 1990. This compares to a maximum individual IRA contribution of $2,000.

Secondly, 401(k) plans usually offer three or more investment choices. Guaranteed Investment Contracts (GICs) offered by insurance companies are highest in popularity. (A GIC is basically a long-term certificate of deposit, with a substantial variable-interest penalty attached for early withdrawal.) Stock in the plan-holding company is another common choice, followed by stock and bond mutual funds.

Another selling point of the 401(k) is the participant's ability to receive (free of IRS penalty) pre-retirement age distributions in the form of either hardship withdrawals or hardship loans. Such things as college expenses, first-home purchase, or the expenses of illness qualify. This reassures participants—particularly younger ones—who might otherwise be reluctant to commit large dollar amounts to a retirement plan.

The 401(k) may sometimes be the only plan offered by a company, or may supplement an employer's traditional defined benefit, guaranteed contribution plan. Many employees who participate in both a traditional plan and a 401(k) may find their income higher after retirement than before.

For further information on the workings of 401(k) plans, or for advice on how best to make your customers aware of the benefits of these plans, contact Collin W. Fritz and Associates, Ltd. CWF offers the following 401(k) services:

- prototypes - used to establish or update either the financial institution's or a customer's 401(k)
- forms and documentation
- consulting
- educational services

Call 1-800-346-3961 PD

IRA Beneficiary Change Overrides Earlier Designation

How "irrevocable" is an IRA beneficiary designation? Does a subsequent beneficiary designation override a previous one? In a New York case, a deceased accountholder's daughter appealed the estate's awarding of IRA proceeds to a later named third party beneficiary. The daughter contended that the IRA account should at least be split, with deposits made prior to the second beneficiary designation going to her, and later deposits to the subsequently-named beneficiary.

However, the court (Supreme Court of New York for Suffolk County; 1989) said "No". It upheld the bank's treatment of the IRA account as a single trust—not individual instruments. It also noted that in this case, the form used to designate the second beneficiary clearly informed the accountholder that this act negated previous designations. This wording is common to most beneficiary designation forms, and clearly should be present to prevent any potential misunderstanding.

In issuing its opinion, the court also noted that—had the deceased accountholder wished a division of the IRA proceeds—a joint beneficiary designation could have been made. PD

Form 5498 for IRAs/ SEPs Due May 31

Certain IRA transactions as well as fair market values (FMVs) for the 1989 tax year must be reported to the IRS by May 31, 1990.

Information required by the IRS on the 1989 Form 5498 includes all regular IRA contributions for 1989 in Box 1, all IRA rollovers – Box 2, and FMVs (determined as of December 31, 1989) – Box 4 – for all accounts. The May 31 deadline applies to 5498s submitted either in paper form (less than 250 accounts) or on magnetic media.

At the same time this information is being reported to the IRS, certain information must also be provided to accountholders. This includes an accounting of all regular IRA contributions, and IRA rollovers. (Fair market values do not have to be reported to customers at this time, since they received these reports (or should have) on or shortly after January 31, 1990.) Reports to customers can be made either on Form 5498, or with a similar statement containing the same information.

July 2 Extension for Electronic Media

However, an extension to July 2, 1990 has been given to the comparatively smaller number of banks that wish to file on electronic media. This is NOT THE SAME AS MAGNETIC MEDIA, but is a direct computer-to-computer data transmission by phone modem. The extension was given due to the setup time needed to transmit data this way, combined with the late announcement date. PD

How Does a Divorce Affect the RMD Calculation?

A recent IRS private letter ruling (9011031) considered whether a divorced IRA accountholder was entitled to modify the formula which the IRS has set forth in the proposed regulation 1.408-8 for calculating an accountholder's required minimum distribution (RMD).

It is well known that private letter rulings cannot be cited as precedent. One analyzes them because they do give a "sense" of the formal position the IRS would take on a similar or identical issue, and how the IRS analyzes the question.

In this particular case, the IRA accountholder attained age 70-1/2 in 1988. Thus, the deadline for taking his required minimum distribution for 1988 was April 1, 1989. The deadline for his 1989 distribution was December 31, 1989. The accountholder was going through a divorce at this time. On March 16, 1989, a qualified domestic relations order (QDRO) was entered requiring him to transfer 50% of his IRA to his former spouse.

The IRA accountholder then asked the IRS to rule that his miminum distribution for 1989 be based on his life expectancy and 50% (rather than 100%) of his account balance as of December 31, 1988. Note, that the IRS was not asked to consider the use of a revised balance in the calculation formula (account balance as of previous December 31st divided by the pertinent life expectancy factor) for 1988 or 1990, only for 1989.

The IRS ruled that there was no authority to modify the calculation for a divorce, or for any other reason. Thus, the IRS ruled that he must use 100% of the account balance as of December 31, 1988 to determine his required minimum distribution for 1989. The IRS did indicate that this balance would be decreased by his 1988 required minimum distribution amount which he had not taken by December 31, 1988. This special adjustment is specifically authorized by the proposed regulation.

As mentioned previously, the IRS was not asked to discuss the balance to be used for 1988 and 1990. For 1988 the balance as of December 31, 1987 would be used. For 1990, the balance as of December 31, 1989 would be used, but this balance would now be much lower (i.e 50%) because of the QDRO.

This IRS ruling is consistent with the basic concept of the proposed regulation, that an event (rollover, transfer, death, etc.) shall not affect the minimum amount required to be distributed for the year the event occurs, but the amount for subsequent years will be affected. Thus, the divorce will not affect the 1989 calculation but will affect all subsequent years.

Certainly, this IRA accountholder may feel it is unjust that he has to calculate his required minimum distribution based on 100% of his account balance when he now has only 50%. But such is the rule. To avoid the result suffered by this IRA accountholder, a person going through a divorce in the last quarter of the year may well want to make sure that the IRA transfer (or Qualified Plan transfer) takes place before December 31st. PD

Rollover into Same IRA Permitted

A typical IRA rollover deposit commonly finds an individual moving money from some type of employer retirement plan into his or her own IRA when they leave the employer plan.

Is there a qualifying rollover when the funds are withdrawn from, and later redeposited into, the same IRA?

In an example elaborated upon in IRS Technical Memorandum 9010007, 1989, an IRA owner on two separate occasions (in separate years) withdrew $1,500 from his account for personal use, then redeposited the same amount in the same IRA. The maximum rollover time frame of 60 days was met both times.

Was this permissible, or should the accountholder have been required to include the withdrawal/distribution as gross income for that year? Should the 10% early distribution tax also apply?

The IRS determined that the withdrawal was actually a tax-free rollover, since the funds were redeposited in the same or another qualifying IRA account within 60 days, and the funds had only been rolled over once in that year. They therefore were deemed not includable in the individual's gross income for that year, and for that reason, were also not subject to the 10% early withdrawal penalty.

A further question existed, however. Was the redeposit of these funds considered an excess contribution, and therefore subject to a 6% penalty? Code section 4973(b) exempts rollover transactions from the "excess contributions" category. Therefore no penalty was imposed.

The effect of this IRS position suggests the legality of tax-free use of one's IRA funds for up to 60 days, provided the funds are returned to the same or another qualifying IRA within that period, and the funds have not been rolled over previously within one year.

New Filing Deadline for Prototypes "Indefinite"

The deadline for submitting master or prototype - including regional prototype - plans has been extended by the IRS to an as-of-now indefinite date.

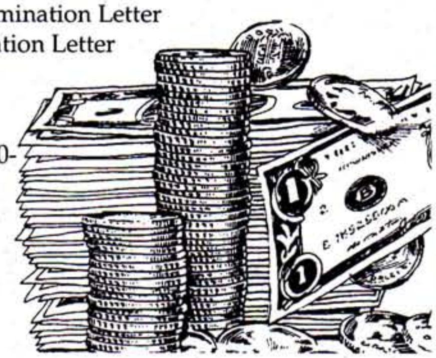
The new deadline will be 90 days after the date that proposed regulations under Code section 401(a)(4) are published in the Federal Register. (Code section 401(a)(4) provides that the contributions or benefits under a qualified plan must not discriminate in favor of highly compensated classes of employees.)

The proposed regulations are EXPECTED to be published in the next two to three months, thus initiating the 90 day deadline therefrom. We will keep you informed through The Pension Digest when the date is officially set.

The IRS announced this extension in both Revenue Procedure 90-21 and Announcement 90-48.

New User Fees In Effect; More Soon To Be

A revised schedule of user fees for "requests for ruling" has been issued by the IRS. These are contained in IRS Rev. Proc. 90-17. In many of these cases fees have been increased. As previously announced in The Pension Digest, most of the fee revisions are effective for requests received after March 31, 1990. Several categories, however, have effective dates beginning after September 30, 1990. These are the fees for Employee Plans Opinions, Notifications, Determination Letter requests, and Exempt Organizations Determination Letter requests.



In the case of these September 30 effective date categories, the fees set forth in Rev. Proc. 90-17 will become effective only if legislation is enacted to extend the user fee program beyond September 30, 1990. All other category fees, however, are now in effect.

Mass vs. Non-Mass Submitter Fee Discrepancy Widens

One important change is the increase in qualified plan filing fees for nonmass submitters (individually designed prototype plans), which are paid on a per-adoption-agreement basis by sponsoring organizations. This fee has risen from $1,000 prior to March 31, to the current fee of $3,000 per adoption agreement.

In contrast, a sponsoring organization's word-for-word identical adoption of a mass submitter's basic plan document has risen from $50 to $100 per adoption agreement (the same is true for adopters of mass submitter's regional prototype plans). Despite doubling in price, the cost disparity keeps the adoption of a mass submitter's prototype an attractive option to an individually designed prototype plan.

Other Important User Fees

- "All Other Rulings"

This catch-all category includes miscellaneous Ruling Letters on employee plans, under a wide variety of Revenue Procedures, section interpretations and rulings. This fee rose from $400 to $1,250. However, the fee will be $500 for those individuals, trusts, and estates or tax exempt organizations with total income or gross receipts of less than $150,000.

- Requests for approval to become a nonbank trustee (under Section 1.401-12(n) of the Income Tax Regulations; fee rises from $1,000 to $3,000.

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Summaries in Case Law Development

The following case summaries provide examples of court decisions that help to set direction and precedent in various areas of pension plan law dealing with fiduciary liability.

The summaries are very brief. Further information you may desire on any one of them may be had by contacting CWF in writing, at P.O. Box 426, Brainerd, MN 56401.

Recent Cases Dealing With Fiduciary Liability

1. Useden v. Acker. U.S. District Court, S.D. of Florida, 3-29-89). A bank made a loan to an ERISA plan so that it could buy employer stock at a substantially discounted price. An attorney acted as legal counsel for the plan presumably advising that such a purchase would not be a prohibited transaction. The plan failed to make its note payments since the employer suffered financial difficulty and could not make a contribution. In addition, the price of the stock fell below the price which the plan had paid. The court ruled that neither the bank nor the attorney were plan fiduciaries under ERISA.

2. O'Neill v. Davis. U.S. District Court, N.D. of Illinois, 721 F. Supp. 1013, 9-20-89). A Federal district court in Illinois has ruled that the voting of plan shares by plan trustees is a fiduciary act under ERISA and that the trustees are bound to exercise in the sole interest of plan participants. Any voting of shares for personal interests is a violation of ERISA.

3. Gray v. Baier. (U.S. District Court, District of Columbia, 8-30-89). The court ruled that a former participant could not recover against the plan administrator for breach of a fiduciary duty because any recovery must be made on behalf of the plan. In addition, the request that the plan be disqualified because it was discriminatory was dismissed because the Tax Court - not the District Court - is the proper forum.

4. Curtis Guidry v. Sheet Metal Workers National Pension Fund, et al.(U.S. Supreme Court 1-17-90). The court held that although a union official had embezzled funds from the union, the plan was a separate legal entity, and held that absent an exception to the general statutory bar, the anti-alienation provision of ERISA prohibits the remedy of a constructive trust. While it may seem distasteful to allow what appears to be an inequitable result, the anti-alienation statute represents congressional policy choice. Exceptions to the policy (as with domestic relations orders) must originate with Congress.

5. Herberger v. Shanbaum, 4-5-90. The U. S. Court of Appeals (5th Circuit at New Orleans) has ruled that Guidry indicates that the anti-alienation provision of ERISA is so great that a former trustee's benefit was not subject to offset even in the situation where he had breached a fiduciary duty owed the plan.

6. Francis P. Brown v. Lawrence Roth et al. (U.S. District Court, District of New Jersey 1-30-90). The court held that an accountant who performed only administrative services was not a fiduciary under ERISA and could not be held liable for violations of fiduciary duty even though the accountant had invested along with the plan in second mortgages which had become worthless. The accountant did not exercise undue influence and did not provide investment advice on a regular basis or pursuant to an agreement that such advice would be the basis for investment decisions.

7. GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc. (U.S. Court of Appeals for llth Circuit, 3-1-90). An investment company was held liable for breach of ERISA fiduciary duties when it invested over 70% of plan assets in long term bonds when it had not considered the plan's needs for cash. A subsequent need for cash resulted in the premature sale of bonds at a loss.

8. Cecil L. Williams, et al. v. Caterpillar, Inc. et al, (U.S. District Court, N.D. of California, 720 F. Supp., 9-5-89). The court ruled that employees were not entitled to any contractual relief for oral statements allegedly made that demotions in job positions and pay would not adversely affect their pensions. ERISA does not incorporate any state law theory of promissory estoppel or provide damages for a fiduciary's misrepresentations to a beneficiary. ERISA's goal of protecting the interests of all plan participants would be undermined by allowing oral modifications of ERISA plans. PD

New User Fees —
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• Accounting rulings including accounting period, method, and earnings and profits requests other than those submitted on Forms 1128, 2553, 3115 and 5452; also including change of accounting method or period, made pursuant to a published automatic change revenue procedure. Fee is raised from $300 to $2,500.

• Employee Plans Determination, Notification and Advisory Letters -defined benefit and defined contribution plans involving affiliated service groups and leased employee arrangements, under 100 participants; fee raised from $450 to $700.

• Employee and exempt organization adopters of master and prototype, or other pre-approved plans, as well as short amendments (form 6406). Fee rises from $100 to $125.

(For a complete schedule of all 52 fee categories, send a stamped, self-addressed envelope and enclose $5.00 to cover cost of duplicating, postage and handling, to Collin W. Fritz and Associates, P.O. Box 426, Brainerd, MN 56401.) PD