THE Pension Digest

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AN ENCORE REVIEW OF IRS ANNOUNCEMENT 90-1

WHAT SERVICE INCENTIVES CAN IRA/KEOGH CUSTOMERS LEGALLY BE OFFERED?

The February Pension Digest briefly discussed the new prohibited transaction rules set forth in IRS Announcement 90-1. This Announcement described those offers of cash, property or services OUTSIDE OF A RETIREMENT PLAN that can legally be made to a potential IRA/Keogh customer, without creating a "prohibited transaction."

Now, with "IRA marketing season" at hand, further elaboration on the topic may be helpful.

After consulting with the Department of Labor (DOL), the IRS issued Announcement 90-1, granting temporary relief from its prohibited transaction rules with respect to offering cash, property or services to stimulate IRA/Keogh deposits. This relief is considered temporary. But until the DOL acts to the contrary, meeting the requirements of 90-1 will protect both accountholder and financial institution from the consequences of a prohibited transaction.

On the subject of cash or property incentives, 90-1 referred institutions back to a proposed 1983 exemption for specific guidelines. For IRA/Keogh deposits of less than $5,000, the cash or property offering to the accountholder cannot have a fair market value of more than $10. For deposits of more than $5,000, the fair market value can be no more than $20.

But Announcement 90-1 pays significantly more attention to the subject of the offering of SERVICES to stimulate account deposits, which the 1983 rules did not address. It describes circumstances in which the offering of these services WOULD NOT constitute a prohibited transaction.

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The IRS indicated that the following general requirements had to be met. The service must be consistent and incidental to the business of banking and must be per-mitted by the governing laws. In addition, the IRA/Keogh must receive a rate of return which is within a reasonable range of the prevailing rates of return for comparable investments that are generally offered to all customers. That is, the IRA must not be receiving less because of its receiving the service.

In addition, the following three specific requirements must be met if the services were not offered on or before December 31, 1989.

1. In determining eligibility for the services to which this announcement applies, IRA and Keogh accounts must be treated in the same manner as other accounts maintained by the financial institution.

2. The provision of the services to which this Announcement applies may not result in a lower return on the IRA or Keogh investment than the return on comparable investments maintained by the financial institution that are generally offered to all customers (except to the extent prohibited by applicable banking or securities laws) regardless of whether they avail themselves of such services; and

3. The services to which this announcement applies must be generally available (with or without a service charge or fee) to other customers of the financial institution.

In reviewing any marketing program which links IRAs with non-IRA accounts or services, the critical consideration is to determine what is being given the customer—cash, property or services. This determination is not always a simple one.

If what you are giving is a service, then you are bound by the new rules above. If you are giving cash or property, then you are still bound by the old $10/$20 limits.

Example: a new program would pay any existing depositor (IRA or non-IRA) the current interest rate plus a bonus of 20 basis points (.20%) if they are willing to make a new deposit of $1,000 or more within the next 45 days. The new deposit could be to either an IRA or a non-IRA account. Any problems with the prohibited transaction rules? We believe there could be, since the bonus basis points could be given because of an existing IRA account, but paid to a non-IRA account. Is this bonus a service, or is it cash or property? We believe it is the latter, and therefore must meet the $10/$20 limits.

A second example: a new program would pay a bonus of 15 basis points to any current depositor (including an IRA accountholder) who would also open a checking or savings account. There are no prohibited transaction concerns here since it is the IRA (if existing) which will benefit.

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BE CAUTIOUS IN RETURNING PENSION OVERPAYMENT

A pension plan participant should never act too hastily when a plan administrator tells them that an error has occurred with respect to their pension distribution. For the reasons discussed below, you the banker should help your customer by telling them to talk with their legal or tax advisor before taking any action.

How could such a "payment error" situation arise?

Overpayments: someone is paid more than they should have been paid. Quite simply, whoever was responsible for calculating the termination payout did it incorrectly. Overpayments happen more often than pension plan administrators would like to admit, and can happen for numerous reasons. This article focuses on what should be done when an overpayment has occurred. Underpayments also happen. But that is a subject for a future article.

Example: Sara Blanco rolled over to your bank what she believed to be a $15,000 lump sum distribution on December 10, 1989. The pension firm which does the work for the plan administrator contacted her on September 10, 1990 saying they believe she was overpaid by $1,500. They want her to repay the full $1,500, as she was only 90% vested rather than 100%. She agrees that her vesting service only entitled her to 90% of her account balance and that she should have been paid $13,500, not $15,000. To support its request for repayment the plan administrator has written to Sara. They make the statement that the bank should not report this $1,500 as taxable to Sara since it was not eligible to be rolled over.

The point to be made here is that you should see "red flags" when someone (in this case the plan administrator) tries to tell you how to do your reporting. In another case it might be an accountant who asks you to do some "special" reporting. You must make the determination if a reporting request is correct, or is simply being made to help someone cover their error.

Must, or should, Sara immediately repay the $1,500 with no further discussion or negotiation?

The answer is definitely "no".

The plan administrator's explanation was certainly incomplete and probably incorrect. Sara will have tax problems because of this situation.

Sara made an excess contribution when she contributed that $1,500. Since she made the contribution in 1989 and did not correct it by the tax filing deadline for 1989 taxes (April 16), she owes the 6% excise tax, or $90.00. She should file an amended return and pay the $90.00 plus any interest which has accrued. Prior to returning the entire $1,500 to the plan, she should make sure that the plan administrator is willing to pay all or some portion of this amount, plus the cost of preparing the amended tax return. The 6% excise tax will not be assessed for 1990 if she withdraws it prior to 12-31-90.

In summary, when a customer comes to you with a similar situation (he/she rolled over too much because the plan paid them too much money), know that your customer should see their legal or tax advisor before agreeing to pay the plan back. They should also be paid (or retain some money) to cover any tax difficulties they will have because of the error. PD

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A third example: a bank offers a checking account for $3 per month , but it waives this fee for certain customers who maintain a minimum balance in other accounts. The bank proposes to expand its free checking to include IRA customers with $2,000 balances. Are there any problems? We don't think so but we are not totally sure. It was this type of proposal which caused the IRS to issue the new rules for services. The waiver of the $3 monthly charge exceeds the $10/$20 limits. But since this appears to be a service (and not cash or property), these dollar limits do not apply. Of course, the three rules above must be met, and it is assumed they will be.

Because of the complexity of these new rules and the harsh consequences if you are wrong, we strongly recommend consulting with your legal advisor before any "linked" IRA marketing program is started. It may save some serious headaches.

IRS TO AUDIT TERMINATED QUALIFIED PLANS

The IRS in Announcement 90-96 has stated that it will be auditing 400 pension plans which have terminated without seeking a favorable determination letter. This is a pilot program to see if there is sufficient noncompliance so that an expanded audit program would "pay for itself". If so, the IRS will institute a special emphasis examination program in 1991 which will focus on plans that meet the criteria indicating potential noncompliance.

A plan sponsor, of course, is not required to file for a favorable determination letter when they terminate their plans.

Our educated guess is that the IRS will find that the audits will generate substantial tax dollars. If a plan is not qualified when funds are distributed, then any recipient must include these funds in income and such amounts do not qualify for 5/10 averaging or to be rolled over. Any such funds rolled over would constitute an excess contribution.

How does the IRS know? The Form 5500 contains an express question on it

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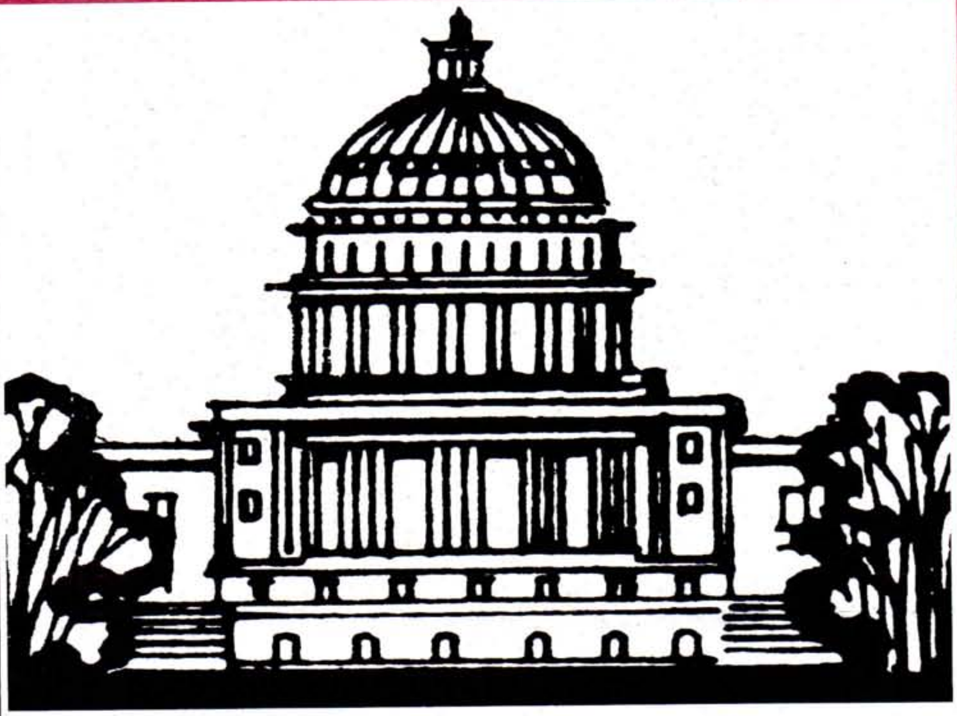

Will stalled budget have provisions affecting IRAs, SEPs and Qualified Plans?

In a recent budget speech, President Bush mentioned IRAs, special savings accounts and the topic of capital gains. He also emphasized the need to resolve the budget situation prior to October 1, 1990.

Bush, along with most of Congress, has concluded that something must be done about our country's low savings rate. With respect to IRAs, he has in the past proposed to change the IRA rules so that first time home buyers could receive an IRA distribution and not be subject to the 10% excise tax.

The effect of this type of change would certainly be that people in the age group from 20-45 would contribute substantially more than they do now, since they could use the IRA to accumulate their down payment. If the President is really behind this change, it is possible that it may come to pass. (Marketers, will you be ready?)

Because of the continuing need for tax revenue, it appears less likely that the President is willing to restore some of the former deductions for IRA contributions made by active participants in an employer retirement plan. This restoration is what the banking industry would really like to see.

Democrats have proposed restoring some or all of the lost deductions. The Democrats continue to argue that if President Bush wants to restore capital gains relief for the wealthy, then he should give something to "the little guys," and that something is to restore the full IRA deduction.

We will keep you informed of these legislative negotiations, because IRAs and qualified plans could certainly be impacted.

SUMMARY OF IRA EXCISE TAXES

The two large charts (B and C) below summarize the excise taxes which pension plan sponsors, IRA accountholders and financial institutions have had to pay. Point #1 is that there has been a substantial increase in the total amount paid—from $17 million in 1986 to $255 million in 1989. Point #2 is that of the $255 million for 1989, only 6.48 million (lines 2 & 3) comes from IRAs, whereas nearly $244 million (line 4) arises from qualified plans. The qualified plan taxes come primarily from two sources: (1) the 10% tax for underfunding a pension plan and (2) the 15% excise tax which applies when an employer terminates a defined benefit plan and takes back the excess. Point #3 comes from chart "C", which compares the first two quarters of 1989 to 1990. There has been a small decrease in total taxes assessed.

The chart immediately below summarizes the two IRA excise taxes assessed for the last four complete fiscal years (i.e. those ending 9-30-86, 9-30-87, 9-30-88 and 9-30-89). The two excise taxes are the 6% tax for excess contributions and the 50% tax for not complying with the 70-1/2 rules.

A	1986	1987	1988	1989
6% Tax	$2,905,000	$4,783,000	$7,097,000	$5,709,000
50% Tax	461,000	759,000	723,000	771,000

Note that the 6% tax decreased from 1988 to 1989 and it has increased slightly for the first 6 months of 1990, as compared to 1989 (Chart C). Even so, the tax revenues have increased significantly since 1986. The 50% tax has increased steadily each year, but the collection of the 50% tax for the first 6 months of 1990 has actually decreased substantially.

It is quite clear that IRA customers still have more problems complying with the excess contribution rules than they do with the 70-1/2 minimum distribution rules. That may change as more IRA accountholders reach the 70-1/2 category.

Further breakdowns are shown below:

B

REPORT OF EXCISE TAXES
FOR FISCAL YEAR 1986 – 1989
(In thousands of dollars)

Source of Revenue	1986	1987	1988	1989
Employee pension plans, total	17,021	291,159	171,213	255,063
Excess contributions to an IRA, 6%	2,905	4,783	7,097	5,709
Tax on underdistributions from an IRA, 50%	461	759	723	771
Employee benefit plans, total*	7,884	261,504	156,507	243,791
Prohibited transactions, 5%	---	---	12,054	10,764
Nondeductible contributions, 10%	---	---	4,731	2,216
*Failure to meet minimum funding standards, 10%***	---	---	58,821	87,847
Excess contributions to custodial accounts, 6%	---	---	8,358	489
Disqualified benefits, 100%	---	---	1	3
Excess fringe benefits	---	---	0	73
Certain ESOP dispositions, 10%	---	---	638	610
Prohibited allocations of ESOP securities, 50%	---	---	169	217
Reversion of qualified plan assets, 15%	---	---	71,494	138,703
Excess contributions to certain plans, 10%	---	---	241	2,870
Penalties, total	5,770	4,114	6,887	4,792

* Expired September 30, 1985 (P.L. 96-510). Reimposed in January 1987 (P.L. 99-499).
** Reflects percentage increase from 5% to 10% effective January 1989.
Note: Detail may not add to totals because of rounding.
*** Less than $500.

C

REPORT OF EXCISE TAXES
FOR FIRST TWO QUARTERS OF FISCAL YEAR 1990
(In thousands of dollars)

	First Quarter		Second Quarter		Combined		
Source of Revenue	1989	1990	1989	1990	1989	1990	Change
Employee pension plans, total	25,481	24,524	50,605	47,132	76,086	71,656	-4,430
Excess contributions to an IRA, 6%	580	439	829	1,146	1,408	1,585	+177
Tax on underdistributions from an IRA, 50%	124	37	51	(126)	175	(90)	-265
Employee benefit plans, total	23,997	22,978	49,053	40,844	73,050	63,822	-9,228
Prohibited transactions, 5%	1,497	1,340	3,554	1,881	5,050	3,221	-,1829
Nondeductible contributions, 10%	447	374	757	395	1,204	769	-435
Failure to meet minimum funding standards, 10%	6,981	10,007	13,061	13,284	20,042	23,290	+3,248
Employee plans, other	511	103	133	15	184	118	-66
Reversion of qualified plan assets, 15% (1-1-89)	14,847	10,960	30,717	24,856	45,563	35,817	-9,746
Excess contributions to certain plans, 10%	175	194	832	413	1,007	607	-400
Penalties, total	780	1,090	673	5,269	1,453	6,339	+4,886

IRAs – Marketable and WORTH Marketing

(This is the first of a continuing series on pension plan marketing, which will become a frequent departmental feature in The Pension Digest.)

Why Market IRAs? . . . what's in it for your institution?

Most financial institutions can benefit from generating additional deposits. Yes, there are exceptions, situations in which additional deposit dollars could not be safely or profitably matched with a borrower. This could be the case where a local or regional economy is in a downturn, and borrowing cannot be easily stimulated.

But most institutions CAN use more deposits.

That's where IRAs come in.

• IRAs can bring in deposits ranging from $2,000 per year for a typical depository account, to $200,000 for a rollover – sometimes more!

• IRAs are long-term investments, assuming you service your customer well, and provide competitive interest rates. Your IRA depositors aren't going to move their money with the same bank-hopping frequency that drives some regular savings account customers to pursue microwaves and stadium blankets from bank to bank. IRA funds are deposits that SHOULD be with you for along time.

• IRAs can mean big dollars, right now. With the rise in workers approaching retirement age – and many taking early retirement – there are LOTS OF DOLLARS in employer pension plans that will be looking for a new home. Yes, there are other investment choices, but not many that combine the virtues of tax shelter and favorable earnings, with little or no risk. These are great candidates for IRA rollovers.

• IRA customers are heavy users of other bank services, including consumer lending, insurance, mortgage, etc. The typical IRA customer is a 4-5 account person. If you can draw them in through an IRA transaction and serve them well, chances are you will get more of their business.

Is there still a viable market? . . . who needs an IRA?

• Very few people today believe they can live comfortably on Social Security income alone. Yet only about 30-35% of the nation's workers have a retirement plan of their own, or where they work. That leaves many more who SHOULD have a plan such as an IRA.

Certainly not all can afford to fund an IRA, or will choose to. But many among this group both can and should.

• Many within the population segment known as the "baby boomers" are entering their 40's, which – statistically – is the prime entry period for IRA customers.

• Others are looking for an uncomplicated, predictable minor tax shelter, if they qualify for IRA contribution deductibility. Even if their contribution is not tax deductible – due to participation in another retirement plan – their account earnings ARE tax-deferred. Once an account has a sizeable balance, tax-deferred earnings can be substantial.

How can the potential customer be motivated? What's your "message"?

Motivating the potential IRA customer does not have to involve "fear-mongering." There are plenty of credible reasons why many SHOULD be apprehensive about having no retirement savings plan.

• If we're to live the kind of lifestyle after retirement that we've grown used to, it's been projected that we will need roughly 85% of the annual salary earned in the last several years of employment. Very few expect Social Security to provide that.

• For many people, as much as 25% of their life will be spent in retirement. If retirement income is inadequate, it can be inadequate for a long time.

• If we begin a retirement savings plan too late in life, it may still not offset the disparity between what Social Security provides, and what we need.

• An IRA DOES PROVIDE TAX BENEFITS for many Americans, depending upon income level, or their participation in an employer's retirement plan. If you perceive this as a "hot button" for some IRA prospects, push it!

Effectively conveying information such as this to your IRA prospects will help you service their genuine retirement planning needs, and help you land new IRA accounts. PD

(Next issue, we'll take a closer look at some of the demographic characteristics of IRA accountholders. Having that information should help you in your pursuit of more IRA customers.)

Audit — *Continued from page 3*

asking whether the plan has terminated and whether a favorable determination letter on the termination has been requested.

We are unsure whether this pilot program covers one person Keoghs or not. We expect that it may cover some one person plans, but that the large majority of plans to be audited would be multiple-participant plans. We also do not think one should conclude that—since the audit is being done in 1990—that the years being audited are only 1989 or 1990.

We again emphasize the rule that a bank update its prototype QP/Keogh customers in a timely fashion, especially those who wish to close out their Keoghs. The rule is: "update, then terminate."

Should a terminated Keogh plan be filed with the Key district for a favorable determination letter?

It is your customer's responsibility to make this decision. For one person plans, the answer is probably still that a filing will not be made since the IRS filing fee is $225.

However, you may wish to advise your non-filing terminating Keogh customers that the IRS may at some point in the future ask for additional information, since a termination filing was not made.

For a multiple-participant plan, the filing should be made. Most bank trustees correctly believe they have significant liability unless there is a favorable determination letter indicating the plan was qualified at the time of termination. PD

✓✓✓✓✓✓✓✓✓✓✓✓✓✓Check It Out

Question: Our bank president wishes to buy tax-exempt bonds with some of his IRA funds. He then wishes to withdraw the interest paid on these bonds, and hopes to pay no income tax on these withdrawals. Will he pay income taxes or not?

✓ He will pay taxes. The general rule is that an IRA distribution is included in income unless it is excluded under a specific statutory rule. There is no exclusion for income which is derived from a tax-exempt investment. Likewise, there is no special capital gains treatment given funds invested in IRAs.

Question: How many rollovers may a person have from a Qualified Plan/Keogh in a 12-month period?

✓ Unlike IRAs, there is no rule which limits you to one rollover from a qualified plan in a 12-month period. However, keep in mind that a rollover from a qualified plan is only permissible if you meet very stringent rules. There must either be a qualified total distribution or a partial distribution. No other distribution from a qualified plan qualifies to be rolled over.

Question: A customer asked if – to maintain full insurance coverage – he needs to move some of his IRA deposits to another bank, since his IRA balance is $25,000 and his Keogh balance is $85,000?

✓ No. The FDIC recently changed its FDIC coverage rules so that the $100,000 limit applies separately to IRAs and Keoghs. This new rule went into effect on July 29, 1990.

Question: Our bank has decided to assess the early withdrawal interest penalty to those IRA accountholders who are simply moving their funds to another custodian prior to the maturity of a time deposit. We have also decided to start imposing a closing fee (no funds remain in the account). What administrative steps will we wish to take?

✓ You must make sure that your IRA plan agreement authorizes the charging of such fees. Most documents will reference you to a schedule of fees. You will need to furnish your existing customers with a schedule of these new fees. With respect to any new customers you will need to furnish them with the fee schedule plus modify your projection schedule so that both of these fees are taken into account in projecting the amounts that would be available at the designated times.

Question: A very good customer wished to make his 1991 contribution today on September 8, 1990. Can he do this?

✓ No. A person who pre-funds their IRA will be making an excess contribution, and all of the related rules apply. A custodian or trustee who knowingly allows a customer to pre-fund his IRA may well share in whatever tax penalties may be assessed. 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.

A Novel Tax Exemption Argument Which Did Not Work

Taxpayers are always trying to devise legal arguments to reduce the amount of taxes that must be paid. IRA accountholders are no exception. (See also the Check It Out question in which the bank president thought he could withdraw tax exempt interest payments tax free from his IRA.)

A taxpayer recently came up with a "new" argument for nontaxation, in private letter ruling 9031046. The taxpayer was a surviving spouse who had rolled over (to an IRA) funds originally accumulated by the decedent in a section 403(b) annuity. The decedent had died in 1988.

In 1989, the surviving spouse requested a ruling from the IRS that Internal Revenue Code section 1014(a) applied and therefore, the spouse had a step-up in basis as of the date of death. A ruling was requested to allow the taxpayer to withdraw without taxation this "basis amount" plus related earnings. The customer apparently wanted to undo the rollover.

The IRS rejected the argument for the following reasons.

Section 1014(a) does provide a step-up in basis for certain property. However, section 1014(c) indicates that this special treatment will not be given to property which constitutes a right to receive an item of income with respect to a decedent under section 691. The IRS found this 403(b) money to be income with respect to the decedent. In addition, the IRS found Code section 408(d)(1) to apply. This section provides that any amount paid or distributed out of an IRA shall be included in the gross income of the payee or distributee as provided in section 72, unless one of the special exceptions applies. None of those special exceptions apply to this situation. Thus, the spouse beneficiary will be taxed once the funds are distributed. PD