THE Pension Digest

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# Prohibited Transaction Update

Collin W. Fritz and Associates' consultants and seminar instructors often serve as a barometer for possible problem areas in the pension industry. Whether the purchase of bank stock by a bank employee for a self-directed IRA is a prohibited transaction has been a topic of many recent questions. For an in-depth treatment of this question we refer you to the December 1989 issue of The Pension Digest. However, we have continued to receive questions and have seen enough new developments on the issue to merit further review here.

Generally, the owner of a self-directed IRA is a fiduciary to that IRA. This means that when investments are made, as directed by the accountholder, a certain duty is owed to the IRA by its owner in determining those investments. Fiduciary duty involves a "prudent man" standard, one that has evolved in courts of law over the years to mean that investments must be made "with care, skill, prudence and diligence under similar circumstances that a prudent man acting in a like capacity and familiar with such matters would use in conducting an enterprise of like character and with like aims." In plain English that means that investments must be made carefully, providing enough diversification of plan assets and monitoring investments to assure a reasonable rate of return. This duty is owed even though it is their own personal IRA.

Certain transactions fall short of this standard, and are therefore prohibited. Additionally, transactions with certain persons, deemed to be disqualified persons, are also prohibited. These persons and transactions are defined by Internal Revenue Code Section 4975 and the Employee Retirement Income Security Act (ERISA), but enforcement is left to the Department of Labor. The DOL has provided a procedure wherein they will review a situation and issue a letter determining whether a transaction is prohibited. This, however, is a lengthy process, and the wiser choice is to try to avoid the situation in the first place.

The situation we have seen most often is one in which a bank officer or employee with a self-directed plan wishes to buy stock in the bank where the plan is held. This specifically includes subsidiary banks holding a plan where the stock purchase desired is from the parent bank or holding company. In previous rulings, the DOL has said that a parent corporation is <u>not</u> a disqualified person in regard to IRAs established by a subsidiary bank "...solely by reason of its ownership of the bank." This statement is the application of the focus of the tax and labor body of the law. It provides some reassurance as well as the argument that the situation described <u>may</u> not be prohibited.

However, the DOL must also apply the traditional focus of the trust laws and civil enforcement of fiduciary responsibility, and this is done by a careful scrutiny of each situation, fact by fact. In its prior letter rulings, the DOL has stated that even without the disqualified person status, there may be questions as to the degree of involvement that the bank and its officers had in the transaction. DOL in fact stated that this sort of transaction by officers and directors of the bank is <u>likely</u> to be prohibited.

To determine prohibition the DOL would question the degree of personal interest that the officers and directors as IRA participants would have in the proposed transaction, which may affect their best judgment as fiduciaries to their IRA. It is easy to imagine the circumstances that might put a bank officer and IRA accountholder on different sides of an issue. When that is the same person, there is a clear conflict of interest. What is best for the IRA may not be the best for the bank, and the

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**Update** —*Continued from page 1*
conflict of interest is resolved by the DOL in favor of fiduciary duty to the IRA.

In a recent letter (June 1990) the wholly owned subsidiary bank had IRS approval to offer its self-directed IRA to the general public, to its employees, and the employees of the parent company. Neither the parent nor the subsidiary was to offer investment advice or recommendations. The bank had asked for an opinion on whether the bank and parent company employees' ownership of parent company stock through the self-directed IRA was a prohibited transaction.

The DOL raised the question of personal interest that had been predicted in the earlier letter.

The analysis stated that the subsidiary, though not an employer, is a disqualified person. Under that set of facts, the subsidiary—though it did not select investments—may be relied upon by the participant (as a fiduciary) to <u>select the seller</u> of the investments. As a wholly owned subsidiary, it would have an interest in the fortunes of the parent company (bank), which could influence its decision making.

Once again it was found that the party which was to make the fiduciary decisions for the IRA and the party being relied upon to make stock purchase decisions (here, the seller of the stock) could be the same individual. This degree of personal interest is the key factor in the DOL decision that employees of the wholly owned subsidiary and the parent company are disqualified persons. This sort of purchase is a prohibited transaction. The DOL again made its ruling in favor of the fiduciary capacity that the individual holds to the self-directed IRA.

What we are seeing here is the DOL taking an ever broader view of what is prohibited, even while repeating that the parent company is not a disqualified person by reason of its ownership alone. What we stress is that each situation is dependent upon its particular facts, and vitally important due to the harsh result of having IRA status removed and penalties levied. To prevent a prohibited transaction, the conservative approach in a questionable situation is to involve legal counsel in any decision before going forward. PD

# Marketing
## Pension Products and Services

# *Marketing That <u>ANY</u> Institution Can Do*

Virtually ANY bank can do a better job of marketing IRAs.

While having a substantial budget for IRA promotion is certainly helpful, those without this luxury need not be stymied for promotional opportunities.

***"Contact" Marketing,***

In-Bank . . .

♦ Make IRA/pension services a VISIBLE department or sub-department within your bank. Use prominent signage within the bank to make pass-through traffic EASILY AWARE OF THIS EMPHASIS.

♦ Have a person or persons with TITLED IRA <u>responsibility</u>, even if they perform other functions in the institution. Having someone referred to as an "IRA specialist" or "IRA counselor" makes IRAs sound pretty important—which they are—and presents these individual(s) as particularly qualified.

♦ Appoint, and—when successful—reward an individual or group who have as part of their professional responsibilities the conception, proposing and implementation of new or better methods of promotion IRAs. But be equally ready to recognize or reward input from other departments. Sometimes the best ideas come from the most unexpected places.

♦ Your staff need to be shown—and to believe—that IRAs are important. (If bank staff—or leadership—doesn't believe this, it is bound to hurt IRA marketing efforts.)

♦ Place simple-yet-visible reminder and point-of-purchase promotional materials—posters, banners, desk stand-ups or "tents" that refer to IRAs—in high traffic, waiting, or even office areas. Place them anywhere that high "people numbers" will be present, or where any customer or visitor can be expected to spend a substantial period of time.

♦ Create an incentive for tellers and other staff to generate IRA referrals. Whether this reward for <u>converted</u> referrals is monetary compensation, an extra vacation day, perhaps a premium such as those your bank may already be offering other new accounts . . . whatever it is, give staff an incentive to mention and thoughtfully promote IRAs.

♦ IRA hand-outs/stuffers . . . when a customer completes a transaction, slip them a simple IRA promotional piece, either prepared by and purchased from a banking or pension supplier, or created with the cooperation of your printing vendor or advertising/marketing agency. Do this, of course, within reasonable bounds of likely prospecting; no 18-year-olds or other demographically weak prospects, please.

♦ Seminars . . . sponsor and hold informational seminars for customers and noncustomers alike, on the subject of IRAs. Presenters can either be staff members, or IRA/pension plan specialists. The latter approach will of course have a cost attached to it, but will probably draw a larger audience if promoted even minimally well. While this is an education rather than a "selling" function, it <u>will eventually have sales consequences</u> if you've exposed the right people to this information.

USE YOUR DATABASE . . . identify as best you can those existing customers who do not have an IRA, but who match some or all of the key IRA customer profile items. <u>An existing customer is your best prospect</u> for virtually any type of product or service sale.

♦ Market to them by mail and/or phone.

More on that next time . . . PD

# Reporting IRA Distributions . . .

## Use of Reason Codes "8" and "P"

IRA custodians and trustees (or their service bureaus) are in the final stages of preparing to furnish their IRA accountholders with the proper reporting form for reportable distributions in 1990.

For those IRA accountholders who had a reportable distribution(s) resulting in the IRA being closed at the end of the year, you are to complete a 1990 Form 1099-R. You are to furnish a Form W-2P for any distribution(s) which did not result in the IRA being closed. You must furnish these forms to the accountholder no later than January 31, 1991.

This article will address two subjects. The first **(A)** is to clarify when Reason Code P is used on the 1990 Forms W-2P or 1099-R, and when Reason Code 8 is used. (The other reason codes are not discussed in this article. They were addressed in the January and March 1990 issues of The Pension Digest.)

The second topic **(B)** is an expanded discussion of the types of transactions which result in having to use Code 8 or P. These transactions are withdrawals of current year contributions, and excess contributions. We will not argue with anyone that this is a very complex subject.

To administer the distribution (withdrawal) of these contributions properly, the IRA custodian must determine the date of both the contribution and the distribution.

Citing from the IRS instructions for the 1990 Form 1099-R:

**Reason Code P—Excess contributions plus earnings/excess deferrals taxable in 1989.** See the explanation for Code 8. IRS suggests that anyone using Code P for the refund of an IRA contribution under section 408(d)(4) advise payees, at the time the distribution is made, that the earnings are taxable in the year in which the contribution was made.

**Reason Code 8—Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in 1990.** Use Code 8 for an IRA distribution under section 408(d)(4), unless Code P applies. Also use this code for corrective distributions of excess deferrals, excess contributions, and excess aggregate contributions, unless Code P or D applies. For information about reporting corrective distributions, see Notice 89-32, 1989-1 C.B. 671, Notice 88-33, 1988-1 C.B. 513, and Notice 87-77, 1987-2 C.B. 385.

### *(A) Use of Reason Code P ("Prior Year")*

The 1990 Forms W-2P and 1099-R will use a reason Code P for any contribution made in 1989 if it was designated for 1989 (not 1988) and was withdrawn during the period of 1-1-90 to 4-15-90 plus extensions, if any.

### *Use of Reason Code 8*

The 1990 Forms W-2P and 1099-R will use a reason Code 8 for any one of three situations. First, it is to be used if an accountholder made a contribution in 1990 for 1990, and withdraws it in 1990. Second, it is used if an accountholder made a contribution in 1990 for 1989 and withdrew it before 4-15-90, plus extensions. Third, it is used when an accountholder made an excess contribution in an earlier year (1989, 1988, 1987, etc.) and now withdraws it in 1990. (If the 1990 withdrawal of a 1989 excess contribution took place between 1-1-90 and 4-15-90, then the reason code to be used would be a "P".)

*"We will not argue with anyone that this is a very complex subject."*

### *(B) Discussion:*

Reason Code P is used when a customer makes a current year contribution in the same calendar year, and withdraws it in the next calendar year, but on or before April 15 of that year.

Code P appearing on the 1990 Forms tells the IRS that the amount distributed may be taxable on the accountholder's 1989 return (P for "prior year").

### *Current Year Contributions*

For 1990, a current year contribution is any contribution made from 1-1-90 to 4-15-91, if made for 1990. It includes all contributions, whether excess contributions or otherwise. (An excess contribution is an impermissible contribution, whatever the reason.)

Any contribution made during the current year may be withdrawn as long as the three applicable rules are met (withdrawn by 4-15-91 plus extensions, if any; no deduction allowed; and the related income withdrawn).

### *A Taxing Exception*

A special rule in the Internal Revenue Code states that the income related to this current year contribution will be taxed in the year in which the contribution was made (e.g. 1990) even though the distribution takes place in 1991. This is an exception to the general rule that the customer is taxed in the year in which they receive an IRA distribution.

### *Several Situations*

For example, an IRA accountholder who makes a contribution on 8-5-90, but who withdraws it on 3-15-91 has withdrawn a current year contribution. For referencing purposes, this is Situation #1.

How and when do you as the IRA custodian report it? How and when does the accountholder report it on his or her tax return?

The custodian will report it for the year the distribution takes place. Thus, you will generate a 1991 Form W-2P or 1099-R and use a reason Code P. The P tells the IRS that the income is taxable for 1990 and should have been reported on the customer's 1990 tax return.

Since the income is taxable to the customer on his or her 1990 return, the IRS instructions strongly suggest to the IRA custodian that they tell the customer that the income is to be included on their 1990 return. This is the reason many consulting firms such as Collin W. Fritz and Associates, Ltd. have designed a special disclosure form (Form #67 Special Explanation

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# ✓✓✓✓✓✓✓✓✓✓✓✓✓✓Check It Out

**Question: Our accountholder has not taken his Required Minimum Distribution (RMD) for 1988, although one was taken for 1989 and one will be for 1990. Is there a penalty to the bank and/or the customer? What is your recommendation to correct the situation?**

✓ Our first recommendation would be for you and your customer to correct the account as soon as possible, and definitely before December 31, 1990. The IRS considers this an excess accumulation (under-distribution). It must be reported with the customer's tax return, for each year that the excess accumulation has occurred. It is reported on IRS Form 5329, Part III. While the form is somewhat confusing, the excess accumulation needs to be reported as the "Minimum Required Distribution" on line 12. The "Amount Actually Distributed," line 13, in this case will be zero. (If an amount was distributed, but not enough to cover the RMD, the actual amount distributed would go in line 13.) Line 14 is the difference between lines 12 and 13, while line 15 is the penalty tax amount of 50% of line 14. For each year that this excess accumulation is left uncorrected, the taxpayer, your customer, needs to amend their tax return and file Form 5329. There are no specific IRS penalties as such to the bank, but the IRS does not address possible legal responsibilities to the bank's customer.

**Question: Our customer turned 70-1/2 in 1985. They made their timely election and RMDs were started timely. However, they did not re-elect in 1987 when the distribution laws changed. What method of figuring RMDs should we be using?**

✓ Starting in 1987, RMDs are to be figured using the ages as of December 31, 1987, of the accountholder and beneficiary (where applicable). If the re-election had been made by December 31, 1987, the recalculation or one year reduction method would be used, using the UNISEX life expectancy tables made effective for 1987 and later calculations. If, however, no re-election was made, the recalculation method will be used because the IRS has stated that if the accountholder doesn't choose not to recalculate, the custodian/trustee MUST recalculate. Single life or joint life expectancy would be continued as previously elected.

**Question: Our accountholder wants to dissolve a Keogh and roll over the money into an IRA. What do I need to know to do that?**

✓ In this case and in the case of 401(a) plans other than Keoghs, you should first see the plan document or 402(f) notice. The plan must be qualified and properly amended before it can be terminated. Also, this information will be useful to determine whether the distribution is one that can be accepted for rollover. Remember, it must be either a total distribution (including lump sums) or a partial distribution received for reasons of the employee's death, disability or separation from service. Second, and probably most important, you should advise your client to see his/her tax attorney or advisor. Keoghs and qualified plans are eligible for 5 and 10-year averaging while IRAs are not. It may be that maintaining the Keogh or qualified plan, or using a conduit rollover, will be of far greater tax shelter value than a simple IRA.

**Question: Can our accountholder transfer an IRA to a living trust?**

✓ Answer: "No," is the simple answer to the question. Many attorneys and tax advisors are recommending to their clients that they establish a revocable living trust and that they transfer the ownership of most, if not all, of their assets to the revocable trust. Normally the trustee of the revocable trust is the person establishing the trust. The Internal Revenue code requires that an IRA have as its trustee/custodian a bank or similar regulated entity. This is the reason an IRA cannot be owned by the revocable trust.

However, the IRA can name the revocable trust as the IRA beneficiary so that after the accountholder's death, the terms of the revocable trust will indicate to whom the fund will be paid. When a revocable living trust is named as the beneficiary, then for purposes of the required minimum distributions calculation, the life expectancy factor must be based on the single life of the accountholder and not on joint lives.

If in fact a revocable living trust is made the owner of an IRA account, then this will be seen as an "assignment," taking it out of IRA status and making it taxable. You might refer your accountholder to Articles II and IX of Form 5305-A, as well as the disclosure statement.

*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.*

**Codes 8 & P**—*Continued from page 3*

Regarding the Withdrawal of a 1990 Current Year Contribution).

The IRA accountholder would need to include the distributed amount on his or her 1990 Form 1040.

### *Some General Code 8 Guidelines*

Reason code 8 is to be used when an accountholder makes a current year contribution during the carryback period (in 1991 for 1990) and withdraws it in the same year (1991). For referencing purposes, this is Situation #2.

It is also used when a person makes a current year contribution during the regular period (in 1991 for 1991) and withdraws it in the same year (1991). For referencing purposes, this is Situation #3.

Code 8 is also used when a person has made a true excess contribution in a year prior to the "then-current" tax year, and then withdraws it during the current tax year. Note that the accountholder is not required to withdraw the related income for an excess contribution withdrawn after the due date for the tax year of the original contribution. For referencing purposes, this is Situation #4.

There is one final observation. With respect to IRAs, the IRS instructions for Forms W-2P and 1099-R state that the amounts in respective boxes 9 or 1 (gross distribution) and boxes 10 or 2 (taxable amount) will be the same except when the reason code is a P or an 8.

When the reason code is P or 8, then the IRA custodian is to report the gross amount in box 9 or 1 respectively, and only the related income in box 10 or 2. Note that there will be income in situations #1, #2 and #3 as set forth above, but there is no income in situation #4.