The Pension Digest

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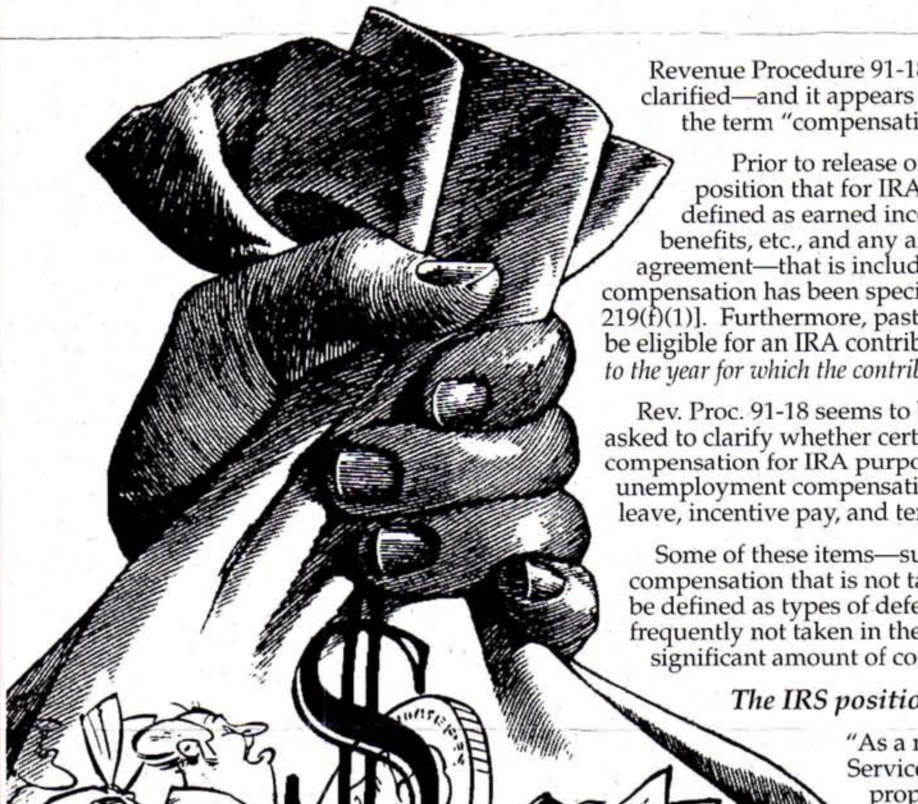
IRS Rev. Proc 91-18 Clarifies, Expands Compensation Definition for IRA Contributions



Revenue Procedure 91-18 issued by the IRS in March of this year clarified—and it appears broadened—the Service's interpretation of the term "compensation" for IRA contribution purposes.

Prior to release of Rev. Proc. 91-18, the IRS had taken the position that for IRA contribution purposes, compensation is defined as earned income—whether in salary, wages, fringe benefits, etc., and any amount issuing from a divorce or separation agreement—that is includable in one's gross income. Deferred compensation has been specifically excluded [IRS Code section 219(f)(1)]. Furthermore, past IRS interpretations have made clear that to be eligible for an IRA contribution, compensation was to be *attributable to the year for which the contribution is being made.*

Rev. Proc. 91-18 seems to be modifying this stance. The IRS was asked to clarify whether certain kinds of compensation can be used as compensation for IRA purposes. These included disability pay, unemployment compensation, accrued annual leave (vacation), sick leave, incentive pay, and termination pay.

Some of these items—such as vacation or sick leave pay—are compensation that is not taxable until paid out. In a sense they could be defined as types of deferred compensation, since they are frequently not taken in the year earned. In the past this has created a significant amount of confusion.

The IRS position as stated in Rev. Proc. 91-18 is that:

"As a matter of administrative convenience, the Service will treat as a 'safe harbor' the amount properly shown in box 10 (Wages, tips, other compensation) less any amount properly shown in box 14 (nonqualified plans) on Form W-2, Wage and Tax Statement for 1990."

Thus disability pay, unemployment compensation, accrued annual leave (vacation), sick leave, incentive pay and termination pay, can apparently be included for purposes of calculating an IRA contribution, since they are includable in box 10 of Form W-2 when received and reported as part of an individual's gross income calculation for that year. PD

Also In This Issue — How to Advise Desert Storm Participants on Their IRA Contribution Extension • IRS to Issue Letters on Defined and Target Benefit Plans • Contribution Information Due to IRS, Customers by May 31 • Pension Digest Comprehensive Index Now Available • Marketing—Newsletters Revisited • IRS Amends Proposed and Temporary Regulations on Highly Compensated Employees, "Separate Lines of Business" • Super IRA, Gramm-Rudmann Sponsor Comments• ✓ Check It Out

How to Advise Desert Storm Participants on Their IRA Contribution Extension

As has been widely publicized, Operation Desert Storm participants have been given extensions for filing their 1990 tax returns. This also applies to making IRA contributions. Bank personnel should be prepared to provide customers with the following information if requested.

Desert Storm participants have been given extended contribution deadlines that match the extensions given them for filing their 1990 tax returns. These extensions are as follows:

1) Taxpayers assigned to the designated campaign area between August 2, 1990 and January 1, 1991 have until 285 days after they left the combat zone to make such contributions.

2) Those posted to the combat zone after January 1, 1991 are given a formula by which to compute their extension. They are to:

> total the number of days between the date they entered the combat zone and April 15, and add 180 to this number. This is the number of days extension they will receive.

The IRS notes that taxpayers using this extension should write the words "Desert Storm" at the top of their return. PD

IRS to Issue Letters on Defined and Target Benefit Plans

On April 15th, 1991, the IRS began its previously announced program of issuing opinion, notification and advisory letters approving master and prototype, regional prototype, and volume submitter defined benefit and target benefit plans.

In approving these plans, the IRS will take into consideration the revised plan requirements brought about by the Tax Reform Act of 1986 (TRA 86), and legislation since that time, but prior to (not including) the Omnibus Budget Reconciliation Act of 1990. PD

Contribution Information Due to IRS, Customers by May 31

One of the important IRA reporting requirements that financial institutions must meet is to provide account contribution information by May 31st, for account activity in and for the preceding year. This is to be provided to the IRS via Form 5498, and to the customer as well.

If no contributions were made in 1990 or thru April 15, 1991 for 1990, then no report need be made to the customer. This is unlike fair market value reporting which institutions completed prior to January 31, which is required for *any* open account, regardless of whether contributions took place for that reporting year.

Most Banks Use Form 5498

The easiest way to fulfill the bank's contribution reporting responsibility to its customers is to send them a copy of the 5498 sent to the IRS. This is not mandatory however, and a substitute form could be used. If so, however, the following message must appear on the substitute: *"This information is furnished to the Internal Revenue Service."* The substitute form must also contain the instructions that appear on the back of the IRS 5498 form.

Late Filing Penalties

As we explained in depth in the January, 1991 Pension Digest, penalties for failure to file with the IRS or report to customers the 5498 contribution information, carry a $50 per failure penalty, unless such due to reasonable cause. There is no cap or maximum aggregate penalty amount.

"Other Enclosures"

While very limiting restrictions apply to the mailing of a number of other forms to customers, for the 5498 the IRS more liberally allows financial institutions to "... combine the statements with other reports or financial or commercial notices, or expand them to include other information of interest to the recipient." PD

Pension Digest Comprehensive Index Now Available

Past issues of The Pension Digest are valuable both for their still-valid treatments of many pension subjects, and also for the perspective they provide on developments and changes in pension plan regulations through the years. Many subscribers who maintain a Pension Digest file have requested a comprehensive index to help in referencing past subjects.

A complete index of articles appearing in back issues (cross-referenced by subject) is now available, dating from December, 1990 back to 1985. For your copy, send $5.00 to cover duplication and handling to:

Pension Digest Index
Collin W. Fritz & Associates
P.O. Box 426
Brainerd, MN 56401 PD

Marketing
Pension Products and Services

Newsletters Revisited

In the December, 1990 Pension Digest discussion of direct marketing, we very briefly touched on the topic of retirement plan newsletters as a means to serve customers, and to increase your pension business. It's a topic that deserves full treatment all by itself.

In-Depth Communication

When a subject is deep and complicated . . . when the benefits you're trying to convey seem intangible and far away, good communication becomes critical. That's certainly the case for retirement plans. Putting off the cares and responsibilities of tomorrow is—unfortunately—a very human trait. If it's a choice between making a $2,000 IRA deposit or a down payment on a new car, guess which will usually win?

Retirement is somewhere over the horizon for the majority of the population. But that new car is just around the corner, often championed by some of the world's best practitioners of the sales profession.

To promote retirement plans to those who need them takes ongoing communication, a repetition of the very different realities facing those who plan for retirement, and those who don't.

One of the best tools for this is a newsletter, using that word a bit loosely. Why loosely? Because each institution is slightly different in size, promotional budget and customer expectations. One bank may feel the need to do a four-page, three-color "designed-to-the nines" format to match a high profile image and promotional style. Another institution may be able to use a fact-sheet that's as simple as two sides of a standard 8-1/2 x 11 sheet of paper, with word-processor generated copy rather than typographer or MAC-generated type.

The key is to match your retirement plan message to your overall communications style, and convey the *right* messages, to the right people.

Here are some retirement plan newsletter do's and don'ts:

• Designate one person to be in charge. Certainly you can have a number of staff members contribute. But clearly define where the buck stops.

• Break down your customer/prospect information needs. This will shape the information you try to convey in your newsletter:

– existing plan accountholders; who might be encouraged to contribute more; who can be educated about enhanced earning opportunities such as self-directed IRAs; who needs to be informed about important elections, penalties, distribution needs, etc. IRAs will probably be your major focus, but don't forget about customers with business plans such as a SEP, 401(k) or Keogh.

– current bank customers without retirement plans; this group needs to better understand the basic reasons and methods for starting a retirement program.

– current non-users with *business plan* potential. Using examples of satisfied small business plan users from within your customer base may be a great motivator if you can get permission.

– targeted non-bank customers; these are people who—whether individuals or business prospects—you would like to have as customers of your bank. (Of course these people should be receiving copies not only of pension communications, but other sales material as well.)

Canned . . . or Compiled?

A convenient, often cost-effective option is to use a retirement services firm to produce your newsletter. Such newsletters are usually mostly generic, but can be personalized with your bank's logo or identifiers. You can often choose between completely "stock" subject matter, or part stock/part custom, with material supplied by you. This option is at additional cost, of course.

It's a no muss, no fuss way to produce a pension newsletter, **but the canned newsletter also has its limitations.**

• it's most economical when purchased in large quantities

• it can seem over-designed for some institutions that keep a lower promotional profile

• there's a significant loss of control of content when you buy a canned version. This approach limits the degree to which you can tailor newsletter information to your particular customer base needs

• clearly, however, using a canned retirement plan newsletter is better than none at all.

Obtaining Materials for "Your Own" Publication

If you create your own retirement plan newsletter, your biggest obstacle will be gathering information. There are several possibilities, including:

• for certain subjects, adapting information from a banker's publication like this one

• gathering information from periodicals, including newspapers, news magazines, publications targeted to senior citizens, or (at times) to the accounting and insurance professions, government and consumer publications. Many sources are non-copyrighted. Others may be usable with credit attribution.

• using the accumulated knowledge of your institution's pension staff. If the most experienced are not the most talented writers, assign one who *is* to the post of "editor." Provide some added incentive for staff participation in this important venture.

Methods of Printing

If you produce your own newsletter, your local printer is your best resource. Some newspapers also double as job printing shops and can do it as well. Be sure to shop around, and ask to see examples of other jobs like the one you envision.

Consider the one-time expense of having a talented graphic designer create a format for your newsletter, including front-page nameplate or banner, and perhaps page borders for the rest of the publication. This will enhance any newsletter, whether it's typeset by a printer, or outputted from a word processor.

If your newsletter printing job is *really* simple, and quantities low, you could reproduce it yourself on your own duplication equipment. But remember that this—like any other promotional venture—either enhances or detracts from your overall image.

Distribution

Distribution can be in-lobby, stuffed in statements, via blanket mailings, or target mailed to specific identified prospects—both existing customers and selected non-customers.

Certainly such a publication should be available on-premises. If you have a general bank newsletter, it could be included as a supplement to that (and should therefore be designed from the beginning to work that way).

If your accountholder information is stored in a computer database—with the proper demographic and account information fields—you should be able to do some sorting and selectively mail to those who are logical prospects for retirement plan products.

No doubt about it, there will be lots of details for you to work out. But none should deter you from making retirement plan—retirement *need—communications a priority for your financial institution.* PD

IRS Amends Proposed and Temporary Regulations on Highly Compensated Employees, "Separate Lines of Business"

Highly Compensated Employees–

The term "highly compensated employee" is used in several IRS Code sections that relate to qualified retirement plans, qualified cash or deferred arrangements, and other employee benefit plans, in order to determine whether or not these plans unlawfully discriminate in favor of highly compensated employees. New Code sections 414(q) and 414(q)-1T give guidance in making such determinations.

Under the amended proposed regulations, categories of highly compensated employees will include:

1) officers in a firm receiving compensation above a certain threshold level for that firm.

2) employees who (a) receive more than $50,000 annually, and (b) are among the top 20% in compensation of that firm's employees.

In arriving at a fair representation of point two, certain employees are excluded. These include employees who:

- have less than six (6) months service accrued
- work less than 17-1/2 hours per week
- work less than six (6) months during the year
- have not attained age 21
- are covered under a collective bargaining agreement
- are nonresident aliens with no U.S.–derived income from their employer

Qualified Separate Lines of Business–

This factor is important when an employer's minimum coverage and minimum participation requirements for an employer-sponsored qualified retirement plan are being judged. If "separate lines of business" under that employer's ownership can be verified to the IRS' satisfaction, that employer can typically reduce the number of qualifying plan participants, and therefore reduce liability for plan contributions on their behalf.

The amended proposed regulations provide:

1) a qualified separate line of business must employ at least 50 persons on each day of the year.

As with the highly compensated, certain employees are also excluded for "separate lines. . ." determinations. These include:

In making these exclusions, length-of-service or age requirements must not be lower than those outlined above under points one through four of amended regulations on highly compensated employees.

2) collectively-bargained employees are not excluded when calculating the 50-employee threshold.

3) the time period for determining who is or is not excluded for purposes of calculating the 50-employee requirement is *the testing year* (as specified under regulations section 441(r), *not the determination year* or *look-back year.*

Effective Date

These revised regulations are effective for plan years beginning on or after January 1, 1987. However, only those plan years beginning after January 1, 1991 *must* comply with these revised temporary regulations. Plan years beginning before January 1, 1991 will comply if they meet *either* these new regulations, or the prior regulations that these revisions have replaced.

✔✔Check It Out

Question: Can I make my regular 1990 IRA contribution after the April 15, 1991 filing date? I have properly extended my tax return.

✔ Answer: No! All regular IRA contributions for the past tax year must be deposited into an IRA by the due date of your personal tax return, <u>not including extensions</u>. (See article on Desert Storm exception, page two.)

Question: Can I make a 1990 SEP contribution to my IRA after the due date of my personal tax return?

✔ Answer: Yes! SEP contributions can be made for the 1990 tax year as long as your personal tax return has been properly extended (*and* if other than a self-employed individual, the business tax return must also be properly extended).

Question: I made my 1990 IRA contribution in 1990. After doing my tax return, I find out now I cannot deduct it. It is now after April 15 and I have not yet removed it from my IRA. Can I now withdraw it without having to apply the normal IRA pro rata distribution rules?

✔ Answer: No. Once April 15th passes, the normal IRA pro rata distribution rule must be used. This is a confusing subject, and even many accountants are confused. A non-deductible contribution is not necessarily an excess contribution. Before April 15th (plus extensions) <u>any</u> contribution may be withdrawn without having to apply the pro rata tax distribution rules. After April 15th only excess contributions may be withdrawn without having to apply these pro rata tax rules. For Form 1099-R purposes, the withdrawal of a nondeductible contribution after April 15th should be coded a 1 (premature, no known exception) or a 7 (normal) and not an S or a P.

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.

Super IRA

Gramm–Rudman Sponsor Comments

Senator Warren B. Rudman, vocal advocate and (with Phil Gramm) co-author of the bill requiring a balanced Federal budget, recently urged that the widely talked about new Super IRA be funded by spending cuts, not tax increases. The Super IRA would allow penalty-free early withdrawals from IRAs for first-time home buyers, and for educational and medical expenses.

Rudman asked Super IRA chief sponsors Lloyd Bentsen and William Roth to concentrate on refining their cost estimates of the tax consequences of the bill. The legislative Joint Committee on Taxation and the U.S. Treasury Department are also preparing estimates. Some Congressional sources are speculating that the bill could reduce Federal tax revenues an average of $4 billion per year over a five-year period.

The Pension Digest EXTRA

A supplement to your monthly pension newsletter.

Certain "Tiered Matching" 401(k) Prototypes Must Be Amended

On April 5, 1991, the IRS mailed a letter to all sponsors of 401(k) prototypes. The purpose of the IRS' letter was to inform certain prototype sponsors that they must submit "amended" prototypes. Why?

The IRS had issued favorable opinion letters on various standardized 401(k) prototypes which contained a "tiered matching" formula. These standardized plans may allow an adopting employer to select options in the adoption agreement that provide for increasing matches.

A Deferral Incentive

The purpose of such a formula is to induce nonhighly compensated employees to make larger deferrals. For example, if the employee defers 1% of the compensation, then the employer typically will contribute 1%. But if the employee defers 2% of compensation, then the employer might choose to contribute 3% of compensation. If the employee defers 3%, the employer might contribute 6% of compensation, and so on.

An IRS Reversal

The IRS has now decided that this type of tiered formula has the potential to favor highly compensated employees. Such potential for discrimination violates the concept of a standardized prototype, which by its terms must not have the potential of allowing any discrimination which is not authorized by existing law.

Since the tiered formula might result in impermissible discrimination, any standardized prototypes containing such a provision must be changed to delete it. **Such tiered formulas would still be permissible in nonstandardized prototypes, however.**

The deadline for such amendments is April 4, 1992.

The IRS has sent the letter to all sponsors of 401(k) prototypes because the Service does not have the financial resources to review all of the 401(k) prototypes for which they have previously issued favorable opinion letters.

The IRS is therefore placing the burden of determining whether your 401(k) prototype needs to be amended, on your institution and your mass submitter.

Step one is to determine if you need to amend your prototype.

Be sure to consult with your mass submitter or legal advisor if you have any questions about whether your plan contains an increasing tiered formula.

If you use the standardized 401(k) prototype of Collin W. Fritz and Associates, Ltd., you will *not* need to amend your 401(k) prototype. CWF's prototype does contain a tiered formula (see paragraphs (D)(1)(b)(2) and (E)(1)(b)(2)), but it only allows decreasing rather than increasing contribution matching.

If you must amend your prototype, you will presumably have to again pay the IRS filing fee of $100 per adoption agreement.

The effective date of any such amendment shall be the first day of the first plan year within the period from April 5, 1991 to April 4, 1992. For example, a plan with a January 1st to December 31st plan year would have an effective date of January 1, 1992. Just as a bank would need to amend such a prototype, an employer/customer would be required to amend its plan within this same period. PD