THE Pension Digest

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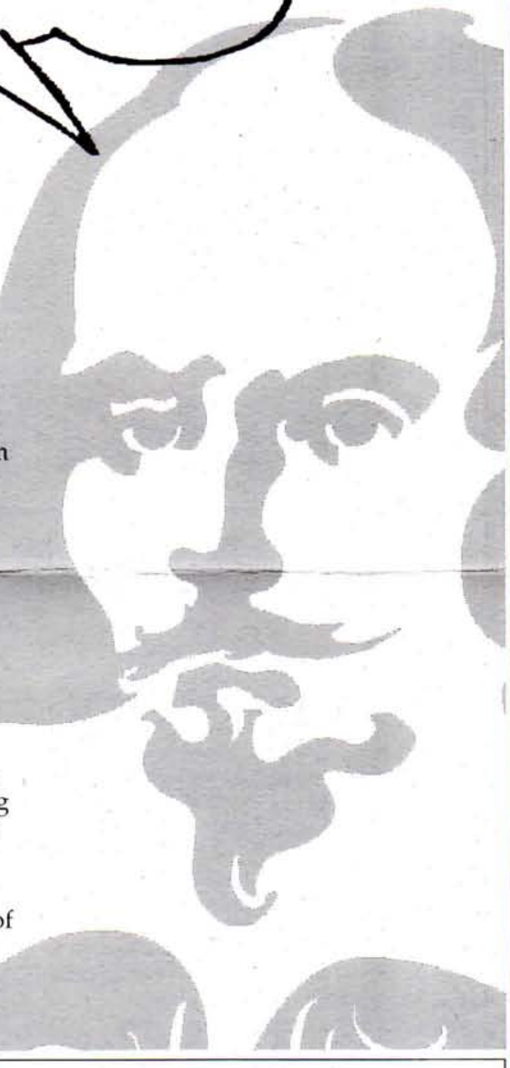
To Fee . . . or Not to Fee, Will Be Key IRA Question



The subject of IRA administration and handling fees is of growing concern to financial institution decision makers. IRA accounts are among the more labor and technology-intensive products offered by these institutions. For that reason many are considering implementing fees, or adding additional fees, to enhance the profitability of these accounts.

But there are some very specific, very compliance-sensitive considerations in charging fees, which banks must observe if they are to avoid potential IRS penalties. Of equal concern to these institutions should be maintaining the best possible customer relations, through full and complete disclosure of any and all fees and/or restrictions on IRAs opened by their customers.

Reserving the Right to Charge Fees

Whether or not financial institutions currently do charge fees, or may someday consider doing so, this privilege must be reserved when an IRA plan agreement is executed. Otherwise, fees may not be implemented at a later date without amending the plan and obtaining customer consent to the changes.

Reserving this privilege to charge fees is accomplished via Article IX language in the IRA plan agreement. Among possible fees are set-up, annual administration fees, termination fees, transfer fees, and others. Although the Article IX language is a general statement describing the institution's right to charge fees, if charged they should be specified in a separate schedule attachment.

Financial Projections & The Impact of Fees

When a customer opens an IRA, the custodian institution must make a reasonable projection of the earnings that the IRA may be expected to generate over time. If fees are charged, these must be included in the projection given to the customer. This may be a manual process, or calculated by software, such as CWF's DISCLOSE projection software.

But what happens if no fees are currently charged when the account is opened, and are instituted at a later date, having been reserved or authorized by appropriate Article IX language? Although it may impact customer relations if not handled carefully, financial institutions do have the right to install fees, without revising the no-fees projection made previously.

By including the appropriate language in Article IX, the bank has alerted the customer to the possibility of fees at the outset, and is therefore within its rights. Initiating such new fees is certainly a delicate customer

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relations matter, and an action that needs to be handled with proactive communication and explanation.

Banks that do not take these steps carefully may find some IRA customers reacting negatively and looking for another custodian.

If customers can be shown that IRA fees are on the same footing as other financial product/service fees, the negative impact may be lessened. But certainly, moving from a no-fee to a fee service is a delicate transition.

How Fees Are To Be Paid

The Article IX language should ideally spell out how IRA administration and handling fees will be paid; specifically, whether the bank may deduct such fees from the IRA account, and when. In some cases the IRS does not provide an option. But in others, fees may be paid with out-of-pocket customer dollars.

Unquestionably, controlling the payment of fees through account deductions rather than billing is in the bank's interest from a cost-effectiveness standpoint. Therefore a clause in the Article IX language specifically authorizing the institution to deduct any or all fees from the IRA account balance may be desirable.

But this bookkeeping advantage should be weighed against the customer's interests, which lies in maintaining the maximum amount of tax-sheltered dollars in their IRA. More on that in the next section.

For fees that may be optionally paid out-of-pocket by the customer, the institution may want to reserve the right to deduct such fees if not paid within a specified time, such as within 30 days of billing.

IRS Rules on Which Fees Must be Paid From Account vs. Out-of-Pocket Dollars

This is a question of considerable importance to the IRA accountholder, because it impacts their total account balance, and therefore the amount of income that is tax sheltered.

If fees are deducted from the IRA account balance, this reduces the total that is in the fund to generate additional tax-deferred earnings. If fees can be paid out-of-pocket, an IRA account can be kept at maximum contribution and earnings levels.

Allowable Fee Payment Method:

- Annual administration fees may be paid out-of-pocket, and the fee taken as a miscellaneous deduction on the accountholder's income tax.
- Brokerage fees for self-directed accounts cannot be paid for with out-of-pocket dollars, but must be paid from the account balance.
- Interest penalties on early withdrawals from savings instruments (such as CDs) within the IRA are also not payable with out-of-pocket dollars, but must be deducted from the account balance.

Note on Early Withdrawal Penalties

If the custodian institution has a policy on waiving early withdrawal penalties, this should be stated in writing on any fee attachment provided to the customer. As nice as waiver-of-penalty is for customers, (and acceptable to the custodian if they are redepositing into another instrument with the same institution) there is a measurable amount of time/resources involved in the surrender and setup process. At minimum, an institution may wish to set a limit on the number of penalty-free early withdrawals.

Fees in Question

The following fees present some doubts as to whether they may be paid out-of-pocket versus out-of-account. The IRS has not issued rulings on how these fees can be paid. Therefore, the safe course is to assume that they must come out of the account balance, to avoid the possibility of an excess contribution.

- account close-out fee (if charged) — customers often don't pay attention to this at account opening time. It may therefore be worth emphasizing at such time.
- distribution/payout fee (if charged)
- transfer fee (if charged)
- minimum distribution calculation fee (if charged)

Summary

Competitiveness concerns have a definite impact on whether fees are charged for IRA services. Many customers are certainly rate and fee sensitive. The cost of providing IRA services fee-free must be weighed against the benefits of maintaining these long-term deposits, and holding other existing accounts and acquiring new ones from the same IRA customers. But custodian institutions also must be realistic in their evaluation of how much can be "given away" in the bargain. PD

Is Form W-9 Needed for IRAs?

The IRS Form W-9 (Request for Taxpayer Identification Number and Certification) is commonly used to obtain the TIN of individuals involved in certain real estate transactions, who acquire or abandon secured property, pay mortgage interest, receive certain regular income that may be subject to backup withholding, or make contributions to an Individual Retirement Arrangement (IRA). Under the right set of circumstances, any of these could be subject to backup withholding.

Although the W-9 form specifically refers to IRAs, custodians have typically not used this form to obtain the customer's TIN. Instead they have obtained the TIN on their particular IRA plan agreement. Since the release of the revised Form W-9 in April, 1990, however, there has apparently been some confusion over whether IRA customers must now fill out the W-9 to comply with IRS regulations.

This confusion among some custodian institutions may have arisen from slightly different language on the newest Form W-9. The Certification Instructions (just above the signature space) now mention IRA contributions, whereas the previous W-9 version did not.

However, in examining the old (December, 1988) and new forms, this change of language seems only to be a correction for the sake of uniformity throughout the form. IRAs are specifically mentioned in two other places on both old and new versions of the W-9 form. Furthermore, we have been told by the IRS that the Service has not changed its intent or procedures with the release of the revised W-9 form.

But that does not mean that there is no confusion, even among IRS staff members. Though we did not set out to do so, we received interpretations from more than one IRS representative on the matter of W-9 use, and unexpectedly encountered directly opposing opinions on whether use of the W-9 form is required.

An initial telephone conversation with the IRS' Technical Section in St. Paul, Minnesota, indicated that "yes," use of the W-9 was clearly required, because of the references to IRAs on the form, and because of the possibility that an IRA account could potentially become subject to backup withholding, through failure to provide a proper TIN with a prior distribution. The IRS representative said that use of the W-9

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IRS Procedures for Responding to Defects in Qualified Plans

The IRS has recently established two administrative mechanisms or procedures or dealing with plan qualification defects. A qualification defect can either be a "form defect" or an "operation defect."

Consequence of a Plan Defect

When a plan is defective, the following taxes are owed: the additional tax which is due from the plan sponsor because the deduction for its contribution is disallowed; the additional tax which is due from the trust because its income is now taxable; and the additional tax which is due from each participant because they must include in their respective incomes their appropriate share of the plan assets as determined under the facts of each case.

The ideal for the IRS is to collect from the plan sponsor, the trust and the participants for the maximum amount of the additional taxes.

In the real world, however, the IRS' normal course of action many times in the past was to forgive the taxes if the employer/plan sponsor agreed to make retroactive corrections. The IRS especially did not like to penalize the employee participants by requiring them to pay additional taxes when it was the employer who had failed.

Two IRS Options

The two programs discussed below indicate that the IRS will apparently not be taking such an easy or lax approach in the future.

These two programs illustrate typical situations in which the IRS will seek to collect a monetary payment from the plan sponsor in lieu of the additional taxes, or those situations where the IRS will not seek a monetary payment because they do grant forgiveness.

The first IRS program is called the Employee Plans Closing Agreements Pilot program. The acronym is CAP. The second IRS program is called the Administrative Policy Regarding Sanctions.

Summary of CAP

A closing agreement is another term for a settlement agreement. The Internal Revenue Code in section 7121 authorizes a closing agreement so that the IRS and taxpayers can settle issues in dispute. The IRS believes closing agreements to be a proper approach when the IRS has determined that a qualified plan has such defects that it could be disqualified (qualified status revoked).

In this action, the IRS will look primarily to the employer to make a cash payment — an amount to be negotiated in lieu of the IRS trying to collect the various taxes from all three parties. In addition, the plan must be retroactively amended to correct all defects. The closing agreement can be appropriate for both form and operational defects.

Situations That A CAP Will Remedy

The IRS considers a closing agreement a workable solution to a plan disqualification in four typical situations: (1) failure to amend a plan for TEFRA, TRA 84 and REA; (2) improper application of an integration formula; (3) partial termination; or (4) operational top-heavy violations.

. . . CAP Not Suitable

The IRS does not see a closing agreement as suitable in the following types of disqualifications: (1) significant discrimination in favor of highly compensated employees; (2) exclusive benefit violations resulting in diversion of trust assets; or (3) repeated, deliberate or flagrant violations. The only suitable result in these cases is true plan disqualification.

Administrative Policy Regarding Sanctions

In contrast, the IRS has adopted an Administrative Policy Regarding Sanctions which addresses only operational defects.

The IRS understands (thank goodness) that certain operational violations may be so minor that, as an administrative matter, it is not productive for the IRS to pursue the sanction of disqualification. The IRS has decided that it may exercise discretion to treat an operational violation as nondisqualifying if six criteria are satisfied. These criteria are designed to measure the magnitude of the operational violation and the care with which the plan has otherwise been administered.

The Six Criteria

1. The operational violation must be an isolated, insignificant instance. If the same error occurs in successive years, then the error is not isolated. Also, if multiple unrelated violations occurred in a single year, then the error is not isolated. However, when multiple related violations occur in a <u>single</u> plan year, the violations may still be treated as nondisqualifying events.

2. The plan must have either (i) a history of compliance with section 401(a), both in form and operation (other than the nondisqualifying event), or (ii) if the plan does not have a history of compliance (such as a newly adopted plan), the violation was corrected before examination, and there is no evidence of noncompliance in other areas.

3. The plan sponsor or plan administrator must have established practices and procedures (formal or informal) to ensure compliance with section 401(a), including procedures involving the area in which the violation occurred.

4. Established procedures must have been followed, but through an oversight or mistake in applying those procedures, an operational violation occurred.

5. Where dollar amounts are involved (such as excess contributions or excess allocations), the amounts are insubstantial in view of the total facts of the case.

6. The taxpayer must have made an immediate and complete correction to cure the violation once it was discovered so that no participant or beneficiary suffered substantial detriment.

In summary, the IRS in the two procedures described above has tried to formalize its internal procedures for handling substantial and insubstantial defects in qualified plans, to ensure fair and evenhanded treatment of such cases. PD

SAR–SEPs — A Plan Option More Business Customers Need to Understand

Many small employers do not establish any type of retirement program for their employees because they wrongly assume that such a program always requires the employer to make contributions.

Under a SAR-SEP (salary reduction SEP) plan, it is the employee who contributes his or her own money via a salary reduction contribution. That is, the employer does not need to contribute any cash.

Why would employees ever be satisfied with a plan to which the employer never contributes any money?

The primary reason is that many employees are part of a two-income family and — under the Tax Reform Act of 1986 — they lost the right to deduct their IRA contributions. That is, they lost tax deductions from $2,000 to $4,000.

For example, a couple earning more than $50,000 would not be entitled to deduct their IRA contributions if one or both were an active participant in a pension plan. However, if one or both employers had a SAR-SEP, each could salary-defer up to 15% of their compensations. This deferral has the same result as an IRA tax deduction did. But the deferral amount can exceed $2,000.

As with 401(k) plans, there are some special nondiscrimination rules which must be met by a SAR-SEP. Even so, any small business which does not currently have any type of pension plan is a potential candidate for a SAR-SEP, and the deposits which will flow into it.

Every financial institution should educate its business customers on this opportunity. But the administration of the SAR-SEP should be left to the customer's tax advisor. PD

✓✓✓✓✓✓✓✓✓✓✓✓✓✓Check It Out

Question: Our customer will turn 59-1/2 in one month, at which time he will be eligible to take distributions from his IRA without the 10% penalty for early withdrawal. He has asked whether he may take a rollover distribution, and not have to roll the funds back into an IRA account, since he will be 59-1/2 before the 60-day rollover time limit expires.

✓ Answer. No, he may not take a rollover contribution and fail to complete it. Any rollover distribution taken must be rolled back into an IRA account within the 60-day time period. Thereafter, he may begin taking distributions.

Question: Our customer is a nonresident working in the State of Iowa, and making contributions to an Individual Retirement Account. We've been told that there is a difference in how resident and nonresident IRA accountholders are treated, with respect to withholding from IRA distributions. Is this true? What are an accountholder's options?

✓ Answer. On the Federal level, any U.S. citizen accountholder may choose to have withholding taken from their distributions, or may elect out of Federal withholding.

But state policies differ greatly. Some states have no withholding. Others have options, such as the one you describe that differs depending on residency. In Iowa for example, a resident accountholder may elect out of Federal withholding (usually 10%), and may elect out of Iowa state withholding, which is at the rate of 5%.

But nonresidents have fewer options. They may elect out of Federal withholding, but they may not elect out of Iowa state withholding.

Why? State government and state services are paid for out of tax revenues. For this reason, states expect to receive taxes from wages paid by employers in their state. But IRA contributions are typically tax sheltered at the time the income is earned. The only opportunity for taxation is at the time of distribution. Thus, Iowa for example, wants to withhold to ensure getting these tax revenues as expeditiously as possible.

We believe many states are currently not making a serious attempt at tracking dollars contributed to tax-sheltered retirement plans, for purposes of later taxation. We further believe, however, that this will begin to change as state governments, strapped for tax revenues, gradually discover more options for generating these revenues.

Question: When we need only small quantities of various IRA or pension forms, is it legal to simply photocopy IRS or vendor forms for customer and bank use?

✓ Answer. The IRS provides most such forms free of charge. It therefore would be allowable to copy their forms if you are out of originals.

However, the forms designed and printed by private pension vendors are generally copyrighted, and may not legally be copied for use in any quantity. And, realistically speaking, since multiple copies of most pension forms are required for bank filing and customer use, there is relatively little saving when you compare the true cost of duplication, to the cost of purchasing multi-part forms from such vendors. 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

Form W-9—*Continued from page 2*

form would provide evidence of the bank's "due diligence" in having properly attempted to obtain the correct TIN number for reporting purposes.

But a subsequent call for further clarification resulted in our being referred to a new contact person, and receiving an opposite opinion. This second contact referred to the following clause in the W-9 form's general instructions, paragraph two:

"Note: if a requester gives you a form other than a W-9 to request your TIN, you must use the requester's form."

According to this IRS staffer, this means that if the bank — the "requester" — provides an IRA plan document as the means to obtain the accountholder's TIN, this is the form that must be used by the customer.

Our position, based on our past recommendations and on this second IRS opinion, is that use of the W-9 is not required, as long as the IRA form used by the custodian/trustee does indeed obtain the customer's correct Taxpayer Identification Number.

However, a written request for opinion has also been made by CWF to the IRS office in Chicago. In the next issue of The Pension Digest, we hope to be able to report further on this written request. PD