THE Pension Digest

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IRA Amending: Why, When, and How

This issue of *The Pension Digest* features extensive coverage of the process of amending IRAs. In addition to this article, you'll also find information on the recently issued IRS Revenue Procedure 92-38, with comments on its implications for amending prototype and non-prototype IRAs (see article adjacent).

Amending is one of the least frequent functions of IRA administration. It only happens when tax laws and regulations change, when parties to the IRA contract change as institutions change hands or merge, or when institutions change their own policies and rules with respect to IRAs. Because of the relative infrequency of major law changes, many IRA personnel have never been through an amending procedure.

Now, observing the degree of confusion that seems to be accompanying the issuance of IRS Revenue Procedure 92-38, we felt it appropriate to discuss the general subject of amending, including both required and discretionary amendments, and how a financial institution should respond to an amending situation.

Required vs. Discretionary IRA Amending

REQUIRED IRA AMENDING, generally speaking, is dictated by the provisions of Articles I-VIII of the IRA plan agreement. These are the core rules and regulations governing IRAs, and are a part of every IRA plan.

One of the distinguishing characteristics of required IRA amending is the fact that a financial penalty can be assessed against the custodian/trustee institution for failing to make such amendment(s).

DISCRETIONARY IRA AMENDING, again generally speaking, usually relates to Article IX of the plan agreement, if present. "If present" is stipulated because the IRS' basic IRA documents 5305 and 5305-A, and even some private-vendor derivatives, have only the core provisions, Articles I-VIII.

From a flexibility standpoint, the best plans for financial institutions to offer HAVE ARTICLE IX LANGUAGE. What does Article IX do? Article IX allows a number of flexibilities and options, among others:

- the charging of special IRA fees, such as annual administration, termination, transfer, etc.

- special provisions relating to IRA beneficiaries

- "customer-protective" default options in the event distribution elections are not made in timely fashion, to prevent an unwanted lump-sum distribution

- provisions in the event of sale/merger of the custodian institution

When a New IRA Plan Agreement is Issued...

The basic document of the IRA - the plan agreement - is periodically changed in response to tax legislation passed by congress, or rules changes or interpretations initiated by the IRS. When this happens, a new "model plan agreement" is issued by the IRS.

When the new documents become available, financial institutions opening IRAs for customers will begin using the new version of the plan agreement, either in the actual IRS version, or a private vendor version that incorporates the basic plan provisions.

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Rev. Proc. 92-38 And Necessary IRA Amending

Institutions Cautioned Against Overreacting – Who Will Be Affected, And When . . .

On May 18, 1992, the IRS issued Revenue Procedure 92-38, which contained two items of importance to financial institutions. These pertain to IRA prototype amending, and to new IRA model form changes. While most institutions offering IRAs will be affected eventually, there is no reason for any institution to be stampeded into immediate amending decisions, or to put their IRA program on "hold" while awaiting further developments.

The Crux Of The Changes

A. Institutions Using IRA Prototypes

The most important impact will be felt by the smallest percentage of financial institutions, those using IRA prototypes.

Most institutions use either the IRS' Form 5305 or 5305-A, or a private vendor's equivalent, such as CWF's IRA #50 or #50-P Easy Form. These private vendor versions use the same essential language as the IRS forms, but generally add some additional flexibilities, such as the privilege to charge certain fees, to offer certain beneficiary provisions, etc.

A much smaller number use a custom-drafted "prototype" IRA plan document. Revenue Procedure 92-38 requires that any prototype sponsors who applied for and received IRS favorable opinion letters on their prototype *before* January 31, 1990, must amend these prototypes by May 18, 1993 (one year from Rev. Proc. 92-38's issuance), to include added language that reflects the new minimum distribution rules, including the Minimum Distribution Incidental Benefit (MDIB) rule.

The Rev. Proc. itself actually contains model amendment language that can be used in this amending process. Other options include submitting custom-drafted amendment language to the IRS for approval

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A. Amending of Existing Plan Agreements

But what about existing plans? When changes are made to Articles I-VIII of the the plan agreement language, existing plans are brought up-to-date with the new provisions by the process of amendment, usually a printed document with the appropriate new plan language that is physically attached to the original plan agreement.

B. Amending the Disclosure Statement

When changes are made to the IRA plan agreement, most likely it will also be necessary to modify the plan's disclosure statement, because this is where the IRA regulations found in Articles I - VIII are summarized for the customer in easily-understood laymen's terms.

C. How About the Financial Disclosure?

The plan's Financial Disclosure — the section of the disclosure that projects plan earnings — generally need not be amended for prior plans when subsequent changes are made to the plan agreement. (Later we will discuss circumstances when providing a new financial disclosure is advisable.)

Differing Philosophies on Disclosure Amending:

Discretionary or Mandatory?

Most pension experts agree that when a new plan agreement is issued, the disclosure statement will be amended. But they differ considerably about disclosure amending for other IRS actions, such as letter rulings, announcements, Revenue Procedures, etc. Some believe that any change in the rules that has "a material effect" on IRAs, demands amending of the disclosure statement.

Others maintain that amending need be done only when the IRS issues a new plan agreement. CWF prefers to err on the conservative side, and believes that any ruling or regulation that alters procedures or plan consequences in a significant way, should be communicated to customers and incorporated into their plan agreement, via amendment.

...An Example of Important "Disclosure-Only" Amending

When the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) was passed by Congress, it did not change the language of the basic IRA plan agreement. It did, however, make obsolete several provisions of the disclosure statement. One of the most critical affected the "active participant" status of spouses, and thereby had a major impact on the deductibility of their IRA contributions.

It stipulated that if one spouse was an active participant in an employer-sponsored retirement plan, the other spouse was also an active participant, regardless of whether these married persons filed their taxes separately or jointly.

This requirement adversely affected the IRA status of many Americans, who thereby faced diminished or eliminated IRA deductibility. Any IRA accountholder who relied on their disclosure statement for tax guidance would have been greatly misled, if their IRA custodian had not provided an amendment to the disclosure to incorporate these changes.

Further precedent emphasizing the advisability of amending a disclosure statement despite the absence of a new IRA plan agreement is found following the Tax Reform Act (TRA) of 1986. This was perhaps the most far-reaching legislative action since the beginning of IRAs, yet required no change to the basic plan agreement. This amending need was recognized by the IRS, which stated that its Announcement 86-121 (which summarized the TRA 86 changes) could be used to update the disclosure statement.

These are examples of changes other than the issuance of a new plan agreement, that nonetheless merited amending of the disclosure.

...Impact of New Bank Terms/Practices on Financial Disclosure

The IRS requires a financial disclosure to give the IRA accountholder some conception of the potential growth of their IRA contribution(s). Usually these are not guaranteed, but are conditional projections or approximations, based on terms and conditions at the time the IRA plan is opened.

A. Interest Paid on the IRA investment

At the time the account is opened, the interest rate used in the institution's financial projections cannot exceed the rate actually paid on the instruments in which IRA funds are invested, if deposited in a fixed-return account. Otherwise the customer could be deceived by an over-inflated prediction of earnings. In the eyes of the IRS, it's alright to underestimate, but a clear case of non-compliance to overestimate.

If the interest paid on such instruments drops below that used on your financial disclosure projection forms, a new schedule for making financial disclosure projections must be used for any new accounts opened. Interest paid must at least equal that projected at the time of plan opening. But this is not an amending situation for existing accounts.

B. Fees

If certain fees are in place at the time of plan opening - including amounts charged for annual administration of an IRA, termination fees, transfer charges or the like - they are to be factored-in when the financial projection is made and reduce the projection accordingly.

When These "Ground Rules" Change... ...Fees Added After Plan Opening

The charging of IRA account fees for terminations, transfers, annual administration, etc., has become more commonplace as more and more financial institutions look for added ways to generate fee income, and to cover the true costs of maintaining these highly regulated retirement plans.

If the bank's IRA plan agreement already has a provision allowing it the discretion to charge fees - as many do in their Article IX language - all it need do when instituting a fee or fees is to provide a notice to IRA accountholders of the new fees.

But if there is not such a provision in the plan for charging fees, this must be addressed if the institution's procedures are to change. CWF's conservative approach is to have a new IRA plan agreement — with appropriate Article IX language addressing the issue of fees — signed by the customer, and to prepare a new financial disclosure.

GENERAL OBSERVATIONS ABOUT AMENDMENTS AND CONSENT

Viewing the amending process in its simplest terms, all substantive changes to an IRA plan agreement should be communicated to accountholders, incorporated into their plans, and - when necessary - a signature or consent obtained by them.

A. No Consent Needed

An important governing phrase in this matter of consent is Article VIII of all IRA plan agreements based on the IRS Forms 5305 and 5305-A. It indicates that a custodian institution may make amendments for the purpose of complying with law changes WITHOUT the accountholder's consent.

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These changes are typically those found in Articles I-VIII of the plan agreement.

B. Consent Required

But any other amendment - those of the discretionary type - is to "...be made with the consent of the persons whose signatures appear below." IRS Forms 5305/5305-A DO NOT indicate what constitutes consent - whether it must be in writing, or may be "implied consent." Private vendor plan agreements having appropriate Article IX language specifying how consent is determined, are therefore desirable. They can spell out how consent will be determined, or even reserve for the bank the right to make virtually any change without consent.

If the plan agreement you use is silent on the issue of consent, the only truly foolproof approach is to request a customer signature when making discretionary amendments.

SIGNED vs. NEGATIVE CONSENT AMENDING

If obtaining customer consent is deemed a necessary formality, there are two ways to proceed:

A. Send customers an amendment, requesting them to sign, date and return.

B. Send the amendment without a request for signature, but indicating to the customer that if no response is made, they (the customer) will be deemed to have agreed to the change. This is termed "negative consent."

Be sure you check your state's laws on negative consent, which may or may not agree with what the IRS says. This determination should be made by your institution's legal counsel.

DOCUMENTING AMENDMENTS

In addition to actual amending, you must be able to PROVE to the IRS that you did the necessary amending. For "law change" amendments, and in amendment situations where implied consent is acceptable, it may be sufficient to keep a master file of amendments, a sample of each amendment, and a list of the accountholders who received each.

But a better, more "compliance-certain" approach is to keep a copy of any amendments in each customer file. And in cases where a signed consent is required, this is the ONLY way such consent can be proven.

AMENDING FOR MERGERS & ACQUISITIONS

When a bank is purchased, or when its corporate structure is changed due to the process of merger, amending must generally be done even if the accounts of both institutions have been properly administered and are in compliance with IRS regulations.

This is so because when the corporate structure or ownership of a financial institution changes, so too do the parties to the IRA contract.

...must accountholders approve a custodian change?

The word "contract" is a very key term. Unless the IRA document language allows the parties to the agreement to change without accountholder approval, in our opinion and that of many other pension consultants, such a provision cannot be changed without the consent of the original signatories of the contract. To repeat the Article VIII language cited earlier, amendments other than those made to comply with law changes, "...may be made with the consent of the persons whose signatures appear below."

Language pertaining to change in ownership or custodian would typically be found in Article IX language of the IRA plan's disclosure statement, if it is a private vendor document. An example from CWF's #50 or #50-P Easy Form reads:

"1.9 Sale of Custodian—Successor Custodian: If another institution purchases the custodian or any of its deposits, then you hereby agree or consent that this legal entity will be the successor custodian of your IRA funds with all duties and rights as listed in paragraph 2."

If the account was opened with an IRS Form 5305 or 5305-A, however, there will be no such provision.

...obtaining customer consent

If obtaining customer consent is deemed a necessary step, there are two ways to proceed...the signed consent or negative consent described above.

You may:

A. Send an amendment, requesting the accountholder to sign, date, and return to your institution.

This is the approach we prefer and recommend...

Or:

B. Send the amendment without request for signature, indicating that if the accountholder does not respond to the contrary, they will be deemed to have consented to the change by "negative consent."

AMENDING PROTOTYPE IRAs

While most IRA custodians and trustees use either the IRS Model Forms 5305 or 5305-A, or a private-vendor plan agreement based on its language, others use specially drafted IRA documents known as "prototypes." These must be submitted to the IRS for review and approval prior to use, and if found acceptable are issued a "favorable opinion letter."

In most cases, these too must be amended when a substantive change in IRA language or administrative procedures requires the amending of Form 5305-A or 5305-based plans.

Model language may be provided for such amending — as with Rev. Proc. 92-38 — or specially drafted amending language may be submitted to the IRS for approval. PD

BRIEF HISTORY OF RECENT REQUIRED AMENDING

AMENDMENT CHART

The Year	Law Change	Should the Disclosure Statement Have Been Amended?	Was the Plan Agreement Affected?
1982	Tax Equity & Fiscal Responsbility Act (TEFRA)	Yes	Yes—A new plan agreement dated 11-83 was issued.
1984	Tax Reform Act of 1984 (TRA-84)	Probably	No
1986	Tax Reform Act of 1986 (TRA-86)	Yes	No
1987	New IRA Distribution Regulations	Yes	Yes—A new plan agreement dated 12-87 was issued.
1988	Technical and Miscellaneous Revenue Act of 1988 (TAMRA)	Yes	No

Most Form 5500EZ Annual Return Filings Due July 31
. . . all terminating one-participant plans should also file

What Businesses/Plans File Form 5500EZ?

In general, any "one-participant pension benefit plan" is required to file the Form 5500EZ annual return if aggregate plan assets at the end of the plan year are more than $100,000. This includes employers who have multiple plans which together total more than $100,000. In such cases, a Form 5500EZ must be filed for each such aggregating plan.

. . . When?

The technical filing deadline is ". . . the last day of the 7th month following the end of the plan year . . ." For businesses operating on a calendar-year basis, this is July 31.

Exceptions to the "One-Participant" Rule

The Form 5500EZ is filed not only by true "one participant" businesses, but also husband/wife businesses, and partners or partners/spouses in a partnership-governed business.

Other Requirements

Furthermore, to be eligible to use the Form 5500EZ, the plan must not provide any benefits for other than the above-mentioned people, and must meet the minimum coverage requirements of section 410(b) without being combined with any other plan covering other employees of the business. The plan also must not cover a business which is part of a controlled group, affiliated service group, or which uses leased employees.

Types of pension benefit plans covered include defined benefit plans, profit-sharing plans, money purchase plans, stock bonus plans, employee stock ownership plans (ESOPs), and 401(k) plans.

Who Need Not File Form 5500EZ?

As was true for reporting for the 1990 plan year, those businesses that do not have aggregate plan assets of $100,000 or more are not required to file.

. . . terminating plans are treated differently

The exception to this under-$100,000 exclusion is any plan that is terminating. "All one-participant plans should file a Form 5500EZ for their final plan year even though the plan assets at the end of the year are less than $100,000," according to IRS instructions.

Deadline Filing Extension

Employers may receive up to 2-1/2 months filing extension if a timely request is made, using Form 5558. One person plans automatically qualify for an extension until the due date of the employer's federal income tax return if:

a) the plan year and the employer's tax year are the same;

b) the employer has been granted an extension to file its federal income tax return, to a date later than the normal 5500EZ filing deadline;

c) a copy of the IRS extension of time to file the federal income tax return is attached to the Form 5500EZ filed with the IRS. PD

✔✔Check It Out

Question: Our bank just received a check and a transfer notice from the U.S. Government concerning Thrift Savings Plan funds for an individual who wishes to transfer these funds to an IRA with us.

Must we issue a Form 5498, as we would in other dissimilar plan transfers (as in a QP to IRA) in which the funds come direct to us, but the paperwork is completed as in a rollover—with the sending entity preparing a 1099-R, and we the receiving entity a 5498?

✔ Answer. This is one of those exceptions that proves the rule. Unlike most dissimilar plan transfers, a transfer from a U.S. government TSP does not require a 5498, and the TSP plan will not be issuing a 1099-R.

Question: A woman just brought in a check for $38,000 issued by a pension plan naming her husband as the payee. Assuming this is a payout which otherwise qualifies to be rolled over, may she roll over these funds to her IRA if he has endorsed the check to her?

✔ Answer. No. The tax rules allow only the person who is paid the funds to permissibly roll them over. Although the husband could give his wife this $38,000 (less applicable taxes) as a gift, she could not roll over such a gift. 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.

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by the deadline date, or converting – via amendment – to a standard language, non-prototype IRA plan.

Institutions that have received favorable opinion letters *after* January 31, 1990, are not required to amend their IRA prototypes.

B. Institutions Using Standard Plan Agreements – New IRA Forms To Be Issued

In Rev. Proc. 92-38 the IRS also announced that it will be reviewing and modifying its standard Form 5305 and 5305-A. This will also mean that private vendor IRA plan agreements, like those available from CWF, will change too. This will impact new IRA accounts, and is expected to require amending of prior IRA plans.

When Will This Happen?

Some IRA forms and services providers are already taking orders for IRA amendments, to be shipped when the new forms are available. But in our conversation with the IRS official who has been assigned to review and make needed revisions to the 5305 and 5305-A Forms, she indicated that it is unlikely that the new forms will be available before the end of the year. It could possibly be longer.

No decisions have thus far been made as to how – or how much – the forms will be modified.

How Much Time Will I Have To Amend Old Plans?

. . . Should I Act Now?

If past patterns hold true, the time period allowed for amending of prior plans will probably be one year from the date of the new plans' issuance.

Making sweeping commitments now for the handling of this relatively distant amending procedure may or may not be in your institution's best interest.

For similar reasons, we do not consider it advisable to put your institution's IRA activity on "hold" status in anticipation of changes, which could result in unnecessarily giving up a share of your market to a competitor.

In this interim period, no accounts that you open properly using correct, current forms, will be found non-compliant.

Rev. Proc. 92-38 Also A Hot Topic On Our Consulting Hotline

We have received an extremely high number of inquiries on the impact of Revenue Procedure 92-38 via our consulting hotline, and have been able to ease the concerns of a number of IRA professionals who were alarmed by what they had heard – and not heard – about it.

(If you're not already a consulting subscriber, this is just one example of the value of day-in, day-out, immediate access to the expertise of IRA consulting professionals. For further information on our hotline consulting service, call us at 1-800-346-3961.) PD