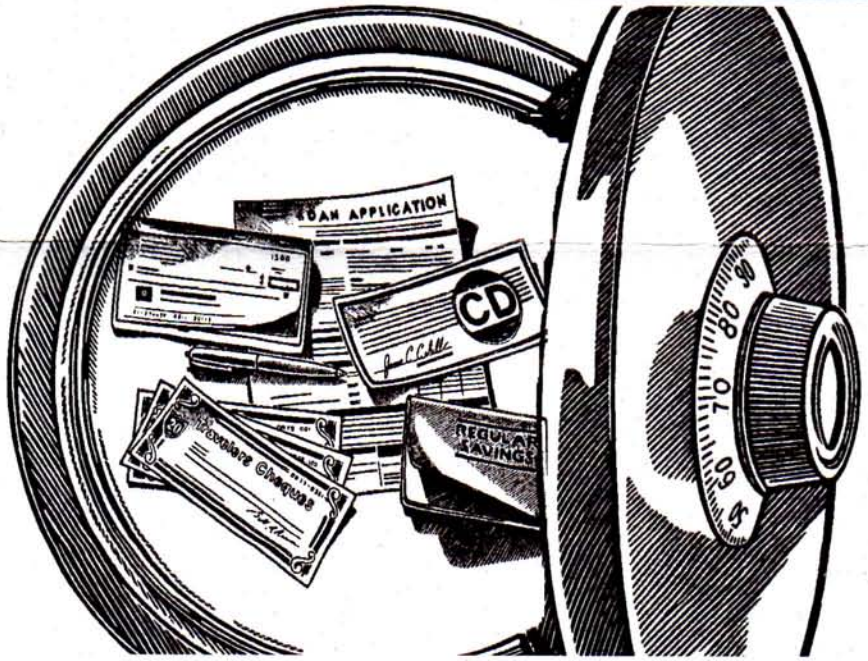
THE Pension Digest

Published Since 1984 Collin W. Fritz & Associates, Inc., *"The Pension Specialists"* March, 1993



Relationship Banking & Prohibited Transaction Class Exemption 93-2

The history of the Department of Labor's opinions and actions concerning "relationship banking" programs and pension plans is an extended and complicated one. It began in 1989 when DOL took the position that - with respect to IRAs and Keogh plans - relationship banking programs (the linking of free or reduced cost services to the establishing or funding of a plan) often constituted a prohibited transaction (PT).

This harsh PT position could potentially have caused many IRA or Keogh plans that were opened or funded under financial institution incentive programs to lose their tax-deferred status - to be "deemed distributed" - in most cases resulting in an added tax burden on the accountholder or plan participant.

In the wake of strong protests from the American Bankers Association, state banking associations, and many private banks and holding companies, the IRS issued temporary relief from this DOL advisory opinion, with Announcement 90-1, January 8, 1990. These rules were to be in effect while a request for "administrative exemption" was considered.

Nearly three years later, that request for exemption having been considered, the IRS has issued Prohibited Transaction Class Exemption 93-2 - PTE 93-2 for short. It will take effect May 11, 1993. Until that time, the rules of Announcement 90-1 may be followed. Or an institution may immediately begin complying with PTE 93-2.

A SUMMARY OF ANNOUNCEMENT 90-1 RULES EFFECTIVE UNTIL 5/11/93

These rules as issued were quite general and not particularly detailed, especially when compared to the new rules of PTE 93-2.

1) In determining eligibility for the services ... 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 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.

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

*** NOTE THAT multi-participant IRAs, established pursuant to SEP-IRA plans, were not covered under the temporary relief provided by Announcement 90-1. Thus, the very same free or reduced-cost program offered to an individual IRA holder under 90-1's relief, could conceivably have resulted in a prohibited transaction for a multi-participant SEP-IRA plan.

PTE-93-2 provides relief by allowing multi-participant SEP-IRA plans to be included in relationship banking programs.

SUMMARY OF NEW RULES UNDER PTE 93-2

As you will see, these rules are much more specific.

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A bank may offer certain services (at no cost or a reduced cost) to its IRA/Keogh customers without having a prohibited transaction result if certain conditions are met. Simply put, the deposit balance in an IRA or Keogh may be taken into account for purposes of determining if the person for whom the IRA or Keogh is established is eligible to receive services (outside of the IRA/Keogh) at reduced or no cost if certain rules are complied with.

Condition/Rule #1 - For the IRA or Keogh plan, the deposit balance which will be considered in determining eligibility for the service must be established or maintained for the exclusive benefit of the participant covered under the IRA or Keogh, his or her spouse or their beneficiaries. By definition, an IRA or Keogh should meet this rule.

Condition/Rule #2. The services to be received by the bank customer must be of a type which the bank itself could offer. Thus, services offered by a controlled non-bank affiliate or a third party would not be covered (e.g. brokerage services). However, service is defined to encompass incidental products of a de minimis value if provided by a third person pursuant to an arrangement with the bank, and if these services are customary banking services. For example, many banks contract with vendors of checks to provide checkbooks. Such are permitted.

Condition/Rule #3. The services (provided by the bank or an affiliate) to the IRA/Keogh accountholder must also be offered to customers who do not maintain IRAs or Keoghs with the bank.

Why? The DOL does not want any service programs designed just to favor IRA/Keogh accountholders. And, DOL does not want the bank to offer the person who has the IRA or Keogh, rewards *outside* of the IRA/Keogh at the expense of paying earnings to the IRA/Keogh itself.

This rule precludes the furnishing of services as an incentive only for establishing or maintaining an IRA/Keogh.

Condition/Rule #4. In the eligibility determination, the deposit balance required by the bank for the IRA or Keogh accountholder to receive the service must be equal to (or less than) the lowest balance required for any other type of account receiving the same service.

Department of Labor example A:

"For example, if a bank establishes a relationship banking program under which a customer will be eligible for reduced or no cost services if he maintains a savings account balance of $1,000, or a Certificate of Deposit (CD) balance of $5,000, section II(d) would be satisfied if the minimum balance required for IRAs or Keogh Plans to receive services under this program is $1,000 regardless of whether a savings account or CD investment is selected for the IRA or Keogh Plan."

Also, the IRA or Keogh plan must be entitled to receive the same services for which any qualifying non-IRA or non-Keogh accountholder qualifies. This in effect precludes "price discrimination" by account type.

If the bank establishes a multi-level relationship banking program (determines eligibility on the basis of an aggregate balance of different types of account balances), then the deposit balance required by the bank for the IRA or Keogh must be weighted in the same manner as the dollar amount in the type of account with the lowest minimum balance eligible to participate in that level of the program. For example, a savings account balance may not be weighted dollar for dollar if an IRA or Keogh is weighted at $.50 for each dollar. See the following DOL excerpt.

Department of Labor example B:

"For example, this rule will not be satisfied if a bank offers a package of services under a program which: (1) Requires customers to maintain an aggregate balance of $10,000 or more; (2) counts only those accounts with a minimum balance of $1,000; and (3) counts, for purposes of aggregation, CDs and checking account balances on a dollar for dollar basis, and passbook accounts, IRAs and Keogh Plans on the basis of 50 cents for each dollar in such accounts."

If the bank offers different packages of services depending on the amount of the customers' balances, the IRA or Keogh customer must be eligible to receive the same level of services that non-IRA and non-Keogh customers are eligible to receive under the particular relationship banking package.

Department of Labor example C:

"For example, if a bank establishes a multi-level relationship banking program, under which a Level I customer is eligible for reduced or no cost services if he maintains a savings account balance of $1,000 or a CD balance of $5,000, the minimum balance required under section II (d) for IRAs or Keogh Plans would be $1,000, and the IRA or Keogh Plan customer must be eligible to receive the same Level I services as non-IRA and non-Keogh customers. Similarly, if a Level II customer is eligible to receive additional services if he maintains a savings account balance of $5,000 or a CD balance of $10,000 the minimum balance required for the IRA or Keogh Plan would be $5,000, and the IRA or Keogh Plan customer must be eligible to receive the same Level II services as non-IRA and non-Keogh Plan customers."

If the bank program treated all banking deposits/balances as fungible (i.e. equal), then this condition/rule would be met.

Condition/Rule #5. The rate of return on the IRA/Keogh investment must not be less than the rate of return on an identical investment that could have been made at the same time at the same branch by a customer who is not eligible for, or who does not receive, the reduced or no cost services.

The DOL has stated its belief that this rule will assure that the bank will offer to IRAs and Keoghs the same investment opportunities which are available to other customers of the bank who do not receive reduced or no cost services. Special services will not mean reduced earnings or opportunities for IRA or Keogh accounts.

The bank will need to make sure it has such identical investments available if it adopts a service program.

This rule does not prevent a bank from offering a more favorable rate of return on an IRA or Keogh plan investment which is otherwise identical to an investment available to other customers. This is true whether or not there is participation in a relationship banking program. IRAs and Keogh may be favored. They may not be discriminated against.

Additional Comments and Summary Points

1. The bank cannot give credit to the IRA/Keogh accountholder for non-deposit IRA/Keogh investments (e.g. self-directed assets, which are non-deposits). A deposit balance includes any account upon which a reasonable rate of interest is paid.

2. A primary reason the DOL issued the PTE 93-2 exemption is to assure that the rate of return earned on an IRA or Keogh plan investment is not sacrificed in favor of a customer's receipt of reduced or no cost services.

3. The persons receiving services who are entitled to relief under the exemption are the individual covered under the IRA or Keogh and his or her beneficiaries who are family members.

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PTE 93-1 Officially Allows Incentive Premiums to IRA, Keogh Accountholders

(A companion story in this issue discusses Prohibited Transaction Class Exemption 93-2, which provides exemptive relief for the inclusion of IRA, Keogh and SEP plans in relationship banking arrangements for free or reduced-cost banking services. The subject of this article, PTE 93-1, applies instead to cash, property or other considerations given to IRA or Keogh owners, and — unlike PTE 93-2 — has no provision to include SEP participants.)

The use of incentives to generate business for financial institutions is a longstanding practice. Everything from stadium blankets to toasters, calculators to television sets has been used at one time or another.

In the promotion of certain kinds of business these practices are engaged in essentially at the institution's discretion, based on their marketing philosophy and bottom line. But when it comes to retirement plans, the rules of additional regulatory agencies such as the Department of Labor (DOL) enter the picture, and provide limits to what is allowable.

In the mid-1970's the DOL examined the practice of financial entities offering various premiums for opening or contributing to IRA and Keogh plans, and initially found them to be in violation of prohibited transaction (PT) rules. The regulatory objection to offering retirement plan deposit incentives is the potential for diminished benefits or earnings *within* the plan, because of the cost of benefits (premiums) offered *outside* the plan.

But in the face of numerous requests for prohibited transaction exemptions, the DOL in 1983 made the decision to consider the granting of a "class exemption" allowing limited offerings of premiums, retroactive to January 1, 1975. It took 10 years — until February 11, 1993 — to finalize the exemption, known now as PTE 93-1. PTE 93-1 applies to IRA and Keogh plans, but not to multiple participant SEP-IRA plans, whereas PTE 93-2 *does* apply to multiple participant SEP plans.

Here are PTE 93-1's Provisions:

- The IRA or Keogh plan associated with the payment of cash, property or other consideration, must be established solely to benefit the participant, his or her spouse and their beneficiaries.

- the special cash, property or other consideration is to be given only in connection with the initial establishment of the plan, or the making of additional contributions, including the transfer of assets from another plan into an IRA or Keogh.

- During any given tax year, the total fair market value of the cash, property or other consideration given to an IRA accountholder or Keogh plan participant may not exceed: (1) $10.00 for deposits of less than $5,000, or (2) $20.00 for deposits of $5,000 or more.

- In cases where the "consideration" or item of value is group term life insurance, the conditions of PTE 93-1 are met if, during any taxable year, no more than $5,000 of the face value of the insurance is attributable on a dollar-for -dollar basis to the assets of the IRA or Keogh.

- This exemption does not apply to an IRA that is an employee benefit plan under Title I of ERISA.

Some Pertinent Definitions:

— "taxable year" means the taxable year of the individual. In the case of transfers of assets from previously established plans, then the calendar year in which the transfer was received into the new plan is considered to be the taxable year.

— "fair market value", as used in determining the allowable value of a premium or other consideration, may be the cost to the financial institution, rather than an item's so-called "street value" or average purchase price by an individual.

— The term "members of his or her family" refers to the beneficiaries of the individual for whose benefit the plan was established, as the term "family" is defined in Code section 4975(6), or brother, sister, or spouse of a brother or sister.

(This differs slightly from the provisions of PTE 93-2, wherein the plan must have been "established and maintained for the exclusive benefit of the participant...his or her spouse or their beneficiaries."

Example:

George Herman has an existing IRA, to which he makes a $5,000 rollover deposit from a 401(k) plan. He receives for his deposit a coffeemaker that sells in department stores for $29.95, but which costs the bank only $19.95 to purchase. Does this constitute a prohibited transaction? Why?

The answer is "no". Why not? Because the premium's "fair market value" — at least as defined by DOL — is $19.95 (not the local over-the-counter price), which is less than the $20.00 maximum for deposits of this size. PD

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The definition of "member of his or her family" includes brothers, sisters and spouses of brothers or sisters. However, a bank may certainly define its program to limit the number of family members entitled to receive relationship banking services under its program.

4. SEP-IRA participants and the businesses that sponsor them will greatly benefit from the relief provided by PTE 93-2, as of 5/11/93. (We believe that owner-partner SEP plans will also be covered.)

Multi-participant SEP-IRA plans included in such relationship banking programs must, however, offer participants "the unrestricted authority to transfer their SEP balances to IRAs sponsored by different financial institutions."

In order to allow multiple-participant SEP-IRA plans to be included in relationship banking programs, the IRS had to provide "relief from ERISA sections 406(a)(1)(D) and 406(b) as well as Code section 4975," which typically govern multi-participant SEP-IRAs, and otherwise prohibit such relationship banking situations.

5. A bank is able to include in a relationship banking program those services that are available to all customers at no cost. A bank is also able to offer fee services free of charge to those customers who are participating in a relationship banking program.

6. It appears from PTE 93-2 that a bank may consider loan balances in determining eligibility to receive services at reduced or no cost.

7. PTE 93-2 does not require a bank to include IRAs and/or Keoghs in their relationship programs. The bank should do so only if the rules are satisfied.

8. Services provided to the IRA or Keogh account in the ordinary course of an affiliate's business are NOT covered by this exemption.

The DOL states that another exemption may apply for this situation. There is an exemption for such services provided by an affiliate of the bank if such services are of the type that the bank itself could offer, consistent with applicable banking law, and are offered by the bank on a regular basis to customers who do not maintain IRAs and Keoghs plans with the bank.

It is this exemption which would need to be met for in-house brokerage situations or similar arrangements.

9. PTE 93-2 deals only with services, and only certain services. It does not deal with cash or other property (i.e. premium type programs). PTE 93-1 does. See article elsewhere in this issue.

The definition of services does include incidental products, but they must be of a de minimis value, they must be provided by a third party (not an affiliate), must be pursuant to an arrangement with the bank, and must be directly related to customary banking business. Free checks, for example.

10. Certain IRAs and Keoghs are NOT entitled to the relief granted by the exemption. These cannot be considered in a relationship banking program. A bank needs to "red flag" such accounts, if any, and not allow their deposit balances to be included. These include:

a. IRAs established pursuant to an Employer/Employee Association Sponsored IRA Program are not eligible.

b. IRAs established pursuant to A Nonqualifying Payroll Deduction IRA Program are not eligible. Such a program would be an employee benefit plan for ERISA purposes. A non-qualifying plan is one which is an employee benefit plan as defined in 29 CFR 2510.3-2(d)

Keoghs which are employee benefit plans for ERISA purposes (i.e. those with participants other than sole owners, partners or spouses of sole owners and partners) are not eligible. This means participants in multiple participant plans are not eligible. If the plan sponsor files the Form 5500-C/R it is ineligible. If the plan sponsor files the Form 5500-EZ (or would file but for the $100,000 minimum requirement), then he or she would be eligible.

Exemption Requests Denied

In the period during which the DOL was accepting comment in preparation for its release of PTE 93-2, it received a request from the American Banking Association (ABA) that it allow relationship banking "binding arrangements" existing before the PTE 93-2 effective date of May 11, 1993 to stand, without causing a prohibited transaction, if they met the more flexible rules of Announcement 90-1.

Further, ABA requested that "binding IRA and Keogh plan investments" made before the effective date also be allowed to stand, if they too met the rules of Announcement 90-1.

The DOL did not honor this request, declaring that financial institutions had been "fully aware of the temporary nature of the Announcement, and had the opportunity to develop or alter their relationship banking packages accordingly." Thus, any existing binding arrangement or binding investment must comply with the rules of PTE 93-2, as of May 11, 1993. PD