THE Pension Digest

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Truth in IRA Savings

IRAs & Truth-in-Savings — How They Interrelate

The Truth-in-Savings (TIS) rules apply to consumer deposit accounts, including IRAs.

The TIS rules as they apply to IRAs are separate from the rules which the Internal Revenue Code applies to IRA accounts.

Until now, IRA forms have been primarily designed to comply with IRS rules, not banking law rules. The Truth-in-Savings Act will impose additional disclosure rules which you must take as seriously as you do the disclosures you make for IRS purposes.

Although it would certainly be possible to incorporate the Truth-in-Savings disclosures in IRA application forms, in most situations it will be easier to comply with the TIS rules by having separate disclosures (forms).

From our experience, we believe that after de-regulation (1982 until now) many financial institutions have not consistently used a written agreement to establish the terms of the deposit between the financial institution and the accountholder. The basic approach in many cases was: the financial institution did what its software permitted and what it decided its policy would be. The communication of these policies to customers was semi-informal.

For example, many people thought that the use of a vendor's IRA application form established the terms of the deposit. The forms of most vendors (e.g. Collin W. Fritz and Associates, Ltd.) were not designed to achieve this result. The IRA custodian's personnel would indicate the term of the deposit, the interest rate, the method of compounding, the interest penalty, etc. on the IRA application so that the projection schedules could be determined. The purpose of these IRA application forms (CWF's 50P and 52P) was to comply with the IRS rules for projection schedules, not to establish the terms of the deposit. Although CWF and other vendors designed forms to handle the terms of the deposit agreement (CWF's Forms 401 to 406), many institutions chose not to use these forms.

If your institution has not consistently used a separate written agreement to establish the savings account or the time deposit agreement,

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IRS Expands Relief for IRA "Current Year Contributions" Withdrawal

...additional year grace given to withdraw contributions made in carryback period; action may discourage early contributions, non-deductible contributions

The primary reason to contribute to an IRA should be to provide funds for one's retirement years. But in reality, a major motivator is to reduce current year tax obligations. For a great many workers, "no deduction" (because of active participation in another retirement plan) translates to "no contribution." Statistics from the pre-1986 period to the present bear this out. As the percentage of the U.S. population able to deduct an IRA contribution has dropped over the years, so too has the number of Americans making those contributions.

...Background on prior Withdrawal Procedure

IRA law (Code section 408(d)(4)) was written to encourage taxpayers to make

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you will wish to give serious consideration to doing so now. It will make your compliance with future TIS requirements much easier.

The main impact of Truth-in-Savings on an IRA custodian will be that the custodian will need to comply with the account disclosure rules. However, it is worthwhile to briefly mention three related compliance topics before discussing the disclosure rules. Each of these topics will be discussed in more detail in future issues.

Topic #1 — Fees. More and more IRA custodians are beginning to assess fees with respect to their IRA deposits, in addition to any interest penalty for the early surrender of a time deposit.

The most common fees are: (1) for distributions and (2) for transfers. Less common are administrative/ maintenance fees and set-up fees. To the extent that these fees may be assessed against a deposit account (i.e. savings, time deposit or money market), you as the IRA custodian must disclose this possibility. The solution is to use a special schedule: Disclosure of IRA Fees. It is probably best that this schedule be customized so that only the fees you will charge will be mentioned. But you also could use a generic Schedule of IRA Fees, completing only those fees which you will assess, and marking the others N/A (not applicable).

Topic #2. The annual percentage yield calculation must be performed for IRA deposits as for other deposits. The APY calculation must be made for account disclosures, advertisements and for periodic statements. In general, the annual percentage yield for account disclosures and for advertising is an annualized rate that reflects the relationship between the amount of interest that would be earned for the term of the account and the amount of principal used to calculate that interest.

Topic #3. There are now new rules governing the advertising of such accounts which must be complied with. Very briefly, "an advertisement shall not be misleading or inaccurate and shall not misrepresent a depository institution's deposit contract. An advertisement shall not refer to or describe an account as "free" or "no cost" (or contain a similar term) if any maintenance or activity fee may be imposed on the account."

The Requirement to Furnish Account Disclosures

An account disclosure is a summary of the terms of the legal agreement governing the deposit, between the depositor and the financial institution in which he or she has chosen to deposit his or her funds.

When must these disclosures be furnished?

1. At Account Opening — The general rule is that the disclosure must be furnished before the account is opened. If the account is being opened by mail or telephone, then the disclosure must generally be mailed or delivered no later than 10 business days from the time the account is opened.

2. When Requested by a Consumer — The disclosure must be provided if a person is present in your institution and requests it. If the person is not present but calls or writes and requests the disclosure, your institution must mail or deliver the disclosure within "a reasonable time," which has been defined to be 10 business days.

3. Disclosures to Existing Customers

Type #1 – To Those Entitled to Receive Periodic Statements and Who Have an Account Type Available on June 21, 1993. There is a requirement to furnish either a notice informing the customer that he or she may ask to be furnished the disclosure, or furnish the disclosure itself. The notice must be included on or with the first periodic statements sent on or after June 21, 1993 (or on or with the first periodic statement for a statement cycle beginning on or after that date). However, this requirement only applies to a customer who receives a periodic statement. This requirement will not generally apply to IRAs since IRA statements are not generated four or more times a year.

Type #2 – Upon Renewals to Existing Customers. If the time account has a term of more than one month, then the disclosure must be furnished at least 30 days prior to the maturity date. Some special rules do apply with respect to grace periods.

If the time account has a term of less than one month, then there is no requirement to furnish a disclosure before the renewal unless there is a change in a term (other than interest rate) which is required to be disclosed.

Type #3 – To Nonautomatic Renewing Accounts. If the term of the account is one year or less, then there is no duty to furnish any type of notice or disclosure prior to maturity that the account does not renew, or whether you will continue to pay interest after maturity.

However, if the term of the account is more than one year, then you must disclose the maturity date and whether interest will be paid after maturity. This notice must be mailed or delivered to the consumer at least 10 calendar days prior to the maturity date.

Type #4 – Adverse Changes in Terms of the Agreement. If the institution amends the deposit agreement in such a way that the annual percentage yield will decrease or new terms will adversely affect the consumer, then a notice describing the changes and the effective date of the changes must be mailed or delivered at least 30 calendar days before the effective date of the change. This requirement does not apply to changes in the interest rate for variable accounts, or for any changes in accounts with a maturity of one month or less.

Type #5 – To Those Receiving Periodic Statements After June 21, 1993. A periodic statement is a statement setting forth information about an account (other than a time account or a passbook savings account) that is provided to a consumer on a regular basis four or more times a year. This requirement will not generally apply to IRAs since IRA statements are not generated four or more times a year.

The statement is required to include the following disclosures:

1. The annual percentage yield earned during the statement period.

2. The dollar amount of interest earned during the statement period.

3. A listing of each fee (type and dollar amount) debited to the account during the statement period.

4. The total number of days in the statement period, or furnish the first and last day of the statement period.

Special Rule: If your institution uses the average daily balance method and uses a period other than the statement period, then the annual percentage yield earned and interest earned must be based on that different period. The total number of days, or furnishing the first and the last day of the period, must be stated for both periods. PD

Withdrawal Relief—*Continued from page 1*

early contributions to IRA plans, rather than waiting for the tax year deadline to contribute. This is certainly the best approach from the standpoint of maximizing IRA earnings.

One of these intended encouragements was a rule allowing contributions for a given tax year to be withdrawn up to the time of that year's tax filing deadline (plus extensions) without having to apply the pro rata rules for tax of distributions. Such a contribution is known as a "current year contribution." Given this option, taxpayers theoretically should have little reason to wait until tax deadline time to make their IRA contributions. If a contribution made earlier in the year was later found to be non-deductible, it could be withdrawn by the tax filing deadline.

***(This is different from withdrawal of a "true excess" contribution – an amount that cannot be contributed whether deductible or nondeductible. These can be withdrawn even after the tax filing deadline.)

A Prior Rule Example

Under these old rules, for example, a contribution for 1991 made between January 1, 1991 and April 15, 1992, could be withdrawn from the IRA without penalty by the 1991 tax filing deadline of April 15, 1992, plus extensions. This is the instruction that has traditionally been found in IRS Publication 590, "Individual Retirement Arrangements (IRAs)."

... Now, a New Withdrawal Interpretation

But the IRS has now adopted a different position, expanding the allowable current-year-contribution period to provide relief for taxpayers. Why did the IRS determine that "relief" was necessary?

IRS Non-Deductibility Notification Often Too Late

This is being done because practical reality doesn't always match the theoretical. Some workers file their income tax return assuming their IRA contribution is deductible, only to learn later from the IRS that it is not. The time delay for receiving notification of nondeductibility from the IRS is very unpredictable. It is very commonly received after the tax filing deadline has passed, denying taxpayers the opportunity to withdraw their contribution in time to avoid being subject to the pro rata rules. And if taxpayers file their taxes on or just before the deadline, late notification is inevitable.

Publication 17 Direction Adds Additional Year for Withdrawal

This "catch 22" situation is what the IRS was hoping to partially correct when it announced – in its Publication 17 for tax year 1992 – a new position for the withdrawal of a current year contribution:

"If you made contributions in 1992 for either 1991 or 1992, you can withdraw them tax free (except for any earnings on them) by April 15, 1993 (or a later date if you have an extension to file your return). You can do this if:

- You did not take (or did not receive) a deduction for the contribution you withdraw, and
- You also withdraw any interest or other income earned on the contributions. You must report this income on your 1992 return."

Thus the IRS added one full year to the period in which a 1991 contribution could be withdrawn as a "current year contribution," if – and only IF – that contribution was made in the carryback period of January 1 to April 15, 1992, rather than during the calendar year of 1991.

Result is Only Partial Relief

Examining the IRS' example above, one sees that the difference of just one day in making one's contribution can mean one entire year in the allowable "withdrawal of current year contribution" period.

If a contribution was made on January 1, 1992 for 1991, the deadline for withdrawal was April 15, 1993. But if that same contribution had been made on December 31, 1991 for 1991, – just one day earlier – the deadline would have been April 15, 1992 (plus extension), or one year less.

To examine this in a current context, a contribution made by December 31, 1992 for 1992 would have had to be withdrawn by April 15, 1993, the tax deadline just passed (plus any extensions). But if that contribution had been made one day later, January 1, 1993 for tax year 1992 (during the carryback period), the deadline for withdrawal is April 15, 1994, plus extensions.

New Rule is a Disincentive for Early Contribution

The new rule clearly provides a disincentive for making an IRA contribution early...contributing for a given tax year in that same calendar year. "Why not" – taxpayers will say – "make my contribution after the first of the coming year, and get an additional year's grace period for its withdrawal?"

It may be that the IRS has allowed as much relief as the current law as written allows. Indeed, we spoke to the IRS and even this current new interpretation is not technically correct. Perhaps in the end, the way to provide the most complete relief would be to change the law, and extend the withdrawal privilege to contributions made before the carryback period.

New Relief May Hurt Concept of Nondeductible IRA

One may wonder further what effect this and potential additional relief will have on non-deductible IRA contributions. The question begging to be asked is: "How far back in time should the IRS go in allowing a taxpayer to withdraw a contribution?" If it becomes easier and easier to withdraw a contribution long after it is made, it is easy to envision a drop in the number of nondeductible IRA contributions, even though they may make sense from the standpoint of accumulating savings for retirement.

Will This Affect Forms Use?

Many financial institutions have a special form to be used when a customer withdraws a current year contribution. CWF's form for this purpose is Form #67, Special Explanation Regarding the Withdrawal of a 1993 Current Year Contribution. Because of the recent redefinition of the term "current year contribution" by the IRS, your forms (if CWF, version 1/93 or earlier) may pose a potential problem.

According to the old definition, "current year contribution" is defined more restrictively than the just-released new IRS definition. Unless you can be sure that your institution's staff will use existing forms but apply the new and more liberal time frame rule for withdrawing a current year contribution, we advise you to replace your old forms.

Since this is not one of the more commonly used forms, we feel that the comparatively minor expenditure required to replace them is advisable, in order to avoid inconsistent application of the rules of withdrawing a current year contribution.

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An IRA Contribution Withdrawal Dilemma

Question #1: Our bank has a customer with the following situation. She made her 1991 IRA contribution of $2,000 (in 1991) thinking it was fully deductible. The IRS just sent her a letter (in March of 1993) informing her that she owes them an additional $592.25 (28% times $2,000 plus interest and penalties). The reason they disallowed the deduction is that she was an active participant for IRA purposes, since her employer contributed $376 on her behalf to a profit sharing plan.

What options does she have? Can she now withdraw the $2,000 as an excess contribution? She really would not have made the contribution if she had known that it would not be deductible.

Our customer says that she talked with one of the IRS representatives that handle telephone consulting calls, and was told that she could withdraw the contribution as an excess contribution. She is considering withdrawing it, and would like us to code this distribution as an "8" or a "P".

✔ Answer. Should you? — No. This contribution was permissible even though it was nondeductible. This means the contribution technically was not an excess contribution.

If you distribute this amount, the general tax rule is that it is subject to taxation per the pro rata formula as follows:

"Amount Distributed" x "Nondeductible Account Balance" ÷ "Total Balance" = "The Nontaxable Portion of the Distribution"

The remaining amount is taxable. (If the accountholder never made any nondeductible contributions, then the entire portion of an IRA distribution is always 100% taxable.)

For example, if an accountholder has an IRA balance of $20,000, of which the nondeductible portion is $2,000, then 10% of any distribution will not be taxed, but 90% will. So, if she were to withdraw $2,000, then she would include $1,800 in her income and pay taxes on it.

This general tax rule does not apply when any current year contribution is withdrawn before the tax filing deadline (normally April 15th). It also does not apply to the distribution of an excess contribution after the due date.

However, in the situation discussed above, the contribution was not an excess and it was not withdrawn on or before April 15, 1992. Thus, the general tax rule does govern. This means that she could not withdraw her $2,000 without having to apply the pro rata formula. This means that most likely some portion of the distribution would be taxable, a result that she may not expect.

As your experience shows, IRS consultants at the local level will from time-to-time make the statement that such a contribution could be withdrawn as an excess. The IRS may even in actual practice allow such contributions to be withdrawn as excesses, even though they technically are not.

The tax concerns of this customer, however, are not identical to the concerns of your institution. The task of your institution is to report "gross" tax transactions and not to determine the effect of such transactions. Since this distribution is not technically an excess, the distribution code to be input on the Form 1099-R should either be a 1 or a 7, not an 8 or P. You may instruct your customer or her accountant that they can furnish an explanation with the tax return as to why the withdrawal should be treated as the withdrawal of an excess (nontaxable) contribution. Although the IRS should technically not accept this approach, they may feel generous and do so.

We do authorize the photocopying of this article for the purpose of furnishing to your customer and their accountant for review.

Question #2: Would the answer be the same if the same situation as set forth in Question #1 existed, except that she had made her 1991 contribution on March 3, 1992 (during the carryback period)? Also assume that she withdrew the $2,000 plus related income of $110 on March 22, 1993 (before the tax filing deadline).

✔ Answer. No. In general, the pro rata taxation rules would not be applied. She would withdraw the contribution and pay tax (and the 10% pre-59-1/2 tax) only on the portion required to be included in income.

Review the article on page 2 — "IRS Expands Relief for Withdrawing Current Year Contributions." The IRS in the 1992 Publication 17 defines a current year 1992 contribution as being one made in 1992 whether for 1992 or 1991. In Publication 590 a current year 1992 contribution is one made in 1992 for 1992. Next year Publication 590 will take the same position as Publication 17. Since the original contribution (for 1991) was made in 1992, she would have had until 4-15-93 (plus extensions) to correct it. The IRA custodian should use a code "P" for such a distribution. 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.