THE Pension Digest

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Truth in Savings Still Confounding Many

The many consulting and seminar questions we respond to on a daily basis have convinced us that some financial institutions are not properly handling deposit transactions correctly with respect to the Truth-in-Savings requirements for IRAs.

To clarify some lingering uncertainties, we are recapping a portion of a discussion of these subjects that appeared in the April, 1993 Pension Digest.

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. That is, the IRA custodian will need to furnish account disclosures as required by the rules.

However, it is worthwhile to briefly mention three related compliance topics before discussing the disclosure rules.

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.

Continued on page 2

A Discussion of Excess SEP Contributions

Most retirement plan practitioners are familiar with the concept of excess contributions to IRA accounts. But far fewer understand excess contributions as they apply to SEPs, or Simplified Employee Pensions. The purpose of this article is to help readers understand the potential consequences when a contribution is made that results in an excess SEP contribution.

As much as we would like the issue to be clear-cut, the Internal Revenue Code does not provide a completely comprehensive definition of an excess SEP contribution. Practitioners must rely on the IRS' limited definitions, the methods it describes to correct an excess SEP contribution, and interpretation of the IRS rules both individually and collectively. (A listing of Code sections to be considered when judging the permissibility of a SEP contribution appears at the end of this article.)

The consequences of an excess SEP contribution are potentially even more damaging than for an excess IRA contribution (which generally results in a 6% excise tax on the excess amount). This is because:

A. SEPs are often plans that involve numerous individuals, and improper con

Continued on page 2

Also in this issue –

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Truth-in-Savings—*Continued from page 1*

3. Disclosures to Existing Customers

Type #1 – Upon Renewals to Existing Customers. If the time deposit 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 #2 – 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 #3 – 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 changes. 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 #4 – 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, if generated, 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

JOT IT DOWN

QP Amending Reminder: Don't Miss December 31, 1994 Deadline

Financial institutions acting as sponsors of qualified plans for business customers (or their own plans) are reminded that any required plan amending not yet executed must be completed by December 31, 1994. Otherwise, adverse tax consequences resulting from plan disqualification will result. This amendment deadline represents the final stage in qualified plan changes brought about by the Tax Reform Act (TRA) of 1986. Most of the changes were effective for plan years beginning January 1, 1989.

Many consider the IRS to have been relatively generous in allowing the balance of the TRA '86 changes to not become effective before now.

If You Use CWF Plan Prototypes ...

If you use a qualified plan prototype provided by Collin W. Fritz and Associates, be sure your institution has remained up-to-date with proper adoption agreements signed in 1990, 1991 or 1992 for each business customer and a favorable opinion letter dated May, 1990 or later. (Although you may have been assured in the past by your personnel that this was completed, it is advisable that you re-check to be sure.) If not, you may already have plans that are in a state of noncompliance.

If you have been successful in getting these aforementioned adoption agreements signed by all your customers, you have done well with respect to this updating. But if not, and if some customers persistently fail to do so, you must take action to limit your own liability. One such step, which may seem extreme but is nonetheless advisable, would be to resign as custodian of the plan.

For Further Information ...

For more information on the amending process and the document(s) needed to complete the amending, please call us at 1-800-346-3961. PD

SEP Contributions—*Continued from page 1*

tributions may disqualify the entire plan for all;

B. The SEP contribution amounts are often greater than a regular IRA contribution; and

C. An excess SEP contribution may lead to an automatic IRA contribution, which itself may be an excess – or at least unwanted – contribution.

Timing is of key importance. If possible, an employer (and his or her plan custodian) should make the determination that there are SEP problems before the tax filing deadline. When this can be done, contributions can be withdrawn or corrected to avoid negative consequences.

First, Some SEP Basics

- A SEP is a special category of employer-sponsored retirement plan. It uses an IRA as the depository for the investments, not a separate trust as with a true "qualified plan." A SEP is not a qualified plan as most pension practitioners use the term.
- Only a business – including a one-person business – can establish a SEP plan.
- An employer makes contributions for its employees and (within limits) receives a tax deduction for them, and the employee for whom the contribution was made is not taxed on this amount, or its earnings, until withdrawn. Generally an employer may make a deductible contribution of up to 15% of compensation, or $22,500, whichever is less.
- SEPs are authorized by Code section 408(k). If these requirements are met, then a qualifying SEP plan exists. If not, then contributions made to the plan are deemed NOT to be SEP contributions.

(This is where an improper SEP contribution can have an adverse or unwanted impact on a participant's IRA plan. Contributions disqualified as SEP contributions automatically become IRA contributions. Depending on the individual's income and other contributions already made for the same year, this may or may not be an excess IRA contribution. And, depending on income and his or her employer retirement plan participation status, it might or might not be tax deductible, even if allowable.)

- There are two types of SEP plans: the "regular" SEP in which the employer makes the contributions, and a salary-reduction SEP, under which an employee is allowed to contribute a bonus or a portion of their compensation – tax-deferred – into their SEP plan. (This is defined in Code section 408(k)(6).)

Requirements for Having a SEP

- A participation requirement, defining which employees can or must participate to have a valid SEP plan.

Continued on page 3

SEP Contributions—*Continued from page 2*

• A requirement not to discriminate with respect to contributions.

• A requirement that contributions may be withdrawn by an employee at any time.

• Contributions must be made under a written allocation formula, and a top-heavy requirement (if applicable).

Recognizing an Excess SEP Contribution, and Consequences if Uncorrected

In the following examples, we will discuss several scenarios that involve potential excess SEP contributions.

Example #1. ABC Corporation has six employees who are entitled to receive a SEP contribution. Management has decided to contribute 10% of compensation. Because of an administrative error, contributions are made for only four employees. A contribution of 10% is made to an IRA account for each of the four.

	Compensation	SEP
Maria Sims	$80,000	$8,000
Davis Peters	35,000	3,500
Paula Hanson	25,000	3,500
Mike Ruttger	20,000	2,000
Mimi Rogers	18,000	missed
Larry Arneson	16,000	missed

Consequences: The contributions which were thought to be SEP contributions are, in fact, not. To have a SEP, all six employees need to receive contributions. From the employer's (ABC Corporation) perspective, the fact that these contributions are not SEP contributions means that the four employees have additional compensation subject to the withholding rules, FICA taxation and income taxation. Thus, ABC Corporation will need to correct the four Form W-2s accordingly, and an accompanying Form 941, summary of withholding tax.

From the employee's perspective, the fact that these contributions are not SEP contributions means that each person who received a contribution has, in effect, made a regular IRA contribution in an amount which may not qualify (i.e. an excess IRA contribution). In addition, they may not be eligible to deduct the contribution amount even if it does qualify.

Each employee will need to decide and act if he or she wishes to use the rules of Code section 408(d)(4) to withdraw their "current year" contribution. Keep in mind that if these are excess contributions and are not withdrawn, then section 219(f)(6) will most likely work to each year convert $2,000 from being an excess contribution to being a current-year contribution.

(For further discussion of the consequences and means to correct excess contributions, see the April, 1993 and December, 1991 issues of *The Pension Digest.*)

Example #2. TTT Corporation has four employees who are entitled to receive a SEP contribution. Management has decided to contribute 10% of compensation. Three employees receive 12% contributions, but one employee receives only 7%.

	Compensation	SEP	
Bruce Roe	$80,000	$9,600	12%
Dolly Burton	35,000	4,200	12%
Polly Unger	25,000	1,750	7%
Mike Cato	20,000	2,400	12%

Consequence: The IRS has not given total guidance in this situation. In its proposed regulation written in July, 1981, the IRS stated that there would be a SEP to the extent of 7% of compensation (the percent that all received) and that there would be excess allocations only to the extent of 5%. It is not clear if the IRS follows this approach in all cases. The IRS might take the approach that the entire SEP was disqualified, not just to the extent of the excess.

We speculate that the IRS might no longer follow the approach of the proposed regulation, because in certain situations it has chosen not to. For example, the proposed regulation states that a rate of contribution which decreases as compensation increases will be considered uniform. The IRS now takes the approach that uniform means uniform, or equal. That is, higher paid employees cannot receive a lesser percentage contribution than other employees.

Example #3. JJJ Corporation has four employees who are entitled to receive a SEP contribution. Management decides to contribute 18% of compensation. This is possible because Code section 404(h) does provide for a deduction carryover if the employer contributes more than it is able to deduct. (Code section 404(h) contains the limitation that the amount deductible in a tax year for a SEP shall not exceed 15% of the employee's compensation.) However, the amount of the excess contributed over the amount deductible for a tax year shall be deductible in the succeeding tax years in order of time, subject to the 15% limit of the preceding sentence.

However, Code section 402(h)(2) provides that any contribution in excess of 15% (or such other amount after applying the integration rules) will be considered to have been paid to an employee, and immediately taxable in that tax year. The effect of this rule is that an employer may contribute more than 15%, but this excess will not be a qualifying SEP contribution. It will be treated as additional compensation to the employee, and will be treated as an IRA contribution of that person, subject to the regular IRA contribution and deductibility limits. This will not, however, disqualify the plan.

Pertinent Sections of the Internal Revenue Code ... & Their Relationship to SEP-IRA Plans

408(k) – rules for standardized SEPs

408(k)(6) – rules for SAR-SEPs

408, other than (k) – all rules dealing with IRAs

402(h) – special tax rules for SEPs

404(h) – special deduction rules for SEPs

4972 – a 10% excise tax is assessed the employer when it contributes more than it can deduct for that year to a retirement plan

4973 – a 6% excise tax applies when there is an excess IRA contribution

219(f)(6) – automatically converts an excess IRA contribution into a regular contribution in some situations

4979 – a 10% excise tax is assessed with respect to certain excess contributions to SAR-SEP plans

QP VCR Program May Be Extended to SEPs, TSAs

Since being initiated, the IRS' Voluntary Compliance Resolution (VCR) program has given qualified plan administrators the opportunity to correct plan defects in a relatively inexpensive, non-confrontational manner. The VCR program allows plan administrators to voluntarily "own up" to plan defects, and correct them as painlessly as possible, thereby restoring compliance and ensuring their continued viability as plans.

Now, this option may be extended to cover Simplified Employee Pension (SEP) and 403(b) Tax Sheltered Annuity plans. Common defects of SEP plans include the exclusion of workers who should be eligible to participate, and the misallocation of contribution amounts. With respect to TSAs, compliance problems often include exceeding dollar limitations, failure to provide universal availability, and failure to comply with the required beginning date for annuity payments. Be watching for more news on this program.

Another IRA Enhancement Bill Proposed

After numerous legislative introductions and equally numerous failures in the last several years, another effort to liberalize IRA contribution and access rules is being advanced in the U.S. Congress. While not yet introduced in the House, a pending Senate bill is said to currently have more than 50 co-sponsors, and broad support from both parties.

The effort is being led by long-time IRA reform advocates J.J. Pickle, D-Texas (a senior member of the House Ways and Means Committee), and Senators William Roth, R-Delaware, and John Breaux, D-Louisiana. The term "Super IRA" used in prior legislative initiatives has also been attached to this legislation.

Features of the proposed legislation include:

- Raising the contribution deductibility threshold, to allow those with higher incomes who also participate in an employer plan to make a tax deductible IRA contribution.
- In addition to retirement security, IRA assets could be used for first-home or childrens' college expenses. This includes a provision to waive the 10% early-withdrawal penalty for those under age 59 1/2.
- Catastrophic health care needs and supplementing unemployment compensation (after 12 weeks) would also be allowed uses for IRA assets, without penalty.
- In-the-home, noncompensated workers would also be allowed up to a $2,000 IRA contribution annually.
- IRA contribution amounts would be indexed to inflation, in $500 increments.
- The after-tax "IRA Plus" concept would also be revived, allowing after-tax contributions to earn tax-free interest, if held in the account for at least five years.

Sponsors of the legislation claim that its impact would be to increase national savings by approximately $40 billion annually, and have the long-term effect of improving the U.S. economy.

Comments

All of the above would make IRAs more attractive. Tax-deductible contributions – the biggest incentive for taxpayers – would once again be a reality for more workers. One of the most important provisions might be the indexing of IRA contribution deductibility. The Tax Reform Act of 1986, which provided deductibility phaseout for active participants based on their income, did not provide indexing. Thus each year, as active participant workers' incomes increase, they become less able to deduct their IRA contributions.

This has been a gross inequity when compared to employer-sponsored retirement plans, most of which have by law the provision for indexing of contribution deductibility. In most cases, with each successive year a larger contribution can be contributed and deducted from the participant's income tax.

We will keep you up-to-date on this legislation as it proceeds through Congress. PD

✓✓✓ Check It Out ✓✓✓

Question: Our institution offers both standardized and nonstandardized profit sharing, money purchase and 401(k) prototype plans, and I really don't understand what is meant by the terms "standardized" and "nonstandardized." Can you explain?

✓ Answer. For purposes of answering this question we assume the national office of the IRS has issued your institution a favorable opinion letter for each of the prototypes you offer. The value of these "opinion" letters differs depending upon whether the prototype is standardized or nonstandardized.

An employer who adopts an approved standardized prototype and does not maintain other plans has IRS "reliance" and does not need to make a filing at the IRS Key District office for a determination letter. An employer who adopts an approved standardized prototype and also adopts its "paired" prototype also has reliance for both plans and does not need to make a filing at the IRS Key District office for determination letters. An employer who adopts a standardized prototype but also has one or more other plans which are not paired, does not have reliance and would need to make a filing of each plan at a Key District office.

An employer who adopts a nonstandardized prototype must request a determination letter from the Key District if it wants reliance that its plan is "qualified," regardless of the opinion letter issued to the sponsoring institution.

A standardized prototype plan is one in which there can be no impermissible discrimination as long as the terms of the plan document are followed. Why? The plan is written in such a way that there cannot be any impermissible discrimination. A plan to be standardized must be written so that:

1. All of the employees who have met the age and service requirements must be eligible to participate;

2. The eligibility and participation requirements must be the same for all employees and cannot favor the highly compensated;

3. Plan contributions must be allocated based upon a participant's total compensation; and

4. An employee who is a participant must be allocated a contribution even if she or he was not credited with 1,000 hours of service, and even if he or she was not employed on the last day of the year. Exception: If the person who quit had 500 or less hours of service, he or she does not need to be allocated a portion of the contribution.

A nonstandardized prototype is any prototype which is not standardized.

What is most positive about a standardized plan is that the adopting employer has "reliance" from the IRS without having to incur the expense of making a filing with the IRS at the Key District level. The fee is composed of two parts: (1) the IRS filing fee and (2) the fee for the preparer of the filing. Such a filing normally costs in the range of $500 to $1,000. A negative about a standardized plan is that the employer will have to make contributions for employees who do not work 1,000 hours, and in some cases, for those employees who quit during the year.

A nonstandardized prototype plan is one which does not meet one of the above requirements. Example #1: The prototype allows for the employer to exclude a certain classification of its employees. Example #2: The prototype allows for the employer contribution to be allocated only to those employees who are credited with 1,000 hours of service and who were employed on the last day of the plan year. (Please note that most prototypes provide, as CWF's do, that a participant without 1,000 hours or who is not employed on the last day of the plan year will still be allocated a pro rata portion of the employer's contribution if they left work on account of retiring, death or becoming disabled.)

An employer who adopts a nonstandardized prototype will normally wish to file it with the Key District office so that the IRS will issue a favorable determination letter. As mentioned above, the cost for such a filing would range between $500 to $1,000. An employer can recoup this cost quickly when contributions do not have to be made for those "employed" employees who did not have 1,000 hours, or for those terminated employees who had more than 500 hours.

A business customer should decide which prototype – standardized or nonstandardized – best suits its needs. 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.