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Waiving the Early Withdrawal Interest Penalty, and Truth-in-Savings Issues

The current interest rate market is one in which interest rates paid for deposits are rising, or can be expected to rise. That is, the interest rate which a financial institution offers for a deposit made on November 4, 1994 will probably be greater than the interest rate it agreed to pay for a deposit made on April 13, 1993.

It has been a standard practice of the financial industry that a depositor be required to pay an early withdrawal penalty (based generally upon interest earned or to be earned) if he or she withdraws the deposit prior to its maturity.

However, it has also been a standard practice that an IRA custodian has the discretion to waive the early-surrender interest penalty for an IRA accountholder who is 59 1/2 or older. The authority for this discretion is Federal Reserve Regulation D — Reserve Requirements. Regulation 204.2(c)(1) contains the definition and requirements to have a "time deposit." One requirement is that withdrawals may not be made within six days after the date of the deposit, unless the deposit is subject to an early withdrawal penalty of at least seven days simple interest. But there are exceptions. The current law contains a footnote which reads as follows:

A time deposit, or a portion thereof, may be paid before maturity without imposing the early withdrawal penalties specified by this part:

(a) Where the time deposit is maintained in an individual retirement account established in accordance with 26 U.S.C. 408 and is paid within seven days after establishment of the individual retirement account pursuant to 26 CFR 1.408-6(d)(4), where it is maintained in a Keogh (H.R. 10) plan, or where it is maintained in a "401(k) plan" under 26 U.S.C. 401(k); provided that the depositor forfeits an amount at least equal to the simple interest earned on the amount withdrawn;

(b) Where the depository institution pays all or a portion of a time deposit representing funds contributed to an individual retirement account or a Keogh (H.R. 10) plan established pursuant to 26 U.S.C. 408 or 26 U.S.C. 401 or to a "401(k) plan" established pursuant to 26 U.S.C. 401(k) when the individual for whose benefit the account is maintained attains age 59 1/2 or is disabled (as defined in 26 U.S.C. 72(m)(7)) or thereafter.

(c) Where the depository institution pays that portion of a time deposit on which federal deposit insurance has been lost as a result of the merger of two or more federally insured banks in which the depositor previously maintained separate time deposits, for a period of one year from the date of the merger;

(d) Upon the death of any owner of the time deposit funds;

(e) When any owner of the time deposit is determined to be legally incompetent by a court or other administrative body of competent jurisdiction; or

(f) Where a time deposit is withdrawn within ten days after a specified maturity date even though the deposit contract provided for automatic renewal at the maturity date.

Thus, this footnote gives the bank the discretion to waive the interest penalty when the IRA accountholder attains age 59 1/2 or is disabled. Note that the bank is not required to waive the interest penalty.

Therefore, the common practice on the retail side of many financial institutions has been to ***always waive*** the interest penalty for an early withdrawal of a time deposit when the IRA accountholder is 59 1/2 or older.

When To Waive

Obviously, this is a management decision. The first purpose of this article is to suggest that it may not be desirable to always waive the interest penalty.

The second purpose of this article is to suggest that whatever your policy is with respect to this issue, your institution will want to make sure that it is complying with the Truth-in-Savings rules.

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Don't Hold Breath for Pension Bill in '94

Informed sources on Capitol Hill say it's unlikely that any tax bills containing pension reform will pass the U.S. Congress this year, primarily because of Democratic leadership disinterest in pressing for such legislation at this time. The House-passed Tax Simplification and Technical Corrections Bill (HR 3419) has had preliminary work done on it by the Senate, and includes such provisions as elimination of the $5,000 Death Benefit Exclusion (DBE) on lump-sum distributions from qualified plans to beneficiaries, as well as elimination of five-year-averaging of lump-sum distributions. Other provisions include a so-called uniform retirement age, and provisions on 401(k) plans.

It is said that Senate Finance Committee Chairman Daniel Moynihan (D-NY) does not plan to take up any tax measures this year, and indeed that this bill will not even be heard by his committee before 1995.

This is not related in any way to the efforts of several Senators and Representatives who are seeking support for a so-called IRA enhancement bill (reported in the August *Pension Digest*), that would, among other things, liberalize contribution, deductibility and withdrawal provisions. PD

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Early Withdrawal Interest—*Continued from page 1*

The next 3 to 18 months may be a time when interest rates increase. If so, your institution may wish to reconsider your policies with respect to waiving the interest penalty for those IRA accountholders 59 1/2 and older.

Past experience has shown that in times of increasing interest rates many IRA accountholders 59 1/2 and older are not shy, and will surrender their existing time deposits prior to maturity (without being assessed an early withdrawal penalty) simply to buy your current time deposits which are now paying a higher interest rate. Worse yet, some of those accountholders may wish to move their funds to a competing financial institution.

There is obviously an important difference between the IRA depositor, age 65, who has a 5-year CD (paying the highest interest rate) who now withdraws 8% of his or her account balance as a normal distribution, versus the IRA depositor, age 65, with the same CD who wishes to move all of the funds to a competitor (bank, credit union, brokerage firm, etc.).

It is also reasonable that an IRA custodian may wish to limit its generosity to its 59 1/2 and older IRA accountholders. That is, the financial institution may wish to place a reasonable limit on the number of times a customer may upgrade his or her time deposit. An unlimited right to surrender time deposits may not be a wise business decision. A reasonable limit might be once per year, or once per term of the time deposit.

Enter Truth-in-Savings

If a financial institution will not always waive the interest penalty, then it is CWF's opinion that there will need to be compliance with the Truth-in-Savings Disclosure Rules. These rules require that the account disclosure must describe the conditions (how, when and why) for the assessment of the early withdrawal penalty.

In section 230.4 of Regulation DD — Truth-in-Savings — the rules are set forth as to what must be included (i.e. the content) in account disclosures. Section 230.4(6)(ii) reads as follows:

(ii) Early withdrawal penalties. A statement that a penalty will or may be imposed for early withdrawal, how it is calculated, and the conditions for its assessment.

The question for IRA/Truth-in-Savings compliance purposes is: does the IRA custodian/trustee need to define with specificity when the interest penalty will be assessed?

We think so. The regulation requires that the account disclosure describe how the interest penalty is calculated and the conditions for its assessment. We do not believe it acceptable any more to simply have the account disclosure state that "we as the IRA custodian have the discretion to waive the penalty." We agree that there might not be a problem if the institution in this situation always waives the penalty. But there is a problem if the institution does not always waive such penalty. The institution must disclose in what situations the penalty will be assessed and how the amount of the penalty is calculated.

Set forth below are two possible account disclosure provisions which could be added to a "standard" disclosure.

1. "If this deposit has been made pursuant to an IRA agreement, then we will not assess the penalty for early withdrawal if you have died or if you are 59 1/2 or older when a retirement payment is made to you. A retirement payment is a payment to you which equals or is less than 30% of your total IRA account balance at the time of the distribution. Since a retirement payment requires that you be paid the funds, a transfer will never be a retirement payment and will be assessed the interest penalty." Or ...

2. "If this deposit has been made pursuant to an IRA agreement, then we will not assess the penalty for early withdrawal if you have died or if you are 59 1/2 or older and have some or all of the funds paid to you (or considered paid to you), you reinvest the same day the total amount withdrawn with us in a different deposit instrument and you have not had any other surrender of a time deposit with respect to the applicable IRA for which the early withdrawal penalty was waived within the preceding 12 months.

"In addition, we will not assess the penalty for early withdrawal if you are 59 1/2 or older when a retirement payment is made to you. A retirement payment is a payment to you which equals or is less than 30% of your total IRA account balance at the time of the distribution. Since a retirement payment requires that you be paid the funds, a transfer of IRA funds will never be a retirement payment and will be assessed the interest penalty."

A standard disclosure is set forth below:

Penalty for Early Withdrawal

You agree to pay us the following fee if you withdraw any portion of your deposit within six days after the date of your deposit or within six days after any subsequent early withdrawal:

☐ $__________ or ☐ the amount equal to ________ (days/months) simple interest which would have been earned by the deposit; and

You agree to pay us the following fee if you withdraw any portion of your deposit after six days after the date of your deposit or after six days after any subsequent early withdrawal and prior to the maturity date:

☐ $__________ or ☐ the amount equal to ________ (days/months) simple interest which would have been earned by the deposit.

These fees ☐ will or ☐ will not apply to the withdrawal of interest earned by the deposit. If any interest may be withdrawn prior to maturity, the annual percentage yield as disclosed assumes that interest remains on deposit until maturity, and that such a withdrawal will reduce your earnings. PD

QP Plan Amendment Due Dates for TRA '86 Compliance

Qualified plans and their administrators have had a very lengthy time frame for amending plans to comply with the provisions of the Tax Reform Act of 1986 (TRA '86). But this grace period will be ending in 1995, as spelled out with the release of amending deadlines by the IRS' Brooklyn Key District in a recent *EP & EO Newsletter*.

The deadlines are keyed to the end of the 1994 plan year. To the right is a table showing plan-year frameworks, and the corresponding required amendment dates.

Determination Letter Procedure for Those Correcting Plan Provisions

Plan sponsors wishing to correct disqualifying plan provisions that were identified in the determination letter process, and seeking to take full advantage of the remedial amendment period to do so, must make determination letter application to the appropriate Key District office by the same dates identified above. PD

Plan Year	Required Amendment Date
01/01 - 12/31	12/31/94
02/01 - 01/31	01/31/95
03/01 - 02/28	02/28/95
04/01 - 03/31	03/31/95
05/01 - 04/30	04/30/95
06/01 - 05/31	05/31/95
07/01 - 06/30	06/30/95
08/01 - 07/31	07/31/95
09/01 - 08/31	08/31/95
10/01 - 09/30	09/30/95
11/01 - 10/31	10/31/95
12/01 - 11/30	11/30/95

Proxy Voting In Qualified Plans & IRAs — *Who Votes?*

In today's financial marketplace, it is commonplace for qualified plans (QPs) and IRAs (self-directed or trust) to hold stock as an investment. As long as the applicable plan document allows this, holding stock in and of itself does not present any problems. Stock as a QP or IRA investment, however, does raise some ancillary issues. How to vote the stock and who votes it are the issues we will examine in this article.

When an individual or entity owns a share of stock, one of the rights that goes along with that ownership is a right to cast one vote per share owned when deciding various corporate matters. These matters could include election of the corporate board of directors and decisions on various corporate issues. Normally the corporation will issue what is called a "proxy." A proxy is a written document whereby the stockholder authorizes another individual or individuals to vote on their behalf. Some of the proxy documents are very general and just state that the proxy designated can vote the shares in any manner that they see fit. Other proxy documents ask for the stockholder to direct the proxy's vote on certain issues.

The question we have here is: when the stock is held by a QP or IRA, who completes the proxy document and decides how the proxy is to vote? For qualified plans, the Department of Labor (DOL) has recently provided some guidance. The DOL has issued Interpretative Bulletin 94-2 that deals with voting proxies and the fiduciary duties that go along with proxies. Prior to this Bulletin, the DOL had issued two letters addressing this issue. The Bulletin reiterates what the earlier letters stated.

In the letters and the Interpretive Bulletin, the DOL states that the fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock. They go on to say that it is the exclusive responsibility of the plan trustee to vote the proxies unless either (1) the trustee is subject to the direction of a named fiduciary pursuant to ERISA section 403(a)(1); or (2) the power to manage the assets has been delegated by a named fiduciary of the plan to an investment manager under ERISA 403(a)(2). ERISA 403(a)(1) says that if the plan expressly provides that the trustee is subject to the direction of a named fiduciary who is not a trustee, the trustee is obligated to follow the fiduciary's directions.

ERISA 403(a)(2) states that if a named fiduciary delegates investment authority to an investment manager, the trustee does not have exclusive authority over plan assets and as such is relieved of the obligation to manage the assets. The basic conclusion to be drawn from these DOL statements is this: the trustee of a qualified plan is generally obligated to manage the plan assets and, as such, to vote any proxies connected to a stock investment held by the plan. This proxy voting responsibility of the trustee can be shifted in two cases. The first is one in which the plan expressly states that the trustee is subject to the direction of a fiduciary of the plan who is not the trustee. The second is when a plan fiduciary has appointed an investment manager for the plan.

In this case, it is the responsibility of the investment manager to vote the proxies unless the named fiduciary has reserved to itself the right to direct a plan trustee regarding voting proxies. If an investment manager has been appointed, it is still the responsibility of the plan fiduciary to monitor the investment manager's activities in relation to the plan. This includes monitoring how the manager voted proxies. As part of this monitoring process, the DOL states that whoever is responsible for voting proxies must maintain written records of how the proxies were voted.

The named fiduciary has the responsibility to ensure that the plan assets are managed solely in the interest of the participants of the plan. As such, the proxies must be voted in a manner that is prudent, reasonable, and in the best interest of the plan participants and beneficiaries.

A third exception to the trustee voting proxies also exists. ERISA section 404(c) created what are called "individual account plans." Qualified plans that fall under this section are those that permit the participants to exercise control over the assets in their account and provides them a broad range of investment alternatives. One of the aspects of "control" of their individual accounts includes voting of proxies. If a plan is a 404(c) type plan, the decision as to how proxies are voted is shifted to the plan participant. Any qualified plan trustee or named fiduciary needs to make sure their plan qualifies as an "individual account plan" before permitting plan participants to direct proxy voting.

While there is some guidance for proxy voting in qualified plans, we have been unable to locate any materials on proxies and IRAs. As such, this article will detail what we think should be done. Any IRA custodian/trustee should consult their legal counsel for guidance when confronted with the proxy issue. The proxy issue with IRAs should only exist when dealing with self-directed or trust IRAs. Our general feeling is that it is the responsibility of the IRA custodian or trustee to vote proxies connected to IRA assets. When dealing with a trust IRA where the trustee has investment discretion, it would seem to us that the responsibility for voting the proxy would definitely be the IRA trustee's. It is our feeling that the responsibility could possibly be shifted to the accountholder if there was written documentation that specified who was to vote any proxies connected to the IRA assets. This would be completed when the IRA accountholder was selecting the IRA investment. We make this statement based on what the DOL has stated under ERISA 404(c). If the DOL follows the same line of thought evidenced in ERISA 404(c) it would seem that IRA accountholders may be able to vote proxies in some cases. It is important to remember, however, that ERISA does not apply to IRAs and that there is nothing from the DOL or IRS in writing on this issue as it pertains to IRAs. Caution, therefore, is the key word. It would be our recommendation that until further guidance comes from DOL or IRS, the safest course of action is that the custodian/trustee take responsibility for proxy voting.

A last consideration in who votes a proxy is whether or not a prohibited transaction results if the IRA accountholder or qualified plan participant votes the proxy. Internal Revenue Code section 4975 states that a prohibited transaction occurs if there is any use by or for the benefit of, an asset of the plan by a disqualified person. If voting the proxy benefits the accountholder or plan participant outside of the plan, it is entirely possible that the DOL/IRS would rule a prohibited transaction had occurred. This would result in disqualification of an IRA and penalties to the qualified plan participant.

Therefore, care is needed. If a potential conflict of interest could arise that would influence how the individual voting a proxy would vote, that individual should not vote the proxy. At that point, either the plan trustee should vote the proxy or the proxy should not be voted at all. Legal counsel's advice is needed, since this is a complex area of the law and the IRS and DOL have not provided much guidance. PD

QDRO Fees Not Chargeable to Participant, Alternate Payee

Can a qualified plan participant be charged fees when their plan incurs expenses related to a qualified domestic relations order (QDRO) dividing their plan assets in a divorce situation?

The issue arose when a company requested an opinion letter on its intent to amend its profit-sharing plan, to provide that any costs incurred in determination and administering of a qualified domestic relations order would be charged to the account of that participant.

An opinion letter issued by the Pension & Welfare Benefits Administration (PWBA) stated that no charge, either direct to an individual or against the account, could be levied against a plan participant or an alternate payee (the one receiving assets under the QDRO).

This, it stated, would "encumber" the alternate payee's right to receive benefits under the QDRO, a statutory right mandated by ERISA.

However, PWBA indicated that a reasonable fee for QDRO expenses could be charged against the plan as a whole, rather than the account of the participant or alternate payee. PD

PBGC Takes Over Two More Pension Plans

In a continuing saga that threatens to further undermine worker confidence in corporate retirement plans, the Pension Benefits Guarantee Corporation (PBGC) has taken over two more corporate pension plans, in order to administer benefit payouts to their employees.

Schwinn Bicycle Company, which filed for bankruptcy in 1992, is no longer funding its two plans and will eventually be unable to fund benefits when they become due. Schwinn has approximately 1,000 employees covered under its plans, with plan assets totalling about $7 million, and plan liabilities $16 million. An agreement is now being signed by Schwinn making PBGC the trustee of its plans.

In similar action (just approved in US District Court), the pension plan of Washington Industries, a clothing manufacturer based in Nashville, Tennessee, is also being taken over by PBGC. Its plan has 4,300 participants, assets of $22 million and liabilities of $37 million. PBGC has announced that most of Washington Industries' retirees will continue to receive full benefits, but some may receive reduced benefit amounts due to the limitation of PBGC's guarantee liability. PD

IRS Plan Audit Guidelines Defined

By releasing guidelines for its own examiners, the IRS has in effect given pension plan administrators a degree of guidance on what compliance concerns will be most focused upon during a pension plan audit procedure.

Here, in summary form, are some of the concerns that are most focused upon.

Terminating Plans

Examiners focus on plan qualification issues at this time, in particular for such things as proper amending.

Prohibited Transactions

Employer securities and employer real estate are major focal points when reviewing a plan for potential prohibited transactions. Guidance is given as to the maximum percentage of plan assets that may be invested in employer securities and real estate, and how to accurately determine the actual percentage. Guidance for determining whether or not acquisitions are actually arm's-length transactions is also given.

Plan Asset Valuation

Of particular concern is whether a plan is accurately and fairly valuing hard-to-ascertain assets, such as real property and limited partnerships. Guidelines focus on obtaining the employer's independent appraiser reports, and comparing mortgages against the fair market value of property.

Determining Earned Income For Self-Employed

Earned income *after* plan contributions is the primary focus of examiners reviewing one-person plans. The complexity of many earned income calculations is tacitly acknowledged in its instructions to examiners. In the case of age- and service-weighted plans, and those defining compensation as a percentage of net profit or a discretionary dollar amount, examiners are told to "get help" from their Field Office or the National Office, rather than attempt to do themselves!

Compliance With Sections 401(k), 401(m)

The guidelines for 401(k)s and matching contributions focus on the actual deferral percentage (ADP) and actual compensation percentage (ACP) tests for 401(k) plans. Aggregation of family member incomes for testing purposes, correction of excess contributions, and dealing with excess deferrals are also given a considerable amount of attention.

Copy Of IRS Announcement Available From CWF

For a copy of the actual IRS Announcement 94-101 describing these instructions in detail, send $5.00 and a self-addressed stamped envelope to CWF & Associates, Ltd., P.O. Box 426, Brainerd, MN 56401. PD