THE Pension Digest

Published Since 1984 Collin W. Fritz and Associates, Inc., *"The Pension Specialists"* March, 1995

FDIC New "Pass-Through" Insurance Rules

The purpose of this article is to discuss the new FDIC "pass-through" insurance regulation (12 CFR Part 330.12) and to explain what administrative procedures a financial institution will need to implement to comply with the new rules. The deadline for implementing these new procedures is July 1, 1995.

In general, an institution will need to have the proper disclosure/notice forms, complete them correctly, and furnish them in a timely fashion.

The rule as written applies to all employee benefit plans — 401(k) plans, section 457 plans, defined benefit plans, profit sharing plans, money purchase plans and all one-person Keogh plans. That is, the definition of "employee benefit plan" is so written that it covers one-person Keogh plans as well as multiple-participant plans.

It may be somewhat simplistic, but the concept of pass-through coverage is to provide insurance coverage even though the deposit amount is for more than $100,000. The reason is that the pension deposit is for many participants and not just one. This concept of pass-through insurance does not seem to apply to one-person plans, but the regulation as written does cover deposits by one-person QP/Keogh plans.

Apparently, the FDIC did not carve out an exception for one-person QP/Keogh plans because they did not feel that there were that many of them. In addition, it appears that the FDIC also believes that a plan with one participant is just as entitled to be informed of an institution's capital standing as a plan with tens, hundreds or thousands of participants.

Note that the requirement to furnish various disclosures to employee benefit plans does not apply to SEP plans since a SEP plan uses IRA accounts as the funding vehicle for each participant. This requirement also does not apply to regular IRA accounts. For FDIC insurance purposes, SEP-IRAs are aggregated with all "regular" and "conduit" IRAs and insured to the extent of $100,000.

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Some Miscellaneous Thoughts on Completing the Form 1099-R

1. The amount to be reported in box 1 and 2a is the amount received by the individual. Even though box 1 is titled "gross distribution" and box 2 is titled "taxable amount," the amount to be reported is the amount which was received. For example, Rita Bloom's time deposit #324 had a balance of $1,140, but after subtracting an early surrender interest fee of $30, she received $1,110. Thus, the amount inserted in box 1 and 2a is $1,110. The instructions clearly state, "However, in the case of a distribution by a trust representing CDs redeemed early, report the net amount distributed."

2. Keep in mind that the Form 1099-R is used to report distributions from qualified plans and annuities as well as IRAs. There are both numeric and alphabetical codes which inform the IRS of the "reason" for the distribution and whether or not the 10% excise tax will apply.

The numeric codes are 1, 2, 3, 4, 5, 6, 7, 8 and 9. All of these codes except 6 (section 1035 exchange) and 9 (PS 58 costs) will be used for IRAs. QPs will use all codes except the 6.

The alphabetical codes are A, B, C, D, E, F, G, H and P. The only alphabetical code used by an IRA will be the P. Distributions from IRAs do no qualify for 5/10 year averaging, capital gain exclusion, excess contributions plus earnings/excess deferrals taxable in the second previous year, excess annual additions under section 415, charitable gift annuity or direct rollovers to an IRA or QP plan. Note: to have a direct rollover, the distribution must come from a QP plan or a section 403(b) annuity. Thus, the G or H code will not be used for a distribution from an IRA. PD

Integrating a SEP or a QP Plan

Many times a pension consultant will suggest that a business which is considering establishing a plan may wish to consider integrating a QP or SEP plan. The purpose of this article is to explain the concept of integration. Your institution may find it beneficial to be able to make it possible for your business customers to adopt or create an integrated plan. This would mean your institution would need to sponsor a SEP and/or QP prototype. Be aware that one-person plans have no need for an integrated plan.

The overriding concept of pension tax law is that a SEP or QP plan is generally not permitted to discriminate in favor of highly-compensated individuals. There are always exceptions and "integration" is one of those exceptions. The intent of integration is to favor the highly compensated, and what is nice is that the law expressly authorizes such favoritism.

As pension consultants, we see that many financial institutions have shied away from offering integrated plans. There are probably a number of reasons — the cost of sponsoring the prototype document, and the desire to stay away from a complicated subject. Many accountants and attorneys have adopted the same attitude. People like what is simple.

An integrated plan is more complicated than a nonintegrated plan; there is no doubt about it. But there is also little doubt that many owners of small businesses will appreciate the larger contributions which they are entitled to make for themselves under an integrated plan. These larger contributions are something for which they are willing to pay a fee.

The rationale for Code section 401(1) is as follows. The federal program of social security has been explained as a federal retirement program. From a mathematical standpoint, a comparison of the ratio of the benefit which a nonhighly compensated person is paid or will be paid from social

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Section 330.12 creates, for insurance purposes, three types of deposits for employee benefit plans.

The first type is a deposit of an employee benefit plan which qualifies for pass-through coverage. In this case the noncontingent interest of each participant in the plan is entitled to $100,000 of coverage. Eligibility for pass-through coverage is determined at the time the deposit is accepted. If the institution accepting the deposit meets the applicable capital standard as of the date of the deposit, then the deposit qualifies for pass-through insurance for the entire term of the deposit. However, if the institution accepting the deposit does not meet the applicable capital standard, then the deposit is ineligible for pass-through coverage for the entire term of the deposit.

Here is an illustration of pass-through insurance. CWF, Inc. maintains a profit sharing plan. This profit sharing plan has 12,500 participants. CWF expects that during the next three months it will need $650,000 to pay benefits to employees who have separated from service. Thus, CWF deposits $650,000 into a short-term savings or time deposit account. How much of this $650,000 deposit is entitled to FDIC insurance coverage?

If this deposit of $650,000 is entitled to "pass-through" coverage, then the entire $650,000 is insured. Without pass-through insurance coverage, the deposit would only qualify for $100,000 of insurance coverage and $550,000 would be uninsured.

In general, "pass-through" insurance means that each participant's pro rata portion in the account is individually insured up to $100,000. In the above example, it was assumed that no one participant had an allocated share of the $650,000 of more than $100,000, because the maximum per person is $100,000.

Pass-through insurance is available only if the financial institution is authorized to accept brokered deposits pursuant to section 29 of the Act—FDI Act (12 U.S.C. 1831f(a))—or the institution meets each applicable capital standard and the depositor receives a written statement that such deposits are eligible for insurance coverage on a pass-through basis.

The second type of pension deposit defined in Section 330.12 is one which does not qualify for pass-through coverage. In this case the deposits shall be aggregated and insured in the amount of $100,000 per plan.

The third type of deposit is a special category and is really a subcategory of the first deposit type. Under this third type the following types of retirement plans shall be aggregated and insured in the amount of up to $100,000 per participant: (1) an IRA; (2) an eligible section 457 plan and (3) any individual account plan as defined in section 3(34) of ERISA and any plan described in section 401(d), to the extent that participants and beneficiaries have the right to direct the investment of assets held in their individual accounts. However, this third type of deposit insurance will not apply to deposits under section 457 and individual account plans unless the plan qualifies for pass-through coverage.

To illustrate this third deposit category, let's assume that Jill Terry has made the following deposits or that the following deposits have been made with First ABC Bank on her behalf: (1) $42,000 in her IRA invested in a four-year time deposit paying 6.5% and (2) $51,000 as invested in a five-year time deposit paying 7.75% by the 401(k) plan trustee pursuant to her self-direction. This 401(k) plan has made other pension deposits with this First ABC Bank totalling $200,000. If the 401(k) deposit on behalf of Jill qualifies for pass-through coverage, then Jill has full insurance coverage on her aggregated balance of $93,000. If the 401(k) deposit for Jill does not qualify for pass-through insurance, then Jill would not be fully insured with respect to the $51,000.

Why did the FDIC come up with this new rule requiring the furnishing of notices/disclosures with respect to pass-through insurance?

The FDIC law was changed in 1991. Section 311 of the Federal Deposit Insurance Corporation Improvement Act of 1991 included a requirement that effective December 19, 1992, depositors in certain retirement and other employee benefit accounts are entitled to "pass-through" deposit insurance coverage based in part on whether the insured institution satisfied certain capital standards. This was a major policy change — for the first time Congress decided to link the level of insurance coverage with the capital level of the financial institution. Under current law, the linking of the level of insurance coverage to the capital standing of the institution applies only to deposits related to employee benefit plans.

After the new law was enacted, the problem became — how was a depositor to find out the institution's capital standard? A pension plan trustee would certainly be sued if he or she deposited funds and they were not fully insured.

The FDIC's new rule requires that a financial institution accepting pension deposits furnish various disclosures so the depositor can be informed of its capital status.

When must the disclosures be furnished? There are four situations when a financial institution must furnish a disclosure. The required content of the disclosure varies depending upon which of the four situations applies.

Situation #1. Disclosure Upon Request.

If a depositor of any employee benefit plans requests it, a financial institution must provide a clear and conspicuous written notice of the following:

1. The institution's leverage ratio;
2. Tier 1 risk-based capital ratio;
3. Total risk-based capital ratio;
4. PCA capital category (prompt corrective action); and
5. A statement that in the institution's judgment there would be pass-through insurance coverage if the deposit was made at the time the information is requested.

This notice must be provided within five business days after the institution receives the request. The request can be made either orally or in writing. "Receipt" means when an institution receives a request and not when it is received by a designated department of the institution. The institution has fulfilled its duty if it mails or delivers the required materials within the five business days.

The prompt corrective action (PCA) capital category ranges from well capitalized to critically undercapitalized.

The FDIC has stated that the capital information to be disclosed is to be based on the most recently available data and need not be as of the date of the deposit. For example, the FDIC has stated that institutions that are clearly well capitalized, and have experienced only minor variations in their capital ratios since the filing of the last quarterly Call Report, may use those capital ratios. The FDIC also stated that as of 9-30-94 only 279 of 12,774 insured depository institutions were less than well capitalized so this should not create a major burden.

The FDIC has made the following comments regarding the form or format of the notice/disclosure:

> "The FDIC has decided not to establish any specific forms or procedures on the required disclosures except for a general requirement that the required disclosures be "clear and conspicuous." This phrase is believed to be more representative of the standard that disclosures must be in a reasonably understandable form. It does not require that disclosures be segregated from other material or located in any particular place or be in any particular type size.
>
> Institutions may, at their discretion, use any of the above or other disclosure methods as long as it meets the "clear-and-conspicuous" standard and the time requirements. For example, an institution that is opening an employee benefit plan account may provide a separate written disclosure statement to the customer or reference the specific section of the deposit agreement that contains the disclosure information."

Situation #2. Disclosure Upon Opening of an Account.

If a depositor of any employee benefit plan opens any account comprised of employee benefit plan funds, then the financial institution must provide a clear and conspicuous written notice of the following:

1. An accurate explanation of pass-through coverage as set forth in section 330.12(a) and (b).

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security to his or her level of compensation (i.e. benefit/compensation) to the similar ratio for a highly-compensated person shows that the ratio for the nonhighly compensated person is higher. That is, the social security law is expressly written to discriminate in favor of the nonhighly-compensated employee over the highly-compensated person.

The federal tax law at section 401(l) takes into account this discrimination. If the social security benefit favors the nonhighly compensated, then to a certain extent federal tax law governing private pensions will allow reverse discrimination in favor of the highly compensated. It must be remembered that federal law at this point in time does not require a private business to establish a pension plan. Sometimes laws need to be written to encourage businesses to do something they otherwise would not do. Being able to integrate a plan with social security is one feature which might encourage a business to establish a plan for its employees that it otherwise might not have been inclined to establish.

Set forth below are two examples of the benefit achieved by having an integrated plan. The first example is of a corporation with six employees. The second example is of a sole proprietor (e.g. a farmer) who has two employees. Note the higher amounts which the highly-compensated employees/owners receive when the plan is integrated.

Example #1: The St. Paul Medical Clinic, Ltd. has six employees with the following compensations (and ratios). The Clinic elects to contribute 15%, or $45,000 for 1994. The integration level is defined to be $20,000. The contribution amount of $45,000 would be allocated as follows. Since the integration level is $20,000, the maximum disparity rate is 1.3%.

Employee	Total Compensation	Allocation When Integrated	Allocation When Nonintegrated	Increase or Decrease in Allocation
Sara Phillips	$ 125,000	$ 19,771	$ 18,750	$ +1,021
David Bollin	95,000	14,820	14,250	+570
Beth Long	35,000	4,917	5,250	-333
Paula Wright	17,000	2,075	2,550	-405
Mark Flaherty	15,000	1,831	2,250	-419
Maggie Waters	13,000	1,586	1,950	-364
Total	$ 300,000	$ 45,000	$ 45,000	-0-

Example #2: David Skiba is a farmer who conducts business as a sole proprietor. He sponsors an integrated SEP plan which is integrated at the level of $15,000. He has two employees, Marc Respert and Tom Holmes. Marc was paid wages of $12,506 for 1994. Tom was paid wages of $1,235 for 1994. David's Schedule F showed he had net earnings of $77,759 before he made a SEP contribution on behalf of Marc and Tom. The SEP contribution which David will be making for 1994 is 15% of the sum of $12,506, $1,235 and his "adjusted" compensation amount of $61,671 (calculation shown below). Therefore, the SEP contribution will be $11,311.80 ($75,412 X 15%). It would be allocated among the three of them as follows:

Employee	Total Compensation	Allocation When Integrated	Allocation When Nonintegrated	Increase or Decrease in Allocation
David Skiba	$ 61,671	$ 9,616	$ 9,251	$ +365
Marc Respert	12,506	1,543	1,876	-333
Tom Holmes	1,235	153	185	-32
Total	$ 75,412	$ 11,312	$ 11,312	-0-
	X .15			
	$ 11,312			

In the calculation above, David Skiba must use his "adjusted" compensation which was determined as shown here:

$ 77,759	Amount of Net Earnings From Schedule F Prior to Any SEP Contribution
- 1,696	The SEP Contribution for Marc and Tom
$ 76,063	Net Earning From Schedule F
- 4,776	1/2 of His Self-Employed Tax
$ 71,287	Net Amount
- 9,616	His Own SEP Contribution Amount
$ 61,671	= Adjusted Compensation

There is a four-step formula which is generally used to determine the "integrated" allocations.

The total allocation is the sum of the amount calculated under each step. This formula is complex since the maximum disparity rate depends on the integration level set.

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What is Integration? —

Internal Revenue Code section 401(l) reads as follows:

[Sec. 401(l)]

(l) Permitted Disparity in Plan Contributions or Benefits. —

(1) In General. — The requirements of this subsection are met with respect to a plan if —

(A) in the case of a defined contribution plan, the requirements of paragraph (2) are met, and

(B) in the case of a defined benefit plan, the requirements of paragraph (3) are met.

(2) Defined contribution plan. —

(A) In general. — A defined contribution plan meets the requirements of this paragraph if the excess contribution percentage does not exceed the base contribution percentage by more than the lesser of —

(i) the base contribution percentage, or

(ii) the great of —

(I) 5.7 percentage points, or

(II) the percentage equal to the portion of the rate of tax under section 3111(a) (in effect as of the beginning of the year) which is attributable to old-age insurance.

(B) Contribution percentages. — For purposes of this paragraph —

(i) Excess contribution percentage. — The term "excess contribution percentage" means the percentage of compensation which is contributed by the employer under the plan with respect to that portion of each participant's compensation in excess of the integration level.

(ii) Base contribution percentage. — The term "base contribution percentage" means the percentage of compensation contributed by the employer under the plan with respect to that portion of each participant's compensation not in excess of the integration level.

REMINDER

Since April 15, 1995 falls on a Saturday, the tax filing deadline is April 17 (the following Monday). Thus, IRA contributions can be made on April 17.

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Step One: Contributions and forfeitures will be allocated to each participant's account in the ratio that their total compensation bears to all participants' total compensation, but not in excess of 3% of their total compensation.

Step Two: Any contributions and forfeitures remaining after the allocation in Step One will be allocated to each participant's account in the ratio that their compensation for the plan year in excess of the integration level bears to the excess compensation of all participants, but not in excess of 3% of their compensation in excess of the integration level.

Step Three: Any contributions and forfeitures remaining after the allocation in Step Two will be allocated to each participant's account in the ratio that the sum of their total compensation and their compensation in excess of the integration level bears to the sum of all participant's total compensation and all participants' compensation in excess of the integration level, but not in excess of the amount determined by multiplying the sum of your total compensation plus the amount in excess of the integration level by the profit-sharing maximum disparity rate. If these contributions and forfeitures are insufficient to permit the full allocation to be made, each participant's amount will be reduced on a pro rata basis.

Step Four: Any remaining employer compensations or forfeitures, if any, will be allocated to the account in the ratio that their total compensation for the plan year bears to all participants' total compensation for that year.

Definitions: The integration level is equal to: (A) The taxable wage base for the current year; (B) $__________ (A dollar amount less than the taxable wage base.); or (C) _______% of the taxable wage base (not to exceed 100%).

The taxable base is the maximum amount of earnings which may be considered wages for a year under section 312(a)(1) of the code in effect as of the beginning of the plan year. The taxable wage base for 1994 is $60,600.

The maximum profit sharing or SEP disparity rate is equal to the lesser of: (A) 2.7%; or (B) The applicable percentage determined in accordance with the table below:

1. If the integration level used is equal to the taxable wage base, the applicable percentage is 2.7%.
2. If the integration level:

is more than	but not more than	the applicable percentage is
$0	X*	2.7%
X* of TWB	80% of TWB	1.3%
80% of TWB	y**	2.4%

*X = the greater of $10,000 or 20% of the TWB

**Y = any amount more than 80% of the TWB but less than 100% of the TWB.

The actual mathmatical calculation is shown in "Table A" at the bottom of this page.

In summary, it can be beneficial for owners of small businesses to adopt an integrated profit sharing or SEP plan. The owners will appreciate the ability to receive larger contributions.

Although a small business owner can expect to pay a fee to his or her accountant or pension consultant to perform the allocation work, the larger contribution should more than offset this larger fee. PD

TABLE A

Employee	Total Compensation	Total Comp. Above the Integration Level	Combined Totals	Ratio for Steps 1 and 4	Ratio for Step 2	Ratio for Step 3
Sara Phillips	$125,000	$105,000	$230,000	.41667	.5385	.4647
David Bollin	95,000	75,000	170,000	.31667	.3846	.3434
Beth Long	35,000	15,000	50,000	.11667	.0769	.1010
Paula Wright	17,000	-0-	17,000	.05666	---	.0343
Mark Flaherty	15,000	-0-	15,000	.05000	---	.0303
Maggie Waters	13,000	-0-	13,000	.04333	---	.0263
Total	$300,000	$195,000	$495,000	1.00000	1.0000	1.0000

Employee	Step 1	Step 2	Step 3	Step 4	Total
Sara Phillips	3,750	3,150	2,990	9,881	19,771
David Bollin	2,850	2,250	2,210	7,510	14,820
Beth Long	1,050	450	650	2,767	4,917
Paula Wright	510	-0-	221	1,344	2,075
Mark Flaherty	450	-0-	195	1,186	1,831
Maggie Waters	390	-0-	169	1,027	1,586
Total	$9,000	$5,850	$6,435	$23,715	$45,000

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2. The institution's PCA capital category (prompt corrective action); and

3. A statement whether or not, in the institution's judgment, the funds being deposited would qualify for pass-through coverage.

This notice must be furnished simultaneously with the account opening.

Situation #3 - Disclosure When Pass-Through Insurance Coverage Is No Longer Available.

A financial institution will be required to furnish a notice to all of its existing employee benefit plan depositors when it has been furnished a notice from a regulator or is deemed to have notice that it is no longer permitted to accept brokered deposits under section 29 of the Act and it does not meet the capital standards. This written notice must be furnished within 10 business days of such notice.

The financial institution must provide a clear and conspicuous notice or disclosure. It must disclose: (1) its new PCA capital category and (2) that new, rolled-over or renewed deposits of employee benefit plan funds made after the applicable date (i.e.the date no longer eligible for pass-through coverage) will not be eligible for pass-through coverage under sections 330.12(a) and (b).

Situation #4. A Special Disclosure

An institution may well be holding some deposits on July 1, 1995 which were not eligible for pass-through coverage when originally made. This would be certain deposits made between December 19, 1992 and June 30, 1995. That is, the institution must identify if it accepted any pension deposits in the past not entitled to pass-through coverage and then inform those depositors of this fact because a portion of their deposit would then be uninsured.

This disclosure is to be provided within 10 business days after July 1, 1995. Thus, the deadline is July 14, 1995. PD

SEP Amendment Deadline

If an employer has established a SEP by use of the Form 5305-SEP, it must adopt the March, 1994 version on or before March 31, 1995. The prior version was dated June, 1991. PD