THE Pension Digest

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RECORD RETENTION FOR IRAS

IRAs have been around since January 1, 1975. The paper piles or microfiche files are growing. Much of the information is quite old. IRA custodians rightfully want to know – what IRA documents must be retained and for how long? Or, when can they discard IRA records?

There are few specific record-retention rules, so the rules are not as definite as is desired. You will need to weigh your desire to discard the information versus the conservative response of retaining the information.

Why must an IRA custodian or trustee keep any records?

There are three basic reasons: (1) since you are a fiduciary you must furnish an accounting to your accountholder; (2) since the IRA plan agreement is a contract, you must perform the duties you have promised under the contract; and (3) since you are an IRA custodian, you are required to report to the Internal Revenue Service and the accountholder certain "tax transaction" information.

Simply put, you retain IRA information for one or more of the following reasons: (1) the IRS or some other regulator will assess a fine if you do not maintain such records; (2) you need the records to protect against a possible law suit by an IRA accountholder, a designated beneficiary or some other family member and (3) you wish to render excellent service.

How long must an IRA custodian keep various IRA records?

The answer will vary depending upon whether you are retaining the records for the IRS or the accountholder and will vary depending upon what specific record is involved. We will discuss the IRS rules first.

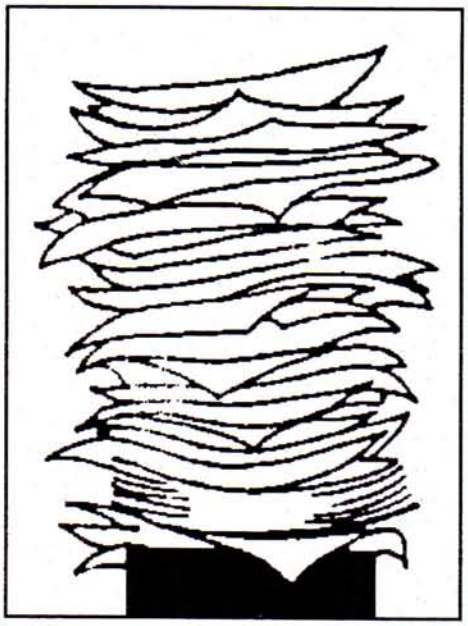
One would think that the Internal Revenue Code and the IRS would have well-developed rules. They do not. The general retention requirement is set forth in section 6001 of the Internal Revenue Code and the related regulations. The rule is that records must be kept as long as the contents thereof may become material in the administration of any Internal Revenue law. A very broad rule which in practice is limited is explained below.

The Internal Revenue Code in many instances requires a third party (someone other than the IRS or the taxpayer) to prepare an Information Return so that the IRS and the individual is informed that a "tax transaction" has occurred. With respect to IRAs, an IRA custodian is required, as applicable, to prepare a January statement reporting an IRA's fair market value, a Form 5498 and a Form 1099-R. The IRA custodian must prepare these forms on an annual basis and is subject to a fine of $50 for each January statement or Form 5498 it is required to prepare but fails to do so. The IRA custodian is subject to a fine of $25 per day to a maximum of $15,000 for the failure to prepare a required Form 1099-R.

It may seem very surprising, but the Internal Revenue Code does not contain a statute of limitations if an IRA custodian or another reporting entity fails to prepare or furnish a required form. In contrast, the Internal Revenue Code does contain a three-year statute of limitation for most taxpayers. Code section 6501 provides the general rule that the amount of any tax imposed by the Internal Revenue Code must be assessed within three years after the taxpayer has filed his or her return. If not assessed within three years, then the individual will not need to pay such tax. The purpose of a statute of limitations is to put an end (i.e. achieve finality) to an imperfect situation. As you would expect, a longer period of time (six years) is provided if the taxpayer has materially misstated an item of income or expense. There is no statute of limitations if there has been fraud.

Since there is no statute of limitations with respect to failing to prepare a January statement, a Form 5498 or a Form 1099-R, then an IRA custodian, in theory, stays liable forever to the IRS if it has failed to prepare one or more of these forms.

The IRS in actual practice, however, takes a more reasonable approach. The



IRS will normally apply its three-year rule. Thus, if the IRS can no longer collect the additional tax due from the taxpayer, then it will not assess any penalty against the IRA custodian. We can imagine, though, situations where an IRA custodian has failed to furnish almost all required forms and we would not expect the IRS to be very forgiving .

The IRS has made the following statements regarding retaining records of magnetic media filings. In Revenue Procedure 49-43 (Information Returns: Magnetic Media: 1994 Specifications) in section 9(.15) the following statement is made:

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.15 In general, payers should retain a copy of the information returns filed with IRS or have the ability to reconstruct the data for at least 3 years from the reporting due date, with the exception of Form 1099-C. A financial entity must retain a copy of Form 1099-C, Cancellation of Debt, or have the ability to reconstruct the data required to be included on the return, for at least 4 years from the date of the return. Whenever backup withholding is imposed, a 4-year retention is required.

Recommendation for Retaining The 5498 and 1099-R Forms

At a minimum you must retain the Forms you submitted to the IRS and the related documentation for at least three "tax" years. This means you should retain the 1994 Form 1099-Rs until 3-1-98, since they were due on 2-28-95. You should retain the 1994 Form 5498 until 6-1-98, since they will be due on 5-31-95. This means you could discard the 1991 forms. Being conservative, we recommend that you retain the 5498 and 1099-R forms for at least four years.

Retention of IRA Records for Non-IRS Purposes.

Since you, as the IRA custodian, are a fiduciary, you certainly have recordkeeping requirements in addition to those imposed by the Internal Revenue Code. As a general rule, the IRS is not concerned about the designation of beneficiaries and the investment of the contributions. Your accountholder is normally very concerned about these subjects, and you must be, too.

The Comptroller of the Currency has issued the following regulation for national banks exercising fiduciary powers. It illustrates what will most likely be required of any financial institution rendering IRA services. The regulation is 12 CPR 9.8 Books and Accounts and reads:

(a) Every national bank exercising fiduciary powers shall keep its fiduciary records separate and distinct from other records of the bank. All fiduciary records shall be so kept and retained for such time as to enable the bank to furnish such information or reports with the Comptroller of the Currency. The fiduciary records shall contain full information relative to each account.

(b) Every such national bank shall keep an adequate record of all pending litigation to which it is a party in connection with its exercise of fiduciary powers.

(c) Solely for purposes of examination by the Comptroller of the Currency, a national bank shall retain the records required by this part for a period of 3 years from the later of the termination of the fiduciary account relationship to which the records relate or of litigation relating to such account, unless applicable law specifically prescribes a different period.

The key words are: (1) full information relative to each account and (2) the retention period is to be three years from the latter of termination of the relationship or of litigation unless applicable law specifically prescribes a different period.

IRAs are contracts. Each state normally has a statute of limitation which applies to causes of action for contract disputes. A statute of limitations is simply a law which places a time limit on when one party may sue another party. Once the time limit passes, a law suit is no longer possible. These statute of limitations normally provide for a period longer than three years. For example, the state of Iowa provides ten years for a cause of action related to a written contract. The state of Minnesota provides six years.

Our general conclusion is that an IRA custodian then must retain its IRA records for that period of time during which it could be sued under the contract law of the applicable state. For those of you who only do business in one state, you will only need to be concerned about one state's time limit. For those of you who do business in many states, you will need to know each state's limit.

This time period (six, seven, or ten years) does not start to run until the IRA is closed. An IRA account is closed when the accountholder or the beneficiary, as applicable, has withdrawn all the funds or assets so that the fair market value of the account is zero.

Question #1: Can the IRA plan agreement be written to contain a provision that the IRA custodian need retain contribution and other administrative records only for the most current three to four years, and that during that time it will provide them with "accountings," and if they do not object within set time frames, then they will be deemed to have agreed with the accounting records and would be bound thereby?

Question #2: Does this then mean that your institution must retain every record ever produced or can you cull some records? There are two types of culling. The first type is to discard a record permanently. The second type is to remove the record from a "current" file and to place it in a historical file which will be accessed only if necessary.

There is no one way which an IRA custodian must use to maintain IRA records. Most institutions establish individual files and then also establish one or more master files. A master file is one which contains a record or information prepared on a "group" basis and not on an individual basis. Different approaches can be used as long as the administrative goals are met. The administrative goals are — being able to properly account to your IRA accountholder what money or assets he or she has within his or her IRA, and being able to demonstrate to the IRS or any other regulators that you have complied with all governmental reporting requirements.

Set forth below are various types of IRA forms and documents which an IRA custodian must retain. The question to be answered for each document is - how long must they be retained?

1. IRA plan agreements; 2. IRA disclosure statements; 3. amendments to the plan agreement; 4. amendments to the disclosure statement; 5. beneficiary designations; 6. Form 5498 and the customer statement; 7. Form 1099-R; 8. contribution documentation; 9. distribution withdrawal documentation; 10. withholding documentation; 11. investment information; 12. special FDIC disclosures; and 13. Truth-in-Savings disclosures.

Retention of Plan Agreements/ Disclosure Statements and Related Amendments

The plan agreement and the amendments to the plan agreement are very important because they comprise the contract. Must you retain all copies of prior plan agreements and amendments or do you need to retain only the most recent copy?

The rules are unclear. The most conservative approach is to retain all copies. Why?

This is a situation where an IRA custodian owes similar but different duties to the IRS and the accountholder.

IRA regulations require that you furnish a complying plan agreement and disclosure statement at the time the IRA is opened. An IRA custodian is subject to a $50 fine for each failure to do so. Would the IRS today fine an institution for failing to properly establish an IRA in 1975 or 1988, or would the IRS limit its period of review to the last two to three years? No one really knows. The IRS has not written what its audit guidelines are. Although there does not seem to be any rule which would limit the IRS's review to just two t

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IRA & Qualified Plan Loans as an Investment

IRA accountholders and Qualified Plan participants are increasingly directing their plan assets into an growing array of different types of investments. Often this is done with the hope of increasing the rate of return they experience on their retirement dollars. Other times, however, this investment direction may be desired for a different reason, that being to help out a family member. This article will focus on a particular type of IRA and QP investment, that being a loan from the QP or IRA to an individual or business.

There is nothing in the Internal Revenue Code or ERISA that prohibits a loan as an investment per se if it is handled correctly. There are, however, dangers that must be avoided at all costs or a prohibited transaction will result. The result of a prohibited transaction in an IRA is total disqualification of the IRA, subjecting all the funds to taxation and penalties. If a prohibited transaction occurs in a Qualified Plan, the result can be penalty taxes imposed on the plan that start at 5% of the transaction amount a year and can rise to 100% of the transaction amount. As can be seen, the consequence of a prohibited transaction can be very expensive, but generally it is more expensive for an IRA than a QP.

What types of loans would result in a prohibited transaction? To begin with, Internal Revenue Code section 4975 and ERISA section 406 both prohibit any loan between the plan and a disqualified person. The accountholder and/or QP plan participant are disqualified persons as defined in these bodies of law. Any business the accountholder or participant controls 50% or more of is also defined as a disqualified person. As such, a loan by the IRA or QP could not be made to the individual accountholder or an entity controlled by that individual. These sections also prohibit the accountholder from guaranteeing any loan made by the plan.

What about other entities the individual does not control but is involved with? It is also evident from a number of IRS and Department of Labor rulings that loans to these entities would be prohibited. Private Letter Ruling #9119002 provides ample evidence of this. In this section, a QP participant had a loan made from his QP account to a partnership of which he owned 39%. While this partnership technically did not qualify as a disqualified person, the IRS ruling was that a prohibited transaction had occurred. Their rationale is one they use often. This loan benefitted the accountholder outside of the Qualified Plan. They stated that this type of transaction constituted dealing with the plan assets in the accountholder's own interest. A prohibited transaction was the result. This situation illustrates that even in situations where it may first appear from the Code that a prohibited transaction didn't occur, the IRS and DOL can still rule in the opposite manner, using the position that if the person receives a benefit, direct or indirect, outside of the plan because of a transaction, a prohibited transaction has occurred.

Certain family members of the IRA accountholder or QP participant are also classified as disqualified persons. The problem normally confronted today is determining which family members these are. Both the Internal Revenue Code and ERISA define family members as any spouse, ancestor, lineal descendant, or spouse of a lineal descendant. It is very clear then that there can be no loan made by the IRA or QP to the spouse, parents, children, grandparents, grandchildren or spouses of these individuals by the accountholder's IRA or QP account. Neither section, however, makes any mention of siblings or their spouses. Does this then mean that an IRA or QP could make a loan to the individual's brother-in-law, sister, or a business controlled by one of these persons, for example? It would appear that it does not. In a number of written documents, the IRS and Department of Labor (DOL) appear to have extended the statutory definition of a "family member" to include siblings and their spouses. In a number of DOL Advisory Opinions, in Prohibited Transaction Exemption 93-1, and in the IRS Internal Audit Manual, the statement is made that both the DOL and the IRS will use Code section 267 to determine who are family members when applying the prohibited-transaction rules. Code section 267 does include siblings and their spouses as family members. As such, it appears that both agencies intend to include these people as disqualified persons under the prohibited-transaction rules. This would mean that any loan by the plan to such an individual would result in a prohibited transaction.

The question now becomes, "Does the IRS and DOL have the authority to make this extension?" At first glance it would appear they do not. Both IRC 4975 and ERISA 406 have very definite definitions of family members that do not include siblings or their spouses. It would appear Congress did not intend for siblings and their spouses to be included in the definition of a disqualified person. As such, an argument could be made that the IRS and DOL cannot extend these rules to these types of family members. This is an argument that an accountholder would probably be forced to make in court as it is apparent the IRS and DOL intend to enforce the rules under their stated position. These agencies' argument will be that IRC section 4975 contains numerous references to IRC section 267. In every situation, except for the definition of a disqualified person, section 267's definition of the term "family member" is used when applying the prohibited transaction rules under 4975. The IRS and DOL will argue that this was simply an oversight and 267's definition is the one Congress intended. They will also argue that any loan to a sibling or sibling's spouse results in a direct or indirect benefit to the accountholder or results in the accountholder using plan assets in their own interest. Again the result would be a prohibited transaction.

With this confusion, what should an IRA custodian/trustee or a QP plan custodian/trustee do if an accountholder wishes to have their account make such a loan? The safest course of action is to not permit it. It is very apparent that the IRS and DOL would rule the loan prohibited and force the accountholder into court to fight the ruling. If the accountholder insists upon making such a loan, a number of steps should be taken. The first one is that the accountholder's own legal counsel should prepare a written opinion that states they do not feel this transaction is prohibited. Secondly, the accountholder should sign a direction of investment document, directing the loan be made. This document should contain a "hold harmless" provision where the accountholder releases the custodian/trustee from liability for the transaction and agrees to take total responsibility for it. Third, if the loan is made, it needs to be treated as any other loan. Proper loan documentation and disclosures are required. It must be secured with collateral. All loan payments are to be made to the plan's custodian/trustee, not the individual. The accountholder may not guarantee the loan himself. Additionally, the interest rate on the loan must be equivalent to the prevailing market rate in that area for a similar type of loan. Fourth, if this is an IRA, establish a new IRA with a separate IRA plan agreement just for the loan. The only asset in that IRA is this loan. This will help should the loan be deemed a prohibited transaction. It will help because the only IRA disqualified will be the one with the loan in it.

Our recommendation at this time is to not permit loans to these family members. While there may be an argument that the IRS and DOL shouldn't rule as they have been, it will be an expensive argument for the accountholder to make. PD

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four years, one would hope the IRS would do so. Because the IRS has not stated a less stringent position, we must recommend that for IRS purposes the IRA custodian retain all copies of plan agreements, disclosures statements and amendments.

The original plan agreement is the original contract. Subsequent amendments modified this contract. To determine compliance with the prior contracts you need copies of these prior contracts. Thus, we believe your duty to keep a full record with respect to each IRA requires you to retain all plan agreements, disclosure statements and contracts. Therefore, we certainly recommend that you keep a copy of each of the plan agreements and the amendments which you have furnished. Maintaining historical files is better than discarding these documents. However, what is most important, is that your files contain the most recent IRA plan agreement and a current disclosure statement.

Retention of Beneficiary Designation Forms

This is an extremely important administrative topic for the IRA custodian. The IRA accountholder, as the initial beneficial owner of the IRA assets, has the right to determine who will receive them after his or her death. Most IRA plan agreements state that the most recent beneficiary designation form will control the disposition of the IRA after death. Most plan agreements also allow the accountholder to change his or her designation from time to time.

An IRA custodian does not want to lose or misplace beneficiary designation forms because it then runs the risk of paying the wrong person or having to go to court to determine the proper party. We suggest that you keep copies of all beneficiary designations, but each file must clearly show which is the most recent or the controlling designation.

Once the accountholder dies, the IRA custodian will now need to service the designated beneficiary(ies) because he or she becomes the beneficial owner of the account. The IRA custodian wishes to have well-maintained records and procedures in this area.

Because of the growing amounts of money in IRAs, one can expect increased legal arguments over who is entitled to receive IRA funds. Again, your institution wants to have excellent procedures and records in this area.

Retention of Contribution, Distribution and Withholding Forms

We recommend that you keep all contribution forms so that you can provide a full accounting to your accountholder.

An IRA custodian should use a contribution form. This is true even if there is no IRS rule or regulation which requires an IRA custodian to use this form. This form is useful because it gathers the information necessary to properly "account" to the accountholder, plus it makes the checking of the completion of boxes 1 and 2 on the Form 5498 very easy. A wise IRA custodian keeps two copies of each IRA contribution form. One contribution form would be placed in the accountholder's individual file, and one set would be placed in the master contribution/5498 file for that year. We strongly recommend keeping a master file of the contribution forms because it provides an easy way to determine if you have properly reported the regular and the roll-over contributions on the Form 5498. You should keep all contribution forms which are placed in the individual's file. You should retain only for three or four tax years the contribution forms retained for the master Form 5498 file.

An IRA accountholder should also use an IRA distribution or withdrawal form. This form is used to gather the information needed to prepare the Form 1099-R, perform the proper accounting functions, and satisfy the withholding rules. We would also recommend that you keep all distribution forms. Again, you should use a duplicate set so that you have one for the individual file and one for your distribution/Form 1099-R file which will allow you to easily determine whether you have prepared the Form 1099-Rs correctly. You must keep forever the distribution forms which are placed in the individual's file. You would keep the distribution forms retained in the Form 1099-R file for only three to four tax years.

We would expect that the distribution form which you use contains the withholding information, so you will be complying with the withholding rules. Your retention of the distribution forms will allow you to show compliance. Be sure to retain a record that you have furnished the "annual reminder" notice as you are required to do in some situations.

Retention of Investment Instruction, The Investment Records and TISA Records

Most IRA custodians/trustees have the IRA accountholder review various investment options and then instruct them how they wish to invest their funds. An IRA custodian should pay special attention to this topic.

An investment instruction record is a fancy term for the accountholder's instruction to buy a specific savings account, time deposit, or certificate of deposit.

Investment record also means the instruction (oral or written) to buy and sell mutual funds, bonds, stocks, etc.

All of these records should be retained because they are necessary to properly account to the accountholder. It would seem possible that the plan agreement could stipulate that such records would only be retained for a set period of three to four years and thereafter would not be retained. The conservative approach is to retain these records for the life of the IRA plus the statute of limitations. Much of this information is certainly information which could be placed in a historical file.

As has been mentioned numerous times in this newsletter, TISA applies to IRAs which are invested in savings and time deposits. With respect to record retention, the TISA rules are set forth at section 230.9(c) of Regulation DD as follows:

> (c) *Record retention. A depository institution shall retain evidence of compliance with this regulation for a minimum of two years after the date disclosures are required to be made or action is required to be taken. The administrative agencies responsible for enforcing the regulation may require depository institutions under their jurisdiction to retain records for a longer period if necessary to carry out their enforcement responsibilities under section 270 of the act.*

Discussion of Retention of Other Administrative Forms.

IRAs are hard to administer because there are many special types of transactions all needing a special type of administrative form. There are rollover certification forms, transfer forms, 70 1/2 RMD election forms, 70 1/2 distribution instructions, beneficiary distribution instructions, beneficiary elections, etc. We recommend that all such special forms be retained because they were designed to limit the contractual responsibilities of your institution.

Conclusion

There are certain IRA records which must be retained for the entire life of the IRA, plus six or ten years after the IRA is closed. The reason is that the IRA is a contract, and the statute of limitations for contract actions is normally longer than the time periods required by the IRS or other regulators. However, it may well be possible to shorten the time-retention periods by having the IRA plan agreement define the record-retention requirements.

According to IRS instructions, an IRA custodian/trustee needs to retain the 5498 and 1099-R forms for only three years (running from the due date).

The overriding rule is that the IRA custodian must be prepared to give a full and complete accounting to the IRA accountholder. To do this, records are needed even though they relate to transactions which happened a long time ago. PD