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SEPs and the FDIC Pass-Through Notice Rules/ Examples of Pass-Through Insurance Coverage

The FDIC has recently clarified (or changed) its position on whether or not SEP-IRAs are entitled to receive the FDIC pass-through insurance notice(s).

The FDIC has now stated its position that a depository must furnish the person making a deposit to a multiple-person SEP-IRA with the applicable pass-through notice when applicable, but that the depository is not required to furnish the notice to a one-person SEP-IRA plan. Please note that in the March newsletter we stated that you did not need to furnish the notice to a SEP because the FDIC's position had been to always aggregate SEPs with IRAs for insurance coverage purposes. Also note that one-person QP or Keogh plans must receive the applicable notice. There is no logic to the IRS' position why a one-person QP plan must receive the notice and a one-person SEP need not receive the notice. The current regulation simply provides for this result.

Until relatively recently, FDIC regulation 330.12 dealt with the subject of the insurance coverage available to the various types of employee benefit plan deposits, including IRA deposits. This regulation now covers a second subject — the notices a depository must furnish a person who makes or may make a deposit of employee benefit plan funds.

The purpose of this article is to further discuss the topic of pass-through coverage. Numerous illustrations are provided. You will see that the rules are quite unsettled with respect to how a SEP-IRA will be treated for insurance-coverage purposes. The FDIC will need to furnish additional guidance.

Since the FDIC has now determined that some SEP plans must receive the FDIC pass-through notices because a SEP meets the definition of being an employee benefit plan, does this mean that the FDIC is rethinking its prior position as to coverage also? That is, if a SEP plan is an employee-benefit plan for purposes of the notice provisions, is the SEP plan an employee-benefit plan for purposes of the coverage rules? If so, then in some cases, such SEP deposits would not need to be aggregated with IRAs, but would be aggregated with other employee benefit plan deposits for insurance coverage purposes. As the illustrations below will show, this change in treatment could affect the amount of insurance coverage.

Discussion of the Four (4) Types or Categories That Govern Insurance Coverage

Regulation 330.12 essentially provides for four categories of insurance coverage for deposits of retirement and other employee-benefit plan accounts:

1. Coverage when pass-through insurance applies, but the plan does NOT allow for self-direction. Coverage is $100,000 per participant.

2. Coverage when pass-through insurance applies, but the plan allows for self-direction. Aggregation of the IRA and the plan deposit is required and there is coverage only to the extent of $100,000.

3. Coverage when pass-through insurance does not apply.

The rule is that there is only $100,000 coverage for the plan no matter how many participants and no matter the size of the deposit.

4. Coverage for IRAs, section 457 plans and self-directed individual account plans which are entitled to pass-through coverage.

These types of deposits must be aggregated per person and there is coverage up to $100,000 per person.

Illustrations

Set forth below are illustrations applying the above rules. The amount of insurance coverage does depend upon what insurance category applies to a given deposit. Although the general rule is that a depositor would want his or her deposit to qualify for pass-through insurance coverage, there are some situations where a person is better off if pass-through insurance coverage does not apply.

Example #1. — Nonself-directed QP Deposit Which Qualifies for Pass-Through Coverage/With No IRA Deposit

Pat Richards has a noncontingent deposit of $95,000 under her employer's nonself-directed money purchase plan. The money purchase plan had total deposits of $500,000. All of these deposits qualified for pass-through insurance.

The $95,000 deposit is a category #1 type of deposit and is fully insured since the deposit is less than $100,000. The other $405,000 of plan deposits are also fully insured as long as any one participant's share does not exceed $100,000.

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Glossary of IRA Terms

Collectibles - Antiques, rugs, coins, stamps, gems, metals, and alcoholic beverages are all examples of collectibles. Other personal property can also fall under this definition.

Contingent Beneficiary - Person or persons designated to receive the IRA funds if the primary beneficiary(ies) does not survive the accountholder.

Current-Year Contribution - Any contribution made for or during a tax year where the due date for that year's tax return has not yet passed.

Direct Rollover - A rollover from a Qualified Plan (QP) or Tax-Sheltered Annuity (TSA) that is paid directly to another QP/TSA or an IRA. The check is made payable the IRA custodian, but the transaction is reported as a rollover.

Disability - 100% permanently and totally disabled, meaning the disability will result in death or in the loss of any gainful employment for a period of at least one year.

Disqualified Person - The accountholder, the accountholder's spouse, children, or parents, or any lineal family member, any corporation the accountholder is an officer or director of, any partnership the accountholder is a partner in, and any fiduciary of the account.

Earned Income - Income a person receives in exchange for services they have rendered. It is also any income that

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appears in Box 10 of Form W-2 less the amount shown in Box 16 of that form. Examples of earned income include wages, salary, commissions, bonuses, tips, and self-employment income. Interest, dividends, pension benefits, rent on property owned by the individual, and social security benefits are not earned income.

Excess Contribution - An impermissible contribution, one that exceeds the amount an individual is eligible to contribute. Examples include a regular contribution that exceeds $2,000 a year, a regular contribution that exceeds 100% of a person's earned income, a regular contribution made by someone over 70 1/2, or an impermissible rollover.

Financial Disclosure - A disclosure that includes a financial projection of the value of the IRA in the future, showing the effect continued contributions, interest, penalties and fees would have on the future value of the IRA. The financial disclosure is based on an annual contribution of $1,000, where a regular contribution establishes the IRA, and a one-time contribution of $1,000, where a rollover establishes the IRA. The projection shows the assumed values at the end of each of the first five years the IRA exists and at the time the individual would attain ages 60, 65, and 70.

Form 1096 - IRS transmittal form that must accompany any paper 5498 and 1099-R submission to the IRS. It tells the IRS which form is being submitted, the number of forms being submitted and gives total dollar figures from all of the forms being submitted.

Form 1099-R - IRS Form that is used to report distributions from an IRA or from a Qualified Retirement plan. It is due to the accountholder by January 31, and the IRS by February 28, of the year following the year of the distribution.

Form 4804 - IRS transmittal form that must accompany any magnetic media submission to the IRS of the forms 1099-R and 5498

Form 5329 - IRS form that must be filed by an accountholder that does or could owe an IRA penalty tax. It is filed along with the individual's tax return for that year.

Form 5498 - IRS form that is used to report IRA contributions and the fair market value of the IRA. It is due to the accountholder and the IRS by May 31 of the year following the year for which it is being reported.

Form 8606 - IRS form that must be filed with the tax return in any year a person makes a nondeductible IRA contribution or in any year that they take a distribution if a nondeductible contribution had ever been made to one of his IRAs.

Form W-4P - IRS form that contains a withholding notice and election.

IRA Income Tax Withholding - A partial payment of income taxes owed on an IRA distribution. The taxes are taken out of the distribution from the IRA, normally at a rate of 10% of the distribution.

Income Tax Withholding Election - A written election made by the accountholder instructing the custodian/trustee either to withhold or not to withhold income tax from an IRA distribution.

Income Tax Withholding Notice - A written explanation of the income tax withholding rules. The notice for IRAs informs the accountholder that he has the right not to have withholding, and that the estimated tax rules apply to IRA distributions.

MDIB Life Expectancy Table - The Minimum Distribution Incidental Benefit table is used to determine the life expectancy when there is a nonspouse beneficiary named that is more than 10 years younger than the accountholder. It is found in Regulation 1.401(a)(9).

Nonrecalculation - The life-expectancy factor is determined from the Unisex table in the first distribution year. This initial factor is reduced by one each year thereafter.

Plan Agreement - A written document that must be completed and executed in order to have an IRA. The plan agreement could be an IRA Model 5305 or 5305-A. The 5305 is a trust plan and the 5305-A a custodial plan. The plan agreement could also be a prototype plan drafted for an institution by legal counsel. A prototype plan needs to be submitted to the IRS for its approval.

Premature Distribution - Any distribution made from the IRA before the day the accountholder has attained age 59 1/2.

Primary Beneficiary - Person or persons designated to receive the IRA funds upon the death of the accountholder.

Prohibited Transactions - Improper use of an IRA account by the accountholder or a disqualified person. Examples include a disqualified person borrowing money from the IRA, selling property to the IRA, using it as security for a loan, or purchasing corporate stock with the IRA when the accountholder is a director or officer of the corporation.

Recalculation - Determining a life-expectancy factor each year by taking the accountholder's age to the Unisex life expectancy tables. This can also be done for spouse beneficiaries.

Regular IRA Contribution - An IRA contribution made for a specific tax year by a person who has earned income and is 70 1/2 or less. It is limited to $2,000 or 100% of the accountholder's earned income, whichever is less.

Required Minimum Distribution - A distribution that must be taken by April 1 of the year after the year the accountholder attains age 70 1/2. Distributions must be taken by December 31 of each year thereafter. The distributions are based on either a single or joint life expectancy that can be recalculated or reduced by one each year.

Rollover - A rollover is a distribution of funds from an IRA or a Qualified Plan that is contributed to another IRA within 60 days of the date of receipt. The amount rolled over is not subject to tax. The individual has possession of the funds. The check is made payable to the individual.

SEP - A simplified employee pension is a written plan that allows an employer to make contributions toward his or her own and employees' retirement. The contributions are made to IRAs of the participants.

Seven-Day Right of Revocation - The seven-calendar-day period the accountholder has to revoke the IRA after it is initially established and the accountholder receives a written disclosure statement.

Spousal IRA Contribution - An IRA contribution made to the IRA of a noncompensated spouse based on the earned income of the compensated spouse. It is limited to the lesser of $2,000 or 100% of the earned income of the compensated spouse. The maximum contribution to both spouse's IRAs may not exceed $2,250.

Substitute Form W-P - Normally a vendor's distribution or withdrawal form that contains a withholding notice and election section. It must comply with IRS requirements for substitute forms.

Transfer - The direct movement of IRA funds from an IRA with one custodian/trustee to an IRA with a different custodian/trustee. The accountholder never has possession of the funds; the check is made payable to the new custodian/trustee.

Transfer Due to Divorce - A transfer of IRA funds from the IRA of one spouse to the IRA of the other spouse, subsequent to a court order found in a divorce decree.

Unisex Life Expectancy Tables - IRS approved life-expectancy tables found in Regulation 1.72-9.

Written Disclosure Statement - A nontechnical written explanation of the IRA rules. PD

IRA Fees

As IRA administration has become more and more complex, it has become common for IRA trustees and custodians to charge fees in connection with IRA accounts. It is permissible for a custodian/trustee to charge fees in connection with an IRA. It must be stressed, however, that the plan document must allow the custodian/trustee to charge fees, and the fees must have been disclosed to the accountholder prior to their institution. If the fee was not in existence when the account was opened, the custodian must give written notice of its inception and allow a reasonable time period before instituting the fee. During this period of time, accountholders must be allowed to terminate their account without the imposition of any newly created fees.

Generally the plan document will not specify the type or amount of fees a particular custodian/trustee will charge. The document normally just contains a provision that reserves the right to charge fees to the custodian/trustee. The custodian/trustee must disclosure the actual type of fees and amount of such fees on a separate fee schedule. Additionally, any and all fees must be disclosed any time a Truth-in-Savings disclosure is required.

The last disclosure item an institution needs to be aware of before instituting fees is the effect this will have on their IRA disclosure statement, in particular the financial disclosure section of that document. The rules are very explicit in requiring that all possible penalties and fees be factored into the financial projection most customers are required to receive. In most cases pre-printed financial disclosure tables do not factor in any fees. As such, special disclosure tables will be necessary for any IRA fees charged by an institution.

Discussed below are some of the common types of IRA fees we have seen.

I. Annual Administrative Fees. These are fees that the custodian/trustee charges for the daily upkeep of the account. The amount varies from institution to institution. A common figure is \$25 to \$50 a year. This type of fee is especially common when dealing with self-directed IRAs. These fees may be deductible by the accountholder under Code section 212, as an expense paid for the production of income. To be deductible, the fee must be billed directly to the accountholder. The accountholder must then pay the fee without using IRA funds. It is permissible to use the assets of the IRA to pay the fee, but if this is done, the fee is not deductible. It is not permissible to contribute more than \$2,000 to the IRA to cover the expense of this fee. For example, if Bank A charges a \$50 annual administrative fee, Customer B could not contribute \$2,050 for the tax year. This would result in an excess contribution of \$50. Instead, Customer B would have the choice of writing a separate check to pay the \$50 fee or have the \$50 taken from the \$2,000 contribution.

II. Brokerage Fees. Brokers fees are fees paid to an individual who sells the accountholder an investment for the IRA. These fees usually take the form of commissions. They are not deductible by the accountholder. Any commission paid to a broker out of an accountholder's \$2,000 contribution cannot be deducted nor can more money be added to the account to replace the commissions paid.

III. Termination Fees. This fee is paid when the IRA is terminated or transferred to another institution. This fee must be disclosed to the accountholder when the account is first opened or when the custodian/trustee institutes the fee. This is perhaps the most common IRA fee we see being used today, ranging from \$25 to \$50.

IV. Distribution Fees. This type of fee is owed whenever a distribution is made from an IRA. It is assessed whether the distribution is a total or partial distribution of the IRA assets. These fees commonly run in the range of \$10 to \$25 dollars. They are generally assessed in addition to any CD interest penalties for early withdrawal. PD

✔✔✔ Check It Out ✔✔✔

Question: I am still confused by the administrative tasks associated with rollovers, direct rollovers and transfers. Would you please explain?

✔ Answer. Your tasks will vary depending upon whether your institution's role is that of the payor or the payee/recipient and the type of the transaction. For purposes of this answer, it is assumed that you are the payee/recipient and that the funds will be deposited into an IRA account.

In a transfer situation, the funds must move from and between the same type of plan (e.g. IRA to IRA, QP to QP or TSA to TSA). Therefore, funds cannot move from a QP or TSA to an IRA via a transfer. This movement would only be permissible as a rollover or a direct rollover as discussed below. In a transfer, the check has been made payable to your institution as the IRA custodian for the customer. Your institution should have a signed IRA transfer form as furnished by the sending institution. For data processing purposes this "transfer" contribution will not affect the preparation of the Form 5498.

In a rollover situation, the check has been made payable to your customer. In order to substantiate that the person is eligible to make this rollover contribution, you should have the customer complete and sign a rollover certification form or have the customer furnish you a copy of the section 402(f) notice which the plan administrator furnished indicating what amount is eligible to roll over. Be aware that in a rollover situation, the 60-day rule applies. The "once per 12-month" rule only applies if the distribution comes from an IRA. For data processing purposes, this contribution must be coded as a "rollover" so that it will show up in box 2 of the Form 5498.

In a direct rollover situation, the check has been made payable to your institution (First Entity as IRA custodian for Sally Smith). It looks like a transfer, but it is not. In a direct rollover the funds must be coming from a QP or a TSA. By definition, the funds cannot come from another IRA. When you receive a direct rollover check from a QP or TSA on behalf of your customer, you, as the IRA custodian, want to obtain a copy of the section 402(f) notice which the plan administrator furnished your customer. If you cannot obtain a copy of the section 402(f) notice, then you should have the customer complete a rollover certification form. For data processing purposes, this direct rollover transaction must be coded into your computer system so that this contribution will show up in box 2 of the Form 5498 as a rollover. The IRS does not ask that the IRA custodian distinguish between a direct rollover and a rollover in completing the Form 5498. They are both "rollovers" for Form 5498 purposes. 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.

Pass-Through—*Continued from page 1*

Example #1A. — Nonself-directed QP Deposit Which Does Not Qualify for Pass-Through Coverage/With No IRA Deposit

Same situation as with example #1 except the deposits are not eligible for pass-through coverage. Pat Richards has a noncontingent deposit of $95,000 under her employer's nonself-directed money purchase plan. The money purchase plan had total deposits of $500,000. All of these deposits did not qualify for pass-through insurance.

The $95,000 deposit is a category #3 type of deposit and is not fully insured. The following amount would be insured - $95,000/$500,000 times $100,000 or $19,000. Thus, $76,000 would be uninsured.

Example #2. — Self-directed QP Deposit Which Qualifies for Pass-Through Coverage/With No IRA Deposit

In this situation, Maria Hassel has a noncontingent deposit of $95,000 under her employer's money purchase plan and she has the right to self-direct. The money purchase plan had total deposits of $500,000. All of these deposits qualified for pass-through insurance.

The $95,000 deposit is a category #2 type of deposit (not a type #1) and is fully insured since it is less than $100, 000. Although a self-directed account, there is no other IRA or section 457 deposits with which there must be aggregation.

Example #2A. — Self-directed QP Deposit Which Does Not Qualify for Pass-Through Coverage/With No IRA Deposit

In this situation, Maria Hassel has a noncontingent deposit of $95,000 under her employer's money purchase plan and she has the right to self-direct. The money purchase plan had total deposits of $500,000. All of these deposits did not qualify for pass-through insurance.

The $95,000 deposit is a category #3 type of deposit and is not fully insured. The following amount would be insured - $95,000/$500,000 times $100,000 or $19,000. Thus, $76,000 would be uninsured.

Example #3. — Nonself-Directed QP Deposit Which Qualifies for Pass-Through Coverage/With an IRA Deposit

Sally Gervais has $70,000 of IRA deposits with First National Bank and has a noncontingent deposit of $80,000 under her employer's nonself-directed money purchase plan. The money purchase plan had total deposits of $800,000. All of these deposits qualified for pass-through insurance.

The $80,000 QP deposit is a category #1 type of deposit and is fully insured since it is less than $100,000. The $70,000 deposit is a category #4 type of deposit. Total insured amount is $150,000 since these deposits are insured separately and need not be aggregated.

Example #3A. — Nonself-Directed QP Deposit Which Does Not Qualify for Pass-Through Coverage/With an IRA Deposit

Sally Gervais has $70,000 of IRA deposits with First National Bank and has a noncontingent deposit of $80,000 under her employer's nonself-directed money purchase plan. The money purchase plan had total deposits of $800,000. All of these deposits did not qualify for pass-through insurance.

The $70,000 IRA deposit is a category #4 type of deposit and is fully insured since it is less than $100,000. The $80,000 QP deposit is a category #3 type of deposit and is not totally insured. The following amount would be insured -$80,000/$800,000 times $100,000 or $10,000 would be insured and $70,000 would not be insured.

Example #4. — Self-Directed QP Deposit Which Qualifies for Pass-Through Coverage/With an IRA Deposit

Rita Adams has $70,000 of IRA deposits with First National Bank and has a noncontingent deposit of $80,000 under her employer's self-directed money purchase plan. The money purchase plan had total deposits of $800,000. All of these deposits qualified for pass-through insurance.

The $80,000 QP deposit is a category #1 type of deposit and is fully insured since it is less than $100,000. The $70,000 deposit is a category #4 type of deposit. However, the right to self-direct means that the amounts must be aggregated. Thus, $100,000 will be insured and $50,000 will not be insured.

Example #4A — Self-Directed QP Deposit Which Does Not Qualify for Pass-Through Coverage/With an IRA Deposit.

Rita Adams has $90,000 of IRA deposits with First National Bank and has a noncontingent deposit of $50,000 under her employer's self-directed money purchase plan. The money purchase plan had total deposits of $200,000. All of these deposits did not qualify for pass-through insurance.

The $90,000 IRA deposit is a category #4 type of deposit and is fully insured since less than $100,000. The $50,000 QP deposit is a category #3 type of deposit and is not totally insured. The following amount would be insured $50,000 ÷ $200,000 times $100,000 or $25,000 would be insured and $25,000 would not be insured. Note that there is no requirement to aggregate the QP and the IRA (if required, then $40,000 would be uninsured) since this is required only if the QP deposit is eligible for pass-through coverage.

Example #4B. — Self-Directed QP Deposit Which Does Not Qualify for Pass-Through Coverage and Total Plan Deposits Less than $100,000/With an IRA Deposit

Susie Hanson has $90,000 of IRA deposits with First National Bank and has a noncontingent deposit of $50,000 under her employer's self-directed money purchase plan. The money purchase plan had total deposits of $80,000. All of these deposits did not qualify for pass-through insurance.

The $90,000 IRA deposit is a category #4 type of deposit and is fully insured since it is less than $100,000. The $50,000 QP deposit is a category #3 type of deposit and is also fully insured as the total of the plan's deposits is less than $100,000. Again, there is no requirement to aggregate the QP and the IRA (if required, then $40,000 would be uninsured) since aggregation only required if the QP deposit is eligible for pass-through coverage.

Example #5. — SEP Deposit and an IRA Deposit

Sally West has a SEP-IRA with a balance of $98,000 and an IRA with a balance of $77,000 with First State Bank. The SEP is a multiple-participant plan.

There is no doubt that the IRA deposit of $77,000 is a category #4 type of deposit.

Is the SEP deposit of $98,000 a category #1, category #2 or a category #4 deposit?

Category #1 and category #2 deposits are deposits to an employee-benefit plan. Category #2 deposits are those which are self-directed. A category #4 deposit is essentially an IRA deposit.

Are SEPs self-directed? Most people would consider a SEP to be a self-directed plan. The legal problem is that the only types of plans which are defined to be "self-directed" under the regulation are "individual account plans" as defined in ERISA section 3(34). If this section is read literally, a SEP is not an individual account plan and thus would not be self-directed.

If the SEP deposit is a category #1 deposit, then there is no requirement to aggregate, and separate insurance covers both the $98,000 deposit and the $77,000 deposit.

If the SEP deposit is a category #2 deposit since it is self-directed, then the deposits must be aggregated and insurance would cover $100,000, but $75,000 would be uninsured.

If the SEP deposit is also a category #4 deposit, then insurance would cover $100,000 and $75,000 would be uninsured.

Since the FDIC has concluded that a multiple-participant SEP plan is an employee benefit plan for "notice" purposes, it may be very hard for the FDIC to argue that such a SEP plan is not also an employee-benefit plan for coverage purposes.

Summary

The rules governing pass-through insurance are complex. There are rules which require an institution to furnish certain mandated notices. The FDIC has recently stated that multiple-person SEPs must be furnished the notice but that one-person SEPs need not be. There are also rules to determine what amount of insurance coverage a particular deposit will receive. The FDIC regulation 330.12 is the governing regulation and it is not clear on some important issues. The FDIC will need to state a position on how insurance coverage is to be determined for a contribution to a multiple-person SEP plan. The FDIC may well need to revise regulation 330.12.