THE Pension Digest

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The SIMPLE Retirement Plan

Although President Clinton vetoed the tax bill as passed by Congress, the creation of a new type of employer-sponsored retirement plan seems very likely in the future. The policy makers have decided that a new type of pension plan is needed for small employers. The conference committee adopted the approach of the Senate which had created a simplified retirement plan for small business called the "Saving Incentive Match Plan for Employees" (SIMPLE). The conference committee also voted to discontinue the creation of new SEP plans. This article summarizes the attributes of the new SIMPLE retirement plan. As with everything, this plan has some good features and some not-so-good features. A SIMPLE plan will have very little meaning for a one-person business. Those small businesses who would have established a SEP, will now need to establish a profit sharing qualified plan. Keoghs, to a certain extent, will make a comeback. Most likely, if ever enacted into law, these changes would be effective for tax years commencing on or after January 1, 1996.

What Businesses May Establish a SIMPLE?

To be eligible to have a SIMPLE, an employer must meet two requirements. First, an employer will be eligible if it employed 100 or fewer employees on any day during the year. Second, the employer (or any predecessor employer) cannot currently maintain another Qualified Plan. For these purposes, a Qualified Plan includes a qualified retirement plan, a qualified annuity plan, a governmental plan, a tax-sheltered annuity, and a SEP. Technically, the employer cannot have maintained a retirement plan with respect to which contributions were made or benefits were accrued, for service in any year in the period beginning with the first year the SIMPLE becomes effective and ending with the year for which the determination is being made.

What is the Basic Concept of the SIMPLE Retirement Plan?

A SIMPLE is a simplified version of a 401(k) plan or salary reduction SEP plan. The basic concept is that an employee/participant will be eligible to contribute his/her own funds from his/her payroll or bonus, and that the employer will make matching contributions. Limits exist as to how much the employee may contribute (i.e. electively defer), and there are limits as to the matching contribution the employer must make.

An employee who is eligible to participate in the SIMPLE may elect to have the employer pay him or her in cash or to have the employer make an elective employer contribution to a SIMPLE retirement account on behalf of the employee.

A SIMPLE retirement account is an IRA which meets special rules set forth in a new Code section 408(p). Alternatively, the employer may change its 401(k) plan to comply with the special SIMPLE rules.

An employee may elect to defer an amount not to exceed $6,000 per year. Note that this amount is approximately 2/3 of what is currently permitted under a 401(k) plan or a salary reduction SEP plan - $9,240. The amount which an employee defers must be expressed as a percentage of compensation. The employer must match on a dollar for dollar basis what the employee has chosen to electively defer, up to 3% of the employee's compensation. There is a special rule as discussed later which allows an employer to set its match at less than 3% (but not less than 1%) if certain rules are met.

The $6,000 amount will be adjusted periodically for cost-of-living increases.

A SIMPLE does not permit an employer to make any other type of contributions. An employer is not permitted to make a pro rata contribution (e.g. 8% of compensation) to the eligible employees as permitted with a standard profit sharing plan or a SEP plan.

What Employees Must an Employer Cover in Order to Have a SIMPLE?

In essence, a SIMPLE has a two-year participation requirement. Any employee who was paid at least $5,000 in compensation during each of the preceding two years, and who is reasonably expected to receive at least $5,000 in compensation during the "upcoming" year, must be eligible to participate in the SIMPLE for the upcoming year. Note that under this plan it is the amount of compensation which will determine eligibility and not hours of service. Thus, under a SIMPLE, an employee must be eligible to make his or her elective deferrals and also to receive the mandatory employer matching contribution. An employer will be able to choose to exclude nonresident aliens and employees covered under a collective bargaining agreement. Compensation for an employee is defined to be the sum of his or her Form W-2 compensation plus any elective deferral amount. Self-employed individuals can participate in a SIMPLE. Compensation for a self-employed individual is defined to be his or her net earnings without regard to any contribution under the SIMPLE.

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When May an Employer Make a Matching Contribution of Less Than 3%?

An employer may set its matching rate at as little as 1% of compensation if two requirements are met. First, the employer must notify the employees of the lower percentage within a reasonable amount of time before the 60-day "decision" period commences. Second, the employer cannot set the percentage for the upcoming year at less than 3% if the percentage had been set at less than 3% in two out of the four preceding years. If the SIMPLE was not in existence for all or any part of this four-year time period, then it is deemed that the employer's matching rate was 3% for such year.

What is the Tax Treatment of Contributions?

Contributions to a SIMPLE are excludable from the gross income of the employee.

The employer will be able to deduct both its elective deferral contributions and its matching contributions. With respect to the employee elective contributions, a deduction is allowed only if the contributions are made by the due date (including extensions) of the employer's tax return.

The rules do allow the employer to make contributions after the end of the year if they are made on account of such taxable year and are made not later than the time prescribed by law for filing the return for such year (including extensions). The employee's elective contributions are to be treated as wages for employment tax purposes. That is, these elective deferrals will be subject to social security and medicare taxes. The employers matching contribution will not be subject to such taxes.

The income earned by the contributions will not be taxed until a distribution occurs.

An employee is always 100% vested in any contribution to the SIMPLE account.

An employee who makes an elective contribution to a SIMPLE account will be an active participant for IRA deduction purposes.

The top heavy rules do not apply to a SIMPLE account plan.

What is the Tax Treatment of Distributions?

Distributions will be taxed under the rules generally applicable to IRAs. Distributions prior to age 59 1/2 will generally be subject to the 10% excise tax. However, a 25% tax will be imposed rather than the 10% tax if there is a withdrawal of contributions within the two-year period commencing on an employee's participation in the SIMPLE.

Funds within a SIMPLE-IRA will be eligible to be rolled over to an IRA once the participant has satisfied a two-year participation requirement in the SIMPLE.

What Administrative Rules will Apply to the Elective Deferrals?

An employee will use the 60-day period before the start of any year to decide if he or she will make elective deferrals during the upcoming year, or change prior instructions. For example, if the next plan year will be January 1, 1997, to December 31, 1997, then the employees will be able to decide what elections they will make between November 2, 1996, and December 31, 1996.

A plan may be permitted to be written to allow a participant to increase or decrease his or her deferral instruction during the year, but the plan need not permit this. However, a participant must have the right to stop his or her elective deferrals at any time. Once a participant stops his or her elective deferrals, the plan may be written to not allow elective deferrals to start again until the next year.

The employer is required to contribute an employee's elective deferrals to his or her SIMPLE-IRA within 30 days after the end of the month to which the contributions relate.

The employer is required to contribute its matching contributions no later than its tax filing deadline for such year, including extensions, if applicable.

What Reports Will the Trustee (i.e. the Financial Institution) be Required to Prepare to Comply With IRS and ERISA Rules?

At least once a year the trustee must furnish a report to the IRS. The contents of this report are not all that clear. Presumably the contents of what is furnished to the IRS will be very similar to the information which must be given to the participant.

Within 30 days after the end of each calendar year (i.e. January 30th), the trustee must furnish each participant a statement showing the SIMPLE account balance as of December 31 of such year and the activity for such account during the calendar year. Thus, it appears that an employer will initially be able to require that all SIMPLE-IRAs be established with the same trustee.

The trustee must furnish the sponsoring employer a summary description which must contain the following information:

1. The name and address of the sponsoring employer;
2. The name and address of the trustee;
3. The requirements for eligibility for participation;
4. The benefits provided under the plan;
5. The procedures to be used to make salary-reduction elections;
6. The procedures and effects of withdrawing funds from the SIMPLE; and
7. The procedures and effects of making a withdrawal for rollover purposes.

A trustee who fails to furnish one or more required summary descriptions or statements in a timely fashion will be subject to a penalty of $50 for each day on which such failure or failures continue unless the failure is due to a reasonable cause. Note that the fine is not $50 per account. However, it will apply if you happen to miss just one account.

What Reports Must the Employer Prepare for the IRS and for ERISA Purposes?

The employer must notify each employee of his or her eligibility to make elective deferrals immediately before the employee becomes eligible to make the election. That is, the employer must give notice to the employee just before the 60-day election period commences. The employer's notice must contain a copy of the notice furnished by the trustee. The notice to be furnished will be last year's notice. The employer is subject to a fine of $50 per day if it fails to furnish this notice unless there is a reasonable cause for the failure.

How Will ERISA Apply to a SIMPLE Retirement Account?

Only simplified reporting will be required under ERISA. No reports, other than those required under ERISA section 101(9) shall be required. Thus, there should be no Form 5500 or any similar form to be completed.

An employer who sponsors a SIMPLE will not be subject to any fiduciary liability when the employee or a beneficiary exercises control over the assets in his or her own SIMPLE account. Control exists upon the earlier of (1) an affirmative election with respect to the initial investment of any contributions, (2) a rollover contribution to another SIMPLE account or IRA (including a trustee-to-trustee transfer); or (3) one year after the SIMPLE is established.

How Will the SIMPLE Rules Apply to a 401 (k) Plan?

This law would create a safe harbor for complying with the nondiscrimination requirements which apply to employee elective deferrals and employer matching contributions. That is, there is deemed compliance with the ADP and ACP tests if the safe harbor is satisfied.

The safe harbor is satisfied if, for the year, the employer does not maintain another Qualified Plan, the employee's elective deferrals are limited to no more than $6,000, the employer matches the employee's elective deferrals up to 3% of compensation, and no other types of contributions are made. Under the 401(k), the employer cannot reduce the matching percentage to less than 3%. All contributions under the safe harbor must be 100% vested. A plan meeting the safe harbor is treated as not being top heavy.

Conclusion

The law has not yet been changed to authorize SIMPLE retirement accounts, but the law most likely will be changed to authorize SIMPLE retirement plans. You will want to familiarize yourself with the rules. You will wish to think about how you will inform your customers that you have the deposit accounts and administrative services available to assist your business customers.

As with every tax law, SIMPLE does not necessarily mean "simple" because the rules governing any retirement arrangement are somewhat complicated. The SIMPLE is no different. Although the rules are simpler than for a 401(k) plan and other Qualified Plans, it is arguable whether they are simpler than those which apply to salary-reduction SEP plans or SEP plans.

Many owners of small business will like this plan because they will be able to contribute $6,000 for themselves, and they will only be required to put in a maximum of 3% of their employees' compensation. This appears to be a good deal for such owners as compared to present rules. An IRA custodian should be ready to service such small businesses. Businesses with 2 to 100 employees which make monthly contributions will generate substantial annual deposits.

Possible Partial Repeal of SEPs - Deadline for Establishing SEPs

The general rule is that a business entity wishing to establish a SEP plan for tax year 1995 has until April 15, 1996 (plus extensions).

There may be a new exception in the works.

You are aware that President Clinton vetoed a tax bill.

This tax bill contained a provision which would have taken away the right of many businesses to sponsor a SEP plan. The rule change would have been: if an employer had established a SEP on or before December 31, 1995, then it would have been eligible to continue to sponsor the SEP. However, an employer who did not sponsor a SEP on December 31, 1995, would no longer be eligible to establish a SEP on or after January 1, 1996.

The tax bill would have created a new type of employer sponsored retirement program, called a SIMPLE retirement plan. Congress wants employers to use this new type of plan, and to realize this goal they propose to not allow employers who do not currently have a SEP to establish one in the future.

There is a fair amount of doubt if there will ever be a tax bill. It is also doubtful whether or not December 31st will stay the "last day" for establishing a SEP, or whether Congress might be nice and extend the date to January or February. It does seem unfair since no one was given any notice that both SEPs and SAR-SEPs would be repealed. The belief was that only SAR-SEPs would be changed.

There will definitely be businesses which will prefer to have the old style SEP versus the new SIMPLE plan, as the SIMPLE requires the employer to make contributions in some situations when such contributions would not need to be made under the SEP.

Your customers who are thinking about a SEP may wish to act in early January with the hope that the new tax bill would not use December 31, 1995, as the cut-off date. Congress does have the legal authority to make such a retroactive change. If SEP contributions were made, and then the new tax bill would disallow them by making December 31, 1995 the deadline, it would not be hard to correct them as they could be withdrawn as excess IRA contributions.

In summary, the deadline for establishing and funding a SEP is still April 15, 1996, plus extensions, with the major caveat that Congress and the President might enact a new tax bill which would essentially say; if you did not have the SEP established as of December 31, 1995 (or some other date to be chosen in 1996), then you will not be able to sponsor a SEP. That is, the bill would not allow businesses to establish a SEP or SAR-SEP if they did not already have one established.

Who knows, it may be that Congress did not intend to repeal all SEPs, but that they only intended to repeal SAR-SEPs. Time will tell.

IRA Administrative Deadlines and Other Deadlines

Calendar year 1995 is over. The 1995 IRA administrative year has another five months to run. The purpose of this article is to set forth the various deadlines which apply to IRAs, SEPs and Qualified Plans.

December 31, 1995 (A Sunday)

1. The deadline for those IRA owners who attained age 70 1/2 in a year prior to 1995 to take their required minimum distribution for 1995.

2. The deadline for those IRA beneficiaries who elected the five-year rule to have the inherited IRA completely distributed if the IRA owner had died during 1990.

3. The deadline for establishing a Qualified Plan for tax year 1995 if the business has a calendar year tax year.

4. See the separate article on SEP plans. December 31, 1995, might be the very last day a SEP could be established.

5. The deadline for withdrawing an excess contribution made for a tax year prior to 1995 if the 6% excise tax for 1995 is to be avoided.

Internal Revenue Code section 7503 states that when the last day prescribed by the tax laws falls on a Saturday, Sunday or a legal holiday, the performance of such act shall be considered timely if it is performed on the next succeeding day which is not a Saturday, Sunday or legal holiday (i.e. next business day).

Therefore, people would have had until

January 2, 1996, to meet this deadline.

Any distribution received on January 2, 1996 will be taxed with respect to the 1996 tax return.

January 31, 1996 (A Wednesday)

1. This is the deadline for furnishing Form 945 (Annual Return of Withheld Federal Income Tax Return). However, the deadline changes to February 10, 1996, if you made deposits of all withheld taxes on time. Refer to the instructions to determine to what IRS office you must file.

2. This is the deadline for an IRA custodian to furnish a Form 1099-R to each IRA owner and each IRA beneficiary who was paid a "reportable" distribution during 1995. A fine of $25 per day may be assessed to a maximum of $15,000 for failing to timely furnish this form. For example, if you prepare a Form 1099-R in the name of a deceased IRA owner who was not paid, rather than the beneficiary who was paid, you most likely would face substantial fines.

3. An IRA custodian/trustee must furnish an IRA statement setting forth the fair market value of the IRA as of December 31, 1995, to each of the following: (1) every IRA owner who had an IRA with a fair market value on 12-31-95; (2) every IRA beneficiary with an inherited IRA with a fair market on 12-31-95; and (3) each IRA owner who died in 1995.

In the case of the IRA owner who died in 1995, the IRS gives the custodian the choice of reporting either the fair market value as of the date of death, or a zero along with a note explaining that the custodian will furnish the fair market value as of the date death upon request.

We are still receiving many consulting calls regarding the proper reporting for decedents and beneficiaries of inherited IRAs. Please refer to the May 1994 newsletter for a detailed discussion of this subject. If you would like to receive a copy of this letter, please call us at 1-800-346-3961 and request one. Cost is $2.00.

The November 1991 newsletter contained a detailed discussion of the required contents of this statement. Again, please call us if you would like to receive a copy of this newsletter. Cost is $2.00.

February 28, 1996 (A Wednesday)

You must file with the IRS the individual Form 1099-R's and the transmittal Form 1096 or the magnetic media equivalents.

March 1, 1996 (A Thursday)

This date is not a deadline for the IRA custodian/trustee.

This date is a deadline for certain farmers and fisherman who wish to take advantage of an exception to the estimated tax payment rules. If a farmer files his or her tax return on or before March 1 of the following year and pays all taxes owing, then he or she receives an exemption from having to pay estimated taxes throughout the year. A person normally must pay some penalty taxes if he or she does not file estimated returns and make the required payments by the quarterly deadlines. A farmer's filing deadline is still April 15th, and thus IRA, SEP and Keogh contributions can still be made through April 15th even though the tax return is filed on or before March 1st.

March 15, 1996 (A Friday)

A corporation with a calendar year tax year must file Form 1120 unless it has an extension. Thus, this is the last day for SEP and QP contributions for 1995 by such a corporation.

April 1, 1996

1. This is the deadline for those IRA owners who attained age 70 1/2 in 1995 to make their elections and to take their required minimum distribution for 1995.

April 15, 1996 (A Monday)

1. Last day for IRA contributions for 1995.

2. Last day for 1995 SEP and QP contributions unless the person would have an extension.

3. Deadline for the IRA custodian/trustee to file the Form 990-T. Fiduciaries for certain self-directed IRAS and Qualified Plans that have $1,000 or more of unrelated business income must file Form 990-T.

4. Deadline for withdrawing or correcting an excess contribution made in 1995 or 1996, for tax year 1995. However, if the person had an extension, this deadline would be extended.

May 31, 1996 (A Friday)

1. Deadline to furnish the Form 5498 or a qualifying substitute form to IRA owners and beneficiaries of inherited IRAs.

2. Deadline to furnish all of the individual 5498 forms and form 1096 or their magnetic media equivalents to the IRS.

July 15, 1996 (A Monday)

A corporation with a calendar year tax year can receive an extension for four months from March 15th to July 15th. With such an extension, the deadline for SEP and QP contributions is changed.

July 31, 1996 (A Wednesday)

This is the deadline for your customers with qualified plans with calendar year plan years to file the Form 5500C/R or Form 5500EZ, if applicable, unless an extension would apply.

August 15, 1996 (A Thursday)

Individual taxpayers many times receive an extension to file their tax return from April 15th to August 15th. This is the first extension.

Remember that SEP and QP contributions are permissible.

September 15, 1996 (A Sunday)

The deadline becomes September 16, 1995. This is the last day for a corporation to make a contribution for tax year 1995 if the IRS has granted a second extension on filing its return.

October 15, 1996 (A Tuesday)

This is the last day to make a contribution if the IRS grants a second extension for a taxpayer with a calendar year end. PD

Is One IRA Enough?

Many IRA accountholders and IRA custodian/trustees look at the consolidation of a person's many IRA accounts into one IRA as a way to make everyone's life easier. It is easier for the customer to keep track of what is happening with their IRA funds, and it is beneficial for the IRA custodian/trustee to have all the IRA deposits the individual has. While this might be the "easy" thing to do, it is not always in the best interest of the accountholder to consolidate all IRA funds into one account. There are a number of situations where it is not only beneficial to the accountholder to maintain more than one IRA, in most cases the accountholder should have more than one IRA. This is true even if all IRA funds are to be held by one institution. This article will focus on a number of situations where the IRA accountholder should have more than one IRA account.

To begin with, we must look at what constitutes an IRA. A very common mistake among financial institutions is believing that separate investment instruments, i.e. CDs, savings accounts, etc., constitute separate IRA accounts. This is just simply not the case. To be a separate IRA account, an IRA plan agreement and disclosure needs to be completed, executed and provided to the accountholder. Only with more than one IRA plan agreement does an individual have more than one IRA account. This means, then, that if different IRAs need to be set up for whatever reason, a plan agreement has to be completed and executed for each IRA.

Conduit IRAs

What are some of the reasons for maintaining more than one IRA? The first one is one with which many of you will be familiar. It is an IRA account that is commonly called a "conduit IRA." Conduit IRAs are established when an individual is rolling funds to an IRA account from a Qualified Plan or Tax-Sheltered Annuity. The conduit IRA needs to have its own IRA plan agreement and its own investment instruments. It is kept entirely separate from any other types of IRA deposits. The reason for establishing a conduit IRA and keeping these funds in a separate IRA is that by doing this, the accountholder retains the ability to later remove these funds and roll them back into another employer-sponsored retirement plan. If these funds are mixed in the same IRA as other types of IRA deposits, the ability to roll them back into another employer-sponsored plan is lost forever. The assumption IRA personnel should make then, is that any rollover from a Qualified Plan or Tax-Sheltered Annuity should be put into a separate conduit IRA. If the accountholder does not wish to maintain a separate conduit IRA, a commingling waiver needs to be completed and signed by the accountholder instructing the institution not to establish the conduit and to mix the rollover deposit with other IRA funds. This commingling waiver is found on rollover certification and direct rollover forms. Absent this written instruction, the institution should establish a conduit IRA.

Self-Directed & Trust IRAs

A second situation that can arise where a separate IRA should be established occurs when dealing with self-directed or trust IRAs. As accountholders seek to maximize the return on their IRA deposits, more and more institutions are offering these types of IRAs.

Many times an accountholder wishes to have a mix of IRA investments that include deposit instruments such as CDs and savings accounts offered by the custodian/trustee, and things such as mutual funds, annuities, stocks and bonds that are purchased outside of the custodian/trustee institution. A mix of investment choices such as this does not automatically mean that separate IRA accounts are necessary. Most self-directed and trust IRA plan agreements permit a mix of these types of investments.

Where a separate IRA plan agreement becomes a necessity is when the accountholder wishes to purchase an investment or engage in a transaction with the IRA that is questionable. Internal Revenue Code section 4975 contains a detailed set of rules called the "prohibited transaction" rules. These rules exist to prevent any potential conflict of interest between the IRA and the IRA accountholder and certain individuals and businesses related to the IRA accountholder. The thrust of these rules is that the IRS will not judge an investment or transaction on its merits, but rather will simply prohibit certain transactions and investments where a potential for abuse or a conflict of interest is present.

While past issues of *The Pension Digest* have dealt with prohibited transactions on many occasions, a few examples of what would be considered a prohibited transaction are given here in the way of a refresher.

It would be a prohibited transaction for an IRA account to make a loan to the accountholder, a family member of the accountholder, or a business in which these individuals have an interest. It would be a prohibited transaction for the IRA to purchase stock in a corporation in which the accountholder was an owner, officer, or director. A prohibited transaction would occur if an IRA purchased real estate that was used by the accountholder or a business the accountholder owned. These are just a few examples of prohibited transactions.

The harsh result of finding that a prohibited transaction has occurred within an IRA is that the entire IRA is disqualified and is deemed distributed as of the first day of the year in which the transaction occurred. Notice that the <u>entire</u> IRA is disqualified, not just the amount involved with the prohibited transaction. Many times an investment or transaction that an accountholder wishes to have within their IRA is not clearly prohibited. It falls in a grey, questionable area. It's just not clear whether or not the transaction is prohibited. When you are faced with a situation like this, the prudent course of action is to establish a separate IRA just for the questionable asset. This way, should disqualification occur, only the IRA with the problem asset, and not all the IRA assets, are distributed and taxed. The establishment of a separate IRA with its own IRA plan agreement will protect both the accountholder and the custodian/trustee.

Accountholder Reaches Age 70 1/2

The third situation where separate IRAs can be beneficial is when the accountholder is reaching age 70 1/2. Most of you know that attaining age 70 1/2 means that required distributions must be made. In some situations it can be very beneficial to have more than one IRA for required distribution purposes. Most IRA accountholders wish to minimize their required distributions to the greatest extent possible. We have seen numerous situations where having only one IRA resulted in a much larger required distribution amount than would have been necessary had the accountholder had more than one IRA.

A review of some required minimum distribution basics is necessary to illustrate how this happens. Under the required distribution rules, an accountholder uses a single or joint life expectancy to determine what their RMD is depending on whether or not they have a beneficiary. The accountholder must make an election as to whether the life expectancy will be recalculated each year or reduced by one each year. In determining what a joint life factor will be, the oldest IRA beneficiary named is used. If there is no beneficiary named to the IRA, or if one of the beneficiaries is a nonperson, such as a church, charity, or trust (an irrevocable trust may be an exception), a single life expectancy must be used. Here, then, are some situations where multiple IRAs are desirable.

1. An accountholder has an IRA where he has designated his spouse as beneficiary to 50% of the IRA and a charity as beneficiary to the other 50% of his IRA. If all IRA assets are held by one IRA, he will have to take distributions based on a single life expectancy. This is due to the existence of a nonperson IRA beneficiary. It would be in his best interest to establish separate IRAs for each beneficiary's share. In this way, he could use a joint life expectancy for the IRA for which his wife is the beneficiary. He would still have to use a single-life factor for the IRA that named the charity as beneficiary, but at least a portion of his total RMD is calculated based on a joint-life factor.

2. Another RMD situation that could arise, where more than one account is desirable, is in a multiple-beneficiary situ-

ation. When the accountholder has named more than one primary beneficiary, an effective tool to decrease the total required distribution amount is to have a separate IRA established for each beneficiary's share. This goes back to the basic rule that you must use the age of the oldest beneficiary to determine the life-expectancy factor. By establishing separate IRAs, each beneficiary's age is used to determine the RMD for each IRA. The IRAs established with the younger beneficiaries will have a smaller RMD than would have been the case had all funds been in one IRA, where the oldest beneficiary's age had to be used. Separate IRAs will result in a reduction of the total RMD for the year.

Beneficiary Distributions

Related to 70 1/2 required distributions are beneficiary distributions. The rules found here also lead us to believe that in many cases multiple IRAs are necessary. The options beneficiaries have for distributions depend on when the accountholder died and who the beneficiary is. When the accountholder dies after he has reached his own required beginning date for 70 1/2 distributions, the beneficiary(ies) must continue the schedule established by the accountholder. Only a spouse beneficiary could also treat their share of the decedent's IRA as their own. When the accountholder dies before reaching their 70 1/2 required beginning date, a non-spouse beneficiary can either use a "five-year payout option" or a "life-distribution option." The life-distribution option is a distribution schedule based on the beneficiary's own single life expectancy with distributions beginning not later than December 31 of the year following the year of the accountholder's death. A spouse beneficiary can use the five-year payout, life distribution or treat their share as their own. Life distribution for a spouse beneficiary is based on the spouse's own single life expectancy with distributions beginning not later than December 31 of the year the accountholder would have reached age 70 1/2. Why are multiple IRAs beneficial in a beneficiary distribution situation? Again, an example is in order.

An accountholder has named her husband, who is 74, and her daughter, who is 43, as her IRA beneficiaries. She has started her 70 1/2 distributions based on a joint life expectancy, recalculation with her husband. She dies this year. What are her beneficiarie's options? Since she was past 70 1/2, they must continue the schedule established by her. This means they must continue distributions based on the single life expectancy of the husband. The reason for this is that she elected recalculation. Once a person whose life was being recalculated dies, the survivor drops to a single-life factor. This means they will have to continue distributions based on his single life. The husband, however, could avoid this consequence by establishing a new IRA and rolling the funds into this new account, naming his beneficiaries, and establishing his own 70 1/2 schedule. The daughter can only continue with a payout schedule based on the husband's single-life factor. If separate IRAs had been established, the daughter's schedule could continue based on her life expectancy. This would dramatically decrease the required distribution that the daughter-beneficiary would have to take.

Spouse Beneficiary Older Than Accountholder

Another beneficiary situation where multiple IRAs appear necessary is in the situation where a spouse beneficiary is older than the accountholder. Example: An IRA accountholder dies. The spouse beneficiary is over 70 1/2 and had his or her own IRA. In the spouse beneficiary's IRA, RMDs were based on a joint life, recalculation with the deceased spouse as beneficiary. Once the spouse dies, the survivor must continue their own distributions based on a single life expectancy because of the recalculation election. The spouse has the right to treat the IRA of the deceased spouse as their own. They should not, however, move these IRA funds into their existing IRA. If they do, all funds will have to come out under a single life expectancy, recalculation method. If, instead, they establish a new IRA to receive these funds, they will have the ability to name beneficiaries to this new IRA and establish a different RMD method.

These are just a few of the possible situations and scenarios where multiple IRAs may be necessary and desirable. Remember that an accountholder can have more than one IRA in the same institution. All it takes to establish a separate IRA is a new IRA plan agreement. PD

Update on SEPs and FDIC Pass-Through Notice Requirement and Insurance of IRAs Containing SEP Deposits

The FDIC recently wrote us in response to our letter of September 15, 1995. The July issue of the newsletter contained an article on this subject. Previously, the FDIC had concluded that an insured institution must furnish the required pass-through notice(s) to a SEP maintained pursuant to a multiple-participant SEP. This was a change in FDIC policy. Another question followed, if a multiple-participant SEP plan is an employee-benefit plan for "notice" purposes, is such a plan also an employee-benefit plan for "insurance of deposits" purposes? In the past, the FDIC's policy has always been that SEP deposits must be aggregated with other IRA deposits and the aggregated amount is insured to the extent of $100,000. That is, the concept of pass-through or pro rata coverage does not apply to SEP deposits.

The FDIC's letter is quite interesting and valuable. It is reprinted below. This letter expressly states that "this opinion revises and updates prior opinions issued by the FDIC Legal Division on this subject."

The FDIC's new analysis is: since SEP contributions are deposited into an IRA where the banks act as the trustee for one person, the pass-through coverage rules are irrelevant. Because pass-through coverage is irrelevant, the FDIC will not require an insured institution to furnish the pass-through disclosures required by section 330,12(h). Good news!! For insurance coverage purposes, SEPs and IRAs are still aggregated, and coverage exists to the extent of $100,000.

The FDIC's letter is copied and included with this newsletter. PD

FDIC

Federal Deposit Insurance Corporation
Washington, D.C. 20429

Legal Division

December 7, 1995

Re: Insurance Coverage of Individual Retirement Accounts ("IRAs") Containing Simplified Employee Pension ("SEP") Deposits – 12 U.S.C. § 1821(a), 12 C.F.R. Part 330.

James M. Carlson
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Dear Mr. Carlson:

I am writing in response to your inquiry dated September 15, 1995, which was one of several recent letters we have received requesting advice about deposit insurance coverage on IRAs containing SEP funds. These requests all seek clarification whether SEP-IRAs will be insured as fractional interests in a single pension plan, with pass through insurance for each beneficiary being dependent on the capital requirements of 12 C.F.R. § 330.12(a)-(b), and whether a SEP-IRA depositor is covered by the capital status disclosure rules under 12 C.F.R. § 330.12(h). Although, as you know, the FDIC does not give binding advisory determinations, I can give you my considered opinion as a staff attorney on the legal questions you raise in your letter. Please accept my apologies for the time it has taken to give this question full consideration. For the reasons I discuss below, an individual's SEP funds deposited in an IRA will not be insured differently than other IRA deposits; such funds will be aggregated with any other IRA deposits the individual holds at the same institution and subjected to the $100,000 limit under 12 C.F.R. § 330.12(c)(2).

The present requirements under 330.12(a)-(b) implement amendments Congress made to section 11(a) of the Federal Deposit Insurance Act, 12 U.S.C. § 1811 <u>et seq.</u> ("FDI Act"), in the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 ("FDICIA"). Section 11(a) states that the FDIC should continue to provide "pass through" coverage to benefit plan participants:

> [T]he Corporation shall provide deposit insurance coverage with respect to deposits accepted by any insured depository institution on a pro rata or "pass through" basis to a participant in or beneficiary of an employee benefit plan . . .

12 U.S.C § 1821(a)(1)(D)(i).[1] Congress defined "employee benefit plan" to mean an employee benefit plan as defined by section 3(3) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), 29 U.S.C. § 1000 <u>et seq.</u>, or a Keogh plan as described in section 401(d) of the Internal Revenue Code of 1986, as amended ("Code"), 26 U.S.C. § 401(d). 12 U.S.C. § 1821(b)(8)(B)(ii).

In applying this statute, a SEP plan that provides employer contributions meets the ERISA section 3(3) definition of an employee benefit plan which is incorporated into the FDI Act. In addition, a SEP deposit is also treated as an IRA under section 408(a) of the Internal Revenue Code. 26 U.S.C. § 408(k) ("For purposes of [Title 26], the term 'simplified employee pension' means an individual retirement account . . . ."). However, from a deposit insurance standpoint, the important issue is how the plan funds are legally held and deposited.

A SEP is structured differently from other employee benefit plans. Other ERISA employee benefit plans are required to hold any and all employer contributions and other plan assets in a trust, under the control of a plan trustee for the exclusive benefit of plan participants. 29 U.S.C. § 1103(b)(3). Similarly, Keogh plan assets are held in a trust for the benefit of participants. 26 U.S.C. § 401(a), 401(d). In contrast to these requirements for a special plan trust, SEPs have no plan trust; each participant's funds are required to be held in a regular IRA in his or her own name that meets all the requirements for any IRA under section 408(a) of the Code. 26 U.S.C. § 408(k)(1). IRAs are required to take the form of a trust for the exclusive benefit of an individual. 26 U.S.C. § 408(a).

Congress' use of the words "pro rata" and "pass through" when it amended section 11(a) is, in this case, significant. These terms have long been well-recognized technical terms of art in deposit insurance law, and are known to refer to the separate insurance of the ascertainable, noncontingent interests of multiple beneficial owners of a common fund. Thus, pass through insurance is applicable to the insurance of regular employee benefit or Keogh plans, in which all plan participants' interests are maintained in the same trust.[2] But with SEPs, the employer's contributions are made to an IRA where the bank acts as trustee for one individual participant, and pass through coverage is therefore irrelevant. Nothing in FDICIA indicates that Congress, by enacting section 11(a), intended the FDIC to take pass through insurance beyond its understood application and somehow aggregate legally separate IRA trusts into a single "plan" for deposit insurance purposes.[3] This is also consistent with the FDIC's pre-FDICIA practice of insuring regular employee benefit plans on a pass through basis, but treating SEP-IRAs as IRAs under the now-repealed statutory provision for separate insurance of IRAs. See, e.g., FDIC-91-61 (July 29, 1991).

As a result, IRAs containing funds that originated from a SEP will be treated the same as IRAs containing individual contributions or rollover funds, without reference to the pass through rules contained in sections 330.12(a)-(b) of the FDIC's deposit insurance rules. This means that SEP funds will be aggregated with any other IRA funds, section 457 plan interests, or self-directed employee benefit plan interests subject to section 330.12(c)(2) of the deposit insurance rules. This result would also pertain to any non-SEP IRA that still met the technical ERISA 3(3) definition of an employee benefit plan because of employer sponsorship.[4] Further, since SEPs are insured without reference to the pass through rules, the FDIC will not require insured depository institutions to make the disclosures required by 330.12(h) to SEP depositors.

Please note that this opinion revises and updates prior opinions issued by the FDIC Legal Division on this subject.

I hope this letter responds to your concerns. If you would like to discuss any issues further, I can be reached at (202) 8987265.

Very truly yours,

Jamey Basham

Jamey Basham
Counsel
Regulation and Legislation Section

[1]As you know, Congress also conditioned this coverage on an inquiry whether the depository institution, at the time it accepted the deposit, satisfied certain capital requirements, issued certain notices, or obtained certain regulatory waivers. 12 U.S.C. §§ 1821(a)(1)(D)(ii)-(iii).

[2]One of the purposes of the FDICIA amendments was to extend pass-through coverage to section 457 plans, which could not otherwise qualify for pass-through coverage because the plan participants did not have a non-contingent interest in the plan assets.

[3]This is not to say that the trustee of a regular employee benefit plan or Keogh could expand the insurance available to each plan participant by creating separate trusts under the plan for each participant (assuming for the sake of argument that such an arrangement is even possible under ERISA and the Code). Whereas the use of separate IRA trusts in connection with SEPs is statutorily required by the Code, other ERISA plans and Keoghs can make no such claim to a legal requirement for multiple trusts, which would presumably be created in an effort to evade the plain intent and effect of sections 330.12(a)-(b).

[4]Any IRA, SEP-related or not, can be deemed an ERISA 3(3) plan if contributions are made by the employer, participation is not completely voluntary to employees, the employer endorses an IRA program, or the employer receives compensation from an IRA program. 29 C.F.R. § 2510.3-2(d)(1).