

MANUAL TRANSMITTAL

Department
of the
Treasury

Internal
Revenue
Service

4.72.18

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PURPOSE

This transmits revised text for IRM 4.72.18, Employee Plans Technical Guidance, Nonbank Trustee Investigation Procedures.

NATURE OF CHANGES

IRM 4.72.18 is being revised to correct addresses for submission of Nonbank Trustee applications and for submission of requests for background information on Nonbank Trustee application files or other case files relating to Nonbank Trustee's status.

INTENDED AUDIENCE

Employee Plans Specialists and Group Managers

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4.72.18.1 (07-15-2002)

Overview

- (1) A nonbank trustee or nonbank custodian (referred to hereinafter as “NBT”) is an entity that is not a bank that is permitted to act as a trustee or custodian for the arrangements listed below, if it demonstrates to the satisfaction of the Commissioner that the requirements specified under Reg. 1.408-2(e)(2) through (e)(5)(viii)(F) are met:
- IRC 220 Medical Savings Accounts
 - IRC 401 Qualified retirement plans or trusts
 - IRC 403(b)(7) Custodial Accounts
 - IRC 408 Individual Retirement Arrangements (IRAs)
 - IRC 408A Roth IRAs
 - IRC 457(b) Deferred Compensation Plans of State & Local Government and Tax Exempt Organizations Custodial Accounts
 - IRC 530 Education IRAs
- (2) Approval to act as a NBT falls under the jurisdiction of the Director, EP Division in the Washington office.
- (3) Approved NBTs are investigated for continued compliance by the area offices who report their findings to the Washington office.
- (4) These procedures are primarily for Employee Plans specialists and reviewers (hereinafter referred to as specialists).

4.72.18.1.1 (07-15-2002)

Legislation

- (1) Effective 12/20/95, the provisions under Reg. 1.401-12(n) revised and then moved to Reg. 1.408-2(e). See T.D. 8635, 1996-3 C.B. 52.
- (2) The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) modified IRC 401(d)(1) so that for years beginning after 12/31/1983, the requirement that a trustee of a qualified retirement plan benefiting owner-employees be a bank or an approved NBT no longer applies. However, IRC 401(f) provides that the person holding the assets of a custodial account under IRC 401 must be a bank or an approved NBT.
- (3) Medical savings accounts were enacted into law by the Small Business Job Protection Act (SBJPA), P.L. 104-191, effective for tax years beginning after 12/31/96. See IRC 220(d)(1)(B), augmented by Q&A-10 of Notice 96-53, 1996-51 I.R.B. 5.
- (4) Roth IRAs and Education IRAs were enacted into law by the Taxpayer Relief Act of 1997 (TRA '97) effective for tax years beginning after 1997.
- (5) IRC 457 was amended by the SBJPA and more recently by the Taxpayer Relief Act of 1997 (TRA '97) for eligible deferred compensation plans, as defined in IRC 457(b) (457(b) plans). Notice 98-8, 1998-4 I.R.B. 6, which

provides guidance relating to IRC 457(b) plans, provides that the custodian of such plan must meet the nonbank trustee requirements under Reg. 1.408-2(e).

4.72.18.1.2 (07-15-2002)

Technical Overview

- (1) The trustee or custodian for a medical savings account established under IRC 220 or an IRA established under IRC 408, 408A and 530, and the custodian of a plan qualified or established under IRC 401, IRC 403(b) (7), or IRC 457(b), must be—
 - a. a bank, or
 - b. in the case of a medical savings plan, a bank or an insurance company, or
 - c. another person (not an individual) approved by the Service to act as a NBT. See Reg. 1.408-2(e).
- (2) To act as a NBT, an entity must demonstrate in writing, to the satisfaction of the Commissioner, that the requirements of Regs. 1.408-2(e)(2) through (e)(5)(viii)(F) will be met. See Reg. 1.408-2(e)(1).
- (3) If the requirements are met, the NBT will receive a written notice of approval that will specify the day on which the approval is effective. The NBT is not authorized to accept any fiduciary account before the notice of approval becomes effective. See Reg. 1.408-2(e)(7)(i).
- (4) The continued approval of a NBT applicant is contingent upon the continued satisfaction of the criteria under Reg. 1.408-2(e).
 - a. The NBT must notify the Commissioner, in writing, of any change that affects the continuing accuracy of any representations made in its application. See Reg. 1.408-2(e)(6)(iv).
 - b. If the Commissioner determines that the NBT is unwilling or unable to administer fiduciary accounts in a manner consistent with these requirements, the notice of approval will be revoked. See Reg. 1.408-2(e)(7)(iv).

Note: NBT applications are submitted to the following address:

Internal Revenue Service
 Attention: EP Letter Rulings
 1111 Constitution Ave. NW
 Washington, DC 20224

(5)

Note: Passive trustees or custodians are exempt from certain requirements of the regulations. See Reg. 1.401-2(e)(6)(i)(A).

4.72.18.2 (07-15-2002)

Selection for Investigation

- (1) A list of all approved NBTs is developed for each area by the Director, EP Division and transmitted to EP Exams Program and Review at the beginning of each fiscal year.

- (2) Once each calendar quarter, the EP classification function will select an approved NBT from the list for each area to investigate for continued compliance with the NBT regulations.
- (3) If the Washington office receives or otherwise obtains information that a specific approved NBT does not comply with the regulations, The Washington office may request or recommend (by memorandum) to EP Programs and Review that a NBT investigation occur.

4.72.18.3 (07-15-2002)

**Investigation
and Report
Procedures**

- (1) For background information, a copy of the NBT's application file or other case files relating to the NBT's status, may be obtained by submitting a written request to:

Internal Revenue Service
Attn: Manager, T:EP:RA:TI
Nonbank Trustee Files
1111 Constitution Ave. NW
Washington, D.C. 20224
- (2) The specialist should prepare and send a contact letter, similar to Letter 1346(CG)(5-99), to the NBT. The contact letter should:
 - a. inform the NBT that it has been randomly selected for an investigation to test its continued compliance with the requirements of Reg. 1.408-2(e) through 1.408-2(e)(5)(viii)(F),
 - b. ask for a meeting (if the specialist feels a meeting is necessary), and,
 - c. list the material, documents, and information the NBT must provide to further the investigation; such as:
 1. list of stockholders with their percentage of ownership (See 18.3.2 below),
 2. Copies of several Form(s) 1099-R that were issued for the most recent taxable year (See 18.3.7 below),
 3. by-laws, operating procedures or other controlling document that contains the rules of fiduciary conduct (See 18.3.8 below),
 4. A copy of the bond covering all employees taking part in the performance of the NBT's fiduciary duties (Reg.1.408-2(e)(5)(i)(B)),
 5. A copy of the NBT's balance sheet with auditor's comment showing net worth (See 18.3.11 below), and,
 6. A copy of the auditor's valuation of the fiduciary accounts along with a copy of the auditor's report of the fiduciary books and records (See 18.3.11 below).
- (3) Prepare an investigation and report on Form 5773, EP/EO Workpapers Continuation Sheet, detailing each of the items below.

- 4.72.18.3.1 (07-15-2002)
Employer Identification Number (EIN)
- (1) Report the NBT's EIN. If the EIN is different from the EIN on the approval letter issued by the Washington office, determine and report the reason for the discrepancy.
- 4.72.18.3.2 (07-15-2002)
Continuity
- (1) The NBT must assure the uninterrupted performance of its fiduciary duties notwithstanding the death or change of its owners. See Reg. 1.408-2(e)(2)(i). Determine if the NBT meets the safe harbors of Reg. 1.408-2(e)(2)(i)(B) or (C).
- (2) The Washington office has approved some NBTs who fall outside of the safe harbors based on facts and circumstances. If the NBT under investigation—
- a. falls outside of the safe harbors, determine whether the safe harbors or the facts and circumstances tests were met at the time the application was approved.
 - b. fails to satisfy the safe harbors after the application was approved and the Washington office never considered the NBT's change in facts and circumstances, report that fact and include this item as grounds for proposed revocation. See 18.4(6).
- 4.72.18.3.3 (07-15-2002)
Established Location
- (1) Determine whether the NBT continues to maintain an established business location that is accessible during normal business hours and report the address of that business location. See Reg. 1.408-2(e)(2)(ii).
- 4.72.18.3.4 (07-15-2002)
Fiduciary Experience or Expertise
- (1) Determine if a significant part of the NBT's business continues to consist of administering retirement plans.
- (2) In the alternative, determine if the NBT continues to employ personnel experienced in administering retirement plans. See Reg. 1.408-2(e)(2)(iii).
- Solely formal training, e.g., a college degree, is insufficient to satisfy the expertise requirement.
- 4.72.18.3.5 (07-15-2002)
Financial Responsibility
- (1) Verify that the NBT pays its debts within 30 days of falling due unless they are the subject of a legal dispute. See Reg. 1.408-2(e)(2)(v).
- 4.72.18.3.6 (07-15-2002)
Capacity to Account
- (1) Verify the NBT's competence with respect to accounting for the interests of a large number of individuals including calculating and allocating income earned and paying out distributions to payees. See Reg. 1.408-2(e)(3).

- 4.72.18.3.7 (07-15-2002)
Fitness to Handle Funds
- (1) Verify the NBT's competence with respect to performing activities normally associated with the handling of retirement funds. See Reg. 1.408-2(e)(4), (especially those activities described in (ii)(A)–(D).
- 4.72.18.3.8 (07-15-2002)
Rules of Fiduciary Conduct
- (1) The NBT must demonstrate that the rules of fiduciary conduct specified in Regs. 1.408-2(e)(5)(i) through (viii)(F) are incorporated in operating procedures, by-laws, or some other document that controls the NBT's activities. See Reg. 1.408-2(e)(5). The rules of fiduciary conduct may not be incorporated by reference.
- Note:** Continued compliance with this requirement may be demonstrated by a resolution of the NBT's board of directors (or its equivalent) adopting the rules of fiduciary conduct and a copy of the document or the appropriate section of the document that contains the rules of fiduciary conduct as adopted by the board of directors.
- (2) In lieu of the above demonstrations, the NBT may provide evidence it is operating under applicable statutory requirements either under state or federal law, which mirror the rules of fiduciary conduct.
- 4.72.18.3.9 (07-15-2002)
Passive/Non-passive
- (1) If the NBT has been approved to serve only as a passive trustee or custodian, determine and report whether the trustee or custodian exercises any discretion with regard to the investment of trust or custodial funds. See Regs. 1.408-2(e)(5)(i)(A)(3) and 1.408-2(e)(6)(i)(A).
- 4.72.18.3.10 (07-15-2002)
Fidelity Bond
- (1) Verify that the NBT is a named insured on a bond that is similar to a standard fidelity, stock broker, or financial institution bond with the liability limit of the insurer no less than \$250,000 after all deductibles. See Reg. 1.408-2(e)(5)(i)(B).
- 4.72.18.3.11 (07-15-2002)
Net Worth
- (1) Determine the adequacy of the NBT's net worth from the NBT's most recent audited financial statements in accordance with the formulas in Regs. 1.408-2(e)(5)(ii)(B), (C), (D)(1), and the examples in (D)(2). Representations of management are not acceptable. See Reg. 1.408-2(e)(2)(ii).
- a. The value of all assets held by the NBT in fiduciary accounts is an important element of these formulas. Therefore, it is important to insure that the value of the applicant's fiduciary accounts is accurate. This value is required by Reg. 1.408-2(e)(5)(ii)(E) and should be determined during the audit pursuant to Reg. 1.408-2(e)(5)(iii). The absence of this audit (and the resulting audit report) is grounds for revocation. See 18.4(6).
- b. The applicant may not declare the value of certain assets (such as limited partnerships and stock of closed corporations that are not publicly traded) as indeterminable or consistently report a value of \$0.00, \$1.00 or cost. If they were allowed to do so, the adequacy of

their net worth will become indeterminable. In addition Forms 1099R and 5498 will be under or over stated resulting in the loss of tax revenue or over taxation of the account holder. Therefore, the applicant must value all assets in its fiduciary accounts. For those assets whose value is not easily determinable, the applicant must develop a method for valuing such assets and include a description of the method in the audit report required by section 1.408-2(e)(5)(iii)(A) of the regulations.

- c. If the applicant is unwilling or unable to value all of the assets it holds in fiduciary accounts, the case should be forwarded to the National Office with the recommendation of revocation pursuant to the closing procedures of Chapter 4.2(2) of section 7.6.1 of the IRM because the adequacy of the applicant's net worth can not be determined and any other noncompliance that may be discovered during the investigation.
 - d. The definition of "account" or "fiduciary account" (Reg. 1.408-2(e)(5)(viii)(A)) was written before medical savings accounts, Roth IRAs, education individual retirement accounts, and eligible deferred compensation plans either came into existence or required its trustee to be a bank or approved nonbank trustee. Therefore, the definition of "account" or "fiduciary account" must be expanded to include these accounts. Failure to do so will result in the miscalculation of the applicant's required net worth.
- (2) A NBT who is not specifically approved to act as a passive trustee or custodian may maintain accounts that are non-passive and passive. To determine the required minimum net worth in this case, use the:
- higher percentage formula of Reg. 1.408-2(e)(5)(ii)(B) and (C) for those accounts that are nonpassive, and
 - lower percentage formula of Reg. 1.408-2(e)(5)(ii)(B) and (C) for those accounts that are passive.

Required Minimum Net Worth = (value of passive accounts x 2%) + (value of non-passive accounts x 4%). Reg. 1.408-2(e)(5)(ii)(D) provides relief for members of the Securities Investor Protection Corporation (SIPC)

4.72.18.3.12 (07-15-2002)

Administrative

- (1) Do not investigate an entity that is acting as a NBT and is not on the list of approved NBTs. Instead, determine whether a criminal action has taken place and/or whether taxable events have occurred and act accordingly.
- (2) When a NBT has gone out of business or indicates it is no longer acting as a NBT, determine the status of the fiduciary accounts it handled. The specialist should obtain from the NBT a written statement—
 - a. disclosing whether the accounts were transferred to another entity or distributed to the account owner. In the case of a transfer, the statement must include the transferee's name, address, telephone and person to contact.

- b. that the NBT wants to withdraw its application and remove its name from the list of approved NBTs.
- (3) If the NBT is not currently serving as a NBT but wants to retain its approval letter for future use, the NBT must continue to meet the requirements of the regulations.
- (4) If the accounts were transferred to an entity that is not a bank or an approved NBT, the transfer is treated as a distribution subject to the imposition of tax and/or penalty.
- (5) Use Form 5773 to provide detailed information gathered during the investigation to the Director, EP Division. Prepare a transmittal memorandum and attach the investigation report, case file, any supporting attachments and letter to the NBT. See 18.4. (5). Specify in the transmittal memorandum—
 - the NBT applicant,
 - the results of the investigation,
 - the rationale for the conclusion, and
 - any other relevant information.

Note: Be sure to specify whether the NBT does or does not satisfy the regulations and recommend whether the NBT should be issued a favorable letter or a proposed revocation letter.

- (6) If the report raises any “red flags” during review by the Washington office, additional information or further development of specific facts and circumstances may be requested to determine if any further action is necessary.

4.72.18.4 (07-15-2002)

Closing Procedures

- (1) All NBT investigations are Mandatory Review Cases that shall be closed to the Washington office via EP Mandatory Review.
- (2) The NBTs will be notified by letter of the results of any investigation conducted with respect to their continued qualification as a NBT by either the area office or the Washington office.
- (3) If no problems are discovered, the specialist will prepare a letter. The Washington office will forward the letter to the NBT after the Washington office reviews the case file. The letter must include the following:
 - a. A statement that: “Based upon the results of the nonbank trustee/custodian investigation we recently conducted, we have determined that [the NBT] is operating within the requirements applicable to nonbank trustees/custodians under Reg. 1.408-2(e).”
 - b. A statement indicating the investigation is not an examination under IRC 7605(b),
 - c. The name and telephone number of a person to contact in the area, and
 - d. Signature of the Director, EP Examinations (or delegate).

- (4) If minor problems were discovered which do not require revocation of approval, the specialist will prepare a letter. The Washington office will forward the letter to the NBT after the Washington office reviews the case file. The letter must include—
 - a. a statement that: “Based upon the results of our recent investigation, we have determined that generally [INSERT NBT’s NAME] is operating within the requirements applicable to nonbank trustees/custodians under Reg. 1.408-2(e). However, certain minor deficiencies were noted. Enclosed is an explanation of the deficiencies and the corrective action required.” and,
 - b. the items specified in (2)b, c, and d above.
- (5) EP Mandatory Review will forward the report, the case file, and a copy of the prepared letter under cover of a transmittal memorandum to the Director, EP Division, for all investigations closed under the procedures specified in (3) and (4) above.
- (6) If the investigation indicates that a NBT has knowingly, willfully, repeatedly, or in a grossly negligent manner failed to administer a fiduciary account in a manner consistent with the NBT requirements or is unable to administer any fiduciary account, revocation of NBT status should be recommended. EP Mandatory Review will forward the case file and report, under cover of the transmittal memorandum, to the Director, EP Division recommending issuance of a proposed revocation letter.