

Nothin' free is



WALK THROUGH A GROCERY STORE ON A FRIDAY AFTERNOON and you are likely to have an opportunity to sample the latest food items—for free. Attend a home and garden show and you might receive a free tote bag or pick up a free yardstick. Open your mail any day of the week and you might find free return address labels.

Free. Free. Free. Few of us can resist free stuff. It is a great marketing tool for every kind of business, including financial institutions. But the financial institution must recognize that free stuff often carries a burden of regulatory disclosure or IRS reporting. It's not a heavy burden, but it is one that you must carry.

Three issues make up this burden:

- Truth in Savings and its implementing Regulation DD
- Regulation Q
- IRS reporting rules in the Internal Revenue Code and regulations

● By Jennifer K. McCollough, CRCM,
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Coming in free

**Marketing Tools
Carry a Compliance
and Tax Burden**



And that is the Truth in Savings burden—disclosing sufficient information about the bonus to enable the customer to comparison shop.

Truth in Savings: The Lightest Load?

The Truth in Savings Act and its implementing Regulation DD require that a bank disclose key pieces of information about its deposit accounts to allow consumers to comparison shop for the deposit accounts that best fit their needs. The annual percentage yield (APY) is one such piece of information. The APY is a very “clean” comparative value. It looks at the interest rate being paid on an account and the term of the account and comes up with an annual value a customer can easily compare with accounts at different banks.

But the APY does not tell the customer the whole story. It does not, for example, include the value of any free stuff (bonuses) that might be given to customers in addition to the interest the account will earn. A customer must therefore receive bonus information to more accurately compare deposit accounts.

And that is the Truth in Savings burden—disclosing sufficient information about the bonus to enable the customer to comparison shop. But before you can properly provide bonus information to a customer, you must understand what constitutes a bonus.

Defining “Bonus”

Let’s start with the incentives a bank might offer that are not bonuses. A bonus does not include waiving fees, reducing fees, or absorbing expenses. When you waive the safe deposit box rental fee for a year for each new account customer, you have no bonus worries.

You will have bonus considerations, however, if your giveaway meets both of the following conditions:

- The free item—a premium, gift, award, or other consideration—must have a value of more than \$10. The free item may be in the form of cash, credit, merchandise, or any equivalent.
- The free item must be offered to a consumer in exchange for opening a new deposit account, maintain-

ing an existing account, renewing an existing account, or increasing the balance in an existing account.

Seems simple enough, but let’s apply these conditions to some typical situations to get a better feel for what constitutes a bonus.

EXAMPLE 1: Your bank regularly hands out pens. Each pen is worth \$.39 and anyone who comes into the bank for any reason gets one. This is not a bonus; it does not meet either of the conditions.

EXAMPLE 2: Your bank decides to offer other giveaways and adds yardsticks and flyswatters to the items a person can pick up when at the bank. Again, the items are offered to anyone who comes into the bank for any reason, and the items have a minimal value, less than \$2 apiece. These items are not bonuses.

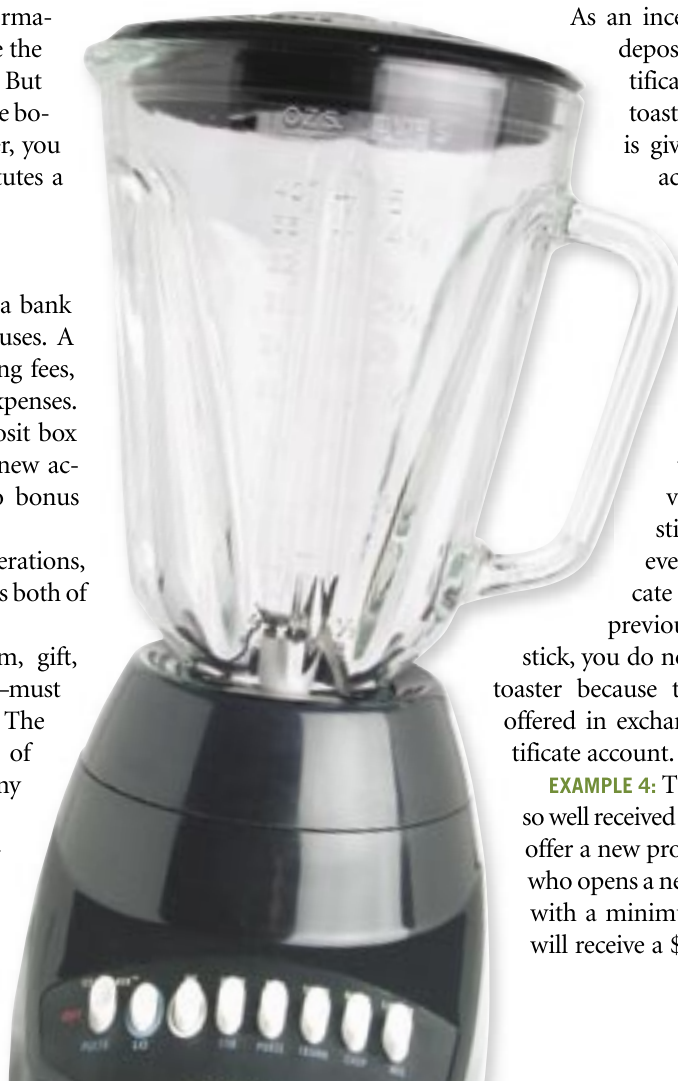
EXAMPLE 3: Later in the year, your bank decides to promote its 12-month certificate of deposit.

As an incentive to customers to deposit \$5,000 in a new certificate, the bank offers a toaster as a gift. The toaster is given only to those who actually open an account.

The bank pays \$9.95 for each toaster.

This is not a bonus. Even though the customer must open an account to receive the toaster (thus meeting one of the conditions), the value of the toaster is still less than \$10. And even though your certificate customers may have previously received a \$2 yardstick, you do not add this value to the toaster because the yardstick was not offered in exchange for opening a certificate account.

EXAMPLE 4: The toaster promotion is so well received that the bank decides to offer a new promotion. Any customer who opens a new 24-month certificate with a minimum deposit of \$10,000 will receive a \$20 gift certificate to be



used at a local DVD store. This is a bonus, because the customer must open a certificate of deposit account to obtain the gift, which has a value greater than \$10.

EXAMPLE 5: With the success of both the toaster and DVD gift certificate programs, your bank decides to link several new promotions. The bank begins a yearlong advertising campaign for its money market savings account. Customers who open new money market accounts with minimum deposits of \$1,000 or who add \$1,000 to existing money market accounts will receive a blender worth \$9.95. If a customer adds another \$1,000 to the money market account within three months, the customer will receive a MP3 player worth \$19.95. And if the customer adds a third \$1,000 to the money market account within the next six months, the customer will receive a set of bath towels worth \$24.95.

In this case, because each item is part of a single ongoing promotion, you must aggregate the value of all three gifts. The total value of \$54.85 is greater than \$10 and the gifts are given in exchange for opening or increasing the balance on an account. You have a bonus.

EXAMPLE 6: The bank offers to pay for the customer's first order of preprinted checks to anyone opening a NOW account with a \$300 minimum deposit during a special promotion period. The value of the checks is \$12.50. The bank will also deposit \$5 to the new account just to "get the customer started." The total value to the customer is \$17.50—but there is no bonus in this case. The \$12.50 cost of the preprinted checks is not a bonus—it is simply a cost the bank absorbs. And the \$5 deposit does not meet the *de minimis* \$10 value needed to constitute a bonus.

Disclosing a Bonus

You should have a pretty good idea at this point how to determine whether you have a bonus or not. But what happens if you conclude that you have a bonus? For purposes of Truth in Savings, you simply have to disclose—at account opening and in your advertisements—details of the bonus. Specifically, in your account opening disclosures you must

- describe the bonus—the amount or type of gift
- explain when the bonus will be given
- list any minimum balance needed to receive the bonus
- describe any minimum time requirement that must be met to receive the bonus

Let's apply the disclosure rules to Example 5, the yearlong money market account promotion with a bonus worth \$54.85. Because this promotion is a bonus, you must include in your account opening disclosures for the money market account a statement such as "You will receive a \$20 gift certificate to DVD Great Store at the time you open your certificate." The minimum balance needed to open the certificate and the term of the account can also be disclosed here but very likely will already have been provided

elsewhere in your disclosures. Just be sure you have all four required pieces of information.

And if you are promoting your money market account and the associated giveaways in the local newspaper, you will need to beef up your advertisement to include

- the annual percentage yield (be sure to use this terminology) plus all disclosures triggered as a result of listing the APY
- any time requirement that must be met to obtain the bonus
- any minimum balance needed to obtain the bonus
- any minimum deposit that must be made (if this deposit is greater than the ongoing minimum balance requirement)
- when the bonus will be provided

Regulation Q Packs a Punch

Truth in Savings and Regulation DD were relatively painless. Regulation Q will not be much of a burden for you either—as long as you understand how the rule works.

You may have noticed as you read through the examples that in each case the giveaway was attached to an interest-bearing account—a savings account, a money market account, a NOW (interest-bearing checking) account. But what if you want to give a bonus to a customer in exchange for opening a checking account?

Neither Truth in Savings nor its implementing Regulation DD addresses whether you are allowed to give a bonus, what or how much a bonus can be worth, or whether only certain accounts may have bonuses. You must look to a different regulation—Regulation Q. This regulation may be short but it packs a bit of a punch. Don't ignore what it has to say.

Regulation Q states that you cannot pay interest on a demand deposit (basically, your non-interest bearing checking accounts) and goes on to explain that a "premium" (Regulation Q's term for "bonus"), whether given in the form of merchandise, cash, or credit, will not be considered the payment of interest if 1) the premium/bonus is given only at the time of opening an account or adding to an existing account; 2) no more than two premiums are given within a 12-month period; and 3) the value of the premium (including taxes, shipping, warehousing, packaging, and handling costs) is no more than \$10 for deposits of less than \$5,000 or \$20 for deposits of \$5,000 or more.

Let's reconsider the six examples but attach the bonus to a regular checking account in each instance. Here's what Regulation Q would allow:

EXAMPLE 1: Your \$.39 pens are not a premium under Regulation Q any more than they are a bonus under Regu-



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lation DD because they are not connected to any account. Anyone who comes into the bank can have a pen.

EXAMPLE 2: Your yardsticks and fly swatters are also not premiums under Regulation Q.

EXAMPLE 3: Any customer who deposits \$5,000 or more in a new checking account will receive a \$9.95 toaster. With sales tax alone, the value of the toaster increases to more than \$10. But the toaster still does not constitute a premium under Regulation Q because it is given only in connection with a \$5,000 deposit. The value of the toaster could be as high as \$20 and not be a premium. But a word of caution: Do not give the toaster to any customer who opens a regular checking account with less than \$5,000 (such as the customer who has \$4,500 today and who will add \$500 on payday just two days from now). If you do, you will be in violation of Regulation Q.

EXAMPLE 4: The \$20 DVD gift certificate given to customers opening checking accounts with minimum deposits of \$10,000 is not a premium (assuming there are no taxes or other costs on a gift certificate).

EXAMPLE 5: This yearlong promotion is going to run afoul of Regulation Q in several ways. For starters, this is an ongoing promotion that calls for three different giveaways. You could not have such a promotion for a regular checking account because you can give no more than two premiums in a 12-month period. Even if you dropped the third giveaway (the \$24.95 bath towels), you still couldn't go forward with the other two giveaways because the MP3 player alone

is valued at more than \$20 when taxes and other costs are added in. And if you decided to go forward with just one giveaway—the blender—you would still have a premium because the \$9.95 plus taxes and other costs will be over the \$10 limit allowed on deposits of less than \$5,000. (Remember, the customer needs a total of just \$3,000 in deposits to receive the gifts.) You will not be able to go forward with this promotion as it is designed.

EXAMPLE 6: Absorbing a fee (the preprinted checks) has been determined not to be a premium under Regulation Q just as it is not a bonus under Regulation DD. So, the free order of checks plus the \$5 that the bank is giving new customers is allowed in connection with a regular checking account.

I Before E, Except After C

With all good rules, there has to be an exception, and Regulation Q has one. Regulation Q states that any premium that is 1) not dependent on the checking account balance and 2) does not require that the funds remain on deposit for a specified length of time is not considered the payment of interest. In other words, a bank can offer a giveaway in connection with its regular checking account that is worth more than \$20 if both conditions are met. For example, your bank could give a customer a \$50 bill as an incentive to open a regular checking account. But you can't require the customer to deposit, say, \$5,000 to open the account; you can't require the customer to deposit \$1 or even a penny, to open the account. Nor can you require the customer to maintain a balance of any amount. Likewise, you cannot require the customer to leave the funds on deposit for any length of time (such as six months or one day or even one hour).

All things considered, you probably don't want to offer \$50 to someone to open an account with a \$0 deposit, especially knowing that the customer could close the account right after opening it (and collecting the \$50), not to mention the fact that your safety and soundness examiners would not likely be happy about such a promotion.

OK. You're carrying the Truth in Savings burden and the Regulation Q burden with little difficulty at this point. But we must add one more straw to this camel's back—Internal Revenue Code rules.

We're from the IRS and We're Here to Help You

Before we start discussing the tax rules, keep in mind that the IRS figures nothing in life is free—or more precisely, "tax free." Specifically, customers who receive a bonus or gift might need to pay income taxes on the amounts received, which may be considered taxable interest or miscellaneous income. Financial institutions that pay bonuses are probably required to report them under Internal Revenue Code (IRC) Section 6041 or Section 6049.

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To determine the value of a noncash premium for reporting purposes, the financial institution must determine the fair market value of the property.

Interest Reporting

To better understand when and what to report, you must first understand the definition of “interest.” For federal income tax purposes, interest is a dollar amount paid in compensation for the use of money. More precisely, for information reporting purposes under IRC Section 6049 (the information reporting provisions for Form 1099-INT), interest is defined as amounts paid in respect of deposits or investment certificates. All interest totaling \$10 or more per year per customer must be reported to both the IRS and the customer.

In addition to paying cash interest, a financial institution may provide a “gift” (also referred to as a premium or a bonus) as an inducement to a customer either to open a deposit account or to add to an existing account. Such gifts are also considered interest, the fair market value of which may need to be reported. The IRS does consider certain *de minimis* or very small noncash gifts to be free of tax and not subject to reporting on Form 1099-INT, under Revenue Procedure 2000-30. Specifically, if a noncash premium costs the financial institution less than \$10 and the premium is given in connection with a deposit of less than \$5,000 (or less than \$20 on deposits of \$5,000 or more), reporting on Form 1099-INT is not required and the customer would not incur taxable income. Note that the *de minimis* rule applies only when the bonus or premium is not cash.

To determine the value of a noncash premium for reporting purposes, the financial institution must determine the fair market value of the property. For example, if a financial institution pays \$11 for each George Foreman grill it gives away, it may report the \$11 it paid for the item on the Form 1099-INT as the fair market value even though the grill may retail for \$14.95.

And remember, even though the dollar amount of interest paid to a customer may not be reportable when viewed by itself and the value of a noncash premium may not be reportable when viewed by itself, the two together may exceed the threshold. If, for example, a financial institution pays a customer \$9 cash (interest on a deposit) and gives the customer a gift worth \$21, then the financial institution must report \$30 on Form 1099-INT.

Unlike the disclosure provisions of Regulation DD, the customer will not receive any notice up front explaining that the financial institution will be reporting to the IRS on Form 1099-INT not only the cash interest the customer receives but also the value of any noncash gift the customer receives. The IRS reasons, after all, that we should all know

that there are few free or nontaxable gifts. And we should all know and accept their reasoning. The Form 1099-INT, sent after year-end to the customer and to the IRS, will be the customer’s only notice that the gift is taxable income.

Other Tax Reporting: Form 1099-MISC

In addition to Form 1099-INT (required under the IRC § 6049), a financial institution may need to report payments other than amounts defined as interest to customers on a Form 1099-MISC. This form, under IRC Section 6041, requires the financial institution to report payments of \$600 or more in fixed or determinable income (versus the interest paid on existing deposits discussed previously). This type of reporting is done for amounts paid to nondepositors, such as a referral fee paid to a third party to induce another person to become a bank deposit or loan customer. This section of the IRC also applies directly to a loan customer to whom you give a gift as an incentive to open a line of credit. And this section applies to a winner in a drawing or contest that is not just for specific customers but open to the general public. For example, a financial institution celebrating the opening of a new branch offers a prize of a \$1,000 savings bond. The winner of the prize must receive a Form 1099-MISC showing the \$1,000 savings bond.

Putting It All Together

Armed with tax reporting information, let’s look at the bonus examples described earlier and determine whether a Form 1099-INT or Form 1099-MISC is needed.

EXAMPLES 1 AND 2: The \$.39 pen or flyswatter or yardstick might be considered advertising, especially if it bears a logo, but it is not interest because it is not paid with respect to a deposit account. No 1099 reporting is required.

EXAMPLE 3: The toaster given to a deposit customer meets the definition of “interest”; however, because the bank paid just \$9.95 for the toaster, no interest needs to be reported because it falls within the *de minimis* rule. Now, if the toaster were \$20, and therefore not within the *de minimis* rule, and the customer were also earning interest on the deposit, the financial institution would aggregate the value of the toaster with the amount of interest paid on the certificate.

EXAMPLE 4: A gift certificate of \$20 also meets the definition of interest. However, the IRS is not clear about whether a gift certificate is “cash interest” or “noncash interest.” Either way, it is not within the *de minimis* rule so the value of the gift certificate must be reported on a Form 1099-INT together with interest paid on the certificate.

The key to correctly disclosing bonuses and reporting interest/gifts is to thoroughly review the rules and document your decisions *before* you begin a promotion.



EXAMPLE 5: The IRS doesn't care how many promotions a financial institution has in a year. It just wants its share. Currently, under a small exception in the Section 6049 regulations, a payor is allowed to report on an "account by account" basis even though the actual Internal Revenue Code provision states that payors should aggregate and report total interest paid to the *customer*. Because of this discrepancy, the safest course of action would be to treat each of the three promotions separately. The fluffy \$24.95 bath towels are reportable on their own, as is the nifty MP3 player. The blender, however, may not be reportable under the *de minimis* rule, depending on the size of the deposit.

EXAMPLE 6: The free check printing (\$12.50 value) is not reportable interest. Instead, the free checks would be characterized as a discount because checks are a necessary part of a checking account.

Promotions Currently in the Marketplace

Financial institutions regularly introduce new promotions. Below is a short list of some used recently around the country.

■ **\$15 off the cost of renting a safe deposit box.** This is neither a bonus nor a premium nor interest. It is not discloseable under Truth in Savings because it is the reduction of a fee, nor is it reportable under the IRC rules because it is treated as a discount.

■ **Frequent-flyer points.** The IRS has ruled in the past that frequent-flyer points earned by an employee or a member of an airline program are not taxable due to the valuation difficulties. Presumably the same reasoning would apply to financial institutions that give their depositors frequent-flyer points redeemable for travel or gifts purchased from a specified airline. At this time, it appears that a Form 1099-INT is not needed. Similarly, because no value can be determined, no bonus disclosures are necessary under Truth in Savings.

■ **Travel certificates.** Certain travel certificates, such as \$25 off an airline ticket of \$250 or more, probably have no meaningful fair market value and should be treated as a nonreportable discount. Likewise, no bonus disclosures would be needed under Truth in Savings.

■ **Grocery cards.** Grocery cards are a bit trickier. Consider

a promotion by an "in-store" branch of a financial institution that offers \$20 worth of free groceries (offered via gift card) to customers who use the financial institution's debit card to purchase their groceries. The question here is, "Who is giving the gift? The financial institution or the grocery store?" And what about fair market value? Is there a fair market value to a customer who buys groceries with cash or a check?

Because the \$20 worth of groceries is offered via gift card, no Truth in Savings disclosures are needed and no reporting is necessary on a Form 1099-INT. But if the promotion is changed to \$20 in cash that may be spent on groceries, Truth in Savings bonus disclosures must be given. Furthermore, the payor would almost certainly need to report the "gift" as interest on a Form 1099-INT.

These types of promotions (which fall outside the specific guidance we have from the IRS) require a case-by-case analysis of the tax reporting regulations. And they require thorough review of the bonus rules under Truth in Savings. In addition, be sure to retain written documentation of the financial institution's conclusion as to why it chose or chose not to report to the IRS or disclose to the customer.

Plan Carefully

The key to correctly disclosing bonuses and reporting interest/gifts is to thoroughly review the rules and document your decisions *before* you begin a promotion.

For Truth in Savings purposes, check the proposed gift against the definition of "bonus." If the gift, cash, or award meets the conditions of a bonus, make the necessary disclosures.

For IRS reporting and withholding, first be sure that the marketing staff submits the details of the promotion to the tax reporting area of your institution for sign-off. (This is tricky stuff and you really must have someone with tax expertise sort out the rules.) This step must happen before the promotion is rolled out on radio, on television, or in print. It may be that the difficulty of capturing the information needed for IRS reporting purposes will make the promotion infeasible. Next, determine whether your gift/interest is reportable on Form 1099-INT as interest (for deposit accounts only), on Form 1099-MISC, or not at all. Finally, if a promotional item is reportable, provide training to frontline staff because they must make sure they obtain tax identification numbers (TINs) for reporting purposes; they may need to solicit customers' TINs using Form W-9 or a substitute.

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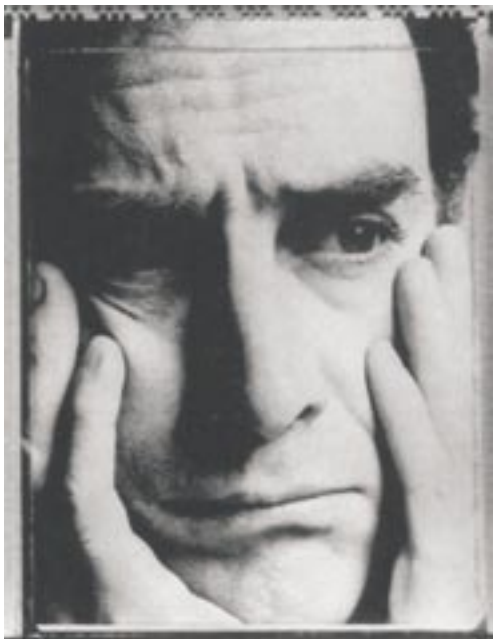
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Ms. Riedlinger is a frequent speaker and author of numerous articles on information reporting and withholding issues published in Bank Personnel News, Journal of Bank Taxation, ABA Bank Compliance Magazine, Journal of International Banking Law and various other trade association publications. She authors A Guide to IRS Information Reporting for Financial Institutions, a complete guide to the IRS Information Returns Program, and publishes the Information Reporting Bulletin. She was appointed to a two-year term on the IRS Information Returns Program Advisory Committee (IRPAC) representing financial institutions. Visit www.taxreportinggroup.com for more information.



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