chapter 9

Responsibilities of Qualified Plan Fiduciaries and Staying Out of Trouble: Prohibited Transactions
Responsibilities of Qualified Plan Fiduciaries
and Staying Out of Trouble:
Prohibited Transactions

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Part I: Responsibilities of Qualified Plan Fiduciaries

I. WHO IS A FIDUCIARY? ERISA §3(21)(A)

A. Broad Definition.

ERISA provides a broad definition of who is a fiduciary. The term includes any person or entity who:

1. exercises any discretionary authority or control with respect to a plan. ERISA §3(21)(A)(i);

2. exercises any authority or control with respect to the management or disposition of a plan's assets. ERISA §3(21)(A)(i);

3. renders investment advice with respect to a plan's assets for a fee or other compensation or has authority or responsibility to do so. ERISA §3(21)(A)(ii); or

4. has discretionary authority or responsibility with respect to the administration of the plan. ERISA §3(21)(A)(iii).

B. Categories of Fiduciaries.

The following persons will be considered to be fiduciaries:

1. Plan trustees;

2. Plan administrator;

3. Members of investment or administrative committee;

4. Investment manager; or

5. Any person who selects or appoints any of these people.

C. Functional Test.

There is generally no consent necessary for a person to be considered a fiduciary. If a person has or exercises authority or control over or oversees or engages in the activities listed in ERISA §3(21)(A), he or she can be a fiduciary. Mertens v. Hewitt Associates, 508 U.S. 248 (1993).
D. Ministerial Functions May Not Be Fiduciary Functions.

1. Persons who perform purely ministerial functions within the framework of policies, interpretations, rules, practices, and procedures established by fiduciaries are generally not fiduciaries. DOL Reg. (29 CFR) §2509-75-8, Q&A D-2.

2. Ministerial functions may include:
   a. application of rules determining plan eligibility for benefits;
   b. calculation of benefits;
   c. preparation of employee communication materials;
   d. maintenance of employee service records;
   e. preparation of required government reports or other reports concerning participants;
   f. orientation of new employees to rights under plan;
   g. collection of contributions and allocation of contributions as provided in plan;
   h. processing of claims.

3. It may be difficult to distinguish between ministerial duties and management responsibilities.

4. Attorneys, accountants, actuaries, consultants, and advisers (other than investment advisers) will not normally be considered fiduciaries in the performance of their normal duties. It is possible, however, for consultants to be fiduciaries. DOL Reg. (29 CFR) §2509-75-5.

II. FIDUCIARY DUTIES. ERISA §404.

A. General ERISA Fiduciary Duties.

1. To act solely in the interest of plan participants and beneficiaries. ERISA §404(a)(i);

2. To act for the exclusive purpose of providing benefits to plan participants and their beneficiaries and defraying reasonable expenses in administering the plan. ERISA §404(a)(1)(A);

3. To exercise the same care, skill, prudence and diligence that a prudent person acting in a like capacity and familiar with such matters would
exercise in the conduct of an enterprise of a like character and with like aims. ERISA §404(a)(1)(B);

4. to diversify plan investments so as to minimize the risk of large losses (unless it is clearly not prudent to do so under the circumstances). ERISA §404(a)(1)(C);

5. To act in accordance with the documents and instruments governing the plan (unless the documents are inconsistent with ERISA). ERISA §404(a)(1)(D); and

6. No fiduciary may maintain indicia of ownership of any assets outside jurisdiction of U.S. district courts. Exceptions in DOL Reg. §2550.404b-1.

III. PLANS COVERED BY ERISA FIDUCIARY RESPONSIBILITY RULES.
ERISA §§4; 401

A. Covered Plans.

Employee benefit plans (welfare plans and retirement plans) maintained by an employer or an employee organization.

B. Exempt Plans.

Plans exempt from rules:


2. Church plans for which no election has been made to have provisions of ERISA apply.

3. Plan maintained solely for complying with workers compensation, unemployment or disability insurance laws.

4. Plan maintained outside U.S. primarily for benefit of persons substantially all of whom are nonresident aliens.

5. Excess benefit plan which is unfunded.

6. Unfunded plans maintained by employers primarily to provide deferred compensation to select group of managers or highly compensated employees ("top-hat plans").

7. Agreement described in IRC §736 which provides payments to retired or deceased partner or deceased partner's successor in interest.

8. Keogh plan covering only owner-employees.
IV. FIDUCIARY PRACTICES.

A. Fiduciary Prudence.

The ERISA fiduciaries are held to a very high standard. Fiduciaries should follow specific procedures and steps in making decisions which include:

1. Consider what information is relevant to the decision.
2. Obtain the information.
3. Analyze the information.
4. Make a reasoned decision that other experts in similar situations would make.
5. Document the decision.

B. Investment Advisors.

ERISA fiduciaries should work with a qualified investment advisor to assist in the investment of plan assets and in the selection of investment options for Plan participants. An investment advisor can assist the Plan Trustees in the following activities:

1. Develop and update on investment policy statement.
2. Assist with the initial fund selection.
3. Provide ongoing fund monitoring and replacement when indicated.
4. Meet with retirement committee quarterly.
5. Document actions and record meeting minutes.
7. QDIA selection.
8. Assist Trustees in determining if Plan fees are reasonable for services.
9. Duty to avoid prohibited transactions and also monitor full Plan for them.
10. Document prudent and appropriate portfolios at the participant level.

C. DOL Target Date Fund Tips for ERISA Plan Fiduciaries.

The Department of Labor (DOL) issued guidance in February, 2013 to help retirement plan fiduciaries select and review target date funds as an investment
alternative. These funds are popular investment alternatives for participants in 401(k) and other individual account retirement plans and can qualify as qualified default investment alternatives (QDIAs).

Target date funds automatically adjust their asset mix to reduce volatility as employees approach their targeted retirement age. These funds differ significantly in their investment strategies, glide paths and fees, so it is important for plan fiduciaries to understand these differences when selecting a fund. A glide path refers to changing investment allocations in stocks, bonds and cash, with the allocation becoming more conservative as the target date nears.

Plan fiduciaries should review the DOL’s process for evaluating target date funds as a benchmark and compare it with their own methods for selecting and maintaining investment options. The guidance encourages fiduciaries to take advantage of commercially available sources of information and services, such as investment advisers, to help them evaluate a target date fund. Other steps plan fiduciaries should take with respect to a target date fund include:

1. Establishing a process for gathering the key information required to decide on a target date fund.
2. Establishing a process for the periodic review of selected target date funds. At a minimum, the process should examine whether there have been any significant changes in the information that fiduciaries previously considered.
3. Understanding the fund's strategies and risks, its underlying asset classes and whether the glide path is to retirement or through retirement.
4. Reviewing the fund's fees and expenses.
5. Inquiring about whether a custom or nonproprietary target date fund would be preferable.
6. Developing the effective employee communications.
7. Documenting the decision-making process.

D. Investment Fiduciaries: ERISA §3(21) vs. §3(38).

1. ERISA §3(21) Fiduciary:

One definition of an ERISA section 3(21) fiduciary is an advisor who renders investment advice for a fee with respect to any monies, investments, or other property of a plan, or has responsibility to do so. Such an advisor serves in a co-fiduciary capacity to the plan and shares fiduciary responsibility and liability with other Plan fiduciaries (i.e.,
investment committee members, trustees). Hiring an ERISA section 3(21) fiduciary may help to mitigate the potential liability of the other plan co-fiduciaries, as the advisor would provide the necessary investment expertise and process to assist in the required investment decision-making process.

A section 3(21) fiduciary assists the Trustees or Plan Committee in evaluating or making investment decisions but the ultimate decision making authority rests with the Trustee or Plan Committee.

2. ERISA §3(38) Fiduciary.

ERISA section 3(38) defines the term "investment manager" as a fiduciary who also is responsible for providing investment advisory services, but with the important distinction of possessing discretionary control over the investment decisions for the Plan. In hiring a 3(38) fiduciary adviser Plan fiduciaries (investment committees, trustees) remove themselves from the ongoing investment decision-making process. However, they cannot eliminate all of their fiduciary responsibility. Procedural prudence remains necessary for all fiduciary decision making. This includes the process for hiring not only an ERISA section 3(21) fiduciary advisor, but potentially even more so for the process of hiring an ERISA 3(38) advisor (because the fiduciaries are turning over control of all investment decisions to the ERISA 3(38) advisor).

In brief, Plan fiduciaries seeking to reduce their liability for investment decisions by hiring an ERISA 3(38) fiduciary advisor must understand that it requires giving up the control over Plan investments and that some, but not all, fiduciary liability can be shifted.

V. FEE DISCLOSURE.

A. Overview.

1. The impetus for greater fee disclosure for tax-qualified retirement plans (particularly 401(k) plans) has come from four separate sources:

   a. Revised Form 5500 Schedule C - Reporting of direct and indirect compensation to service providers to tax-qualified plans.

   b. Department of Labor Final Regulations (effective July 1, 2012) to ERISA Section 408(b)(2) relating to source provider disclosures. 29 CFR §2550.408b-2.

   c. Department of Labor Final Regulations (effective August 30, 2012) to ERISA Section 404(a) relating to disclosures to plan participants in defined contribution plans with participant direction of investments. 29 CFR §404a-5.
B. Revised Form 5500 Schedule C: Reporting of Direct and Indirect Compensation to Service Providers.

1. Plan sponsors of ERISA-covered employee benefit plans generally must file an annual report for the plan on Form 5500. For plans covering more than 100 employees, the Form 5500 must include a complete Schedule C, setting forth information about fees of $5,000 or more paid by the plan for the provision of services.

2. The revised Schedule C:
   a. Broadens the definition of "service provider" whose compensation must be reported,
   b. Provides for reporting of "direct compensation" paid to service providers, and
   c. Requires reporting on indirect compensation received by service providers.

3. Service Provider Redefined.

   Under revised Schedule C, the term "service provider" is defined to include any person who provides services directly to a plan or to another service provider to a plan, as well as any person who provides services in connection with a transaction involving a plan.

4. Direct Compensation.

   Revised Schedule C distinguishes between "direct" and "indirect" compensation paid to service providers. The instructions define "direct compensation" as compensation paid directly by a plan or a plan sponsor to a service provider, as well as compensation paid or debited directly from a plan account. Direct compensation does not include payments made by the plan sponsor that are not reimbursed by the plan. The revised Schedule C requires the plan sponsor to: (a) identify each service provider (subject to the $5,000 threshold), (b) describe the relationship of the service provider to the plan sponsor (or to any person known to be a party in interest to the plan), (c) provide the total direct compensation paid to the service provider, and (d) provide a statement of whether the service provider received any "indirect compensation". If a service provider received direct compensation from several plans, the service provider may use any reasonable method of allocating the compensation among the plans.
5. Reporting Indirect Compensation — General Rule.

"Indirect Compensation" is defined in the instructions as all compensation other than direct compensation, received by a service provider in connection with services provided to the plan or in connection with a person's position with a plan. The instructions indicate that compensation is received "in connection with" services provided to the plan or a person's position with a plan if the payment is based, in whole or in part, on services provided to the plan or on one or more transactions involving the plan. Indirect compensation does not include compensation that a person would have received if the service for, or transaction involving, a plan had not occurred.

a. Indirect compensation includes fees and expense reimbursement payments received from mutual funds, bank commingled trusts, insurance company pooled investment funds in which a plan invests, if the payments are charged against the fund or account and are reflected in the value of the plan's investment. The DOL explanation accompanying revised Schedule C indicates that these fees include "management fees paid by a mutual fund to its investment adviser, sub-transfer agency fees, shareholder servicing fees, account maintenance fees, and 12b-1 distribution fees..." (even if the recipients of these funds provide their services only to the fund). The explanation also indicates that other examples of indirect compensation are finder's fees, float revenue, brokerage commissions, research, other products or services received from a broker-dealer or other third party in connection with securities transactions, and other transaction-based fees received in connection with transactions or services involving a plan.

b. If a service provider receives total compensation of $5,000 or more that includes any indirect compensation, the revised Schedule C must (unless the special rule for "eligible indirect compensation" is applicable) include: (i) the service provider's name and tax identification number, (ii) a statement that the service provider received indirect compensation, and (iii) the total amount of the indirect compensation received by the service provider (actual or estimated). If a service provider receives indirect compensation but is unable to determine the specific amount of the compensation, the revised Schedule C must include a description of the method or formula used by the service provider to determine the amount of the indirect compensation.

c. If a service provider is a plan fiduciary or provides contract administration, consulting, investment advisory, investment management, brokerage or recordkeeping services and received $1,000 or more in indirect compensation from any source, then the revised Schedule C must include, for each person paying such
indirect compensation: (i) the payor's name and tax identification number, (ii) a statement of the total indirect compensation received by the service provider from the payor, and (iii) a description of the indirect compensation and any formula used to determine the amount of the indirect compensation.

6. Special Rule for "Eligible Indirect Compensation".

Under revised Schedule C, a plan sponsor is not required to separately report "eligible indirect compensation" received by a plan service provider. Moreover, if a service provider receives only eligible indirect compensation and certain disclosures are made to the plan, the plan sponsor is only required to report the name and tax identification number of any service provider (or the name and taxpayer identification number of any other person who provided the plan sponsor with the required information about eligible indirect compensation received by the service provider).

a. "Eligible indirect compensation" is defined as indirect compensation that is received by a service provider as fees charged to investment funds in which a plan invests that are reflected in the value of the investment or in the return on investment and that constitute compensation for distribution, investment management, recordkeeping or shareholder services or that constitute commissions, finder's fees, float revenue, other transaction-based fees or "soft dollar" revenue.

b. To take advantage of the alternative reporting method for eligible indirect compensation, a plan sponsor must certify on revised Schedule C that it has been provided with written or electronic materials that disclose the following:

i. The existence of eligible indirect compensation;

ii. The services provided for the indirect compensation or the purpose for the payment of the indirect compensation;

iii. The amount, or an estimate, of the compensation "or a description of the formula used to calculate or determine the compensation"; and

iv. The identity or the party or parties paying and receiving the compensation.

7. Excludable Non-Monetary Compensation.

Revised Schedule C provides that non-monetary compensation, such as business meals, gifts, promotional items and the like, need not be reported.
if it is both insubstantial and tax deductible to the person paying the compensation. The revised Schedule C defines "insubstantial" as gifts or gratuities valued at less than $50 that do not in the aggregate exceed $100 annually from any single source. Gifts of $10 or less need not be counted for purposes of the $100 threshold, but all such compensation must be reported if the $100 threshold is reached or exceeded. Multiple employees of one service provider entity should probably be treated as from a single source for purposes of the $100 threshold.

8. Insurance Commissions.

Service provider compensation that consists only of insurance fees and commissions (which are reported currently on Schedule A of Form 5500) need not be reported on revised Schedule C.


Revised Schedule C provides that the "lead service provider" in a bundled service arrangement generally may report all direct compensation received in connection with the arrangement. If, however, another service provider in the bundled arrangement receives compensation that is (i) a separate charge directly against a plan's investment reflected in the net value of the investment or (ii) paid on a transactional basis, that service provider's direct compensation must be reported separately.

a. For service providers in a bundled arrangement that are fiduciaries or that provide contract administration, consulting, investment advisory, investment management, brokerage, or recordkeeping services, the plan sponsor must report indirect compensation separately (as discussed above) regardless of whether direct compensation received by the service provider is included in a report by a lead service provider.

10. Service Providers That Fail or Refuse to Provide Information.

If a service provider fails to provide a plan sponsor with the information needed to complete revised Schedule C, the plan sponsor must report the name and tax identification number of the service provider and a description of the information that was not provided. The instructions to revised Schedule C make clear that it is the plan sponsor's responsibility to request the necessary information.
C. Service Provider Fee Disclosure. ERISA §408(b)(2). 29 CFR §2550.408b-2; DOL FAB 2012-02 (effective July 1, 2012).

1. Overview.
   a. Persons providing services to an ERISA-covered plan are "parties in interest" of the plan, and ERISA section 406(a) prohibits parties in interest from providing services to a plan. ERISA section 408(b)(2) provides an exemption for "reasonable arrangements" under which parties in interest may provide services to a plan. The prior regulations under section 408(b)(2) required: (i) the services must be appropriate and helpful to the plan, (ii) the arrangement must be terminable by the plan without penalty on reasonably short notice, and (iii) the compensation received by the service providers must be reasonable.

   b. The interim final regulations under section 408(b)(2) provide that, in order to rely on the section 408(b)(2) exemption, service providers will need to assemble and report information relating to their direct or indirect compensation.

   c. Covered Plans. The final regulations define a covered plan as an employee pension plan. Excluded from the definitions are:

      i. Welfare plans;

      ii. IRAs;

      iii. SEP-IRAs; and

      iv. SIMPLE-IRAs.

2. The Regulations Apply to "Covered Service Providers" (CSP).

   These new regulations only apply to covered service providers. Covered service providers are service providers (a) that enter into a contract or arrangement with a plan and reasonably expect to receive $1,000 or more in compensation, direct or indirect, in connection with their services and (b) that provide the following services:

   i. Fiduciary services or services provided to the plan as a registered investment advisor;

   ii. Recordkeeping or brokerage services to a participant-directed individual account plan where the investments options are made available under the arrangement furnished by the recordkeeper or broker; or
iii. Accounting, appraisal, banking, consulting, custodial, insurance, investment advisory (for participants), legal, recordkeeping, securities or other investment brokerage, third party administration, or valuation services for which indirect compensation is received.

3. Disclosure Requirements.

Covered service providers must disclose the following information in writing:

a. Services: Information that must be disclosed includes a description of the services to be provided to the plan.

b. Status: Covered service providers must disclose whether they are providing any services as a fiduciary to the plan or as a registered investment advisor.

c. Compensation: Covered service providers must disclose all direct and indirect compensation to be received by the covered service provider, its affiliates or subcontractors. Direct compensation is compensation received directly from the plan. Indirect compensation generally is compensation received from a source other than the plan sponsor, the covered service provider, an affiliate, or subcontractor.

d. Recordkeeping Services: Because recordkeeping services are so significant to a plan, information concerning those services and costs must be disclosed without regard to whether the services are furnished as part of a bundle or package. For example, covered service providers must disclose whether they are providing recordkeeping services and the compensation attributable to such services, even when no explicit charge for recordkeeping is identified as part of the service contract.

e. Manner of Receipt: The regulations require the written disclosure to describe the manner in which compensation (including compensation for recordkeeping services) will be received, such as whether the plan will be billed or the compensation will be deducted directly from the plan's investments.

f. Investment Disclosure — Recordkeeping and Brokerage Services: Information also must be disclosed about plan investments and investment options. These disclosure obligations apply to fiduciaries to investment vehicles that hold plan assets. They also apply to recordkeepers and brokers who, through a platform or other mechanism, facilitate the investment in various options by participants in individual account plans, such as 401(k) plans.
If the disclosed information changes, then the covered service provider generally must disclose the change as soon as practicable, but no later than 60 days from the date on which the covered service provider is informed of such change. Covered service providers also must, upon request, disclose compensation or other information related to their service arrangements that is requested by the responsible plan fiduciary or plan administrator in order to comply with ERISA's reporting and disclosure requirements, including the Form 5500 requirements.

4. Compensation or Fees.

The Regulations define "compensation or fees" very broadly to include, in addition to money, any other thing of monetary value received by the service provider or its affiliates "in connection with" the services provided to the plan. Examples of covered compensation include, among other things, gifts, awards, trips, research, float, 12b-1 fees, commissions and various other fees.

DOL indicates in explaining the regulations that, if a service provider does not know the exact amount of compensation when it signs a contract with a plan, compensation may be disclosed and expressed in terms of a formula, a percentage of the plan's assets, or a per capita charge for each participant or beneficiary.

5. Regulation Requires Limited "Unbundling".

Compliance with the regulation will require certain "unbundling" of fees; specifically, recordkeeping fees, even when no explicit charge for recordkeeping services is identified in the arrangement. When recordkeepers are paid from compensation received by an affiliate (e.g., recordkeeping fees are a component of an affiliated investment's expense ratio), the recordkeeper must provide a reasonable good-faith estimate of the cost to the plan of the recordkeeping services, including an explanation of the methodology and assumptions used to prepare the estimate.

6. Exemption Relief for Fiduciaries.

The regulations include relief for plan fiduciaries who enter into a contract without knowing that the service provider has failed to comply with its disclosure obligations. To qualify for this relief, the responsible plan fiduciary must not have known that the covered service provider failed or would fail to make required disclosures and reasonably believed that the covered service provider disclosed the required information. Upon discovering that the covered service provider failed to disclose the required information, the plan fiduciary must request in writing that the covered service provider furnish such information. If the covered service provider fails to comply with such written request within 90 days of the request, then the responsible plan fiduciary must notify the Department of

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Labor of the covered service provider's failure not later than 30 days following the earlier of (1) the covered service provider's refusal to furnish the information requested by the written request or (2) 90 days after the written request is made. Finally, the responsible plan fiduciary, following discovery of a failure to disclose required information, must determine whether to terminate or continue the contract or arrangement. In making such a determination, the plan fiduciary must evaluate the nature of the failure, the availability, qualifications, and cost of replacement service providers, and the covered service provider's response to notification of the failure.

D. Participant Disclosure Requirements for Participant-Directed Individual Account Plans. 29 CFR §2550.404a-5; DOL FAB 2012-02 (effective August 30, 2012).

1. Plans not subject to the disclosure rules.
   a. IRAs;
   b. SEP-IRAs;
   c. SIMPLE-IRAs;
   d. Plans not subject to ERISA:
      i. Owner-only plans;
      ii. Governmental plans;
      iii. Church plans.

2. Compliance Dates.
   a. Plan years commencing on or after November 1, 2011.
   b. Initial Annual Statement for fee disclosure due: August 30, 2012 (later of 60 days after plan year commencing after November 1, 2011 or August 30, 2012).
      i. Department of Labor FAB 2013-02 permits annual disclosure to be "reset" for either 2013 or 2014 from August to as late as mid-February. For example, a Plan could elect to "reset" the Annual notice from August, 2014 to January 31, 2015. Notices in subsequent years would continue to be distributed in January.
   c. Initial Quarterly Statement for fee disclosure due: for second quarter 2012; November 14, 2012 (45 days following the close of the first quarter with the initial annual statement for participant fee disclosures).
3. **Plan Related Information — Annual Statement.**

   a. **General Plan Information.**

      i. An explanation of structure and mechanics of the plan including an explanation of how to give investment instructions under the plan.

      ii. An explanation of any specified limitations on such investment instructions including any restrictions on transfer to or from a designated investment alternative.

      iii. A current list of the designated investment options under the plan.

      iv. The identity of any designated investment managers.

      v. A description of any brokerage window.

   b. **Administrative Expense Information.**

      i. An explanation of any fees that may be charged to the plan for general administrative services such as:

         a) Recordkeeping;

         b) Accounting;

         c) Asset Management Charges.

      ii. A description of how the fees are allocated.

         a) Pro rata.

         b) Per Capita.

   c. **Individual Expense Information.**

      i. An explanation of any fees and expenses that may be charged to or deducted from the individual account of a specific participant or beneficiary based on the actions taken by that person. Examples include fees for:

         a) Plan loans;

         b) Distributions;

         c) Qualified Domestic Relations Order (QDRO) processing.
d. **Frequency of Disclosure of Information.**

i. On or before the date on which a participant or beneficiary can first direct his investments and at least annually thereafter.

ii. Change in information: must notify participant or beneficiary 30 to 90 days in advance of such change.

4. **Plan Related Information: Quarterly Statements.**

a. In addition to the plan-related information that must be furnished up front and annually, participants and beneficiaries must receive statements, at least quarterly, showing the dollar amount of the plan-related fees and expenses (whether "administrative" or "individual") actually charged or deducted from their individual accounts during the preceding quarter along with a description of the services for which the charge or deduction was made.

b. If applicable, an explanation should be provided that some administrative expenses were paid from operating expenses such as revenue sharing, 12b-1 or sub-TA fees.

c. The quarterly statement should also include specific investment related expense charges against the specific account of the participant and not on a plan wide basis such as front or back-end loads or redemption fees.

d. The quarterly disclosures may be included in the quarterly benefit statements required under ERISA §105.

5. **Investment Related Information.**

a. Must be provided before the date on which the participant can make the investment and at least annually thereafter with respect to each designated investment alternative offered under the plan.

b. **Identifying Information.**

i. Name of each designated investment alternative.

ii. The type or category of the investment (e.g., money market fund, balanced fund, large cap fund).

c. **Performance Data.**

i. Non-fixed return investment: average return for 1, 5 and 10 year period.
ii. Fixed return investment: fixed or stated rate of return and term of investment.

iii. Benchmarks: 1, 5 and 10 year periods.

d. Fee and expense information (non-fixed return investment).

i. Amount and description of each fee including shareholder type fees.

ii. Annual operating expenses expressed as a percentage (expense ratio).

iii. Annual operating expenses for a one year period expressed as a dollar amount for a $1,000 investment.

iv. Statement that fees and expenses are only one factor to be considered.

v. Statement that cumulative fees and expenses can reduce the growth of a participant's account and that participants can visit the EBSA website.

e. Fee and expense information (fixed income investments).

i. Description of any shareholder type fees.

ii. Any limitations on purchase or transfer.

f. Internet Web Site address containing significant information with respect to each designated investment alternative.

g. Tables and charts similar to those included in appendix to the regulations.

h. A "designated investment alternative" means any investment alternative designated by the plan into which participants and beneficiaries may direct the investment assets held in, or contributed to, their individual accounts. This term, does not include a brokerage window or self directed brokerage account.

VI. PARTICIPANT DIRECTION OF RETIREMENT PLAN INVESTMENTS. ERISA §404(c).

A. §404(c) Relief From Some ERISA Standards.

In the case of individual account plans that permit participants to exercise control over the assets in their accounts, Section 404(c) provides partial relief from the standards that otherwise govern fiduciary conduct.

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1. If participants actually exercise control over the assets in their accounts, plan fiduciaries will not be liable for any losses that are the direct result of the participants' control.

2. The protection of Section 404(c) is available only to defined contribution plans that allow participant-directed investments, such as 401(k) plans and profit sharing plans. Section 404(c) relief is not available for defined benefit pension plans.

B. Compliance Not Mandatory; Failure to Comply with Section 404(c).

Compliance with Section 404(c) is not mandatory and failure to comply with Section 404(c) does not of itself cause a plan to violate ERISA.

1. Failure to comply simply means that plan fiduciaries may continue to be responsible under ERISA for participant-directed investments.

2. Fiduciaries will need to continue to act prudently in selecting and retaining designated investment alternatives for the plan.

C. No Standard for Other Fiduciary Decisions.

The DOL clearly stated that the requirements of Section 404(c) only apply for purposes of determining whether a plan is a Section 404(c) Plan. The regulations are not intended to be applied to determine whether or to what extent a fiduciary with respect to a plan that is not a Section 404(c) Plan satisfied the fiduciary responsibility provisions of ERISA. A plan that does not satisfy the Section 404(c) requirements may have a prudent and well-diversified portfolio.

D. Section 404(c) Requirements. 29 CFR §2550.404c-1.

Department of Labor Regulations prescribe extensive requirements to qualify as an ERISA §404(c) plan. In order to satisfy ERISA §404(c), a plan must permit each participant to:

1. Choose from a broad range of investment alternatives with at least three (3) diversified investment choices (called "Core Alternatives") with materially different risk/return characteristics.

   a. The regulations require affirmative investment elections from plan participants. Simply offering participants the opportunity to make investment decisions may not be sufficient for §404(c) protection.

2. Give investment instructions (e.g. make new investment elections and transfer current balances) at least once every three (3) months and possibly more often if appropriate in light of the market volatility of the investment alternatives;
a. The three (3) month change of investment rule applies to transfers among the Core Alternatives. Other fixed rate options could require a longer minimum time for the investment, but such options would not be considered Core Alternatives.

3. Diversify investments both generally and within investment categories; and

4. Receive current information from the plan that enables participants to make informed investment decisions.

   a. DOL Advisory Opinion 2003-11A states that mutual fund "profiles" can be used to satisfy the requirements that a fiduciary provide a prospectus for each mutual fund either immediately before or immediately following a participant's investment in the fund.

   b. Summary plan descriptions are required to inform plan participants if the plan is intended to comply with §404(c).

E. Retained Fiduciary Duties.

   If a plan satisfies the Section 404(c) requirements, plan fiduciaries remain responsible for, among other things, the following:

   1. the prudent selection and monitoring of plan investment alternatives (such as registered investment advisors, banks, trust companies, mutual funds, insurance companies, etc.);

   2. the proper implementation of participant investment decisions;

   3. the timely dissemination of required information relating to such investment alternatives; and

   4. the avoidance of prohibited transactions (i.e., transactions between the plan and certain parties in interest or transactions involving a conflict of interest among, or self-dealing by, fiduciaries).

F. Default Investments.

   1. The Pension Protection Act of 2006 (PPA) expands section 404(c) protection to include default investments if certain requirements are met.

   2. Effective for plan years commencing after December 31, 2006.

   3. The Department of Labor provided guidance on the appropriateness of default investments including guidance regarding mixes of default investments.
investment and asset classes consistent with long term capital appreciation or long-term capital preservation.

4. A notice must be given to each participant explaining the participant's right to exercise control over investment of his or her account. In addition, the notice must explain how contributions will be invested under the default arrangement. The participant must have a reasonable time after receipt of the notice and before investments are first invested to make such an election.

5. The section 404(c) default investment rules will also apply to automatic enrollment 401(k) plans.

6. Qualified Default Investment Alternatives (QDIA).

A QDIA must satisfy certain requirements under the DOL proposed regulations.

a. With limited exceptions, the QDIA must not hold employer securities. The first exception applies to securities held by an investment company registered under the Investment Company Act of 1940. The second exception is for employer securities acquired as a matching contribution from the plan sponsor.

b. A QDIA must not impose financial penalties or otherwise restrict a participant's or beneficiary's ability to transfer his or her investments to any other investment alternative under the plan.

c. A QDIA must be managed by an investment manager as defined in PPA Section 3(38) or by an investment company registered under the Investment Company Act of 1940.

d. A QDIA must be diversified to minimize the risk of large losses.

e. The QDIA must constitute one of three types of investment products:

i. A life cycle or targeted retirement date fund or account designed to provide varying degrees of long-term appreciation and capital preservation via a mix of equity and fixed income investments based on the participant's age, target retirement date or life expectancy.

ii. A balanced fund that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income investments with a risk appreciation for plan participants as a whole.
iii. An investment fund management service allocating assets for a participant's account to achieve long-term appreciation and capital preservation through a mix of equity and fixed income investments.

iv. A Capital Preservation Fund for a participant's first 120 days of participation.


1. SOA Section 306(b) Blackout Period Notice Requirements for Participants and Beneficiaries under ERISA:
   
a. ERISA Section 101 (29 USC Section 1021) is amended to provide for notice requirements for Blackout periods.

2. SOA Section 306(b)(7): "blackout period" is defined as a period of more than three consecutive business days during which the participants or beneficiaries in an Individual Account Plan are limited to or restricted from their normal right to direct or diversify assets in their accounts or obtain plan loans or distributions. A change in the plan's investment manager will generally result in a blackout period.

3. SOA Section 306(b)(1)(i)(2)(A): The Plan Administrator must notify all affected participants and beneficiaries at 30 days in advance of the blackout period. The Notice shall include:
   
a. the reasons for the blackout period;
   
b. the identification of the investments and other rights affected;
   
c. the expected beginning date and length of the blackout period;
   
d. a statement that the participant or beneficiary shall evaluate the appropriateness of their current investment decisions in light of their inability to direct or diversify assets credited to their accounts during the blackout period.

4. The Pension Protection Act of 2006 provides an exception to the blackout notice requirements for one-participant plans; plans that cover only the owner and the owner's spouse, and plans that only cover partners (or partners and spouses). Such plans are exempt from the blackout notice requirements.
VII. ALLOCATION OF ADMINISTRATIVE EXPENSES BETWEEN PLAN AND EMPLOYER. DOL ADVISORY OPINION 2001-O1A; DOL FIELD ASSISTANCE BULLETIN 2003-3.

A. Plan Assets May Be Used to Pay Reasonable Administrative Expenses. ERISA §404(a)(1)(A)

1. Although ERISA states that the plan assets of a plan must be used exclusively to pay benefits to participants and beneficiaries, ERISA also provides that the plan assets may be used to pay reasonable administrative expenses. There has been much discussion on what are "reasonable administrative expenses".

B. Early Department of Labor Rulings.

1. Kirk Maldonado Letter dated March 2, 1987. The Department of Labor stated that it would not be appropriate for a plan to pay expenses incurred in connection with the provision of services to the plan if the payments are made for the employer's benefit in the normal course of such employer's business or operations. This letter further stated that services provided to establish, terminate or design a plan are "settlor functions" which relate to the employer's business activities, and, therefore, may not be properly paid from the plan.

2. John Erlenborn Letter March 3, 1986. The Department of Labor stated that "settlor functions" refer to a class of discretionary activities which relate to the formation, rather than the management of plans. According to the Department of Labor, these settlor functions are not fiduciary activities subject to Title I of ERISA.

C. Department of Labor opinions.

1. QDRO charges — The DOL does not oppose fees charged to the trust as whole. Prior to 2003, the DOL disapproved of fees charged to individual accounts. DOL Advisory Opinion 94-32 A (8/4/94). In FAB 2003-3, the DOL reversed its position and stated that QDRO changes may be assessed against the benefits of the individual's account to which such QDRO applies. Any offset policy would be required to be explained to the participant in advance (e.g., in the SPD) before any such offset could occur. Such charges must also be noted in the participant disclosure requirements under 29 CFR §2550.404a-5.

2. Plan Loans — The overriding criteria as to whether administrative loan charges are considered reasonable is whether the charges affect the ability of the plan to offer loans to all employees on a reasonably equivalent basis.
3. Settlor Costs — A settlor cost will occur when the employer receives more than an incidental benefit. When an expense may be chargeable both to the plan and to the employer (e.g. bringing a plan into compliance with §401(a)(4)), the sharing of costs would be the most reasonable solution.

4. Plan Terminations — The employer should be charged with the costs associated with the decision of whether to terminate the plan. The plan may be charged with the legal and actuarial costs associated with wrapping up a previously made decision to terminate the plan.

5. Distribution Expenses — Reasonable distribution expenses may be charged directly to the participant.

6. Based upon the Department of Labor's formal and informal opinions, the following expenses are generally employer expenses:
   a. Actuarial reports which provide information to employers with respect to financial impact of plans on employers;
   b. Consulting fees incurred by employers in determining plan design;
   c. Decisions to terminate plans;
   d. Preparation of plan documents;
   e. Amendments to plans if the amendment is a settlor function; and
   f. Closing agreement and EPCRS expenses.

7. Based upon the Department of Labor formal and informal opinions, the following expenses are generally plan expenses:
   a. Actuarial reports that relate to determination of minimum contributions required;
   b. Preparation of summary plan descriptions;
   c. Liquidation of plans upon termination;
   d. QDRO charges; and
   e. Plan amendments if the amendment involves a fiduciary function or is required due to changes in law (e.g., GUST or EGTRRA).

8. Based upon the Department of Labor's formal and informal opinions, the following expenses may be split between the employer and the plan:
   a. Actuarial reports used for the purpose of meeting minimum funding requirements; and
b. Amendments; depending upon the nature of the amendment.

D. Allocation of Expenses to Former Employees

In Rev. Rul. 2004-10, the IRS concluded that a defined contribution plan may charge the accounts of former employees for a pro-rata share of the plan's reasonable administrative expenses while not charging the accounts of current employees.
Part II: Staying Out of Trouble: Prohibited Transactions

I. PARTIES IN INTEREST.

A. ERISA §3(14) lists certain persons or entities defined as "parties in interest". IRC §4975(e)(2) defines a similar group as "disqualified persons". This group includes:

1. A fiduciary;
2. A service provider;
3. An employer any of who employees are covered by the plan;
4. An employee organization whose members are covered by the plan;
5. A 50% or more owner of such employer or employee organization;
6. A spouse, ancestor, lineal descendant, or spouse of a lineal descendent of any of the persons above except an employee organization;
7. A corporation, partnership, trust or estate of which 50% is owned directly or indirectly by persons mentioned above (other than relatives);
8. An employee, officer, director or 10% or more shareholder of any of the persons mentioned above except a fiduciary or relative; and
9. A 10% or more partner or joint venturer of any person above except a fiduciary or relative.

II. EXPRESS PROHIBITIONS FOR PARTIES IN INTEREST. ERISA §406(A).

A. Sale, exchange or leasing of any property between the plan and a party-in-interest. ERISA §406(a)(1)(A);

1. Example (Direct) – Sale between plan and service provider: Susan is an accountant. She prepares Form 5500s for corporation X's profit sharing plan. The X plan owns a limited partnership interest which the trustees are trying to sell. Susan agrees to purchase the property. An appraisal of the property states that the value of the property is $75,000. The trustees agree to sell the property to Susan for $65,000. The sale is a prohibited transaction because, as a service provider to the plan, Susan is a party-in-interest.
2. **Example (Indirect)** – See DOL Advisory Opinion 2006-01A, where a lease between an LLC (owned 49% by the IRA, 31% by the IRA of an unrelated individual, and 20% by the individual who owns the other 32% of corporation X) and corporation X (owned 68% by the IRA owner), where only the corporation was a party-in-interest with respect to an IRA, was treated by the DOL as a prohibited transaction because it resulted in an indirect lease between the IRA and the S corporation.

3. **Contribution of property is generally a prohibited transaction.** A contribution of property (rather than cash) to satisfy a funding obligation is treated as a sale of property to the plan and is a prohibited transaction. *Commissioner v. Keystone Consolidated Industries, Inc.*, 113 S. Ct. 2006 (1993). The DOL has provided guidance on the *Keystone* decision in Interpretive Bulletin 94-3, DOL Reg. §2509.94-3. All contributions of property to a pension plan (money purchase, target benefit, defined benefit) are prohibited transactions. (Note, this is the IRS definition of a pension plan which is being used here. The DOL refers to all plans of deferred compensation, including profit sharing plans, as pension plans.)

   a. **Discretionary contributions of property to non-pension plans are not prohibited transactions.** In a non-pension plan (profit sharing, stock bonus), the contribution is not a prohibited transaction if it is purely discretionary and is unencumbered. If the property is encumbered, IRC §4975(f)(3) treats the contribution of the property as a sale, and thus as a prohibited transaction, even if the contribution would not have been prohibited if the property were not encumbered.

   b. **Repayment of loan with property.** In *Morrissey v. Commissioner*, 76 T.C.M. 1006 (1998), the court ruled that the transfer of parcels of unencumbered real estate to repay a loan from the plan is a prohibited transaction. The court ruled that the payment of the loan with property is within the scope of the *Keystone* decision because the loan, like a minimum funding obligation, is a debt to the plan. Thus, the transfer of the property is in exchange for the cancellation of the debt.

4. **Exemptions.** There are several statutory exemptions and class exemptions from this prohibited transaction rule.

   a. **Sale or purchase of life insurance or annuity contracts.** Individual life insurance or annuity contracts may be purchased by the plan from the participant or employer (PTE 92-5), or may be sold by the plan to the participant, to a relative who is a beneficiary under the policy, or to the employer (PTE 92-6).

      i. **Sale of insurance to the plan (PTE 92-5).** Under PTE 92-5, the plan may purchase from the participant a life insurance...
policy or annuity contract issued on the participant's life, or it may purchase policies from the employer that insure the employer's employees who are covered by the plan. The policies must be held by the plan for the benefit of the participants who are insured under the policies.

ii. Purchase of insurance from the plan (PTE 92-6). Under PTE 92-6, the plan may sell a life insurance policy or individual annuity contract to: (1) the participant insured by the policy, (2) a relative of the insured participant, (3) the employer, or (4) another employee benefit plan. The buyer of the contract also may be a trust established for the benefit of one or more of the persons described in (1) or (2) of the first sentence of this paragraph. To qualify for this exemption, the following conditions must be met.

a) The participant must be the insured on the contract.

b) The contract would otherwise be surrendered by the plan.

c) The participant must have a right of first refusal if he/she is not the buyer.

d) The plan must be "made whole" with respect to the amount paid for the policy.

e) If the plan is a welfare benefit plan, the plan must not, with respect to such sale, discriminate in form or in operation in favor of plan participants who are officers, shareholders, or highly compensated employees.

iii. Investments in qualifying employer securities and qualifying employer real property

a) A purchase or sale of employer securities, or the leasing of property by the plan, would generally constitute a prohibited transaction if the transaction was between the plan and a disqualified person (e.g., the employer or a principal shareholder of the employer). ERISA §407 prescribes rules that permit certain investments by the plan in qualifying employer securities or qualifying employer real property, and ERISA §406(a)(1)(E) prohibits a fiduciary from acquiring, on behalf of a plan, any employer security or employer real property in violation of ERISA §407.
b) In addition, ERISA §408(e) exempts from the prohibited transaction rules, the sale or acquisition of qualifying employer securities, and the sale, acquisition or lease by the plan of qualifying employer real property, that satisfies the requirements of §407. IRC §4975(d)(13) exempts from the excise tax provisions of §4975 any transaction which is exempt because of ERISA §408(e). ERISA §408(e) requires that the transaction relate to qualifying employer securities or qualifying employer real property. Except for certain individual account plans, the percentage of assets held in qualifying employer securities or qualifying employer real property is limited by ERISA §407. See ERISA §408(e)(3). To be an exempt transaction, the sale must be for adequate consideration and no commission may be charged with respect to the transaction.

c) **Definition of qualifying employer securities.** A qualifying employer security is defined in ERISA §407(d)(5) to be a stock or a marketable obligation (i.e., a bond, debenture, note, certificate or other evidence of indebtedness) of the employer. A marketable obligation must satisfy the requirements of ERISA §407(e)(1) and DOL Reg. §2550.407d-5(b), which prescribe pricing rules and limitations on how much of the aggregate amount of the obligation may be held by the plan.

d) **10% is general limit.** If a plan acquires qualifying employer securities and/or qualifying employer real property, the aggregate fair market value of such property held by the plan may not exceed 10% of the fair market value of plan assets, determined immediately after the acquisition. See ERISA §407(a)(2).

B. Lending of money or other extension of credit between a plan and a party-in-interest. ERISA §406(a)(1)(B);

1. **Participant loan exemption.** Loans to plan participants and beneficiaries are not prohibited transactions if the conditions of IRC §4975(d)(1) are satisfied. Although not all participants and beneficiaries are parties-in-interest, all employees are parties-in-interest so any loan to a participant who is an active employee must satisfy the loan exemption requirements at least to avoid sanctions under Title I of ERISA. The exemption requirements are described in more detail in DOL Reg. §2550.408b-1.
Note that this exemption applies to a loan to an employee only if the employee is a participant in the plan.

2. ESOP loans. An ESOP, as defined in IRC §4975(e)(7), may borrow money for the purpose of acquiring employer securities. IRC §4975(d)(3). The employer may make the loan to the ESOP, or the employer may guarantee a loan made to the ESOP from a third party lender.

a. Special scrutiny of transactions. Because of the inherent self-dealing issues involved with an ESOP loan, the IRS and the DOL will scrutinize these transactions. It is recommended that an independent fiduciary approve the loan, to ensure that the interests of the plan participants and beneficiaries are being adequately protected. See Treas. Reg. §54.4975-7(b)(2)(ii) and DOL Reg. §2550.408b-3(b)(2).

b. Primary benefit requirement. The ESOP loan must be for the primary benefit of the participants and beneficiaries, even though the employer also receives incidental benefits from the transaction (e.g., cash obtained from the plan's purchase of employer securities). Treas. Reg. §54.4975-7(b)(3) and DOL Reg. §2550.408b-3(c). An issue relating to the primary benefit requirement arises when an ESOP is terminated before the exempt loan is fully repaid, and the remaining unallocated shares in the suspense account are sold to repay the loan balance. The IRS has ruled on this issue in several private letter rulings.

c. Permissible uses of loan proceeds. The loan proceeds must be used only for the following purposes: to acquire qualifying employer securities, to repay the exempt loan, or to pay a prior exempt loan. Treas. Reg. §54.4975-7(b)(4).

d. Collateral for loan. The exempt loan must be without recourse against the ESOP. The ESOP may give collateral for the loan, but only two classes of plan assets may be pledged: the qualifying employer securities obtained with the loan, or qualifying employer securities obtained with a prior loan that was repaid with the current loan proceeds. Treas. Reg. §54.4975-7(b)(5). A person entitled to repayment under the loan may not have a right to any assets of the ESOP other than: (1) the collateral given on the loan, (2) employer contributions (other than contributions of employer securities) that are made to satisfy the ESOP's obligation under the loan, and (3) earnings attributable to the collateral described in (1) and the investment of the contributions described in (2). Previously existing assets in the plan (e.g., when a profit sharing plan or stock bonus plan is converted into an ESOP) may not be used as collateral on an exempt loan.
e. **Suspense account for unallocated securities.** While qualifying employer securities are held by the plan as collateral on an exempt loan, the plan maintains a suspense account with respect to such securities. The securities must be released during the repayment period of the loan, in a manner which reflects the portion of the loan that has been repaid. The rules for releasing the securities from the suspense account are prescribed by Treas. Reg. §54.4975-7(b)(8). Release of securities may be based on both the principal and interest payments made under the loan, or solely on the principal payments. Where only principal payments are taken into account to determine the rate at which securities are released, the repayment term on the loan may not exceed 10 years. In addition, if only principal payments are taken into account to release securities from the suspense account, and the loan is renewed, extended, or refinanced, the sum of the expired duration of the exempt loan, the renewal period, the extension period, and the duration of a new exempt loan may not exceed 10 years. These additional rules relating to releases based solely on principal payments are provided in Treas. Reg. §54.4975-7(b)(8)(ii).

f. **Class exemptions covering certain loan transactions.**
   i. Interest-free loans to plan (PTE-80-26, as modified by PTE 2000-14, PTE 2002-13 and PTE 2002014);
   ii. Securities lending (PTE 2006-16);
   iii. Short-term debt instruments (PTE-81-8).

C. **Furnishing of goods, services or facilities between the plan and a party-in-interest.** ERISA §406(a)(1)(C);

1. **Exemption for reasonable compensation for reasonable services.** IRC §4975(d)(2) and ERISA §408(b)(2) provide relief from the prohibited transaction rules for service contracts or arrangements between a plan and a party-in-interest if: (1) the contract or arrangement is reasonable, (2) the services are necessary for the establishment or operation of the plan, and (3) no more than reasonable compensation is paid for the services. Additional rules regarding this exemption are provided in DOL Reg. §2550.408b-2 and Treas. Reg. §54.4975-6, with the DOL having primary regulatory authority here, as it does with all prohibited transaction issues (other than collection of the excise taxes under IRC §4975). It is through this exemption that a service provider (e.g., third party record keeper) may receive payment for services directly from plan assets. "Services" for this purpose includes the provision of goods or facilities (e.g., leasing of space by the plan).
a. **Definition of reasonable compensation.** The determination of whether compensation is reasonable is one of facts and circumstances. Restrictions applicable to payment of compensation for services are prescribed by Treas. Reg. §54.4975-6(e). Any compensation that would be considered excessive under Treas. Reg. §1.162-7 (relating to compensation for personal services which constitutes an ordinary and necessary trade or business expense) will not be treated as reasonable compensation under these regulations.

b. **Fiduciary who is full-time employee of employer.** A fiduciary who already receives full-time pay from the employer may not be compensated from the plan except for reimbursement of direct expenses properly and actually incurred. IRC §4975(d)(10). Treas. Reg. §54.4975-6(e)(3) makes clear that this restriction does not apply to a party-in-interest who is not a fiduciary, even though §4975(d)(10) would suggest otherwise.

i. Full-time employee may not receive compensation for acting as trustee. A full-time employee of the employer who serves as trustee of the plan may not receive compensation for serving as trustee, but may be reimbursed for direct expenses incurred in performing such duties.

ii. Reimbursement for direct expenses. The regulations do not define what a direct expense is, but state that a direct expense is not an expense that would have been sustained anyway, even if the service had not been provided, or if the expense represents an allocable portion of overhead costs. Treas. Reg. §54.4975-6(e)(4).

iii. Expense advances. The plan may make expense advances to fiduciaries and employees of the plan if proper accounting is made of the actual expenses incurred. Treas. Reg. §54.4975-6(e)(5) and DOL Reg. §2550.408c-2(b)(4).

c. **No exemption for self-dealing.** The exemption for reasonable compensation does not apply to self-dealing transactions under §4975(e)(1)(E) and (F), at least according to the IRS and DOL. Treas. Reg. §54.4975-6(a)(5)(i) and DOL Reg. §2550.408b-2(e) provide that a fiduciary is engaged in an act of self dealing if he uses his power as a fiduciary to cause additional compensation to be paid to him in a service capacity with respect to the plan.

d. **Example:** See DOL Advisory Opinion 2001-10A (December 22, 2001), where a bank was held to violate the self-dealing rules by charging the plans it maintained for its employees the standard trustee fees that the bank charges clients. Since the bank was
exercising its authority, control or responsibility as a fiduciary of the plan (i.e., the employer-sponsor and plan administrator) to appoint itself as trustee of the plans, resulting in additional compensation to the bank through the charging of its standard trust fees, the acceptance of the fees was an act of self-dealing that was not covered by the reasonable compensation exemption.

D. Use of plan assets by party-in-interest. ERISA §406(a)(1)(D).

1. The income or assets of the trust may not be transferred to, or used by or for the benefit of, a party-in-interest. See IRC §4975(c)(1)(D). This type of transaction is fact-specific, meaning the IRS and DOL will analyze whether under the circumstances a personal benefit is being derived by the disqualified person from the transaction involving plan assets. This is a highly subjective analysis.

2. Indirect transfer. These transactions often involve indirect benefit to the party-in-interest that may not be apparent at first look. In fact, in the ERISA Committee Reports, Congress noted: "[ERISA] also prohibits the use of plan income or assets by or for the benefit of any party-in-interest. As in other situations, this prohibited transaction may occur even though there has not been a transfer of money or property between the plan and a party-in-interest.

   a. Example: Securities purchases or sales by a plan to manipulate the price of the security to the advantage of a party-in-interest constitutes a use by or for the benefit of a party-in-interest of any assets of the plan." See H.Conf. Rept. 93-1280 (1974), 1974-3 C.B. at 469.

   b. Example: Indirect lease between IRA and company substantially owned by IRA owner. In Advisory Opinion 2006-01A, the DOL ruled that a lease between a company owned 68% by an IRA owner (the party-in-interest) and an LLC in which the IRA was an investor constituted an indirect lease between the IRA and the party-in-interest. It also constituted the use of IRA assets for the benefit of the party-in-interest, in violation of IRC §4975(c)(1)(D).

III. PARTICIPANT-DIRECTED ACCOUNTS NOT EXEMPT FROM PROHIBITED TRANSACTION RULES.

A. The prohibited transaction rules are applicable even if investments are participant-directed. In fact, DOL Reg. §2550.404c-1(e)(3) provides that nothing in ERISA §404(c) would provide relief from the applicable excise taxes under IRC §4975 with respect to prohibited transactions engaged in by the participant-directed account.
IV. FIDUCIARY PROHIBITED TRANSACTIONS. ERISA §406(B).

A. In addition to the prohibited transactions listed in ERISA §406(a), ERISA §406(b) prohibits fiduciaries from:

1. Dealing with plan assets in the fiduciary's own interest or for the fiduciary's own account;

2. Acting in any transaction involving the plan on behalf of a party whose interests are adverse to the interests of the plan or its participants or beneficiaries; or

3. Receiving any consideration for the fiduciary's own personal account from any person dealing with the plan in connection with any transaction involving plan assets.

B. Self-dealing by a fiduciary

1. Transactions which might raise self-dealing issues.

   a. Loans made by bank-trustee.

      i. Example: In Martin v. National Bank of Alaska, 828 F.Supp. 1427 (D. Alaska 1993), a bank trustee authorized mortgage loans to be made by a plan to third parties who had taken construction loans from the bank. The mortgage loans were used by those parties to repay the construction loans. The court ruled the trustee was self-dealing because the plan loans were made in the bank's own interest (i.e., to enable the third parties to repay the construction loans). In addition, the origination and servicing fees collected by the bank on the mortgage loans, which were paid by the borrowers directly to the bank, constituted consideration from third parties in connection with the investment of plan assets, another act of self-dealing under §4975(c)(1)(F).

   b. Gratuities paid to trustees.

      i. Example: In Secretary of Labor v. Carell, 17 EBC 1159 (M.D. Tenn. 1993), an administration firm reimbursed the plan trustees for expenses incurred by the trustees' spouses when they attended trustee meetings. The court ruled the payments constituted consideration received by the trustees in connection with plan assets, and constituted self-dealing. Although plan assets were not directly used, the court noted that the gratuities influenced the trustees in their dealings with plan assets. For example, the trustees would be more likely to continue to retain the administration firm to

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perform services for the plan, and to be compensated with plan assets.

2. **Transactions with companies related to (or affiliated with) the fiduciary.** Where there is a relationship or affiliation between a fiduciary and another entity or person, a self-dealing issue is raised when that other entity or person benefits, not just if the fiduciary benefits directly.

   a. **Example:** *Lowen v. Tower Asset Management, Inc.*, 829 F.2d 1209 (2nd Cir. 1987), is an example of self-dealing involving transactions between the plan and companies related to the fiduciary who caused the plans to engage in the transactions. In this case, the fiduciary was the investment manager for the plan. The related companies were a registered broker-dealer and an investment banking corporation. The fiduciary used his authority to invest in companies for which the related companies were engaged to perform services and receive commissions, fees and other consideration.

   b. **Example (partnership in which fiduciary is a partner):** In TAM 9208001, the IRS ruled that a fiduciary engaged in self-dealing when he caused the plan to invest in a loan to a limited partnership in which the fiduciary was a 7.5% partner.

3. **Transactions with entity owned by a plan.** Where the plan is the sole owner of an entity, the underlying assets of the entity are treated as plan assets, pursuant to the "plan asset regulations" under DOL Reg. §2510.3-101. Consequently, the wholly-owned entity is not treated as an entity separate from the plan for purposes of identifying parties-in-interest. Consequently, transactions between the entity and the plan would not be prohibited under ERISA §406 because they would be treated as "intra-plan" transactions. See DOL Advisory Opinion 2005-03A (March 23, 2005) for an example of this situation.

   a. **Example (retention of wholly-owned entity by multiemployer fund to perform services not self-dealing):** In DOL Advisory Opinion 2005-03A (March 23, 2005), the wholly-owned entity performed administrative services for a multiemployer fund that owned the entity. Thus, the retention of the administrative services company by the multiemployer plan to provide administrative services to the plan was not a prohibited transaction because it was merely an "intra-plan" transaction. The DOL cautioned, however, that, with respect to services performed by the wholly-owned entity to other plans, the entity would be a service provider and, thus, a party-in-interest, with respect to such plans. In addition, since the entity is merely an asset of the plan, the plan would become a service provider/party-in-interest with respect to such other plans. Therefore, the fiduciaries of these other plans will need to make
sure that the retention of the multiemployer plan's wholly-owned entity to provide services is a prudent decision, and that there are no transactions between the entity or the multiemployer plan and such other plans that are prohibited under ERISA §406. This would include ensuring that the fees charged for the services provided by the wholly-owned entity are reasonable, within the meaning of the prohibited transaction exemption under ERISA §408(b)(2).

b. **Example (establishment of corporation with IRA assets):** In *Swanson v. Commissioner*, 106 T.C. 76 (1996), IRA transactions involving a domestic international sales corporation (DISC) that was wholly owned by the IRA were not prohibited transactions. The IRA owner, Swanson, was the sole shareholder of Swansons' Tool Company. With IRA assets, Swanson organized Swansons' Worldwide, a DISC, and had all the stock of Worldwide issued to the IRA. Thereafter, Swanson Tool, which exported goods outside of the U.S., paid commissions to Worldwide with respect to the export property. The commissions paid to Worldwide received preferential tax treatment accorded to DISCs under IRC §991. Worldwide in turn paid dividends to the IRA, which were tax exempt. The IRS argued that the sale of the stock in Worldwide was a prohibited transaction under IRC §4975(c)(1)(A) and that the payment of dividends by Swansons' Tool to Worldwide was a prohibited transaction under the self-dealing rules, because Swanson is a fiduciary of his IRA. The case is actually one for reimbursement of Swanson's litigation costs after IRS filed no objection to a grant of summary judgment on the prohibited transaction issues in Swanson's favor. The court awarded Swanson litigation costs, pursuant to IRC §7430, because the IRS had no reasonable basis for its positions.

c. Use of rollover to start up a business. In *Guidelines Regarding Rollovers as Business Start-ups* (referred to as "ROBS"), Memorandum from Michael Julianelle, Director, Employee Plans, SE:T:EP, IRS Employee Plans Bulletin (Special Edition: November 5, 2008), the IRS addresses the acceptability of a rollover strategy being promoted by several promoters. One of the issues addressed by the IRS is the possibility of prohibited transactions arising from these transactions.

4. **Transactions directed by the participant.**

a. **Example (IRA owner treated as fiduciary of IRA):** In DOL Advisory Opinion 93-33A, the DOL notes that when an individual controls the investments in his IRA, he is a fiduciary for prohibited transaction purposes. (In that ruling, the IRA owner invested his
IRA assets in his daughter's business, and was found to be engaged in a self-dealing transaction). Therefore, if the IRA owner directs investment transactions with IRA assets that personally benefits him, he is engaging in an act of self-dealing under IRC §4975(c)(1)(E) or (F). In the IRA context, the consequence of engaging in a prohibited transaction is not excise taxes under §4975, but rather the loss the IRA's tax-exempt status, pursuant to IRC §408(e)(1). Nonetheless, DOL Advisory Opinion 93-33A, and other Advisory Opinions that have dealt with IRA transactions (see, for example, Advisory Opinion 2000-10A, and Advisory Opinion 2006-01A), have consistently applied the fiduciary concepts to the IRA owner that directs the investments of the IRA, but solely for purposes of determining whether the IRA engages in a prohibited transaction.

b. IRA transactions that may raise self-dealing issues. The DOL has raised the issue of self-dealing when an IRA purchases stock in a company in which the IRA owner owns stock, or is a director or officer. The issue is a factual one - does the purchase result in a direct or indirect benefit to the IRA participant (other than in his capacity as the participant in the IRA)?

i. Example: In DOL Advisory Opinion 89-03A, an IRA owner directed the purchase of common stock in the company which employed the IRA owner. The IRA owner was also an owner in that company, but owned only slightly more than 1% of that company. The DOL's discussion indicates that the degree of ownership is a factor here (i.e., the smaller the IRA owner's personal stake in the company and the IRA's ownership in the company, the less likely the investment will result in self-dealing). Also see DOL Advisory Opinion 90-20A (employee of approved nonbank trustee of IRA directing purchase of employer's stock by IRA).

ii. Example (investment of IRA in limited partnership in which IRA owner is a partner): DOL Advisory Opinion 2000-10A deals with an IRA invested in a limited partnership in which the IRA owner was the general partner and family members of the IRA owner had limited partnership interests. The DOL did not find a prohibited transaction arising from the sale of the partnership interest to the IRA because the partnership itself, based on its ownership structure, was not a disqualified person with respect to the IRA (the IRA only had a 39.38% limited partnership interest in the partnership). But the DOL cautioned about possible conflicts of interest that could result in prohibited transactions under IRC §4975(c)(1)(D)
or (E), although it did not rule on these issues because of their factual nature. For example, there could be conflicts of interest later on with respect to the IRA's investment in the partnership since the IRA owner also is the general manager of the partnership. Also, the IRA owner cannot be otherwise dependent upon the participation of the IRA in order for the IRA owner to continue his individual ownership in the partnership. The DOL also noted that, since the IRA owns more than 25% of the partnership, and the partnership is an investment club, the underlying assets of the partnership are treated as IRA assets pursuant to DOL Reg. §2510.3-101. Thus, any person who exercises discretionary authority or control over the partnership's assets would be treated as a fiduciary of the IRA for purposes of applying the prohibited transaction rules under IRC §4975.

c. Example (qualified plan participant found to be a fiduciary of his self-directed account): In Flaherty v. Commissioner, 115 T.C. 269 (2000), affirmed per curiam, 271 F.3d 763 (8th Cir. 2001). In that case, the IRS treated the participant as a fiduciary, for purposes of IRC §4975, since he had control over the investment of his account. Since the participant is a fiduciary, a business substantially owned by the participant (Flaherty) is a party-in-interest, so that a loan from the participant's account to that business resulted in a prohibited transaction.

d. Revenue sharing arrangements: receipt of 12b-1 and similar fees. Rule 12b-1 of the Investment Company Act permits the mutual fund to pay distribution expenses (known as 12b-1 fees). Receipt of 12b-1 fees by a party-in-interest may result in a prohibited transaction. Fees also might be paid by the mutual fund under a subtransfer agency (STA) arrangement (typically a fee for recordkeeping services).

i. Example (12b-1 fees are similar to a commission): In Advisory Opinion 93-12A, a bank holding company's affiliate served as trustee of several ERISA plans and also as investment adviser for several mutual funds. The trustee was relying on PTE 77-4 in investing some of the plan assets in such mutual funds. In a footnote to that opinion, the DOL notes that 12b-1 fees are like commissions, and one of the exemption conditions under PTE 77-4 is that no commission is paid. Therefore, the DOL would not conclude that the PTE 77-4 exemption was available if the trustee received 12b-1 fees. However, Advisory Opinion
2006-06A clarifies the application of 12b-1 fees in the context of the class exemption under PTE 77-3, and presumably the same approach will be applied under PTE 77-4. In addition, other letters provide guidance on how a trustee can properly accept 12b-1 fees.

ii. DOL Advisory Opinions involving 12b-1 and STA fees. The DOL addresses the issues regarding 12b-1 and STA fees more directly in Advisory Opinion 97-15A and Advisory Opinion 97-16A.

e. Bank deposits made with plan assets. IRC §4975(d)(4) permits the investment of plan assets in the deposits of a bank or similar financial institution (or affiliates of such bank or institution) that is the employer sponsoring the plan, or is a fiduciary of the plan making such investments. Treas. Reg. §54.4975-6(b) sets forth the conditions of this exemption.

f. Class exemption allows automatic rollovers to be established with IRAs provided by the plan sponsor or an affiliate of the plan sponsor (PTE 2004-16). In DOL Reg. §2550.404a-2, the DOL provides safe harbor fiduciary relief with respect to automatic rollovers required under IRC §401(a)(31)(B). PTE 2004-16 (69 F.R. 57964 (August 24, 2004)) grants relief to a fiduciary who deposits the automatic rollover in an IRA provided by the employer who sponsors the plan or by an affiliate of the employer. By granting this exemption, a financial institution who sponsors a plan for its employees is not forced to send automatic rollovers to another financial institution.

g. Statutory exemption for investment advice rendered by fiduciary adviser. IRC §§4975(d)(17) and (f)(8) and ERISA §§408(b)(14) and 408(g), as enacted by section 601 of the PPA 2006, provide a prohibited transaction exemption for advice provided by "fiduciary adviser" under an "eligible investment advice arrangement". In addition, the plan sponsor is deemed to have met its fiduciary duties under Part 4 of Title I of ERISA if the conditions of the exemption are met.

i. Transactions to which the statutory exemption applies. If the conditions of the exemption are met, the following transactions would be exempt from the prohibited transaction rules and, thus, would not be fiduciary breaches under ERISA §406 and would be exempt from excise taxes under IRC §4975:

a) the provision of the investment advice to the participant or beneficiary of the plan with respect to
a security or other property available as an investment under the plan,

b) the acquisition, holding, or sale of a security or other property available as an investment under the plan pursuant to the investment advice, and
c) the direct or indirect receipt of fees or other compensation by the fiduciary adviser or an affiliate thereof (or any employee, agent, or registered representative of the fiduciary adviser or affiliate) in connection with the provision of the advice or in connection with an acquisition, holding, or sale of a security or other property available as an investment under the plan pursuant to the investment advice. See IRC §4975(d)(17)(A) and ERISA §408(b)(14)(A).

V. PROHIBITED TRANSACTIONS ARE PER SE VIOLATIONS.

A. A Party in Interest cannot enter into a prohibited transaction or cause or allow a plan to do so regardless of motives.

1. Even if transactions would be considered fair and reasonable and show no evidence of scandal or bad faith.

2. Penalty is personal liability for any losses or repayment of any benefit or profit received by the Party in Interest.

VI. CORRECTION OF PROHIBITED TRANSACTION.

A. Correction of a prohibited sale to the disqualified person (Treas. Reg. §53.4941(e)-1(c)(2))

1. If the plan has sold property to the party-in-interest, undoing the transaction includes rescission of the sale where possible.

2. Amount returned to plan. The amount returned to the party-in-interest must not exceed the lesser of: (a) the cash received by the plan, or (b) the fair market value of the property purchased by the party-in-interest. The fair market value in (b) is determined at the time of the sale and at the time of rescission, and the lesser amount is used. If the party-in-interest earns profits on the property after the sale, the profits must be turned over to the plan.

3. Third party sale. If the party-in-interest resells the property in an arm's-length transaction to a purchaser who is not a party-in-interest, rescission is not required. Instead, correction requires the following.
a. Payment to the plan of the excess (if any) of: 1) the fair market value of the property (or the amount received by the party-in-interest in the arm's length sale, if greater), over 2) the amount that would have been restored to the plan if the sale had been rescinded.

b. Payment to the plan of any profits realized by the party-in-interest during the time he held the property.

B. Correction of a prohibited sale to the plan (Treas. Reg. §53.4941(e)-1(c)(3))

1. If the party-in-interest has sold property to the plan, undoing the transaction includes rescission of the sale where possible.

2. **Amount returned to plan.** The amount returned to the plan must be the greatest of: a) the cash paid to the party-in-interest, b) the fair market value of the property at the time of the original sale, or c) the fair market value of the property at the time of the rescission. If the party-in-interest earns income on the cash received from the sale, the income must be turned over to the plan.

3. **Third party sale.** If the plan resells the property in an arm's-length transaction to a purchaser who is not a party-in-interest, rescission is not required. Instead, correction requires the following.

   a. Payment to the plan of the excess (if any) of the amount the party-in-interest would have paid over to the plan had the sale been rescinded over the amount realized by the plan on the resale.

   b. Payment to the plan of any income realized by the party-in-interest from the cash received in the original sale to the plan.

4. **Self-correcting transaction.**

   a. **Example:** In *Zabolotny v. Commissioner*, 7 F.3d 774 (8th Cir. 1993), property was sold to the plan, but the income derived from the property was so significant that the court held the transaction was self-correcting. In other words, the prohibited transaction was cured immediately following the sale because to undo the transaction would be contrary to the interests of the plan participants. To rescind the sale would place the participants in a worse financial position, which is not consistent with the highest fiduciary standards required by the regulations. The IRS did not acquiesce in this decision.
C. Correction of a prohibited loan or lease to disqualified person (Treas. Reg. §53.4941(e)-1(c)(4))

1. If the plan lends money or leases property to a party-in-interest, correction includes termination of the loan or lease.

2. **Amount paid to plan.** In addition to termination of the loan or lease, the following corrective steps must be taken.

   a. Payment to the plan of the excess (if any) of the fair market value of the use of the property (e.g., fair rental value or fair interest rate) over the amount paid for the loan or lease. Fair market value is determined at the time the transaction began or the time the transaction is corrected, whichever date results in the greater value.

   b. Payment to the plan of the excess (if any) of the amount that would have been paid by the party-in-interest for the remaining term of the loan or lease, had the transaction not been terminated, over fair market value for such use. Fair market value is determined at the time of correction.

3. **Repayment in form of property is separate prohibited transaction.** When correcting a prohibited loan, the repayments due the plan must be in cash to avoid a separate prohibited transaction from occurring.

   a. **Example:** In *Morrissey v. Commissioner*, 76 T.C.M. 1006 (1998), the court ruled that the transfer of parcels of unencumbered real estate to repay a loan from the plan is a prohibited transaction. The court ruled that the payment of the loan with property is within the scope of the decision in *Commissioner v. Keystone Consolidated Industries, Inc.*, 113 S. Ct. 2006 (1993), because the loan, like a minimum funding obligation, is a debt to the plan. Thus, the transfer of the property is in exchange for the cancellation of the debt, creating a separate prohibited transaction on account of the "sale" of the property by the disqualified person to the plan. The court also rejected Morrissey's argument that the transaction was "self-correcting" because the real estate's value exceeded the debt owed. Morrissey was relying on *Zabolotny*, which the court found to be distinguishable. In *Zabolotny*, the royalties generated cash to the plan that clearly provided a financial windfall to the plan participants. In this case, the additional "value" is tied up in the real estate itself. Even if the additional value is based on an accurate appraisal, the plan would have to sell the property to generate such value. The royalties in *Zabolotny* were earned by the plan without the plan's having to dispose of the property transferred.
D. Correction of a prohibited loan or lease to plan (Treas. Reg. §53.4941(e)-1(c)(5))

1. If the party-in-interest lends money or leases property to the plan, correction includes termination of the loan or lease.

2. **Amount returned to plan.** In addition to termination of the loan or lease, the following corrective steps must be taken.
   
   a. Payment to the plan of the excess (if any) of the amount paid to the disqualified person for such use over the fair market value of the use of the property (e.g., fair rental value or fair interest rate). Fair market value is determined at the time the transaction began or the time the transaction is corrected, whichever date results in the lesser value.

   b. Payment to the plan of the excess (if any) of the fair market value for the remaining term of the loan or lease, had the transaction not been terminated, over the amount that would have been paid by the plan under the terms of the transaction. Fair market value is determined at the time of correction.

E. Correction of an excess compensation transaction (Treas. Reg. §53.4941(e)-1(c)(6))

1. If the transaction would qualify for an exemption under §4975(d)(2) or §4975(d)(10), relating to compensation for certain services, except that the compensation paid is excessive, the correction is made by having the party-in-interest return the excess compensation to the plan. A reasonable adjustment for earnings that the plan lost with respect to the payment of the excess compensation should also be included, although the regulation does not make reference to such an adjustment.

F. Correction within 14 days (IRC §4975(d)(23) and ERISA §408(b)(20))

1. Section 612 of the PPA 2006 adds IRC §4975(d)(23) and (f)(11) to exempt any transaction under IRC §4975(c)(1)(A), (B), (C) or (D) (i.e., all prohibited transactions involving sales, exchanges, leases, loans, services, and the use of plan assets, but not the self-dealing transactions described in IRC §4975(c)(1)(E) and (F)) if: (1) the transaction involves the acquisition, holding, or disposition of any security or commodity, and (2) the transaction is corrected within 14 days after the fiduciary, party-in-interest (or other person who knowingly participated in the transaction) discovers (or reasonably should have discovered) that the transaction was otherwise prohibited. A corresponding amendment is made to ERISA, adding ERISA §408(b)(20) and providing exemptions from ERISA §406(a) (but not ERISA §406(b)).
2. Effective date. This exemption is effective for eligible transactions for which the fiduciary of the plan, after August 17, 2006, discovers (or should have discovered) were prohibited transactions.

3. Not available for known prohibited transactions. In the case of a fiduciary, party-in-interest (or disqualified person, in the case of the excise tax provisions), or other person who knowingly participated in the transaction, the exemption does not apply if, at the time the transaction occurs, such person knew (or reasonably should have known) that the transaction would constitute a violation of the prohibited transaction rules. See ERISA §408(b)(20)(C) and IRC §4975(f)(11)(B)(ii).

VII. EXCISE TAX ON PROHIBITED TRANSACTIONS. IRC §4975.

A. IRC §4975 provides for an excise tax in the amount of 15% of the amount involved in the prohibited transaction for the period beginning on the date on which the prohibited transaction occurs and ending on the earliest of:

1. when the transaction is corrected;
2. when a deficiency notice is issued; or
3. the date the tax is assessed. IRC §4975(f)(2).

B. The excise tax is assessed annually for each year that the prohibited transaction is outstanding.

C. Tax calculation for sale transaction. For a sale, the excise tax is calculated by multiplying the amount involved by 15%. A 15% excise tax, as so calculated, is paid for each year (or part of a year) included within the taxable period. Thus, if there is only one taxable year included within the taxable period, the total excise tax is 15% of the amount involved. However, if the taxable period spans multiple taxable years, the actual excise tax is 15% of the amount involved times the number of such taxable years.

D. The excise tax for prohibited transactions occurring prior to August 20, 1996 was 5% of the amount involved in the transaction. It was 10% for prohibited transactions occurring from August 20, 1996 to August 5, 1997, and was increased to 15% for prohibited transactions occurring after August 5, 1997.

1. In Revenue Ruling 2002-43, the IRS stated that the applicable excise tax rate for each prohibited transaction is the rate in effect in the first year that the transaction occurred. The rate is then applicable to all years of the prohibited transaction.

E. Although an additional second tier 100% tax may be assessed if the transaction is not corrected within the applicable period, the party in interest/disqualified person
has an additional ninety (90) days to correct the transaction and avoid the additional tax. IRC §4975(b).

F. The excise taxes on prohibited transactions are assessed against the party in interest/disqualified person involved in the transaction, not against the plan. IRC §4975(a) and (b).

G. The amount involved in a loan for purposes of the excise tax is the interest on the loan amount, not the entire amount of the loan.

1. Determining the end of taxable period for each "new" loan/lease. The taxable period for each "new" loan transaction that arises with each tax year does not end until the entire loan is repaid (with proper interest), because until that time, the actual loan (which is really a single transaction) has not been corrected. Also a new taxable period begins with each "new loan" that is deemed to occur at the beginning of each tax year of the disqualified person.

H. Prohibited transaction excise taxes are paid with the filing of IRS Form 5330.

I. Class exemption (PTE 2002-51) provides excise tax relief for correction of certain prohibited transactions through the VFC Program.

1. On March 28, 2002, the DOL made permanent the Voluntary Fiduciary Correction (VFC) Program, which provides applicants relief from DOL investigations and penalties under ERISA §502(l) with respect to certain fiduciary breach transactions (ERISA §502(l) provides for a 20% excise tax on such transactions). Many of the transactions eligible for relief under the VFC Program are prohibited transactions, so the application of excise taxes under IRC §4975 is also an issue with respect to a disqualified person who engages in the transaction with the plan. To encourage participation in the VFC Program, PTE 2002-51 identifies six types of transactions that are eligible for the VFC Program for which relief from the excise taxes under IRC §4975 is granted if certain conditions are met.

J. Prohibited transaction does not disqualify a plan under IRC §401(a).

1. The prohibited transaction rules are enforced through the excise tax provisions of IRC §4975. A qualified plan which engages in a prohibited transaction does not become a disqualified plan solely by reason of the transaction. IRC §401(a), which lists the requirements for qualification under the tax code, does not refer to the prohibited transaction rules as one of its requirements. However, under certain circumstances, the activities which constitute prohibited transactions might result in a violation of the exclusive benefit rule under IRC §401(a)(2), which is a disqualifying event. These circumstances are rare and the exclusive benefit rule is invoked sparingly by the IRS with respect to prohibited transactions.
K. Prohibited Transaction Example.

1. Party in Interest sells real estate to plan for $200,000 on 12/15/2011 and corrects transaction on 1/15/2014.

2. Excise tax calculation:

   a. 2011: $200,000 x .15 $30,000
   b. 2012: $200,000 x .15 $30,000
   c. 2013: $200,000 x .15 $30,000
   d. 2014: $200,000 x .15 $30,000
   e. Total Excise Tax: $120,000

VIII. TREATMENT OF IRAS WITH PROHIBITED TRANSACTIONS.

A. IRC §4975(e)(1) defines the term "plan" for purposes of applying the prohibited transaction rules under IRC §4975. A plan includes an IRA, but does not include a section 403(b) plan.

B. IRA ceases to be an IRA if owner engages in prohibited transaction. If the owner (or beneficiary) of an individual retirement account, as described in IRC §408(a), engages in any transaction that is prohibited under IRC §4975, the IRA ceases to be an IRA as of the first day of the taxable year in which the transaction occurs. See IRC §408(e)(2)(A). This means the special tax benefits accorded the IRA are lost. Similarly, if the IRA owner of an individual retirement annuity, as described in IRC §408(b), borrows any amount from the contract, the contract ceases to be an IRA as of the first day of the taxable year in which the borrowing occurs. See IRC §408(e)(3).

C. Deemed distribution of IRA assets. If an IRA ceases to be an IRA because of a prohibited transaction described in the prior paragraph, the entire value of the IRA, determined as of the first day of the taxable year for which the account or annuity ceases to be an IRA, is treated as distributed to the IRA owner (or beneficiary, in the case of an IRA for a deceased participant). See IRC §408(e)(2)(B).

1. Example. Sue has a traditional IRA funded with deductible contributions. The IRA is a custodial account maintained with a bank. On June 1, Sue sells property to her IRA for fair market value ($20,000). The total value of the IRA as of the prior January 1 (i.e., the beginning of Sue's taxable year in which the transaction occurred) is $75,000. Although the sale was for fair market value, Sue has engaged in a prohibited transaction with her IRA under IRC §4975(c)(1)(A) and she did not obtain an exemption for this transaction. The result is that her IRA ceases to be an IRA. In addition, the fair market value of the IRA as of the January 1 which precedes the date of the transaction is includible in her gross income for that taxable year, resulting in additional income of $75,000.
D. Is the IRA required to be fully distributed if it loses its tax-exempt status? The tax code does not require that the IRA be fully distributed merely because it loses its tax-exempt status, pursuant to IRC §408(e). However, after the first day of the taxable year in which the prohibited transaction occurs, the IRA is treated as the capital asset of the individual who owned the "disqualified" IRA. The IRA owner's basis in the property held by the IRA would be equal to the amount includible in income under IRC §408(e). Current earnings of the IRA trust or custodial account would be taxable (probably to the IRA owner, as the grantor of that trust) and subsequent sales of assets held in the trust or custodial account would be subject to capital gains.

E. No excise tax on IRA owner when IRA ceases to be an IRA. When an individual retirement account ceases to be an IRA by reason of IRC §408(e)(2)(A), the IRA owner (or beneficiary) is exempt from the excise taxes with respect to the transaction that caused the IRA to cease to be an IRA. See IRC §4975(c)(3).

F. Excise taxes still applicable to other disqualified persons. The exemption from the excise tax explained above is applicable only to the IRA owner (or beneficiary) who engages in the described transaction. If a disqualified person other than the IRA owner engages in a prohibited transaction with the IRA (e.g., prohibited transaction between the IRA and the financial institution which is acting as custodian of the IRA), the disqualified person is subject to the excise tax provisions of IRC §4975.

G. Status of deemed IRA accounts. IRC §408(q), as added by EGTRRA §602, permits a qualified plan, a section 403(b) plan, or a governmental 457(b) plan, to allow for deemed IRA accounts. This option is permitted for plan years beginning on or after January 1, 2003. Under a deemed IRA account provision, the plan permits employees to make voluntary employee contributions to a separate account or annuity established under the plan. In order to be treated as a deemed IRA contribution, the employee must designate the contribution as a contribution to which IRC §408(q) applies. See IRC §408(q)(3)(B)(ii). IRC §408(q)(1) provides that a deemed IRA account is treated as an IRA for all purposes of the tax code. Also see Treas. Reg. §1.408(q)-1 (c), which treats deemed IRAs as separate entities from the underlying plan which contains the deemed IRA feature, and are subject to the rules applicable to IRAs. This would include the prohibited transaction rules under IRC §4975. Therefore, the rules described above would apply to prohibited transactions engaged in with a deemed IRA account in a plan.

H. Loss of Status as IRA May Result in Loss of Creditor Protection for Assets of (Former) IRA.

1. As noted above, if there is even one minor prohibited transaction (PT), the rule is that the entire IRA is treated as terminated and all of its assets distributed to the owner on the first day of the year in which the PT occurred. Creditors are now analyzing the transactions of the IRAs of debtors to find PTs in order to destroy the account's status as an IRA and thereby make the assets of the former IRA subject to attachment.
2. In *In re: Willis*, 2011 WL 1522383 (11th Cir. 2011) the U.S. 11th Circuit Court of Appeals affirmed the judgment of a U.S. Bankruptcy Court in Florida that as a result of a PT an IRA lost its status as an IRA and thereby lost its exemption in bankruptcy. One of the key issues decided by the trial court in *Willis* was whether the Bankruptcy Court has the jurisdiction to determine whether an IRA that received a favorable determination letter (in *Willis*, a Merrill Lynch IRA) can subsequently lose its exempt status thereby subjecting the assets in the IRA to the claims of creditors. The court in *Willis* said that the IRA's determination letter was significant, but where the debtor engages in prohibited transactions, the presumption of qualification is rebutted and the funds are not exempt.

IX. PERMITTED ACTIVITIES. ERISA §408(C).

A. ERISA does not prohibit fiduciaries from:

1. Receiving any benefit from a plan for which the fiduciary is entitled as a participant or beneficiary, calculated and paid on a basis consistent with all other participants and beneficiaries.

2. Receiving reasonable compensation for services rendered, or reimbursement of expenses incurred, while performing services for the plan.

   a. If fiduciary receives full-time pay from employer or union sponsoring the plan, payment is limited to reimbursement for expenses properly incurred.

3. Serving as a fiduciary in addition to being an officer, employee, agent or other representation of a party in interest.

X. PROHIBITED TRANSACTION STATUTORY EXEMPTIONS. ERISA §408(B); IRC §4975(D).

A. Certain loans to participants and beneficiaries.

B. Reasonable arrangements with parties in interest for office space and for legal, accounting, or other services needed for the plan.

C. Certain loans to ESOPs.

D. Certain investments by plans in deposits in banks or similar financial institutions whose employees are covered by the plans.

E. Certain contracts for insurance between a plan and an employer maintaining the plan or party in interest.
F. Provision of ancillary bank services to a plan by a bank or similar financial institution that is a fiduciary of the plan.

G. Exercise by a plan of a privilege to convert securities.

H. Various transactions between a bank and certain common or collective trust funds or pooled investment funds.

I. Distribution by a fiduciary of plan assets in accordance with the plan and ERISA.

J. Transactions required or permitted in accordance with withdrawal provisions in multi-employer plans.

K. Mergers of multi-employer plans, or transfers of assets between multi-employer plans where the PBGC determines they meet ERISA requirements.

L. Qualified transfers of assets from single-employer defined benefit plans to qualified retiree health accounts.

XI. PROHIBITED TRANSACTION EXEMPTIONS UNDER PENSION PROTECTION ACT OF 2006.

A. An exemption permits service providers that are not fiduciaries and have no other relationship to a plan to engage in sales, exchanges, leases, and loans with plans, as long as the plan receives adequate consideration.

B. Parties that engage in prohibited transactions involving securities or commodities are given 14 days from the discovery of the prohibited transaction to take corrective action without incurring a penalty. This relief is not available to parties that know or should have known that the transaction was prohibited or for transactions involving employer securities.

C. Investment funds and limited partnerships will not be treated as ERISA fiduciaries if investments by ERISA-covered plans account for less than 25 percent of assets of the investment fund or limited partnership. Under prior law, the investments of non-ERISA governmental and foreign plans were also taken into account.

D. An exemption for providing investment advice to plan participants is effective for advice provided after December 31, 2006.