Qualified Plans, IRAs and Prohibited Transactions

ERISA and the IRS Code have comparable provisions regarding self-dealing transactions with a Plan Trustee and an IRA Custodian. The IRS Code sets forth the penalties resulting from a Prohibited Transaction (PT). Although a PT loan may at times be a useful tool since the penalties generally apply to the loan interest rather than the loan principal, the best advice to Plan Sponsors is to avoid PTs without exception. However, in order to avoid something, it must be recognizable. Moreover, because of the complexity of the IRS Code and regulations, the IRS and the DOL have difficulty in the administration of the rules tending to make unilateral determinations to the detriment of the taxpayer. For example, it is significant to know when a PT commenced, for in certain cases, if corrected within 14 days of its inception, the penalties do not apply. The Plan Trustee as the legal title owner of the Plan assets must be a party to any transaction. Another rule provides that a PT commences when the parties knew or should have known that the transaction was a PT. In a pending case, the IRS is contending that a Trustee, because of his fiduciary duty, is deemed to have known at the inception of the transaction effectively cancelling the 14 day rule. The decision is on appeal but can not go very high in the procedure because of the relative costs.

A PT is a transaction between the Plan and a disqualified person or "party of interest" as used by ERISA. In a transaction with a third party, the Trustee can not be the disqualified person as the IRS has attempted to assert. The Trustee can only be a disqualified person in the event he transacts with himself in the capacity of an outside contracting party. ERISA specifies the following as disqualified persons:

Any fiduciary, counsel or employee of the Plan
A person providing services to the Plan
The employer sponsoring the Plan for its employees or an employee organization whose members are covered by the Plan
A 50% or more owner (including profit interests and beneficial interests) of C, the Plan Sponsor.
An employee, officer, director or a 10% or more owner of B, C, and D; or a 10% or more partner or joint venturer of B, C and D.

Subject to certain exceptions, ERISA Sec 406 defines a Prohibited Transaction as the following activity between a Plan and a disqualified person:

Sale, exchange or leasing of property
Lending of money
Furnishing goods, services or facilities

There is an exception applicable to an "eligible individual account plan" (ERISA Sec 407(d)) relative to the acquisition of "qualifying employer real property" and "qualifying employer securities," but it is inconsequential in the context of this paper.

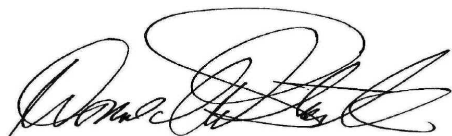
Based on the above, determining whether a transaction is prohibited and who the disqualified persons might be should not be difficult. Nevertheless, there can be facts and circumstances which may concern the parties. For example, it is well established that a Plan or IRA can own a business entity. In the event such
an entity produces active rather than passive income, it will pay income tax. If the entity is a disregarded or pass through for tax purposes, the active income would result in unrelated business taxable income (UBTI). UBTI is taxable using trust tax rates filing form 990-T. Any active income is UBTI. Also, income from a leveraged investment

produces UBTI (i.e. a margin account). Obviously UBTI is to be avoided, but the ownership of a business entity producing only passive income is useful and should not be discouraged.

However, in the process of establishing the business entity by the Trustee or custodian, and the extent of involvement by the beneficiaries and/or Trustee can cause a concern for which there is no guidance. For example, if such a business employed a lineal descendent of the owner of the sponsor, there is a transaction for services since compensation is contemplated and then, more than likely, a PT. If such a result was desired, the use of an eligible individual account plan would provide the appropriate exception. However, assume a beneficiary wishes to serve as the General Partner of a Limited Partnership to facilitate the management of the business. If there is no compensation, it would seem there is no transaction for service. The beneficiary is providing services of the type which could be provided in the capacity of a self directing beneficiary or Trustee in the case of a qualified Plan. Further, since there is no compensation paid or accrued, there would be no "amount involved" to which the PT penalties would apply. I would not discourage such an arrangement.

However, there is always the potential of an overreaching government agency. The fiduciary should be protected by ERISA Sec 414 which provides that no action may commence with respect to a "breach of any responsibility, duty or obligation or violation" after three years of the "earliest date on which the plaintiff had actual knowledge of the breach or violation." However, if the transaction was not terminated three years before discovery and/or is ongoing at the time any action is proposed, knowledge of the breach is assumed to be at the time of the proposed action since there is no guidance as to this circumstance. Then, if corrected within 14 days, penalties do not apply.

Respectfully Submitted,



January 7, 2013

Donald D. Stark

Date