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IRA and QRP Prohibited Transactions

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Learning Objectives

At the completion of this course you will be able to

- understand the sources of prohibited transaction rules,
- differentiate between different kinds of prohibited transactions and penalties,
- identify how to prevent a prohibited transactions, and
- recognize the concepts of unrelated debt-financed income (UDFI) and when it applies.

Icon Legend

Individual Exercise	Group Exercise	Group Discussion
Example	Job Aid	Additional Information

Background

The prohibited transaction rules are designed to ensure that IRA and QRP transactions are handled in a way that benefits the retirement account itself, not the owner of the IRA or the business. In simplest terms, statutes and other guidance on prohibited transactions are intended to prevent conflicts of interest involving our retirement assets.

Congress has granted special tax benefits to promote saving for retirement. In turn, it is expected that savers will not abuse the privilege or take unwarranted risks with assets.

Decisions involving retirement savings should be made with a singular motive—to maximize the accumulation of assets for a person's retirement security, and potentially to benefit a spouse or other beneficiaries.

Potential for Conflicts of Interest

Certain interactions between individuals and assets are always prohibited because of their *potential* for conflict of interest, even though—in a particular set of circumstances—an outcome could be positive. The principle here might be to "presume the worst," and thereby prevent potentially conflicted or negative outcomes.

There are some absolute rules and there are some gray areas regarding prohibited transactions in IRA and in qualified retirement plans (QRPs).

- Some actions or relationships are strictly prohibited in all cases.
- Others are not black-and-white, but in their facts and circumstances may offer the potential for actions or decisions that are not in the best interest of an IRA or retirement plan account.

Test Your Instincts

Before delving into all of the IRC- and ERISA-driven requirements and prohibitions, consider the appropriateness or consequences of the following scenarios.

Test Your Instincts #1

Gabby, whose business isn't doing well, uses her employees' 401(k) deferrals to cover payroll until business improves.

Test Your Instincts #2

William directs his IRA custodian to purchase investment property, which the IRA owner expects to appreciate substantially in value over time. There will be no personal use of the property by William or his family. William will manage the property and make most of the repairs.

Test Your Instincts #3

Katie gives $25,000 from her self-directed IRA to her brother, Raymond, as a personal loan. Raymond signs a promissory note stating that he will make loan payments directly to the IRA custodian at a reasonable stated rate of interest.

Prohibited Transaction Ground Rules

The purpose of the prohibited transaction rules is to ensure that all decisions are made with the integrity of the IRA or QRP account in mind, and serve the long-term retirement interests of the IRA owner or plan participant.

- The prohibited transaction rules do not permit actions that may benefit or reward the IRA owner or participant in ways unrelated to retirement saving objectives.
- The overarching principle is prohibiting certain transactions between a "plan" and those persons identified as "disqualified persons."

Indirect Prohibited Transaction

John Robinson, employer, used his profit sharing plan assets to invest in an apartment building. John now wants to purchase the apartment building from his profit sharing plan. In an attempt to avoid a prohibited transaction, John directs his plan trustee to sell the property to Joe Smith, a person unrelated to John. John agrees to purchase the property from Joe after the transaction between Joe and the plan is completed. The result is still a prohibited transaction because John cannot circumvent the prohibited transaction rules merely by bringing in a third party.

What Is "a Plan?"

Internal Revenue Code section (IRC Sec.) 4975(c) and ERISA Sec. 406 tells us that a "plan" means any of the following.

- Qualified plans governed by IRC Sec. 401(a)
- Qualified annuity plans under IRC Sec. 403(a)
- IRAs under IRC Sec. 408(a) or (b)
- Archer medical savings accounts (MSAs) described in IRC Sec. 220(d)
- Health savings accounts (HSAs) described in IRC Sec. 223(d)
- Coverdell education savings accounts (ESAs) described in IRC Sec. 530
- Roth IRAs under IRC Sec. 408A and savings incentive match plan for employees of small employers (SIMPLE) IRAs under IRC Sec. 408(p) also are considered individual retirement plans for prohibited transaction purposes.

NOTE: *For simplicity's sake, in this course the term "IRA" will include Traditional, Roth, simplified employee pension (SEP), and SIMPLE IRAs, as well as MSAs, HSAs, and ESAs.*

Who Is a “Disqualified Person?”

Although the definition of “disqualified person” is detailed and complex, some parties always are considered disqualified persons and should not take part in prohibited transactions. According to this paraphrased version of IRC Sec. 4975(e)(2), a disqualified person is

A. a fiduciary to the plan (e.g., the IRA owner or plan participant);

B. a person providing services to the plan (e.g., the trustee or custodian);

C. an employer, any of whose employees are covered by the plan (this generally is not applicable to IRAs, but does include the owner of a business that establishes a QRP);

D. an employee organization, any of whose members are covered by the plan (e.g., unions);

E. certain 50 percent or greater owners of C or D above;

F. a family member of A, B, C, or E above (family members include a spouse, ancestor, lineal descendant, and any spouse of a lineal descendant; but not any brothers or sisters);

G. certain 50 percent or greater owners of (or controlling interests in) a corporation, partnership, trust, or estate owned by A, B, C, D, or E;

H. an officer, director, 10 percent or more shareowner, or a highly compensated employee of C, D, E, or G; or

I. a 10 percent or more partner or joint venturer of a person described in C, D, E, or G.

For purposes of (E) and (G), the indirect ownership of stock or profits through attribution from family members (IRC Sec. 267(c)) applies. Under certain circumstances, this law attributes ownership of stock or profit interests of a spouse, ancestor, lineal descendant, or any spouse of a lineal descendent of the individual.

What Transactions Are Prohibited?

IRC Sec. 4975(c) defines a prohibited transaction as any *direct* or *indirect*

- sale or exchange, or leasing, of any property between a plan and a disqualified person;
- lending of money or other extension of credit between a plan and a disqualified person;
- furnishing of goods, services, or facilities between a plan and a disqualified person;
- transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;
- act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account; or
- receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

Prohibited Transactions, Direct or Indirect?

If a transaction directly violates the prohibited transaction rules, simply altering the transaction to remove the disqualified person from direct involvement does not resolve the issue; merely insulating that person from the transaction and enlisting a third party does not make a prohibited transaction permissible.

Under the prohibited transaction rules, a disqualified person must not do indirectly that which must not be done directly. Many times a transaction that appears permissible will violate the general self-dealing rule.

Some examples may help illustrate this concept.

- Purchasing assets from within a plan to keep as one's own
- Selling your own assets to a plan to which you owe a fiduciary duty
- Using property that is a plan asset for your own pleasure or benefit
- Making contributions of time and/or materials, such as when owning a rental property as a plan investment

Applying the Prohibited Transaction Restrictions

Some investments are more likely than others to be found to be problematic in a retirement plan environment (most common to sole proprietors or possibly partners) whose businesses have few rank-and-file employees. Here, there might not be a professional or independent plan administrator, and the investment decisions and actions might not hold up to well-informed scrutiny.

In this sometimes less structured plan administration environment, the investments selected might not be the most common types of investments, for example, mutual funds. Potentially, anything could be considered and great care should be exercised.

Similarly, with IRAs, taxpayers inclined to "push the envelope" may establish relationships with nonbank trustees that are willing to get involved with and hold any of a number of unconventional investments. Nonpublicly traded securities, private limited partnerships, undeveloped land, or other hard-to-value assets may be the specialty of some nonbank trustees, who may be more concerned with helping an IRA investor meet tax and saving objectives than with being aware of and encouraging strict compliance.

Examples of Prohibited Transactions

Following are examples that illustrate the various types of prohibited transactions, which are defined in IRC Sec. 4975(c)(1).

IRC Sec. 4975(c)(1)(A)

IRC Sec. 4975(c)(1)(A) prohibits the sale, exchange, or leasing of any property between a plan and a disqualified person.

Sale or Exchange of Assets #1

Maude maintains a Traditional IRA, which holds $100,000 in cash. Her husband, Jeffrey, owns a salvage business. Maude directs the trustee of her IRA to purchase a $50,000 interest in the business.

Maude’s IRA purchased an interest in property already owned by her husband— who is a disqualified person—which is impermissible.

Sale or Exchange of Assets #2

Michael holds a parcel of land in his owner-only 401(k) plan. Now that he is retiring, he wants to build a retirement home on the property. Michael submits an appraisal to the plan trustee showing that the value of the property is $100,000, and he sends a cashier’s check to purchase the property.

Michael, a disqualified person, purchased land owned by his IRA, which is a prohibited transaction.

IRC Sec. 4975(c)(1)(B)

IRC Sec. 4975(c)(1)(B) prohibits the lending of money or other extension of credit between a plan and a disqualified person.

Lending of Money #1

Donny's profit sharing plan account holds over $200,000 in cash. His father recently started a new business and needs a short-term loan for equipment. Donny offers his father $50,000 in exchange for a promissory note paying 7% interest in 54 monthly installments.

The lending of money between a plan and a disqualified person (Donny's father) is prohibited.

Lending of Money #2

Andrea maintains a Roth IRA that holds $500,000 in cash. Andrea wants the IRA to purchase a new business, but the IRA does not have enough cash to purchase the business outright. Andrea consults with a financial organization that can loan the difference to the IRA. Andrea personally guarantees the debt. Because a personal guarantee is an extension of credit, a prohibited transaction has occurred.

IRC Sec. 4975(c)(1)(C)

IRC Sec. 4975(c)(1)(C) prohibits the furnishing of goods, services, or facilities between a plan and a disqualified person.

Furnishing of Goods, Services, or Facilities #1

Chloe's IRA purchases 1,000 shares of stock in a golf course so that she may receive a lifetime country club membership. Because Chloe is a disqualified person, providing her with a free membership would be a prohibited transaction.

Furnishing of Goods, Services, or Facilities #2

Mark's IRA purchases a piece of commercial real estate from an unrelated third party. Thereafter, the IRA permits Mark's dental practice to operate out of the property for free. The furnishing of facilities between a plan and a disqualified person (Mark) is prohibited.

IRC Sec. 4975(c)(1)(D)

IRC Sec. 4975(c)(1)(D) states that a prohibited transaction will occur if the income or assets of a plan are transferred to or used by or for the benefit of the disqualified person.

Transfer to or Use of Plan Assets #1

Logan is a real estate agent. One of Logan's clients is selling an apartment building in an up-and-coming neighborhood, and Logan represents the client as the listing agent. Logan uses his IRA assets to purchase the apartment building and earns a commission as the real estate agent on the sale.

The IRA assets are used for the benefit of a disqualified person (Logan), which is a prohibited transaction.

Transfer to or Use of Plan Assets #2

Jordan maintains a Traditional IRA that holds property. Jordan's son, Will, lives on the property during the summer months when he's not at college.

This plan asset cannot be used by Will, who is a lineal descendant of Jordan, and is, therefore, a disqualified person (Will).

IRC Sec. 4975(c)(1)(E)

IRC Sec. 4975(c)(1)(E) prohibits a disqualified person who is a fiduciary from dealing with the income or assets of a plan in his own interest or for his own account.

Fiduciary Dealing With Assets in His Own Interest #1

Warren uses $20,000 of his IRA assets to lend money to a limited liability company that he controls and manages.

Warren, as the IRA owner, is a disqualified person and a fiduciary. IRC Sec. 4975(c)(1)(E) prohibits Warren from dealing with the income or assets of the IRA for his own interest.

Fiduciary Dealing With Assets in Her Own Interest #2

Dr. Regina Snow uses assets from her 401(k) plan to purchase 500,000 shares of a new private medical clinic. Because of this investment, Dr. Snow is elected to the board of directors and is named chief of internal medicine.

Dr. Snow, as the plan owner, is a disqualified person and a fiduciary. IRC Sec. 4975(c)(1)(E) prohibits Dr. Snow from dealing with the income or assets of the 401(k) plan for her own interest.

IRC Sec. 4975(c)(1)(F)

IRC Sec. 4975(c)(1)(F) states that a prohibited transaction will occur if there is receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

Receipt of Consideration for Personal Account #1

Stationary Plus, LLC, which is owned by Grace's Traditional IRA, hires Grace as a saleswoman on the weekends. Grace makes a commission on any of her sales and receives an hourly wage paid by Stationary Plus, LLC. A prohibited transaction occurs upon Grace's receipt of wages or commissions from Stationary Plus, LLC.

Receipt of Consideration for Personal Account #2

21st Century Bank is giving away tablets (valued at $100) to anyone who opens a new IRA with a $3,000 deposit. This is a prohibited transaction because consideration is provided for opening the account. The prohibited transaction exemption (PTE) that might have applied here (PTE 1993-1—which deals with gifts rather than services) does not apply because the tablet is valued at more than $10.

Real Estate Investments and Prohibited Transaction Issues

Real estate generally is a long-term investment. The investor's objective usually is receipt of rental income and appreciation of the property's value. The biggest risks associated with real estate investments may be changing economic and environmental conditions in the area.

- Because each piece of real estate is different, there is no readily obtainable pricing as in the securities market.
- Investors who want to sell must find a buyer who wants that particular piece of property.
- Ongoing valuations while the asset is held can be problematic.

Ways to Invest in Real Estate

Direct Ownership

An IRA with sufficient liquid assets could purchase real estate and hold it to generate income. The income and growth could come from rental payments and from capital gains on the property.

Debt-Financed Ownership

An IRA could purchase property with a portion of the purchase price and finance the rest of the purchase through a lender.

Real Estate Investment Trusts (REITs)

A REIT generally is a publicly traded company that holds, manages, and sells real estate. Shares in a REIT usually are traded like a share of stock or a share in a mutual fund. Investing in real estate through a REIT can be attractive to IRA owners because it often produces returns greater than those found with more traditional IRA investments, but without the concerns that other methods of investing IRAs in real estate may warrant.

Real Estate Investment Concerns

Valuations

A financial organization must report an IRA's fair market value each year. Real estate is a unique, illiquid property that may not have a readily available value. As such, the real estate must be valued annually to report the fair market value as required by the IRS. IRS Revenue Ruling 59-60 provides guidance for valuing investments for which the value is not readily ascertainable.

The IRS is now making the scrutiny of hard-to-value assets a high priority, especially in the IRA environment where annual valuations attributable to specific taxpayers are reported to the IRS on Form 5498, *IRA Contribution Information*, and asset distributions are reported on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*

Expenses

Ownership of real estate creates expenses directly related to the real estate in question (e.g., taxes, insurance, and maintenance of the property).

- Payment of these expenses must be made from the IRA assets and not by the IRA owner.
- This payment can come either from other liquid assets in the IRA or through future IRA contributions (subject to the IRA owner's annual contribution limit).

Management of the Real Estate

Financial organizations are responsible for managing real estate held in an IRA.

- This includes collecting rent, paying taxes and insurance, and arranging valuations for fair market value reporting.
- If the IRA owner performs these functions, it is a prohibited furnishing of services to a plan by a disqualified person.

Prohibited Transaction Concerns

Seller/Purchaser

- When the real estate is purchased or sold as a change in the IRA investment mix, the transactions must occur between the IRA and a party that is not a disqualified person.
- The IRA owner may not purchase the real estate from the IRA and replace it in the IRA with cash, and the IRA may not purchase the real estate from any disqualified person, including the IRA owner.
- In-kind distributions, including real estate properly valued, are permissible, just as it would be permissible to distribute securities in-kind to the IRA owner.

Use of Real Estate

- Disqualified persons, including the IRA owner, may not use the real estate owned by the IRA.
- For example, an IRA could not purchase a vacation home that the IRA owner uses for one week per year. This would result in a prohibited transaction under IRC Sec.4975(c)(1)(E).

Environmental Concerns

IRA owners and financial organizations should be aware that environmental issues may arise with real estate investments.

- Property owners may be required to address any environmental problems discovered on the property, and could be financially responsible for the cleanup of any contamination.
- If an IRA is invested in real estate, that IRA's assets must be used to pay for any such cleanup.

UDFI and Real Estate Purchase Concerns

Gwen buys a $200,000 rental property with her IRA. The average value of her mortgage for 2019 is $100,000. Gwen received $20,000 in rental income in 2019. Because her average debt was 50% of the property purchase amount, 50% of the rental income ($10,000) is taken into consideration when calculating her UDFI for the year.

Unrelated Debt-Financed Income

While an IRA can borrow assets to purchase real estate, this type of arrangement can cause the IRA to be subject to the unrelated debt-financed income (UDFI) rules and requirements.

- When an IRA holds debt-financed real estate, any income (e.g., rent) is considered UDFI. If the property generates more than $1,000 in UDFI in a year, the IRA must pay tax on that income.
- This tax is reported on IRS Form 990-T, *Exempt Organization Business Income Tax Return*, and the tax rate generally is higher than the income tax an individual would owe on the same income.
- This same issue can arise with IRA investments in a REIT that uses financing to acquire the property it holds.

Prohibited Transaction Prevention, Penalties, and Correction

Preventing prohibited transactions is worth every effort because the correction for failing to avoid one is usually unpleasant and is not always possible. If a prohibited transaction has occurred, the consequences are as follows.

How should a financial organization respond if it suspects that a client has conducted (or is considering) a prohibited transaction?

- The financial organization generally should avoid making the ultimate determination of whether a proposed transaction is prohibited.
- In situations where a proposed transaction is explicitly prohibited (e.g., selling plan assets to a disqualified person), the financial organization generally should refuse to engage in the transaction.

If the potential for a prohibited transaction is not quite as clear, the course of action taken by the financial organization may differ.

- The financial organization can inform the plan administrator or IRA owner that there is a possible prohibited transaction.
- By giving the individual an opportunity to address the situation, the financial organization can help the individual to understand the nature of the possible prohibited transaction, seek additional counsel, and avoid a potential prohibited transaction.

If the individual still insists on completing the proposed transaction, the financial organization should consider the following options.

- Refuse to permit the suspected prohibited transaction
- Require that the individual sign a “hold harmless” agreement, releasing the financial organization from liability, before allowing the transaction
- Resign as the trustee or custodian on the account by giving proper notice

Alternatively, if an individual insists on engaging in a transaction that the financial organization believes could be prohibited, the financial organization can take steps to minimize the potential risk to the individual and to the organization.

- If the prohibited transaction involves an IRA, establishing a separate IRA for the assets related to the transaction may be a safer course of action.
- Because a prohibited transaction results in the disqualification of the entire IRA, segregation of the assets into a separate IRA that includes only the assets involved in the transaction in question will preserve the qualified status of the other assets if the transaction is later found to be prohibited.

NOTE: *Any action that a financial organization takes in response to a potential prohibited transaction should be based on competent legal advice.*

IRA Penalties for Prohibited Transactions

Although the penalty tax for engaging in a prohibited transaction under IRC Sec. 4975 generally starts out at 15 percent for most types of retirement plans, the penalty tax is more severe for IRAs.

- When an IRA owner or beneficiary is involved in a transaction that is prohibited under IRC Sec. 4975, the IRA loses its tax-exempt status and the IRA owner (or beneficiary) is deemed to have received a distribution on the first day of the tax year in which the prohibited transaction occurred (IRC Sec. 408(e)).
- The distribution amount that the IRA owner is deemed to have received is equal to the IRA's fair market value as of the first day of such tax year and must be included in the IRA owner's income for the year.
- Unless the IRA owner qualifies for an exception (e.g., age 59½ or older, disabled), the 10 percent early distribution penalty tax also applies.

Reporting IRA Prohibited Transactions

Because an IRA prohibited transaction under IRC Sec. 4975 is a deemed distribution, the financial organization must report this on Form 1099-R for the year in which the transaction occurred. To report a prohibited transaction under IRC Sec. 4975, financial organizations should enter code 5, *Prohibited transaction*, in Box 7.

Pledging an IRA as security for a loan is a prohibited transaction under IRC Sec. 408(e)(4).

- Under this section of the Code, if an IRA owner pledges only a portion of her IRA as security for a loan, only the amount pledged is deemed distributed.
- An IRS official commented to Ascensus that in this situation, the financial organization should enter code 1, *Early distribution, no known exception*, or code 7, *Normal distribution*, in Box 7 of Form 1099-R.
- Financial organizations should not use code 5 to report this type of prohibited transaction.

QRP Penalties for Prohibited Transactions

If someone other than the plan participant or beneficiary engages in a prohibited transaction, that person may be liable for certain penalty taxes. In general, there is a 15 percent penalty tax on the amount of the prohibited transaction and a 100 percent additional penalty tax if the transaction is not corrected.

- Fiduciaries to a plan acting only in that fiduciary capacity are not subject to the 15 percent or 100 percent penalty tax.
- Fiduciaries can be subject to other legal remedies for breach of fiduciary duty.

A disqualified person may use IRS Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans*, to report payment of the 15 percent penalty tax incurred as a result of violation of the prohibited transaction rules. When used to report a prohibited transaction, Form 5330 must be filed on or before the end of the seventh month after the end of the disqualified person's taxable year.

Self-Correcting Certain Prohibited Transactions

The Pension Protection Act of 2006 (PPA) provides a statutory exemption that allows certain retirement plan and IRA prohibited transactions to be corrected without additional penalty taxes if done within 14 days of discovery (or within 14 days of when the transaction should have been discovered).

- This statutory exemption covers acts under IRC Sec. 4975(c)(1)(A), (B), (C), and (D) that involve the acquisition, holding, or disposition of any security or commodity that is prohibited.
- The exemption does not apply to real estate transactions and does not apply in situations when the IRA owner, plan participant, or other disqualified person knew or should have known that the transaction was prohibited.

To "correct" means to undo the transaction to the fullest extent possible, to make good any loss to the plan or affected account, and to restore to the plan or affected account any profits gained as a result of the prohibited transaction. If the exemption applies, no penalty is assessed, any tax assessed is abated, and any tax collected must be credited or refunded as a tax overpayment.

Prohibited Transaction Exemptions

In certain instances, transactions that would otherwise be considered prohibited are permitted under either a statutory or a DOL-issued exemption. DOL exemptions either can apply industry-wide (called a "class exemption") or can apply only to the individual who requests the relief. A brief look at all three types of prohibited transaction exemptions follows.

Congressional Exemptions

Congress creates statutory exemptions from the prohibited transaction rules for certain transactions that may appear to be prohibited. For these certain transactions, Congress sees a legitimate reason to permit them because there is not a great likelihood for self-dealing. In a case like this, Congress has issued blanket statutory exemptions permitting these transactions, assuming that certain requirements specified in the statute are met.

Some statutory exemptions under IRC Sec. 4975(d) include

- plan loans to participants or beneficiaries (if detailed requirements are met);
- any contract with a disqualified person for office space, legal, accounting, or other services necessary for the operation of the plan as long as only reasonable compensation is paid;
- investing plan assets in deposit accounts of a bank where the bank is the employer;
- investing plan assets in life insurance company products where the company is the employer;
- the provision of ancillary services to a plan by bank trustees; and
- service by a disqualified person as a fiduciary in addition to being an officer or other representative of the employer.

Prohibited Transaction Class Exemptions

The DOL has the authority to grant prohibited transaction exemptions (PTEs) on a case-by-case basis. The DOL also can grant class exemptions that apply on an industry-wide basis (See IRC Sec. 4975(c)(2)).

Following are brief summaries of some of the class exemptions.

PTE 2004-16

A prohibited transaction normally would occur if a financial organization, as sponsor of its own plan, were to make automatic rollovers of terminated plan participants' account balances to IRAs held by the financial organization itself. Rather than requiring these plan fiduciaries to roll over participants' assets to a competitor, PTE 2004-16 allows such fiduciaries to receive the automatic rollovers of mandatory distributions on behalf of the organization's former employees.

Fee Restrictions

IRA fees and expenses charged to automatic rollover IRAs may not exceed fees charged for comparable IRAs established for reasons other than for the receipt of mandatory distributions. PTE 2004-16 adds more fee restrictions for IRAs established to receive automatic rollovers from a financial organization's own plan.

- With the exception of fees to establish the IRA, ongoing fees cannot exceed the income earned by the IRA, and the IRA cannot pay a sales commission in connection with the acquisition of an investment product for the IRA.
- The DOL believes these restrictions will decrease the potential for self-dealing by such organizations.

Recordkeeping Requirement

Financial organizations that use PTE 2004-16 relief for assets rolled over from their own retirement plan to IRAs at their organization must maintain for six years any records necessary to determine whether the conditions for the exemption have been met. These records must be unconditionally accessible by DOL and IRS representatives and by any IRA owner with an IRA established under the exemption.

PTE 1997-11

This exemption allows broker-dealers registered under the Securities Exchange Act of 1934 to provide free or low-cost brokerage services to IRA, SIMPLE IRA plan, simplified employee pension (SEP) plan, and owner-only (sometimes called "Keogh") retirement plan clients without creating prohibited transactions if several conditions are met.

- The IRA or owner-only plan is established for the exclusive benefit of the participant or beneficiaries.
- The services offered under the arrangement must be compliant with all federal and state laws.
- The services offered under the arrangement must be of the type that the broker-dealer itself could offer.
- For purposes of determining eligibility to receive services, the arrangement satisfies one of the following.
  - Eligibility requirements based on IRA's account value are as favorable as any requirements for other accounts, or
  - Eligibility requirements based on the amount of fees incurred by the IRA are as favorable as the requirement by other types of account.
- The combined total of all fees is not in excess of reasonable compensation.
- The IRA's investment performance is no less favorable than the performance that could have been made at the same time by a client who is not eligible for reduced or free services.
- The services offered must be the same as those offered to nonIRA clients with account values of the same amount or the same amount of fees generated.

PTE 1980-26

This exemption allows limited lending or extension of credit between the employer (party-in interest) and a QRP. The exemption was originally put in place to cover potential liquidity issues a plan may encounter because of distribution demands.

The original exemption was amended to cover year 2000 (Y2K) programming issues and amended again for difficulties related to asset liquidation or data access following the September 11, 2001, terrorist attacks. In April 2006, the DOL amended PTE 80-26 again to cover all potential circumstances in which the plan may require a loan from the employer. The most significant change made by the 2006 amendment is to eliminate the requirement that any loan or extension of credit be paid back within three days.

PTE 1980-26, as amended in 2006, allows for a loan or extension of credit between the plan and the employer as long as all of the following conditions are met.

- No interest or fee is charged to the plan.
- The loan or extension of credit is used only for ordinary plan operating expenses, including the payment of benefits, periodic premiums under an insurance or annuity contract, or purposes incidental to the ordinary operation of the plan.
- The loan or credit is unsecured.
- The loan or credit source is not an (another) employee benefit plan.
- The loan is not to an employee stock ownership plan.
- Any loans with a term of more than 60 days must have a written loan agreement.

The amendment's effective date is retroactive to December 15, 2004.

PTE 1993-1

This exemption allows an individual to personally receive limited consideration (gifts) from the financial organization for opening or contributing to an IRA. During the taxable year, the total fair market value of property or other considerations given to the IRA owner may not exceed $10 for deposits of less than $5,000 and $20 for deposits of $5,000 or more.

Two related prohibited transaction exemptions are PTE 1993-2 and PTE 1993-33. PTE 1993-2 is similar to PTE 1993-1, but instead of gifts, the financial organization can provide an individual with free bank services in connection with opening or maintaining an IRA. PTE 1993-33 expanded PTE 1993-2 to include SEP plans.

Prohibited Transaction Individual Exemptions

After reviewing individual requests for exemption from the prohibited transaction rules, the DOL may grant exemptions. Individual exemptions apply only to the person that filed the request. Following are a few examples of these exemptions.

PTE 2006-04, The Doniar Corporation Profit Sharing Plan (the Plan)

This exemption permitted, in connection with the termination of the plan, the cash sale of a parcel of improved property owned by the plan to a disqualified person with respect to the plan.

PTE 2006-05, Anchorage Area Pipe Trades 367 Joint Apprenticeship Committee (the Plan)

This exemption allowed Local No. 367 of the United Association of Journeymen and Apprentices of the Plumbing and Pipefitting Industry of the United States and Canada, a disqualified person with respect to the plan, to loan the plan $750,000 to finance a training facility constructed by the plan.

Advisory Opinions: Insight Into DOL Interpretations

The DOL answers inquiries from individuals and organizations in the form of advisory opinions, which apply the law to a specific set of facts, or information letters, and which may call attention to well established principles or interpretations.

Advisory Opinion 2011-08A

At issue in this advisory opinion (AO) is whether PTE 1986-128, discussed previously, provides relief for covered transactions engaged in by any person who is a fiduciary solely by reason of rendering investment advice to the plan. Remember that, according to Advisory Opinion 2011-08A, PTE 1986-128 says that ERISA Sec. 406(b) (prohibiting certain transactions between a plan and a fiduciary) will not apply if

- a plan fiduciary's using its authority to cause a plan to pay a fee for effecting or executing securities transactions to that person as agent for the plan, but only to the extent that such transactions are not excessive, under the circumstances, in either amount or frequency;
- a plan fiduciary's acting as the agent in an agency cross transaction for both the plan and one or more other parties to the transaction; and
- the receipt by a plan fiduciary of reasonable compensation for effecting or executing an agency cross transaction to which a plan is a party from one or more other parties to the transaction.

The DOL's opinion is that PTE 1986-128 provides relief for covered transactions engaged in by any person who meets the definition of "fiduciary" as that term is defined in ERISA Sec. 3(21)(A), including a person who is a fiduciary solely by reason of rendering investment advice. Further, a fiduciary or an affiliate who receives a fee for executing securities transactions carried out in accordance with the fiduciary's investment advice would be using its authority as a fiduciary to cause the plan to pay a fee within the meaning of the exemption.

Advisory Opinion 2005-23A

The questions in this advisory opinion are two-fold. Is a financial consultant hired by a participant in a 404(c)-compliant plan to provide investment advice or management a fiduciary providing investment advice within the meaning of ERISA Sec. 3(21) when he advises the participant to take a distribution to invest in assets not available under the plan? Does the advisor engage in a prohibited transaction if the recommended investment pays an additional fee to the advisor? The DOL opinion actually makes three different determinations.

- The definition of fiduciary also applies to investment advice provided to a participant or beneficiary in an individual account plan that allows participants or beneficiaries to direct the investment of their accounts.
- If a nonfiduciary merely makes a recommendation that a participant roll over his or her account balance to an IRA to take advantage of investment options not available under the plan, it will not constitute investment advice with respect to plan assets.
- An advisor who recommends that a participant withdraw assets from a plan and invest them in an IRA does not engage in a prohibited transaction by receiving IRA-related management or other investment fees if he is not otherwise a plan fiduciary.

The DOL's conflict of interest rule, superseded Advisory Opinion 2005-23A.

Advisory Opinion 2003-02A

The DOL issued Advisory Opinion 2003-02A, allowing financial organizations serving in a trust capacity to a retirement plan to offer overdraft protection (in essence, extension of credit) to the plan if an event, such as delayed settlement of securities transactions, would otherwise result in account overdrafts. Without appropriate exemption, such an act could be considered a prohibited transaction because it could constitute providing an impermissible service to the plan by a disqualified person.

IRA Incentives

Clients accepting cash or gifts as an incentive to open IRAs or make IRA contributions have been perceived as performing a prohibited transaction. Over time, three different methods for providing cash or gifts as an incentive have emerged.

- Direct payment to the IRA owner
- Direct deposit into the IRA as earnings or dividends
- Direct deposit into the IRA as a regular contribution

The following discussion addresses the regulatory guidance supporting these various methods.

The $10/$20 Exemption

The $10/$20 exemption (PTE 93-1) is a retroactive prohibited transaction exemption effective January 1, 1975. The prohibited transaction exemption states that an individual (or her family members as beneficiaries of the IRA) will not be subject to prohibited transaction penalties for receiving a premium in conjunction with establishing the IRA or making an IRA contribution provided that

- the IRA is established only to benefit the individual (including his spouse and beneficiaries);
- the cash or property or other consideration is given only in conjunction with opening or contributing to an IRA (including a transfer); and
- during any taxable year, the fair market value of the cash or property or other consideration does not exceed $10 for deposits to the IRA of less than $5,000 and $20 for deposits to the IRA of $5,000 or more.

Private Letter Ruling 201317017

In PLR 201317017, issued February 1, 2013, the IRS addressed whether incentives paid under an IRA Bonus Plan gave rise to information reporting requirements under IRC Sec. 6041 (Form 1099-MISC, *Miscellaneous Income*), IRC Sec. 6042 (Form 1099-DIV, *Dividends and Distributions*), IRC Sec. 6049 (Form 1099-INT, *Interest Income*) or any other information reporting requirements of the code.

IRS Form 1099-MISC

IRC Sec. 6041 generally requires all persons engaged in a trade or business and making certain specified payments of $600 or more in the course of such trade or business to any other person during the calendar year to

- make and file an information return (Form 1099-MISC) with the IRS for each calendar year in which they make such payments, and
- provide a copy of the information return to that person.

Treasury Regulation (Treas. Reg.) 1.6041-1(a)(1)(ii) provides that payments reportable under that section do not include payments of amounts with respect to which an information return is required by, or may be required under authority of IRC Secs. 6042 or 6049.

IRS Form 1099-DIV

IRC Sec. 6042 generally requires all persons making payments of dividends aggregating $10 or more to any other person during the calendar year to

- make and file an information return (Form 1099-DIV) with the IRS for each calendar year in which they make such payments, and
- provide a copy of the information return to that person.

IRC Sec. 6042(b)(2)(B) carves out from the term "dividends" such distributions and payments made to a person described in IRC Sec. 6049(b)(4), unless otherwise provided in regulations.

Treas. Reg. 1.6042-1(b)(1)(vii) excludes from the term "dividend" any amount paid or credited to any person described in Treas. Reg. 1.6049-4(c)(1)(ii), unless certain circumstances occur.

IRS Form 1099-INT

IRC Sec. 6049 generally requires all persons who make payments of interest aggregating $10 or more to any other person during the calendar year to

- make and file an information return (Form 1099-INT) with the IRS for each calendar year in which they make such payments, and
- provide a copy of the information return to that person.

IRC Sec. 6049(b)(2)(B) provides that except to the extent otherwise provided in regulations, any amount paid to a person described in IRC Sec. 6049(b)(4) is excepted from reporting. Individual retirement plans are included as "persons" described in IRC Sec. 6049(b)(4), and the regulations contain no provision providing otherwise. In addition, the regulations provide that an individual retirement plan, as defined in IRC Sec. 7701(a)(37), is an exempt recipient. (See IRC Sec. 6049(b)(4)(B) and Treas. Reg. 1.6049-4(c)(1)(ii)(C)).

Because the incentive payment under the IRA Bonus Plan was characterized as interest or other earnings (e.g., a dividend) paid on an IRA, the payments were not subject to the information reporting requirements of IRC Secs. 6041, 6042, 6049, or any other information reporting requirements.

NOTE: *A PLR may be relied upon only by the person (or persons) requesting the ruling.*

Advisory Opinion 2004-09A

Advisory Opinion 2004-09A declared it permissible for a financial organization to provide an incentive credit (contribution) to an individual's HSA. The DOL based its ruling, in part, on both statute and IRS Notice 2004-50, which allow any individual to make a contribution to another individual's HSA.

Advisory Opinion 2004-09A addresses two specific scenarios: 1) an insurance company offers high deductible health plan (HDHP) products and provides HSAs directly to HDHP participants; and 2) a company offers HDHP products that are marketed through partners or client organizations (described as a bank), and the HSAs are provided through the partner or client organization.

Under both scenarios, $100 cash incentives would be contributed directly to the HSAs. The DOL ruled that such cash contributions would not constitute the transfer of a plan asset for the benefit of a disqualified person, nor would it be an act of self-dealing on the part of any parties to the transaction.

Industry Trends

Financial organizations are increasingly providing cash incentives for depositing IRA assets. Most offers require that the assets remain at the financial organization for a minimum amount of time. Here are some examples of incentives provided by financial organizations.

- Tiered cash incentives characterized as interest or dividends based on the amount of assets deposited.
  - $100 for at least $25,000 of qualifying deposits
  - $150 for at least $50,000 of qualifying deposits
  - $200 for at least $100,000 of qualifying deposits
  - $600 for at least $200,000 of qualifying deposits
- Reimbursement of transfer fees (up to a maximum amount) charged by another financial organization when the client transfers an account with a value above a certain amount.
- Current-year cash contributions. Financial organizations typically will not make the bonus contribution if the bonus could lead to an excess contribution. For example, a financial organization may limit the bonus if
  - clients have already met the annual contribution limit or will exceed the limit with the bonus contributions, or
  - Traditional IRA clients are age 70½ or older during the contribution year.