WHEN CAN AN IRA OR QUALIFIED PLAN INVEST IN A CLOSELY HELD BUSINESS?

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Synopsis: This article explores the various issues that can arise when a qualified plan or IRA invests in a closely held business, issues primarily involving the prohibited transaction and the Plan Asset Rules, and the consequences of violating them.

ARTICLE 1 INTRODUCTION

This article is a detailed analysis of the effects of investments in a closely held business by a retirement plan or IRA. The Plan Asset Rules, listed transaction issues, qualified plans that invest in qualifying employer securities and illustrative cases, opinion letters, and letter rulings are discussed. For the more casual reader, the information is summarized in the "Introduction" in Part I and "Preliminary Observations" in Part II of this Article. These anticipate most of what is discussed in detail in the Parts that follow.

SECTION 1.1 SCOPE OF ARTICLE

One example (one of many) covered in this article--an example illustrating that in this area little is as it first appears--is as follows: Everyone who provides services to an Individual Retirement Plan or a qualified plan is a disqualified person, *per se*. Providing services to an Individual Retirement Plan or a qualified plan is a prohibited transaction, *per se*. Therefore, even in this most common fact pattern, one must look to the exceptions to the prohibited transaction rules. Next one must look to the exceptions to the exceptions; and, yes, even in the example just given, there are exceptions to the exceptions. And the story does not necessarily end even there. At some point the skein can get tangled beyond extrication.

This article explores the circumstances in which a qualified plan or individual retirement account ("IRA"), particularly the latter, can invest in a closely held business, and the possible consequences of doing so. The issues arise frequently in the estate planning context because taxpayers with large rollover IRAs and a lot of business acumen often desire to use their business (as opposed to their investment) skills to maximize their retirement savings. In today's business climate, more and more people are searching for nontraditional investments because of the relatively low returns on publicly traded stocks and bonds. These taxpayers would like their IRAs to own some sort of interest in a business entity, or a real estate development company, or perhaps to cause their qualified plans to own stock in a closely held business (which business may be the plan sponsor, as in an ESOP, stock bonus plan, or any other individual account plan such as a normal profit sharing plan). These business entities, especially FLPs or LLCs, have become very familiar to most estate planners of late, and planning for them is part of "what we do." Moreover, pension lawyers have comparatively little to do with IRAs. Perhaps by default, questions about IRAs seem to cross the estate planner's door with greater frequency than any other class of lawyers. *Please note that this paper does not advocate the use of the techniques explored in it.* It is suggested that it is better to defend a situation where an IRA forms a business entity and is then challenged than to assist in implementing such an arrangement. There are enough of these plans already in place in which detailed knowledge of the law, even if undertaken after the issue is under examination, may prove very useful to know. This paper is intended to provide a detailed dissection of law on the subject, nothing more.

SECTION 1.2 ABBREVIATIONS

This article uses a number of abbreviations. "IRA" means an Individual Retirement Plan. A "SEP" is a Simplified Retirement Plan, described in IRC § 408(k), (A SEP is required to be funded solely by making employer contributions to the IRAs of the participants). "QP" means Qualified Plan. "QRP," "Qualified Retirement Plan," or "Plan" refers to either a QP or an IRA or both. "PT" means a prohibited transaction under IRC[1] § 4975(c)[2] or ERISA[3] § 404 or § 406, collectively sometimes referred to in this article as the "PT Rules." "DQP" means either a disqualified person as defined in IRC § 4975(e)(2) or a party in interest as defined under ERISA § 3(14).[4] "IRA Owner" means the individual who establishes the IRA. The term "IRA sponsor" does not refer to the IRA Owner, but refers instead to the custodian or trustee of the IRA. "Participant" means the IRA Owner or a Participant in a QP. The "DOL" means the Department of Labor. A prohibited transaction exemption (PTE) sometimes refers to either a PTE granted to a class (CPTE), or to a person (IPTE). ERISA allows the DOL to issue both types of exemptions. "PLR" means an IRS Private Letter Ruling. "Notice" means an IRS Notice. The "IRS" or "Service" means the Internal Revenue Service.

SECTION 1.3 ISSUES PRESENT WHENEVER ANYTHING OTHER THAN PUBLICLY-TRADED SECURITIES IS HELD BY AN INDIVIDUAL RETIREMENT ACCOUNT OR QUALIFIED PLAN

If a QRP is going to invest in anything other than publicly-traded securities or other traditional investments, a fiduciary must address a succession of questions. In the case of an IRA, one must locate an IRA sponsor[5] who will allow nontraditional investments. Assuming the IRA sponsor or QP trustee is willing, the most important question is (1) whether or not the acquisition itself will result in a prohibited

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[1] All references herein to the "IRC" or "I.R.C.", are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[2] I.R.C. § 4975 contains over 8000 words and is very convoluted.

[3] Employment Retirement Income Security Act (ERISA) of 1974 § 404, 406; 29 U.S.C. § 1001 (2006), et seq., as amended [hereinafter ERISA]. Most ERISA lawyers refer to the section of ERISA where the cite is found; however, there is also a U.S.C. cite, which leads to a lot of confusion at times. Therefore, only the ERISA citations will be used herein unless otherwise specified. A cross reference between ERISA sections and U.S.C. sections is available at *ERISA in the United States Code*, BENEFITSLINK.COM, http://benefitslink.com/erisa/crossreference.html (last visited Feb. 29, 2012).

[4] 29 U.S.C. § 1002.

[5] An IRA can either be a trust or a custodial arrangement. In either case the sponsor (i.e., the trustee or custodian) must be a "bank" "or such other person who demonstrates to the satisfaction of the Secretary that the manner in which such other person will administer the trust will be consistent with the requirements of this section." I.R.C. § 408(a)(2). Practically speaking, it is rare for the Secretary to be satisfied with non-bank sponsors. However, bank is somewhat broadly defined under I.R.C. § 408(a)(2) as follows:

> (n) Bank. For purposes of subsection (a)(2), the term "bank" means—
>
> > (1) any bank (as defined in section 581),
> >
> > (2) an insured credit union (within the meaning of paragraph (6) or (7) of section 101 of the Federal Credit Union Act), and
> >
> > (3) a corporation which, under the laws of the State of its incorporation, is subject to supervision and examination by the Commissioner of Banking or other officer of such State in charge of the administration of the banking laws of such State.

transaction (PT) under the IRC, ERISA, or both. If not, the next question is (2) whether it is likely or possible that a PT will occur after the acquisition. In order to know whether a PT is even possible, (3) one has to be able to identify the DQPs. The class of DQPs extends beyond the obvious and includes certain, but not all, relatives of a DQP and certain, but not all, businesses in which any of them has an interest. (4) Even if there is an apparent PT, one must know whether or not there is an applicable exemption. (5) Also, one must ask if there is a conflict of interest inherent in the transaction, including anything about the transaction that might affect the independent judgment of the fiduciary; because, if there is, otherwise applicable statutory exemptions may not apply (as a result of DOL or IRS pronouncement by fiat[6]). (6) One must always ask whether the income generated by the investment is unrelated business taxable income ("UBTI"). If it is, one of the primary advantages of an IRA or QP, tax deferred income, will be lost. UBTI issues are beyond the scope of this article. (7) In asking whether or not a PT is involved, one must additionally be mindful of the Plan Asset Rules, addressed in detail in Part VII. The Plan Asset Rules are all too often overlooked. They require that the underlying assets of an entity in which a QRP has a substantial equity interest be treated as if the entity did not exist, i.e., as if the IRA or QP owned the assets of the entity rather than owning the entity, at least for some purposes, such as determining whether the fiduciaries of the entity are treated as fiduciaries of the Plan, and, importantly, whether there have been transactions with the Plan that violate the PT rules as a result of such treatment. There are important exceptions to the Plan Asset Rules that will often apply; but, be forewarned, the exceptions require close study.

This article primarily concerns situations where a fiduciary or other DQP (including a relative of a DQP who is a DQP by virtue of such relationship) (a) has an ownership interest in the business, and (b) provides services to the business (i) with or (ii) without compensation.[7] The second concern addressed, which is really a subset of the first, is where a profit sharing plan (or other "individual account plan") invests in employer stock, which, just exactly like an ESOP, it is permitted to do by statute, but which, upon close examination, only gets statutory protection against the application of the diversification requirements and *some*, but not all, of the self-dealing rules. Obvious acts of self-dealing, such as the purchase or sale of assets by a QRP and a DQP are usually so clear that the article devotes little attention to these PTs, other than briefly to describe where these rules are found.

SECTION 1.4 A CIRCULAR ISSUE TO UNDERSTAND BEFORE TRYING TO COMPREHEND ANYTHING ELSE ABOUT THIS AREA

A "service provider" is a DQP.[8] A DQP who provides "services" to a QRP, is committing a PT,[9] absent an exemption.[10] Taken together, these two rules are broad and circular in operation. Therefore it is critical

[6] This is probably true of ERISA plans, and the IRS steadfastly maintains that it is also true of IRAs, though it has no statutory basis for doing so in the case of non-ERISA IRAs, and only a questionable basis in the case of ERISA plans. *See infra* Parts V.E & IX.C.

[7] Here is an important peek at a subject covered *infra* in Part VI.F. *See* Treas. Reg. § 54.4975-6(a)(5)(iii):

> (iii) Services without compensation. If a fiduciary provides services to a plan without the receipt of compensation or other consideration (other than reimbursement of direct expenses properly and actually incurred in the performance of such services within the meaning of paragraph (e)(4) of this section), the provision of such services does not, in and of itself, constitute an act described in section 4975(c)(1)(E) or (F). The allowance of a deduction to an employer under section 162 or 212 for the expense incurred in furnishing office space or services to a plan established or maintained by such employer does not constitute compensation or other consideration.

[8] I.R.C. § 4975(e)(2)(B).

[9] I.R.C. § 4975(c)(1)(C).

to understand the exemptions from the PT rules. The IRC § 4975(d)(2) exemption for reasonable compensation paid in connection with the operation of the QRP would appear to be the most common way out of the circular service provider problem, if it applies and **if no goods are being provided** the plan by the service provider.[11]

SECTION 1.5 INTERNAL REVENUE SERVICE AND DEPARTMENT OF LABOR MAINTAIN THAT THE EXEMPTIONS GENERALLY DO NOT APPLY TO CONFLICT OF INTEREST TRANSACTIONS, AT LEAST IF THE QRP IS SUBJECT TO ERISA, DESPITE THE ABSENCE OF SUCH A RULE IN THE INTERNAL REVENUE CODE

The IRS and DOL both agree that the exemptions do not apply to the *fuzzy* transactions,[12] so-called and described below, which they consider to be essentially conflict of interest transactions between a fiduciary and anyone else. ERISA § 404(a)(1) requires that a fiduciary always act "solely in the interest of the participants and beneficiaries."[13] This could serve as a basis for the DOL's position that if there is a conflict of interest affecting a fiduciary's judgment (arguably prohibited by the "solely in the interest" rule in § 404), then the statutory exemptions found in ERISA § 408, exempting transactions otherwise prohibited by § 406, do not control. This is a stretch. In this connection it is worth noting that virtually all of the Class Prohibited Transaction Exemptions (CPTEs or simply PTEs) explicitly do not cover ERISA § 404 violations.

There is no counterpart in the IRC to the fiduciary standards set forth in ERISA § 404, including the "*solely* in the interest" rule, nor is there an IRC counterpart to ERISA § 406(b)(2), which prohibits a fiduciary who is acting "in his individual or in any other capacity" from acting "in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan

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[10] *Id.*; I.R.C. § 4975(e)(2)(B).

[11] The exemption in I.R.C. § 4975(d)(1) is probably why a CPTE is necessary when the plan obtains securities from a broker-dealer. *See* CPTE 75-1, 40 Fed. Reg. 50845.

I.R.C. § 4875(d) provides, in pertinent part:

> Exemptions. Except as provided in subsection (f)(6), the prohibitions provided in subsection (c) shall not apply to—
>
> > (2) any *contract*, or reasonable arrangement, made with a disqualified person for office space, or *legal, accounting,* or other services necessary for the establishment or operation of the plan, *if no more than reasonable compensation is paid* therefor;
> >
> > * * * *
> >
> > (10) receipt by a disqualified person of any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan, but no person so serving who already receives full-time pay from an employer or an association of employers, whose employees are participants in the plan or from an employee organization whose members are participants in such plan shall receive compensation from such fund, except for reimbursement of expenses properly and actually incurred;

I.R.C. § 4975 (d)(2), (10) (emphasis added).

[12] I.R.C. § 4975(c)(1)(D)-(F).

[13] ERISA § 404(a)(1), which has no I.R.C. counterpart reads in part:

> "[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries . . ."

or the interests of its participants or beneficiaries." The lack of an IRC counterpart to these ERISA rules is an inconvenient fact that the IRS often chooses to ignore. Applying ambiguous[14] ERISA notions to non-ERISA plans is a double stretch. An IRA is almost never subject to ERISA.[15] The exemptions found in § 4975(d) begin with the statement "the prohibitions provided in subsection (c) shall not apply to . . . ." The IRS has consistently written (c)(1)(E) and (F) out of the coverage of § 4975(d) for reasons of its own. With only the slightest of additional authority, the IRS and DOL do the same with the language found in ERISA § 408(b), which begins with "[t]he prohibitions provided in section 406 [29 U.S.C. § 1106] shall not apply to any of the following transactions." Yet, the Eighth Circuit has called the IRS's bluff. "We reject plaintiffs' reading of the *ambiguous regulation because it conflicts with an unambiguous statute*."[16] This is critical, and so this article will tend to harp on it. The reasons for the difference, and the fact there is one, is well stated in Conference Report 93-1280 for ERISA:

> [T]he labor provisions (but not the tax provisions) prohibit a fiduciary from acting in any transaction involving the plan on behalf of a person (or representing a party) whose interests are adverse to the interests of the plan or of its participants or beneficiaries. This prevents a fiduciary from being put in a position where he has dual loyalties, and, therefore, he cannot act exclusively for the benefit of a plan's participants and beneficiaries. *(This prohibition is not included in the tax provisions, because of the difficulty in determining an appropriate measure for an excise tax.)*[17]

ARTICLE 2 SOME PRELIMINARY OBSERVATIONS AND CONCLUSIONS

The topic of this article and all of its ramifications are so complex that it may be helpful to provide some overall conclusions before delving deeply into the details. The following conclusions are grossly over-simplified, and the reader is encouraged to carefully examine the many complexities addressed in the article before embarking to invest IRA or QP assets in a closely held business.

SECTION 2.1 IS AN IRA OWNER ALWAYS A DISQUALIFIED PERSON?

It is probably safe to assume that an IRA Owner is always a fiduciary,[18] and, hence, always a DQP.[19] The statute does not say this in so many words, so it may be possible to argue otherwise as a "litigation position." [20]

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[14] By ambiguous, it is meant that it is not at all clear, even under ERISA, that the ERISA exceptions specified in ERISA § 408 do not apply if there is a conflict of interest.

[15] There are exceptions to this generalization, discussed *infra* in Part V.F.

[16] Harley v. Minn. Mining and Mfg. Co., 284 F.3d 901, 908-909 (8th Cir. 2002). This case is discussed *infra* in Parts II.K and VI.D.

[17] H.R. REP. NO. 93-1280, 4576 (1974) (Conf. Rep), *reprinted in* 1974 U.S.C.C.A.N. 5038 (emphasis added).

[18] For a contrary view, see Andrew J. Willms, *Purchasing Insurance Inside a Qualified Plan*, http://www.willmslaw.com/epDepthArticles/article41.htm (last visited Feb. 29, 2012). For a comprehensive view of both sides of the argument. *See* Natalie Choate, *Prohibited Transactions, UBTI and IRAs* (unpublished seminar outline, on file with author).

[19] *See* PLR 8849001(Dec. 9, 1988); *but see* PLR 9725029 (June 20, 1997).

[20] I.R.C. § 4975(e)(3) defines a fiduciary as

> any person who—

SECTION 2.2 A DISQUALIFIED PERSON CAN FORM A BUSINESS WITH A QUALIFIED RETIREMENT PLAN WITHOUT NECESSARILY VIOLATING THE PROHIBITED TRANSACTION RULES

The cases,[21] DOL opinions, PLRs, and Notices have repeatedly intimated, and have often actually held, that it is not necessarily a PT for a QRP to form a business entity jointly with DQPs who will have a controlling interest. This might seem somewhat surprising. The operative phrase, however, is "not necessarily." After the entity has been formed, there is a mine field left in the wake.

SECTION 2.3 DIFFERENT RULES FOR QUALIFIED RETIREMENT PLANS SUBJECT TO ERISA AND THOSE THAT ARE NOT

There are slightly different rules for QRPs not subject to ERISA, which include 99.999% of all IRAs (unless SEPs are subject to ERISA, which is a very interesting question[22]), and for QRPs subject to ERISA, which would include most QPs except those covering only owners and their spouses. These differences, though seemingly slight, can sometimes prove dramatic.

SECTION 2.4 PER SE AND FUZZY PROHIBITED TRANSACTIONS

There are per se PTs, found in IRC § 4975(c)(1)(A)-(D). These PTs require a QRP and a DQP to be on both sides of the transaction. They all involve the transfer or leasing of goods between a QRP and a DQP, the lending of money, an extension of credit, or the furnishing of goods, services or facilities between a QRP

> > (A) exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,
> >
> > (B) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or
> >
> > (C) has any discretionary authority or discretionary responsibility in the administration of such plan.
>
> Such term includes any person designated under section 405(c)(1)(B) of the Employee Retirement Income Security Act of 1974.

The statute just quoted could have said, easily enough, that an IRA Owner is always a fiduciary. But it did not.

I.R.C.§ 408(e)(2)(A) provides, with a trace of ambiguity:

> In general. If, during any taxable year of the individual for whose benefit any individual retirement account is established, that individual or his beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such account ceases to be an individual retirement account as of the first day of such taxable year.

In order for the IRA Owner or beneficiary to engage in a PT, the person must be a DQP, so this is some authority for the notion that an IRA Owner or beneficiary must be a DQP, and being a fiduciary would be the easiest way to fit that category.

[21] *Cf.* Ohsman v. Comm'r, 101 T.C.M (CCH) 1471 (2011); Hellweg v. Comm'r, 101 T.C.M. (CCH) 1261 (2011). These recent cases are discussed *infra* in Part II.I.

[22] *See* Lampkins v. Golden, 28 F. App'x 409, 412-13 (6th Cir. 2002), where a SEP-IRA was held to be subject to ERISA, and therefore a state law exemption for IRAs did not apply. But see also In re Vickers, Thomas Earle, (2009, Bktcy Ct TN) 408 BR 131, where state law did exempt a SEP-IRA in bankruptcy. Lampkins is somewhat controversial, and the facts were hard. In accord with Lampkins is In re John E. Diguilio, Debtor., 303 BR 144, 12/04/2003, United States Bankruptcy Court, N.D. Ohio, Eastern Division. Contra, In re Dantone, 167 BR 67, 1993 WL 657277, 07/15/1993, United States Bankruptcy Court, N.D. Mississippi; and LaBarge v. Mehra, 166 BR 393, 01/25/1994, U.S. Bankruptcy Court, E.D. Missouri, E.D.

and a DQP. The *per se* violations are for the most part fairly obvious and straight-forward. *IRC § 4975(c)(1)(D) is a special case. Part of it is fuzzy and part clearly falls within the per se category:*

> (D) transfer to, or *use by or for the benefit of*, a disqualified person of the income or assets of a plan.[23]

The part of IRC § 4975(c)(1)(D) prohibiting a transfer by a QRP to a DQP is a *per* se PT. The part of the statute prohibiting the use of plan assets "by or for the benefit of" a DQP is a *fuzzy* PT.

IRC § 4975(c)(1)(E)-(F) are *fuzzy* PTs. They require that a "fiduciary" somehow personally benefit from a transaction in which plan assets are somehow involved. Note that (E) and (F) do not apply to a DQP who is not a fiduciary! The *fuzzy* part of IRC § 4975(c)(1)(D) is violated if plan assets are "use[d] by or for the benefit of" a DQP (whether or not the DQP is a fiduciary).

Violations of the *fuzzy* PTs are almost always an issue if plan assets and a fiduciary individually cross paths in a manner that does not rise to the level of obvious self-dealing. Often, both a QRP and a fiduciary benefit from a transaction, but there is no direct self-dealing *per se*. Sometimes the best a lawyer can do is to hazard a guess about whether there has been a PT or not. A reasonable opinion in this area requires a very nuanced analysis of the cases and other authorities, authorities that often are of little benefit because they are highly fact determinative, and, sometimes, just arbitrary. Is the benefit incidental? If so, how incidental? Is intent relevant? These are not questions amenable to opinions upon which reliance can be firmly placed.

SECTION 2.5 EXEMPTIONS FROM THE PROHIBITED TRANSACTION RULES

There are exemptions found in IRC § 4975(d) from some of the PT Rules found in IRC § 4975(c): exemptions that the statute says apply to both *fuzzy* and *per se* PTs, but which the Service says apply only to the *per se* PTs. It appears that this position is without any authority, *other than perhaps the Treasury's own regulations*(!),[24] which in this case may actually be open to challenge, and which are only rarely set aside by the courts. This is one case where a challenge could be successful. Regulations that are clearly inconsistent with or contrary to the plain meaning of a statute are occasionally held to be invalid.[25] Much more attention is given later in this article to the question of whether the exceptions

[23] I.R.C. § 4975(c)(1)(D) (emphasis added).

[24] Treas. Reg. § 54. 4975-6(a)(1).

[25] Granquist v. Hackleman, 264 F.2d 9 (9th Cir. 1959) *citing* Miller v. United States, 294 U.S. 435 (1935); Manhattan Gen. Equip. v. Comm'r, 297 U.S. 129 (1936); Helvering v. Safe Deposit & Trust Co. of Baltimore, 95 F.2d 806 (4th Cir. 1938); Kaufman v. United States, 131 F.2d 854 (4th Cir. 1942); Traders Nat'l Bank of Kan. City v. United States, 148 F. Supp. 278 (Mo. D.C. 1956); *aff'd,* 248 F.2d 667 (8th Cir. 1957); Scofield v. Lewis, 251 F.2d 128 (5th Cir. 1958). *See also* Nat'l Muffler Dealers Ass'n v. United States, 440 U.S. 472, 477 (1979), Comm'r v. Engle, 464 U.S. 206, 224 (1984); Chevron, USA, Inc. v. Natural Res. Def. Council, 467 U.S. 837, 842–843 (1984). But note that *National Muffler* appears to have been overruled, in effect, by the recent case of *Mayo Foundation for Medical Education & Research, et al v. United States*, 131 S. Ct. 704 (2011), *aff'g,* 568 F.3d 675 (8th Cir. 2009), *rev'g* & *rem'd,* Regents of the Univ. of Minn. v. United States, 2008 WL 906799 (D.C. Minn. 2008). In *Mayo*, the taxpayer's reliance on *National Muffler* was unsuccessful and the IRS's reliance on *Chevron* prevailed. A detailed discussion of the standard of judicial review of IRS regulations is beyond the scope of this article, but the reader is encouraged to read *Mayo* for a thorough discussion of the issues and the Supreme Court's latest pronouncements on the subject. It appears that the standard in *Chevron*, and not *National Muffler*, is now the exclusive test. This means that if a statute is silent or ambiguous, a regulation will apparently be upheld under any permissible construction of the statute. *Mayo,* 131 S. Ct. at 706. Just what is a "permissible construction of the statute" is not entirely clear. Also, the time-worn distinction between interpretive and legislative regulations appears to have worn away entirely.

from the exemptions are limited to the *per se* PTs found in IRC § 4975(c)(1)(A)-(D),[26] and whether the *fuzzy* PTs found in IRC § 4975(c)(1)(D)-(F) can be interpreted as extending to any conflict of interest.

SECTION 2.6 EXCEPTIONS FROM THE EXEMPTIONS

A further complicating factor is that there are exceptions in IRC § 4975(f)(6) from most of the exemptions found in IRC § 4975(d), i.e., exceptions from the exemptions from the prohibitions found in IRC § 4975(c). Yes, this is confusing. These exceptions from the exemptions from the PT rules apply to (1) a rare type of IRA[27] and (2) QPs covering owner-employees. A crucial question is whether conventional IRAs are excepted from certain of these exemptions. Under the statute, literally read, the twenty-three exemptions found in IRC §4975(d) apply to an ordinary IRA unless the IRA is part of a "trust described in section 401(a) which is part of a plan providing contributions or benefits for employees."[28] Though rare, there are IRAs subject to Title I of ERISA,[29] and some are part of a "trust described in section 401(a) which is part of a plan providing contributions or benefits for employees."[30]

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[26] I.R.C. § 4975(c)(1)(D) has a *per se* part and a *fuzzy* part, as pointed out in Part II.D, *supra.*

[27] As discussed *infra* in Part V.E, virtually all the treatise writers and other commentators believe that (f)(6) applies to all IRAs. RIA Pension Analysis 53,867.2; RIA's EGTRRA Summary, ¶607 New law; Bennett et al. / Taxation of Distributions From Qualified Plans (WG&L) 8.06[3][b]; Bittker & Lokken / Federal Taxation of Employee Compensation (WG&L) ¶3.17. Prohibited Transactions; Perdue / Qualified Pension and Profit Sharing Plans (WG&L) ¶3.12, Prohibited Transactions ¶ 3.12[9][a] Statutory Exemptions.

But that is not what the statute says. The IRS is apparently in agreement with the commentators, but, significantly has only said so in its Manual for examining agents:

> 4.72.11.2 — Identifying Prohibited Transactions
>
> *[Last Revised: 11-01-2010]*
>
> * * * *
>
> (3) The statutory exemptions under IRC 4975(d) (other than IRC 4975(d)(9) and (12)) do not apply to certain types of transactions involving owner-employees (as defined in IRC 401(c)(3)) and persons or entities deemed to be owner-employees. This provision, not applying certain statutory exemptions, can now be found in IRC 4975(f)(6). However, section 616 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) added a limited exception pertaining to loans, thereby making the statutory exemption under IRC 4975(d)(1) available to the extent described in IRC 4975(f)(6)(B)(iii). Generally, a prohibited transaction includes any direct or indirect acquisition of property for the plan or sale of plan property to a(n):
>
> a. Owner-employee.
>
> b. Participant or beneficiary of an individual retirement account or annuity.
>
> c. Shareholder-employee (as defined in IRC 4975(f)(6)(C)).
>
> d. Member of the family (as defined in IRC 267(c)(4)) of the owner-employee, etc.
>
> e. Corporation at least 50 percent of which is directly or indirectly controlled by a person mentioned in a., b. or c. Internal Revenue Manual 4.72.11.2(3).

[28] I.R.C. § 4975(f)(6).

[29] IRAs, or at least IRC § 408(a) IRAs (but not SEPs under 408(k)?), can definitely be subject to Title I of ERISA, although is indeed rare. Indeed, 29 C.F.R. § 2510.3-2(d)(1) provides,

> (1) For purposes of Title I of the Act and this chapter, the terms "employee pension benefit plan" and "pension plan" *shall not include an individual retirement account described in section 408(a)* of the Code, an individual retirement annuity described in section 408(b) of the Internal Revenue Code of 1954

The fact that there are IRAs sponsored by employers for the benefit of employees means that the exceptions found in IRC § 4975(f)(6) to the twenty-three exemptions found in IRC § 4975(d) for such IRAs are not meaningless. It just means that, contrary to the accepted (and uncritical) reading of the statute, normal IRAs, i.e. IRAs that are not part of a "trust described in section 401(a) which is part of a plan providing contributions or benefits for employees"[31] are not excepted from the exemptions.

SECTION 2.7 ATTRIBUTION OF OWNERSHIP

Certain businesses in which a DQP has an interest are DQPs by virtue of such interest (under attribution rules). The attribution rules can be a nightmare, but they are generally only of concern to the *per se* PTs. Problem areas include aggregation for the various fifty percent control tests, and whether interests held by DQPs under IRC § 4975(e)(2)(H) get aggregated up and down the corporate shareholder chain. Generally, once an entity becomes a DQP as a result of the fact that other DQPs control it, various owners, officers, directors, and so forth of the DQP become DQPs themselves. An "(H) DQP" is

> (H) an officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a ten percent or more shareholder, or a highly compensated employee (earning ten percent or more of the yearly wages of an employer) of a person described in

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(hereinafter "the Code") and an individual retirement bond described in section 409 of the Code, provided that—

> (i) No contributions are made by the employer or employee association;
>
> (ii) Participation is completely voluntary for employees or members;
>
> (iii) The sole involvement of the employer or employee organization is without endorsement to permit the sponsor to publicize the program to employees or members, to collect contributions through payroll deductions or dues checkoffs and to remit them to the sponsor; and
>
> (iv) The employer or employee organization receives no consideration in the form of cash or otherwise, other than reasonable compensation for services actually rendered in connection with payroll deductions or dues checkoffs.

This used to be a rarer event than it is today, with the advent of IRA-like plans established by employers, such as § 408(k) Simplified Employee Pensions and § 408(p) Simplified Retirement Accounts, and, importantly, § 408(q) Deemed IRAs under Qualified Employer Plans. Also, I.R.C. § 408(c) entitled "Accounts established by employers and certain associations of employees," recognized that there may be § 401(a) IRAs, and adds additional requirements for them. Whether the underlying plans are subject to ERISA is not always clear. Even if the plan is subject to ERISA because of substantial employer involvement, it is doubtful that an IRA receiving plan contributions is subject to ERISA.

[30] I.R.C. § 4975(f)(6). There is even an IRS form, Form 5306, entitled "Application for Approval of Prototype or Employer Sponsored Individual Retirement Arrangement (IRA)." So such IRAs do exist. Form 5306-A is the form for SEPs, which are sponsored by employers, but which, instead of having a trust, contributions are made to individual IRAs established by the employees. A SEP (i.e., the "plan" itself) might very well be subject to Title I of ERISA, but it is doubtful that an employee's IRA funded by the SEP is likewise subject to ERISA. Authority on this point is scarce. See Lampkins v. Golden, 28 F. App'x 409, 412-13 (6th Cir. 2002), where a SEP-IRA was held to be subject to ERISA, and therefore a state law exemption for IRAs did not apply. But see also In re Vickers, Thomas Earle, (2009, Bktcy Ct TN) 408 BR 131, where state law did exempt a SEP-IRA in bankruptcy. Lampkins is somewhat controversial, and the facts were hard. In accord with Lampkins is In re John E. Diguilio, Debtor., 303 BR 144, 12/04/2003, United States Bankruptcy Court, N.D. Ohio, Eastern Division. Contra, In re Dantone, 167 BR 67, 1993 WL 657277, 07/15/1993, United States Bankruptcy Court, N.D. Mississippi; and LaBarge v. Mehra, 166 BR 393, 01/25/1994, U.S. Bankruptcy Court, E.D. Missouri, E.D.

[31] I.R.C. § 4975(f)(6).

> subparagraph (C), (D), (E), or (G) [for example, of a closely held business that is itself a disqualified person].[32]

This issue arose, but was not thoroughly explored, in a 2006 ERISA opinion letter.[33] Family attribution was also an issue, though again not discussed as thoroughly as would be preferred, in a 2000 ERISA Opinion Letter[34] in which the DOL approved an exasperatingly complicated transaction, which culminated, after a series of reorganizations and acquisitions, with a corporation jointly owned and controlled by the IRA Owner, his family, and his IRA. Not surprising, given the context, the manager of the corporation was Bernard L. Madoff Investment Securities.

SECTION 2.8 THE PLAN ASSET RULES

In many cases anyone who is a fiduciary of a business in which a QRP has an interest will also be a fiduciary of the QRP under the Plan Asset Rules, which can make it very easy to unwittingly violate a PT Rule, even where the fiduciary of the business has no other connection to the QRP. This would make most transactions between the fiduciary of the business and the assets of the business--including getting paid by the business, perhaps--a violation of the PT Rules. State law prohibits most self-dealing transactions between a business and its officers and directors anyway, but the penalty might not be so harsh, and the organizational and operating documents commonly limit state law to allow some self-dealing under certain conditions. If the Plan Asset Rules apply, state law is irrelevant, as are exemptions under it. Note that on close analysis, it appears that the Plan Asset Rules are particularly focused on investment companies, such that it would be appropriate to ignore the corporate shell, since these companies may be making investments similar to the investments the QRP would normally make. Hence, there is a big exception for operating companies, “companies that [are] primarily engaged . . .in the production or sale of a product or service other than the investment of capital.”[35] It is quite possible that a company would not be a DQP, for example, because DQPs did not have more than 50% control, and yet, because employee plans own more than 25% of the business the assets of the business are treated as assets of the plan for purposes of the PT rules, the same as if the business itself were a DQP.

SECTION 2.9 NOTICE 2004-8 AND ROTH IRAS AND LISTED TRANSACTIONS

If the QRP is a Roth IRA, Notice 2004-8[36] is critically important. This notice is examined at length in Part XIII, but because it is so very important, it is previewed in these preliminary comments. The entire

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[32] I.R.C. § 4975(e)(2)(H).

[33] ERISA Op. Letter 2006-01A (Jan. 6, 2006), addressed *infra* in Part X.E.

[34] ERISA Op. Letter 2000-10A (July 27, 2000), which is discussed *infra* in Part X.B.

[35] 29 C.F.R. § 2510.3-101(c).

[36] Notice 2004-8, 2004-4 I.R.B. 333; *cf.,* U.S. v. Kaiser, 609 F.3d 556 (2nd Cir. 2010) (Department of Justice is seeking to enjoin an attorney from promoting the type of transactions described as abusive in Notice 2004-8). *See also* I.R.S. Chief Counsel Advice 200929005 (July 17, 2009); I.R.S. Chief Counsel Advice 200917030 (Apr. 24, 2009). However, in the recent cases of *Ohsman v. Comm'r,* T.C. Memo. 2011-98 and *Hellweg v. Comm'r*, T.C. Memo. 2011-58, the Tax Court sided with the taxpayers in two cases involving Roth IRAs that seemed to involve a clear transaction between a DQP and a Roth.

In *Hellweg*, for example, a case involving the application of Notice 2004-8 among other things, the Roth IRAs of four related taxpayers “each subscribed to 25 percent of the previously unissued stock of ADF International.” Hellweg v. Comm'r, T.C. Memo. 2011-58 at *2. This appears to mean that they formed ADF International, each owning 25% of it. Each of the Roth IRAs then formed separate C-corporations and contributed the stock of ADF International to them. ADF International was a domestic international sales corporation (DISC). The four taxpayers and 11 other individuals--all 15 being “related,” according to the opinion--owned an S-

Notice is highly recommended reading. It raises, without a particularly penetrating analysis, a number of the issues considered herein, issues that can all too easily arise in a transaction of this nature. The Owner of a Roth IRA that invests in a business in which the Roth IRA Owner has an interest most likely has to report this under IRC § 6011 as a "listed transaction," which is quite undesirable. Although the Notice only involves Roth IRAs, the principles presumably would apply to all QRPs, even though they are not "listed." The Notice expresses concern about transactions for less than full fair market value involving a business owner, Roth IRA, and a corporation owned by the IRA and lists various examples of such transactions.[37]

The examples given illustrate nothing unusual, because all transactions between an IRA and anybody would have to be for fair market value. That is a given, and even that is ordinarily no defense. If the scope of the Notice were limited to transactions similar to those about which the concern is expressed—transactions probably fraudulent in and of themselves no matter what the form of the QRP—the Notice would not be noteworthy. But the transactions added to the IRA index *prohibitorum* of "listed transactions" are apparently not limited to the examples cited as being the ones of concern.[38]

Corporation, ADF (not International). *ADF paid commissions to ADF International* on ADF's qualified export sales, which were then passed through to the four C-corporations owned by the Roths. This case is discussed in detail *infra* in Part IX.G. Note for now that Judge Sims found Notice 2004-8 inapplicable. For some reason the IRS did not allege that there was a PT, but instead recognized the income characterization for income tax purposes, but attempted to reallocate it for excise tax purposes. The court said the IRS could not do this, and found in favor of the taxpayers on summary judgment. *Id.* at *12.

[37] In general, these transactions involve the following parties: (1) an individual (the Taxpayer) who owns a pre-existing business such as a corporation or a sole proprietorship (the Business), (2) a Roth IRA within the meaning of §408A that is maintained for the Taxpayer, and (3) a corporation (the Roth IRA Corporation), substantially all the shares of which are owned or acquired by the Roth IRA. The Business and the Roth IRA Corporation enter into transactions as described below. The acquisition of shares, the transactions or both are *not fairly valued* and thus have the effect of shifting value into the Roth IRA.

> Examples include transactions in which the Roth IRA Corporation acquires property, such as accounts receivable, from the Business *for less than fair market value*, contributions of property, including intangible property, by a person other than the Roth IRA, without a commensurate receipt of stock ownership, or any other arrangement between the Roth IRA Corporation and the Taxpayer, a related party described in § 267(b) or 707(b), or the Business that has the effect of transferring value to the Roth IRA Corporation comparable to a contribution to the Roth IRA.

Notice 2004-8, 2004-4 I.R.B. 333 (emphasis added).

The Notice refers to various transactions including accounts receivable. Interestingly, there is class exemption, CPTE 85-68, 50 Fed. Reg. 13293, allowing QRPs to purchase customer notes received by the employer of the plan in the ordinary course of business, and for the employer to repurchase them from the plan. This is sort of surprising. However, unlike the example in Notice 2004-8 involving accounts receivable, the PTE contains a number of safeguards, one of which is that the fiduciary must be independent.

[38] Notice 2004-8 includes the following in its *prohibitorum* of "listed transactions:"

> arrangements in which an individual, related persons described in § 267(b) or 707(b), or a business controlled by such individual or related persons, engage in one or more transactions with a corporation, including contributions of property to such corporation, substantially all the shares of which are owned by one or more Roth IRAs maintained for the benefit of the individual, related persons described in § 267(b)(1), or both. The transactions are listed transactions with respect to the individuals for whom the Roth IRAs are maintained, the business (if not a sole proprietorship) that is a party to the transaction, and the corporation substantially all the shares of which are owned by the Roth IRAs. Independent of their

SECTION 2.10 THE IRS POSITION IS CLEAR: AN IRA OWNER CANNOT GET PAID FOR RENDERING SERVICES TO THE IRA-THE STATUTES, HOWEVER, ARE NOT SO CLEAR

The IRS position is clear that an IRA Owner cannot get paid for rendering services to the IRA.[39] A strong argument can be made that position may be wrong. As mentioned before, a person who renders services is a *per se* DQP.[40] Paying compensation to a DQP *might* be a PT if made from plan assets. If so, it would be a violation of IRC § 4975(c), perhaps a violation of § 4975(c)(1)(D) as a "transfer to, or use by or for the benefit of a disqualified person of the income or assets of a plan," or a violation of (E) as an "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 a violation of (F) as "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."[41]

Even if an action is in violation of § 4975(c), IRC § 4975(d) says that the § 4975 prohibitions do not generally apply where reasonable compensation is paid.[42]

This much is clear. But the IRS says that the statute does not mean what it says. It has two reasons for saying this. Arguably, both reasons are wrong. See below.

SECTION 2.11 THE IRS POSITION IS CLEAR: THE IRC § 4975(D) EXEMPTIONS DO NOT APPLY TO VIOLATIONS OF § 4975(C)(1)(E) OR (F) BECAUSE SELF DEALING IS A *PER SE* PT-THE STATUTE, HOWEVER, IS CLEARLY OTHERWISE

The IRS says that the § 4975(d) exemptions for acts described in IRC § 4975(c) do not apply to IRC § 4975(c)(1)(E) or (F) -despite the unequivocal language of (d), which says that it covers all of the (c) PTs. This position, which is contrary to a plain reading of the statute, is found in Treas. Reg. § 54. 4975-6(a)(1), which says,

> *[S]ection 4975(d)(2) [which exempts certain transactions from the prohibitions found in § 4975(c)] . . . does not contain an exemption for acts described in section 4975(c)(1)(E)* (relating to fiduciaries dealing with the income or assets of plans in their own interest or for their own

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classification as "listed transactions," these transactions may already be subject to the disclosure requirements of § 6011 (§ 1.6011-4), the tax shelter registration requirements of § 6111 (§§ 301.6111-1T and 301.6111-2), or the list maintenance requirements of § 6112 (§ 301.6112-1).

[39] I.R.S. Chief Counsel Advice 200952049 (Dec. 24, 2009).

[40] I.R.C. § 4975(e)(2)(b).

[41] This is an exception to the exemption for compensation found in I.R.C. § 4975 (d)(10).

> (d) Except as provided in subsection (f)(6), the prohibitions provided in subsection (c) shall not apply to—
>
>> (2) any *contract,* or reasonable arrangement, made with a disqualified person for office space, or *legal, accounting*, or other services necessary for the establishment or operation of the plan, *if no more than reasonable compensation is paid* therefor;
>>
>> (10) receipt by a disqualified person of any *reasonable compensation* for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan, but no person so serving who already receives full-time pay from an employer or an association of employers, whose employees are participants in the plan or from an employee organization whose members are participants in such plan shall receive compensation from such fund, except for reimbursement of expenses properly and actually incurred;

I.R.C. § 4975(d) (emphasis added).

> account) *or acts described in section 4975(c)(1)(F)* (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan). Such acts are separate transactions not described in section 4975(d)(2). See §§ 54.4975-6(a)(5) and 54.4975-6(a)(6) for guidance as to whether transactions relating to the furnishing of office space or services by fiduciaries to plans involve acts described in section 4975(c)(1)(E). . . .[43]

The statute says "the prohibitions provided in subsection (c) shall not apply to . . . ;"[44] It does not say "the prohibitions provided in subsection (c)(1)(A)-(D) *excluding (E) and (F)* shall not apply to . . . ." It is astonishing that a final regulation so flagrantly ignores the plain text of the statute without explaining how or why. At least one court thinks the language of the statute controls. In *Harley, et al. v. 3M*,[45] an 8th Circuit decision under the ERISA counterpart to § 4975 and under a DOL regulation that is the counterpart of Treas. Reg. § 54.-4975-6, the court said,

> the plain language of § 1108(c)(2) [the ERISA counterpart to IRC § 4975(d)(10)] sensibly insulates the fiduciary from liability if the compensation paid was reasonable. We reject plaintiffs' reading of the ambiguous regulation because it conflicts with an unambiguous statute.[46]

Like the court in *Harley*, one can reasonably conclude that the regulations are wrong, but taking a position contrary to a published regulation should probably be disclosed on the tax return in order to avoid an accuracy related understatement penalty.

SECTION 2.12 THE IRS POSITION IS NOT ENTIRELY CLEAR: THE IRC § 4975(D)(2) AND (10) EXEMPTIONS DO NOT APPLY TO IRAs BECAUSE OF 4975(f)(6)-THE STATUTE, HOWEVER, IS CLEARLY OTHERWISE

There is a second reason that the IRS claims that the reasonable compensation exemption found in IRC § 4975(d)(2) and (10) does not apply to IRAs. However, its position on this point is only found in the Manual for examining agents, which suggests that at some level the IRS is aware of the problem even if the treatise writers are not.

> 4.72.11.2 — Identifying Prohibited Transactions
>
> *[Last Revised: 11-01-2010]*
>
> * * * *
>
> (3) The statutory exemptions under IRC 4975(d) (other than IRC 4975(d)(9) and (12)) do not apply to certain types of transactions involving owner-employees (as defined in IRC 401(c)(3)) and persons or entities deemed to be owner-employees. This provision, not applying certain statutory exemptions, can now be found in IRC **4975(f)(6)**. . .Generally, a prohibited transaction includes any direct or indirect acquisition of property for the plan or sale of plan property to a(n):
>
> a. Owner-employee.

[43] Treas. Reg. § 54.4975-6(a)(1) (emphasis added). Treas. Reg. § 54.4975(a)(5)(i)-(ii) sets forth the general outlook of the Treasury regarding conflicts of interest, and suggests some ways to avoid the problem. That regulation is reproduced in full in not 153, *infra*.

[44] I.R.C. § 4975(d).

[45] Harley v. Minn. Mining and Mfg. Co., 284 F.3d 901 (8th Cir. 2002). This case is discussed in more detail *infra* in Part VI.D.

[46] *Id.* at 909. *But see* Donovan v. Daugherty, 550 F. Supp. 390 (S.D.Ala. 1982).

b. Participant or beneficiary of an individual retirement account or annuity.

c. Shareholder-employee (as defined in IRC 4975(f)(6)(C)).

d. Member of the family (as defined in IRC 267(c)(4)) of the owner-employee, etc.

e. Corporation at least 50 percent of which is directly or indirectly controlled by a person mentioned in a., b. or c. Internal Revenue Manual 4.72.11.2(3).

IRC § 4975(d) begins its list of exemptions by saying "[e]xcept as provided in subsection (f)(6) . . . ." IRC § 4975(f)(6)(A) says,

> In the case of a trust described in section 401(a) which is part of a plan providing contributions or benefits for employees some or all of whom are owner-employees (as defined in section 401(c)(3)), the exemptions provided by subsection (d) (other than paragraphs (9) and (12)) shall not apply to a transaction in which the plan directly or indirectly—
>
> (i) lends any part of the corpus or income of the plan to,
>
> (ii) pays any compensation for personal services rendered to the plan to, or
>
> (iii) acquires for the plan any property from, or sells any property to,
>
> any such owner-employee . . . .

IRC § 4975(f)(6) continues at great length, and if closely followed, one finds that the term "owner employee" is specially defined to include "share-holder employees," which in turn (*via* IRC § 7701(a)(37)) is defined to include IRAs under IRC § 408(a) and (b). The IRS, informally, and all the commentators, with one noteworthy exception,[47] seem to think this means that most of the § 4975(d) exemptions do not apply to IRAs. This is puzzling, since (f)(6)(A) is very clearly limited in its application to "a trust described in section 401(a) which is part of a plan providing contributions or benefits for employees."[48] Traditional IRAs are not usually held in trust, and they are never part of a plan for employees, nor are they generally thought to be described in IRC § 401(a). IRC § 4975[49] is so prolix that it is possible that someone lost the thread and forgot to look back at the very first clause of the very first sentence of (f)(6)(A). However, there are many types of IRAs other than "traditional IRAs." Although it is not well known, an IRA can be a part of a plan established by an employer for employees and subject to ERISA. IRC § 408(c), entitled "(c) Accounts established by employers and certain associations of employees"[50] and IRC § 408(k), regarding SEPs, specifically allow for this. There is even an IRS form, Form 5306, entitled "Application for Approval of Prototype or Employer Sponsored Individual Retirement Arrangement (IRA)."[51] If such IRAs can be said to be described in IRC § 401(a), then (f)(6)(A) would apply to some IRAs; and, hence, the inclusion of IRA Owners within the definition of "owner-employees" would not be meaningless. Such inclusion just would not be applicable to traditional IRAs.

[47] *See* Choate, *Prohibited Transactions, UBTI and IRAs*, *supra* note 18.

[48] I.R.C.§ 4975(f)(6)(A).

[49] I.R.C. § 4975 in its entirety is over 8000 words long.

[50] *See* Treas. Reg. § 1.408-2(c); I.R.C. § 408(p)-(q).

[51] Form 5306 is discussed *supra* note 30.

If the IRA is not a § 408(c) IRA or one similar to it, established by an employer as part of a plan for employees, in other words, if it is a traditional IRA, (1) it is not usually a trust,[52] (2) it is not established by an employer, (3) it is not for the benefit of employees, and (4) it is not described in IRC § 401(a). Unless all four of those conditions are met, (f)(6) does not apply. Put another way, if any of the four conditions just enumerated are not met, (f)(6) cannot apply if the statute is read as written.

It is therefore reasonable to conclude that (a) the regulations on the subject are invalid and (b) the many pronouncements by the treasury regarding the application of (f)(6) to (d)(2) and (10) are wrong too, at least in the case of IRAs that are not employer sponsored. This is an uncomfortable position to be in.

The authority for the position that (f)(6) only applies to employer sponsored 401(a) trusts, including, perhaps, IRAs subject to ERISA, established by employers for employees, is the plain words of the statute and nothing else. It may be that the issue has never been squarely addressed, or even raised. It seems as if it is just assumed that all IRAs are covered by the proscription.

SECTION 2.13 CONSEQUENCES OF GETTING IT WRONG

SUBSECTION 2.13(a) CONSEQUENCES OF A PROHIBITED TRANSACTION IN THE CASE OF AN IRA

If there is a PT, an IRA will be disqualified as of the first day of the year.[53] At a minimum, this will result in the recognition of income to the extent the value of the IRA at the beginning of the year exceeds basis, if any. In the case of a rollover Roth IRA, basis could be substantial, which should mitigate the damage.

SUBSECTION 2.13(b) CONSEQUENCES OF A PROHIBITED TRANSACTION IN THE CASE OF A QUALIFIED PLAN

In the case of a Qualified Plan there is a 15% excise "of the amount involved with respect to the prohibited transaction for each year,"[54] and if "the transaction is not corrected within the taxable period" an additional tax is imposed of "100% of the amount involved."[55] The tax is to be paid by any (all?) DQPs "who participated in the prohibited transaction (other than a fiduciary acting only as such)."[56]

SUBSECTION 2.13(c) PREMATURE DISTRIBUTION TAX

If the IRA is disqualified or you otherwise take a distribution from it, and you are under age 59½, there will be a premature distribution tax under IRC § 72 (t) of 10% on the entire amount of the IRA.

SUBSECTION 2.13(d) EXCESS CONTRIBUTION TAX

If the IRS determines that there has been an inappropriate shifting of income to the IRA, it will likely treat the transaction as if the income were contributed by you to the IRA, resulting in the imposition of an excess contribution tax under IRC § 4973 of 6% of that amount.[57] This tax applies for each year that the excess contribution is not withdrawn.[58]

[52] It is usually a custodianship, though it could be a trust.

[53] I.R.C. § 408(e)(2).

[54] I.R.C. § 4975(a).

[55] I.R.C. § 4975(b).

[56] *Id.*

[57] Announcement 2005-80, 2005-46 IRB 967. Goldman v. Comm'r, T.C. Memo. 1981-223 (1981).

[58] *Id*.

SUBSECTION 2.13(e) CONSEQUENCES OF FAILING TO REPORT A "LISTED TRANSACTION"

If the transaction is described in Notice 2004-04,[59] IRC § 6011, § 6111(a), and § 6707A[60] require that the transaction be reported by all parties connected with the transaction.[61] The penalty for failure to do so is found in IRC § 6707A.[62] The penalty is "75 percent of the decrease in tax shown on the return as a result of such transaction (or which would have resulted from such transaction if such transaction were respected for Federal tax purposes)," not to exceed "$200,000 ($100,000 in the case of a natural person)." There is a minimum penalty of "$10,000 ($5,000 in the case of a natural person)."[63] The penalty applies for each year the transaction is not reported.[64]

In 2010, the Department of Justice sought to enjoin an attorney from promoting the type of transactions described as abusive in Notice 2004-8.[65] In some of the examples given on the IRS Website,[66] for instance where an IRA owned a doctor's practice, the doctor was seemingly assigning her income to the IRA, which, if true, would invoke taxation under traditional assignment of income principles.

SUBSECTION 2.13(f) REALLOCATION OF INCOME UNDER IRC § 482

The IRS may use IRC § 482 to allocate the income of the Roth IRA to the person or company that the IRS believes is the true source of the income.[67]

SUBSECTION 2.13(g) DIVIDEND TREATMENT

If the business owned by the Roth IRA is taxed as a corporation, the IRS may seek to cause it to recognize gain on transfers to the Roth IRA under § 311(b), and may require inclusion of the payment in the income of the taxpayer as a taxable dividend.[68]

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[59] Notice 2004-8, 2004-4 I.R.B. 333, discussed *infra* in Part XIII.

[60] *See* Treas. Reg. § 301.6707A-1T(a).

[61] Form 8886 is used for this purpose. *See* Treas. Reg. §1.6011-4. The taxpayer also must send a copy of the disclosure statement to the IRS Office of Tax Shelter Analysis (OTSA) at the same time that any disclosure statement pertaining to a particular reportable transaction is first filed.

[62] The penalty has recently been lowered dramatically. *See* 26 U.S.C. § 6707A(b)(1)-(2) (2006).

[63] 26 U.S.C. § 6707A(a)-(b).

[64] Persons required to register these tax shelters under § 6111 who have failed to do so may be subject to the penalty under § 6707(a). Persons required to maintain lists of investors under § 6112 who have failed to do so (or who fail to provide such lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this transaction or substantially similar transactions, including the accuracy-related penalty under § 6662, and as applicable, persons who participate in the reporting of this transaction or substantially similar transactions, including the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

Notice 2004-8, 2004-4 I.R.B. 333.

[65] Complaint for Permanent Injunction and Other Relief, U.S. v. Kaiser, Case 4:10-cv-00612 Document 1 (E.D.Mo. Apr. 12, 2010) *available at* www.justice.gov/tax/PKaiser_Complaint.pdf.

[66] INTERNAL REVENUE SERVICE, *Employee Plans News: Protecting Retirement Benefits Through Educating Customers,* EMP. PLANS NEWS, Feb. 2004, *available at* http://www.irs.gov/pub/irs-tege/se0204.pdf [hereinafter *Employee Plans News*].

[67] *See id. See also* Notice 2004-8, 2004-4 I.R.B. 333.

SUBSECTION 2.13(h) PENALTIES AND INTEREST

It may be several years before the IRS determines that it does not agree with your interpretation of the law. Unless you fight it and win, you could find that the worst of bad consequences are penalties and interest, including interest on late-paid penalties. Even more interest will be due if you choose to go to Tax Court and don't pay first, and ultimately lose.

SUBSECTION 2.13(i) ACCURACY-RELATED PENALTY ON UNDERPAYMENTS

IRC § 6662 imposes accuracy-related penalties on underpayments on taxes of 20% of the portion of the underpayment if, among other things, the underpayment was made in disregard of the regulations and not disclosed.

SECTION 2.14 N. CONCLUSION

A DQP and a QRP can, in fact, jointly own a business, but a PT can result unless the planner exercises extreme caution.

ARTICLE 3 PROHIBITED TRANSACTIONS IN GENERAL (A DETAILED EXAMINATION TO FOLLOW)

SECTION 3.1 PER SE AND FUZZY PROHIBITED TRANSACTIONS

There are two statutes governing PTs. All QRPs are subject to IRC § 4975, and QRPs subject to ERISA are also subject to ERISA § 404, § 406 and § 408. Although the rules are similar, they are not identical, which is somewhat vexing.

[68] Notice 2004-8, 2004-4 I.R.B. 333, *citing* Sammons v. United States, 433 F.2d 728 (5th Cir. 1970); Worcester v. Comm'r, 370 F.2d 713 (1st Cir. 1966).

Most, but not all QPs are subject to ERISA (an IRA is not a QP). Few, if any, IRAs are subject to ERISA.[69] Violation of ERISA could result in disqualification, but this would be unusual. Instead of automatic disqualification, violation of the IRC results in a penalty tax in the case of a QP. IRAs are ordinarily not subject to ERISA,[70] but, like QPs, are subject to IRC § 4975. On the other hand, if an IRA is involved in a PT, there is no penalty imposed on the IRA Owner or the Owner's beneficiaries;[71] rather, the penalty is disqualification of the IRA as of the first day of the year(!).[72]

In the case of an IRA, however, anyone involved in the PT, *other than* the Owner and the Owner's beneficiaries, and interestingly, "a fiduciary acting only as such,"[73] may be subject to the penalty.[74] There are numerous cases where a DQP who was not a fiduciary acting only as such wanted to apportion the penalty tax with the fiduciary and was denied this privilege based upon the § 4975(a) exception for "*a fiduciary acting only as such*."[75]

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[69] SEP-IRAs *might* be an exception. It is certainly an interesting question. See Lampkins v. Golden, 28 F. App'x 409, 412-13 (6th Cir. 2002), In re Vickers, Thomas Earle, (2009, Bktcy Ct TN) 408 BR 131, In re John E. Diguilio, Debtor, 303 BR 144, 12/04/2003, United States Bankruptcy Court, N.D. Ohio, Eastern Division, In re Dantone, 167 BR 67, 1993 WL 657277, 07/15/1993, United States Bankruptcy Court, N.D. Mississippi; and LaBarge v. Mehra, 166 BR 393, 01/25/1994, U.S. Bankruptcy Court, E.D. Missouri, E.D. Also, it is clear that a regular or Roth IRA can be a part of a qualified plan and thereby subject to ERISA.

[70] An IRA is not a qualified plan because it is not described in I.R.C. § 401(a). An IRA is *generally* not subject to Title I because an IRA does not constitute an employee benefit plan. 29 C.F.R. § 2510.3-2(d). Further, an IRA is specifically exempted from Parts 2 (participation and vesting) and 3 (minimum funding) of ERISA. ERISA §§ 201(6), 301(a)(7).

[71] Special rule for individual retirement accounts.

> *An individual for whose benefit an individual retirement account is established and his beneficiaries shall be exempt* from the tax imposed by this section with respect to any transaction concerning such account (which would otherwise be taxable under this section) if, with respect to such transaction, the account ceases to be an individual retirement account by reason of the application of section 408(e)(2)(A) or if section 408(e)(4) applies to such account. I.R.C. § 4975(c)(3) (emphasis added).

[72] I.R.C. § 408(e)(2).

[73] Why the fiduciary is exempt is not readily apparent. See I.R.S. Field Serv. Advice 665 (Aug. 18, 1992) discussed *infra* in Part XII.A, for a discussion of this issue.

[74] The statute reads in relevant part,

> Tax on prohibited transactions.
>
> (a) Initial taxes on disqualified person. There is hereby imposed a tax on each prohibited transaction. The rate of tax shall be equal to *15 percent* of the amount involved with respect to the prohibited transaction for each year (or part thereof) in the taxable period. The tax imposed by this subsection shall be paid by any disqualified person who participates in the prohibited transaction *(other than a fiduciary acting only as such).*
>
> (b) Additional taxes on disqualified person. In any case in which an initial tax is imposed by subsection (a) on a prohibited transaction and the transaction is not corrected within the taxable period, there is hereby imposed a tax equal to *100 percent* of the amount involved. The tax imposed by this subsection shall be paid by any disqualified person who participated in the prohibited transaction (other than a fiduciary acting only as such).

I.R.C. § 4975(a)-(b) (emphasis added).

[75] *See, e.g.,* O'Malley v. Comm'r, 972 F.2d 150 (7th Cir. 1992).

ERISA[76] and the IRC[77] both contain *per se* PTs, *fuzzy* PTs, and enumerated exemptions to the PTs, which exemptions appear in the statute to apply to both the *per se* and the *fuzzy* PTs. The IRS apparently believes the exemptions only apply to the *per se* PTs, not the *fuzzy* ones. This is very puzzling. There is no statutory basis for the IRS's distinction, but it is clearly its position, as reflected in the regulations[78] and other less binding pronouncements.[79] The issue of whether the statutory exemptions apply to the *fuzzy* PTs is explored in great detail in this article because it is critical.

It is generally best to begin with the assumption that any transaction between the IRA Owner, Plan trustee (or any other DQP), and the Plan or its assets (for example, buying, selling or extension of credit) will be prohibited *per se*.[80] This is always true where a service provider (a DQP by definition) renders services to the plan (a PT by definition).

The second class of rules is the ones herein called "*fuzzy*." *Fuzzy* PTs include the ". . . use by or for the benefit of, a disqualified person of the income or assets of a plan,"[81] an "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,"[82] and the "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."[83] (Incidentally, the IRA Owner, QP trustee, and anyone with the power to direct Plan investments, are virtually always fiduciaries.)

The *per se* PTs are described in IRC § 4975(c)(1)(A)-(D) and ERISA § 406(a). They are basically *self-dealing* transactions between the Plan and a DQP.[84] Subparagraph (D) is in part a *per se* exemption, "transfer to .

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[76] ERISA §§ 404, 406 & 408.

[77] I.R.C. § 4975(c).

[78] Treas. Reg. § 54.4975-6(a).

[79] I.R.S. Chief Counsel Advice 200952049 (Dec. 24, 2009). This Chief Counsel Advice (CCA) is discussed in detail *infra* in Part V.E.

[80] I.R.C. § 4975(c)(1)(A)-(C).

[81] I.R.C. § 4975(c)(1)(D).

[82] I.R.C. § 4975(c)(1)(E) (emphasis added).

[83] I.R.C. § 4975(c)(1)(F) (emphasis added).

[84]

> General rule. For purposes of this section, the term "prohibited transaction" means any direct or indirect—
>
> (A) sale or exchange, or leasing, of any property between a plan and a disqualified person;
>
> (B) lending of money or other extension of credit between a plan and a disqualified person;
>
> (C) furnishing of goods, *services*, or facilities between a plan and a disqualified person;
>
> (D) transfer to . . . a disqualified person of the income or assets of a plan;

I.R.C. § 4975(c)(1)(A)-(D).

Additionally, ERISA § 406(a) provides,

> (a) Transactions between plan and party in interest. Except as provided in section 408 [29 U.S.C. §1108]:
>
> (1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect—

. . a disqualified person of the income or assets of a plan," and in part a *fuzzy* PT ". . . use by or for the benefit of a disqualified person of the income or assets of a plan."[85]

The *fuzzy* PTs are found in IRC § 4975(c)(1)(E)-(F) and ERISA § 406(b).[86] The *fuzzy* PTs are basically transactions benefitting a *fiduciary*. Note that a DQP who is NOT a fiduciary cannot violate (E) or (F).[87] For example ERISA § 406(A)-(D)[88] are *virtually* word-for-word identical to § 4975(c)(1)(A)-(D). There is a counterpart in § 406(b)(1) and (3) to § 4975(c)(1)(E) and (F). But ERISA § 406(b)(2) (conflict of interest) has no direct counterpart in § 4975(c)(1). The IRS seems to be of the mind that ERISA § 406(b)(2) and §

(A) sale or exchange, or leasing, of any property between the plan and a party in interest;

(B) lending of money or other extension of credit between the plan and a party in interest;

(C) furnishing of goods, services, or facilities between the plan and a party in interest;

(D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or

(E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 407(a) [29 U.S.C. §1107(a)].

(2) No fiduciary who has authority or discretion to control or manage the assets of a plan shall permit the plan to hold any employer security or employer real property if he knows or should know that holding such security or real property violates section 407(a) [29 U.S.C. §1107(a)].

[85] I.R.C. § 4975(c)(1)(D) ("transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan").

[86]

General rule. For purposes of this section, the term "prohibited transaction" means any direct or indirect— * * *

(E) 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

(F) 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.

I.R.C. § 4975(c)(1) (emphasis added).

ERISA § 406(b) [29 U.S.C. §1106(b)] provides,

(b) Transactions between plan and fiduciary. A fiduciary with respect to a plan shall not—

(1) deal with the assets of the plan in his own interest or for his own account,

(2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries,[N.B. There is no IRC counterpart to ERISA §406(b)(2) in IRC §4975] or

(3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

[87] *See* Treas. Reg. § 54.4975-6(a)(6), Ex. 2.

[88] ERISA § 406(a)(1)(A)-(D).

4975(c)(1)(E) are identical in meaning. This position seems suspect, and the Tax Court seems to have doubts about that position as well.[89]

The greatest difference between ERISA § 406 and IRC § 4975 is that ERISA § 406(b)(2) provides, in a manner that § 4975 does not, that

> a fiduciary with respect to a plan shall not . . .
>
> (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries. . . .[90]

The IRC has no counterpart to ERISA § 404(a), which requires that a fiduciary discharge its duties solely in the interest of plan participants and beneficiaries for the exclusive purpose of providing benefits to those persons and defraying reasonable administration expenses.91

The ERISA § 408 exclusions are exclusions to § 406, not § 404. *These differences between ERISA and the IRC could be critical* because ERISA § 406(b)(2) appears to prohibit transactions involving a conflict of interest *per se*, and § 4975 does not, unless the IRS is correct in its reasoning that § 4975(a)(1)(E)[92] also prohibits conflict of interest transactions *per se*, an argument that seems untenable, though interesting. ERISA § 404(a)(1) arguably stands on its own, unmitigated by § 408, because it is not mentioned there.

It is clear that a self-directed investment instigated by the IRA Owner that benefits the IRA Owner indirectly, solely because it enhances the value of the IRA, is not considered a use by or for the benefit the IRA Owner, nor is such a transaction considered dealing with the IRA for his or her "own account" for purposes of the statute, despite the statute's literal wording. These are transactions with the "fiduciary as such," which are exempted by the second sentence of IRC § 4976(a), and may illustrate why that strange language is there. It is also clear that other benefits to the IRA Owner as a result of a self-directed investment, if trivial or incidental enough, will not necessarily invoke § 4975(c)(1)(E)-(F). Beyond that, not much can be said with confidence about (E)-(F) transactions.

Even if the investment would not initially appear to implicate (A)-(D), because at first blush the transaction is between the QRP and an entity that is not a DQP, there are the "plan asset" rules to consider. These rules, if applicable, require that assets held by an entity be treated as owned by the QRP

[89] *See* Rollins v. Comm'r, T.C. Memo. 2004-260 (2004).

[90] ERISA § 406(b)(2).

[91] Fiduciary duties. (a) Prudent man standard of care.

> (1) Subject to sections 403(c) and (d) [29 U.S.C. § 1103(c) and (d)], 4042 [29 U.S.C. § 1342], and 4044 [29 U.S.C. § 1344], a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan;

ERISA § 404(a)(1)(A).

[92] I.R.C. § 4975(a)(1)(E) addresses an "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 . . ."

(as if the entity did not exist and as if the QRP itself owned the assets). In that case, a transaction between the DQP and the entity owned or partially owned by the QRP, will be treated as a transaction between the Participant and the QRP, most probably resulting in a violation of IRC § 4975 *per se*, in addition to the always possible violation of (E)-(F). The degree of ownership necessary to invoke the Plan Asset Rules[93] may be less than the degree of ownership necessary to make the entity a DQP. A twenty-five percent equity interest held by QRPs in the aggregate will usually be enough to invoke the Plan Asset Rules.[94]

SECTION 3.2 IS THE FORMATION OF A BUSINESS BETWEEN AN IRA AND A DISQUALIFIED PERSON A PROHIBITED TRANSACTION?

Apparently, the formation of a business is not a "transaction," and *a fortiori* is not a prohibited transaction. Authorities for this proposition are numerous, and include, prominently, *Swanson v. Commissioner of Internal Revenue, Respondent*,[95] as well as Field Service Advice ("FSA") 200128011,[96] which seems to acknowledge the authority of *Swanson* on this issue, though not rising to the level of an "acquiescence."

SECTION 3.3 EXEMPTIONS FROM THE PROHIBITED TRANSACTION RULES AND EXCEPTIONS TO THE EXEMPTIONS

Perhaps the most important question facing an IRA Owner who wants to invest IRA Assets in a business is whether or not he or she can or must get paid for the effort. Recall that any payment by a Plan to a DQP is a "transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan,"[97] and is on its face a PT. However, corporate trustees and others do get paid. How is that? The reason is that there is an *exemption* for reasonable compensation,[98] and for many other transactions between a Plan and a DQP that would otherwise be prohibited.[99]

SECTION 3.4 ARE THE EXCEPTIONS TO THE PROHIBITED TRANSACTION EXEMPTIONS, WHICH ARE APPLICABLE TO QPS, ALSO APPLICABLE TO IRAS?

There are also statutory exceptions to the statutory exemptions from the prohibitions. For example, there is an exception to the exemption for Plans covering "owner-employees," defined to include IRA Owners, which means that an owner-employee or IRA Owner cannot use the exemption from the prohibition. But there is a qualification to the exception to the exemption from the prohibition, in that the exception to the exemption only applies if the plan is described in IRC § 401(a), this last qualification being one the IRS consistently ignores. In most cases, any plan covering an owner-employee would be described in IRC § 401(a), but that would only rarely be true of an IRA Owner.

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[93] The Plan Asset Rules are discussed *infra* in Part VII.

[94] Equity participation in an entity by benefit plan investors is "significant" on any date if, immediately after the most recent acquisition of any equity interest in the entity, twenty-five percent or more of the value of any class of equity interests in the entity is held by benefit plan investors (as defined in paragraph (f)(2)). 29 C.F.R. § 2510.3-101f(1).

[95] Swanson v. Comm'r, 106 T.C. 76, 93 (1996).

[96] I.R.S. Field Serv. Advice 200128011 (July 13, 2001). See *infra* Part XII.B for a detailed discussion of this Field Service Advice.

[97] I.R.C. § 4975(c)(1)(D).

[98] I.R.C. § 4975(d)(2), (10).

[99] *See* I.R.C. § 4975(d), as limited by I.R.C. § 4975(f)(6).

For purposes of this article, there are two critical issues where the statute and the IRS's reading of it vary widely. *The first is whether the exception to the exemptions applies to IRAs, and the second is whether the exemptions apply to all PTs.*

SUBSECTION 3.4(a) WHETHER THE EXCEPTION TO THE EXEMPTIONS APPLIES TO ALL IRAS

As mentioned previously, IRS position on audits is that the exemptions do not apply to IRAs.[100] The commentators and treatise writers tend to support the IRS position, uncritically.[101] However, the very first clause of the very first sentence of IRC § 4975(f)(6), the statute that identifies the exceptions to the exemptions, clearly states that they only apply to a trust "described in section *401(a)* which is part of a plan providing contributions or benefits for employees some or all of whom are *owner-employees*."[102]

As anyone at all familiar with benefits law knows, IRAs are only rarely subject to § 401(a) or ERISA,[103] which is why it is astonishing to find that the term "owner-employee" is defined later, via three cross-references, to include IRA Owners.[104] On the other hand, there are indeed IRAs established in trust by employers for employees that are arguably described in 401(a).[105]

Apparently, this skein got too tangled to follow, the drafters lost their way, and the treatise writers failed to read these reticulated statutes carefully enough. After reading all the cross-references necessary to discover unexpectedly that IRA Owners are "owner-employees," it may be that the premise of the statute was by that time forgotten. After all, IRC § 4975 is over 8000 words, ignoring the verbiage in the all the statutes it cross-references.

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[100] Internal Revenue Manual 4.72.11.2(3).

[101] RIA Pension Analysis 53,867.2; RIA's EGTRRA Summary, 607 New law; Bennett et al. / Taxation of Distributions From Qualified Plans (WG&L) 8.06[3][b]; Bittker & Lokken / Federal Taxation of Employee Compensation (WG&L) 3.17. Prohibited Transactions; Perdue / Qualified Pension and Profit Sharing Plans (WG&L) 3.12, Prohibited Transactions 3.12[9][a] Statutory Exemptions.

[102] I.R.C. § 4975(f)(6) (emphasis added).

[103] *See* ERISA § 4(a). Also, 29 C.F.R. § 2510.3-2(d)(1) provides:

(d) Individual Retirement Accounts.

> (1) For purposes of Title I of the Act and this chapter, the terms "employee pension benefit plan" and "pension plan" shall not include an individual retirement account described in section 408(a) of the Code, an individual retirement annuity described in section 408(b) of the Internal Revenue Code of 1954 (hereinafter "the Code") and an individual retirement bond described in section 409 of the Code, provided that—
>
> > (i) No contributions are made by the employer or employee association;
> >
> > (ii) Participation is completely voluntary for employees or members;
> >
> > (iii) The sole involvement of the employer or employee organization is without endorsement to permit the sponsor to publicize the program to employees or members, to collect contributions through payroll deductions or dues checkoffs and to remit them to the sponsor; and
> >
> > (iv) The employer or employee organization receives no consideration in the form of cash or otherwise, other than reasonable compensation for services actually rendered in connection with payroll deductions or dues checkoffs.

[104] I.R.C. § 408(q)(1)(b).

[105] *See supra* discussion in Part II.L.

There is no meaningful discussion of this issue in the literature or the case law. What one finds is that IRC § 4975(f)(6)(B) is invariably footnoted without further analysis as the basis for concluding that it applies to IRAs, probably because that is the Subparagraph (oddly entitled "special rule for *shareholder*-employees") that defines *owner*-employees as including IRA Owners. If an IRA is for some reason a part of a § 401(a) trust, then the treatises are correct, but not otherwise. Perhaps we might have a simple drafting error; else, why would IRAs be mentioned at all?[106] A more probable explanation is that (f)(6) covers employer sponsored IRAs but not traditional IRAs, which, after all, is what it says if it says anything.

IRC § 401(a) begins:

> A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section . . . if . . . if . . . if . . .

Arguably, a trust that is part of a plan of an employer for the exclusive benefit of his employees or their beneficiaries is described in 401(a) whether or not qualified. This would include a 408(c) IRA, but not a traditional IRA. A traditional IRA is not established by an employer, is not for employees, is not part of a stock bonus, pension, or profit-sharing plan, nor is it usually held in trust (though it sometimes is). A 408(c) IRA is an IRA established by an employer for employees, and is part of a stock bonus, pension, or profit-sharing plan, and it must be held in trust.

SUBSECTION 3.4(b) WHETHER THE EXEMPTIONS APPLY TO ALL PROHIBITED TRANSACTIONS

*The second issue is whether or not the exemptions described in § 4975(d) apply to all of the PTs listed in § 4975(c)(1), or just some of them***.** The statute says the exclusions apply to all of the PTs. The IRS says the exemptions only apply to the *per se* PTs of § 4975(c)(1)(A)-(D), and not the *fuzzy* exemptions of § 4975(c)(1)(E)-(F) applicable to fiduciaries (as distinguished from other DQPs). This is a particularly vexing issue because although one can determine with something approaching mathematical certainty whether or not there is a violation of one of the *per se* PT rules, applying the *fuzzy* PT rules is much less certain. This is particularly problematic if, on top of the uncertainty in applying the *fuzzy* PT rules in the first instance, one cannot rely on a specific exemption that the statute provides.

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106 The legislative history suggests that it might be. *See* H.R. REP. NO. 93–1280, at 4607 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5038, 5096.

> [T]he conference substitute applies the new prohibited transaction rules applicable to an owner-employee (for example, no borrowing from the account is permitted) to individual retirement accounts, *with respect to transactions involving the employer or union sponsor of the account*, or other parties in interest.

Id. (emphasis added).

This is reminiscent of the joke that says when the legislative history is unclear one should look to the statute. Here the statute is clear. *Cf.* Harley v. Minn. Mining and Mfg. Co., 284 F.3d 901 (8th Cir. 2002) (discussed *supra* in Part II.K and *infra* in Part VI.D).

The italicized language (the emphasis added) supports the statute in that it appears to qualify the rule by suggesting it applies only "*with respect to transactions involving the employer or union sponsor of the account*," which IRAs would be arguably covered by I.R.C. § 401(a). On the other hand it is virtually heretical to suggest that an IRA Owner is free to borrow from his or her IRA if the conditions of I.R.C. § 4975(d)(1) are met.

This overview gives away the punch line of what is to follow. This is in part because what follows starts out technical and ends up tenebrous. Hopefully, a heads-up preview of the analysis will be helpful.

ARTICLE 4 WHO IS A DISQUALIFIED PERSON/PARTY IN INTEREST?

The class of DQPs includes the usual suspects, and they are identified below. However, membership in the class is not always easily discerned, especially in the case of business in which a DQP or family members have an interest. This article is intended to thoroughly explore the finer points of distinction. This turns out to be difficult, but not impossible.

"Disqualified person" is an IRC term used in IRC § 4975. Its ERISA counterpart is "party in interest." As is the case with PTs, the definitions are similar, but not identical. Most IRAs, excepting, perhaps, SEP-IRAs[107] and other employer sponsored IRAs, are not subject to ERISA. A QP, however, usually needs to take into account both ERISA and the IRC if it covers non-owners.

SECTION 4.1 A. STATUTORY DEFINITIONS

The statutory definition of a DQP is found in IRC § 4975(e)(2) as follows:

> (2) Disqualified person. For purposes of this section, the term "disqualified person" means a person who is—
>
> > (A) a *fiduciary;*
> >
> > (B) a person providing *services* to the plan[!];
> >
> > (C) an *employer* any of whose employees are covered by the plan;
> >
> > (D) an employee organization any of whose members are covered by the plan;
> >
> > (E) an *owner,* direct or indirect, of *fifty percent or more* of—
> >
> > > (i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation,
> > >
> > > (ii) the capital interest or the profits interest of a partnership, or
> > >
> > > (iii) the beneficial interest of a trust or unincorporated enterprise,
> >
> > *which is an employer* or an employee organization described in subparagraph (C) or (D);
> >
> > (F) a *member of the family* (as defined in paragraph (6)) of any individual described in subparagraph (A), (B), (C), or (E);
> >
> > (G) a *corporation*, partnership, or trust or estate of which (or in which) fifty percent or more of—

[107] See Lampkins v. Golden, 28 F. App'x 409, 412-13 (6th Cir. 2002), In re Vickers, Thomas Earle, (2009, Bktcy Ct TN) 408 BR 131, In re John E. Diguilio, Debtor, 303 BR 144, 12/04/2003, United States Bankruptcy Court, N.D. Ohio, Eastern Division, In re Dantone, 167 BR 67, 1993 WL 657277, 07/15/1993, United States Bankruptcy Court, N.D. Mississippi; and LaBarge v. Mehra, 166 BR 393, 01/25/1994, U.S. Bankruptcy Court, E.D. Missouri, E.D.

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,

(ii) the capital interest or profits interest of such partnership, or

(iii) the beneficial interest of such trust or estate,

is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);

(H*) an officer, director* (or an individual having powers or responsibilities similar to those of officers or directors*), a ten percent or more shareholder*, or a *highly compensated employee* (earning ten percent or more of the yearly wages of an employer) of a person described in subparagraph (C), (D), (E), or (G); or

(I) a *ten percent or more (in capital or profits)* partner or joint venturer *of a person described in subparagraph (C), (D), (E), or (G)*.

The Secretary, after consultation and coordination with the Secretary of Labor or his delegate, may by regulation prescribe a percentage lower than fifty percent for subparagraphs (E) and (G) and lower than ten percent for subparagraphs (H) and (I).[108]

A short description of the term "disqualified person," deciphered and reduced to its essence, is as follows: In most cases, one may safely assume that the IRA Owner, the IRA, IRA sponsor (trustee/custodian), and the QP and its trustee are disqualified persons, because they are fiduciaries.[109] A person providing services to the QRP is a DQP![110] Also a member of the family of the IRA Owner (or other DQP) is a disqualified person. Members of the family include the usual suspects, "spouse, ancestor, lineal descendant, and any spouse of a lineal descendant;"[111] but, significantly, the term does not cover collateral relatives (aunts, uncles, cousins), siblings (or, for that matter, spouses of ancestors if the spouse is not an ancestor[112]). Importantly for our purposes, "disqualified persons" also include certain closely held businesses. The operative IRC section is 4975(e)(2)(G), which makes a business a disqualified person if *fiduciaries* own more than fifty percent of the vote, value or capital of the business. Although Subparagraph (G) does not cross-reference the family member definition found in Subparagraph (F), § 4975(e)(4) and (5) cross reference (G) via § 267(c)(4) and back again, all of which is most confusing, but which should lead ultimately to the conclusion that *family members of fiduciaries are aggregated in determining whether a disqualified person owns more than fifty percent of the vote, value or capital of the business*. Again, a member of the family is a "spouse, ancestor, lineal descendant, and any spouse of a lineal descendant."[113]

In FSA 200128011, a father and three of his children --family members under § 4975(e)(6)-- owned separate IRAs. *Each of the four IRAs acquired a twenty-five percent interest in FSC A*, a foreign sales

[108] I.R.C. § 4975(e)(2).

[109] I.R.C. § 4975(e)(2)(A).

[110] I.R.C. § 4975(e)(2)(B).

[111] I.R.C. § 4975(e)(6).

[112] This is probably more relevant in the South than elsewhere.

[113] I.R.C. § 4975(e)(2).

corporation. The Service advised that FSC A was *not* a DQP, even though it was owned in four equal shares by the four IRAs.[114] Why? The reason illustrates a very important if somewhat subtle point. If the father owned his twenty-five percent interest in FSC A outright, rather than in his IRA, any buying and selling between the other IRAs and the father would be PTs. Because the other IRAs were owned by his daughters (members of his family), it would be as if the father's IRA owned a seventy-five percent interest in FSC A and the father himself owned the rest. Clearly any buying and selling between them would be PTs. Why is it different if all the transactions are between the IRAs? The answer, apparently, is that the IRA fiduciaries would be acting only "as such"[115] and no beneficiary would be dealing with the QRP for his or her own interest, other than as a beneficiary "as such." Acting in a manner benefitting the QRP is perfectly fine as long as the Participant is not benefiting personally, except as a beneficiary of the QRP, and is not directly involved personally "other than as a fiduciary as such."[116]

Also included in the definition of "disqualified persons" is "*an officer*, director (or an individual having powers or responsibilities similar to those of officers or directors), a *ten percent or more shareholder***,** [partner or joint venturer],[117] or a highly compensated employee (earning ten percent or more of the yearly wages of an employer)" *of a closely held business that is a disqualified person*.[118] You can well imagine that this category might include persons who have not a clue that they are disqualified persons with respect to the business owner's IRA.

That is not the end of it: if the Plan Asset Rules apply to a business held by the IRA, then the fiduciaries of that business could be fiduciaries of the IRA, adding yet another class of disqualified persons to the mix!

SECTION 4.2 MEMBER OF THE FAMILY UNDER § 4975/RELATIVE UNDER ERISA § 3(15)

ERISA uses "relative" instead of "member of the family." The ERISA definition of "relative" is much more straightforward and to the point than is the definition in § 4975(e)(6), because we do not have to double cross-reference §§ 4975(e)(6), 4975(e)(2)(F), 267(c), etc. to get to what is essentially the same definition found in ERISA § 3(15), which provides simply, in language virtually identical to § 4975(e)(6): "(15) The term "relative" means a spouse, ancestor, lineal descendant, or spouse of a lineal descendant."[119] The terms do not generally include step-ancestors, collateral relatives (brothers and sisters, nephews, nieces, cousins, etc.) or the spouses of collateral relatives.

Under both ERISA and the IRC, the § 4975(e)(6)/4975(2)(F) members of the family "appear" to be ignored in testing whether or not a corporation, partnership, etc. is controlled by disqualified persons under IRC § 4975(2)(G). That is not the end of the story, however.

IRC § 4975(e)(2)(F) includes within the list of disqualified persons certain family members:

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[114] I.R.S. Field Serv. Advice 200128011 (July 13, 2001).

[115] I.R.C. § 4975(a).

[116] *Id.*

[117] I.R.C. § 4975(e)(2)(I).

[118] I.R.C. § 4975(e)(2)(H).

[119] ERISA § 3(15).

(F) a member of the family (as defined in paragraph (6)) of any individual described in subparagraph (A) [Fiduciaries], (B) [Service Providers], (C) [Employers of Plan Participants], or (E) [Controlling Owners of a Business described in C or D];[120]

Misleadingly, § 4975(e)(2)(G) is not enumerated in (F). Section 4975(e)(2)(G) includes within the list of disqualified persons certain partnerships:

(G) a corporation, partnership, or trust or estate of which (or in which) fifty percent or more of—

(i) the combined *voting power* of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,

(ii) the *capital interest or profits interest* of such partnership, or

(iii) the *beneficial interest of such trust or estate*,

is owned directly or *indirectly*, or held by persons described in subparagraph (A) [Fiduciaries], (B) [Service Providers], (C) [Employers of Plan Participants], (D) [Employee Organizations], or (E) [Controlling Owners of a Business described in C or D] [*Not (F), Family Members!(?)*[121]];

Also not to be overlooked are IRC § 4975(e)(2)(H) and (I)-

(H) an officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a ten percent or more shareholder, or a highly compensated employee (earning ten percent or more of the yearly wages of an employer) of a person described in subparagraph (C), (D), (E), or (G) ; or

(I) a ten percent or more (in capital or profits) partner or joint venturer of a person described in subparagraph (C), (D), (E), or (G).

It is not clear how (H) and (I) DQPs are treated when applying the fifty percent tests in transactions involving other DQPs. For example, if a corporation is owned 45 percent by (G) DQPs, and ten percent by (H) DQPs, is the corporation a DQP? Actually, probably not. But for now this is not an unqualified "no."

As previously adumbrated, the exclusion for family members from the definition of control could be very important, depending on one's analysis. A partnership, more than fifty percent of which is owned by fiduciaries, is a disqualified person in its own right, under IRC § 4975(e)(2)(G). What is curious, and perhaps misleading, is that IRC § 4975(e)(2)(G) conspicuously omits in the flush language any cross-reference to § 4975(e)(2)(F), the section that identifies members of the family as disqualified persons. But a close examination of *§ 4975(e)(4)-(6)* reveals—

(4) Stockholdings*.* For purposes of paragraphs (2)(E)(i) and (G)(i) [G being the subparagraph with which we are primarily concerned] there shall be taken into account indirect stockholdings which would be taken into account under section 267(c), except that, for purposes of this paragraph, section 267(c)(4) shall be treated as providing that

[120] I.R.C. § 4975(e)(2)(F); *cf.*, ERISA § 3(14) (providing similar definitions for purposes of ERISA).

[121] Despite this, a convoluted cross-reference to I.R.C. § 267(c) found in I.R.C. § 4975(e)(4)-(5) brings them back in, in modified form, through the back door.

the members of the family of an individual are the members within the meaning of paragraph (6).

(5) Partnerships; trusts. For purposes of paragraphs . . . (G) (ii) and (iii) [G being the subparagraph with which we are primarily concerned] . . . the ownership of profits or beneficial interests shall be determined in accordance with the rules for constructive ownership of stock provided in 267(c) (other than paragraph (3) thereof), except that section 267(c)(4) shall be treated as providing that the members of the family of an individual are the members within the meaning of paragraph (6).

(6) Member of family. For purposes of paragraph (2)(F), the family of any individual shall include his spouse, ancestor, lineal descendant, and any spouse of a lineal descendant.[122]

IRC § 267(c) provides:

(c) *Constructive ownership of stock*. For purposes of determining, in applying subsection (b), the ownership of stock --

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) *An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family*;

~~(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;~~

(4) ~~The family of an individual shall include only his brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants;~~[123]

[Sections 267(c)(3) & (4) have been stuck through to emphasize that § 4974(e)(4) & (5), quoted immediately before § 267(c), looks to § 267(c) to determine constructive ownership of stock, ignoring § 267(c)(3), and that instead of the more inclusive definition of family found in § 267(c)(4) the more familiar, narrower definition of "member of the family" found in § 4974(e)(6), which does not include siblings, is substituted. However, § 4975(f)(6), which provides the exceptions to the exemptions from the PT rules for shareholder-employees,[124] applies the unmitigated § 267(c)(4) constructive ownership definition, and includes siblings of shareholder-employees. All of this is most confusing.]

and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be

[122] I.R.C. § 4975(e)(4)-(6) (emphasis added).

[123] I.R.C. § 4975(e)(4)-(5) say to use I.R.C. § 267(c) "other than paragraph (3) thereof." That is why this portion was stricken, because it should be irrelevant. This qualifies as somewhat subtle.

[124] *See supra* Part II.F; *see infra* Part V.C.

> treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.[125] [Emphasis added.]

The point of going through all of these sections of the IRC is to help the reader apply the constructive ownership rules, which are very important, and not easy to apply without explanation of some of the subtleties involved.

SECTION 4.3 A PARTNERSHIP OR CORPORATION IS A DISQUALIFIED PERSON IF CONTROLLED BY FAMILY MEMBERS

A tortured path eventually leads to the conclusion that a partnership or corporation is a disqualified person if fifty percent or more of the partnership is owned by fiduciaries and their family members. Moreover, in this special case, siblings are not treated as family members. A short form of the analysis is something like the following:

(1) An owner of an IRA is a fiduciary/disqualified person.

(2) Under IRC § 4975(e)(2)(G), a partnership, or corporation more than fifty percent of which is owned by fiduciaries, is a disqualified person.

(3) Under IRC § 4975(e)(2)(F), a member of the family of a fiduciary is a fiduciary, but this turns out to be largely irrelevant and potentially the source of a misleading diversion.

(4) In applying IRC § 4975(e)(2)(F) and (G), family members are not taken into account, but this turns out not to be as helpful as it first appears, because of (5), which is worse.

(5) IRC § 4975(e)(5) specifically provides that in determining control of a partnership under § 4975(e)(2)(G) (ii) and (iii), the constructive ownership tests of § 267(c) shall be used, and those rules require that partnership interests or shareholdings owned by certain family members (*spouse, ancestor, lineal descendant, and any spouse of a lineal descendant, but not siblings)* will be used in determining whether the partnership or corporation is controlled by fiduciaries.

(6) Hence, a partnership or corporation will be a disqualified person if it is controlled by the IRA Owner and/or members of the IRA Owner's family (as defined in IRC § 4975(e)(6)).

SECTION 4.4 AN IRA TRUSTEE OR CUSTODIAN AND AN IRA OWNER ARE ALWAYS DISQUALIFIED PERSONS

An IRA Trustee and IRA Custodian are fiduciaries.[126] Although the statute is not explicit, an IRA Owner is usually a fiduciary, at least in those cases where the IRA Owner has discretion over the IRA investments.[127] Under IRC § 4975(e)(2)(A), a fiduciary is a DQP.

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[125] I.R.C. § 267(c) (emphasis added).

[126] Treas. Reg. § 1.408-2. *See also* Treas. Reg. § 1.408-2(e)(5)(viii)(A).

[127] ERISA Op. Letter 2006-09A (Dec. 19, 2006).

ARTICLE 5 PROHIBITED TRANSACTIONS EXAMINED IN DETAIL

SECTION 5.1 SECTION 4975(C)(1)

As presaged in Part III, “Prohibited Transactions in General,” under IRC § 4975(c)(1) there are *per se* and *fuzzy* PTs, (a)-(c) being *per se* PTs, (d) being part *per se* and part *fuzzy*, and (e)-(f), *fuzzy*:

> (1) General rule. For purposes of this section, the term “prohibited transaction” means any direct or indirect—
>
> > (A) sale or exchange, or leasing, of any property between a plan and a disqualified person;
> >
> > (B) lending of money or other extension of credit between a plan and a disqualified person;
> >
> > (C) furnishing of goods, services, or facilities between a plan and a disqualified person;
> >
> > (D) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;
> >
> > (E) 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
> >
> > (F) 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.[128]

These have been discussed sufficiently above. However a detailed understanding requires a thorough treatment of the exemptions. Sometimes the exceptions are more important than the rules. Recall that a service provider is a per se DQP, and that providing services is a per se PT.[129] But for the exemptions, virtually all dealings with a QRP would be prohibited.

SECTION 5.2 THE § 4975(D)/ERISA § 408 EXEMPTIONS

The IRC § 4975(d) exemptions are roughly paralleled by ERISA § 408. The various PTs are broad and inclusive. If they were literally applied without exception, a fiduciary could never get paid, because that would be the transfer of plan assets to a service provider (a *per se* DQP) for providing services to the plan (a *per se* PT). The same would be true of a DQP receiving benefits the Plan was designed to provide. Fortunately, there are exemptions for transactions like these.

The most relevant exemptions are found in IRC § 4975(d). It reads in part-

> (d) *Exemptions. Except as provided in subsection (f)(6),* the prohibitions provided in subsection (c)[130] shall not apply to—

[128] I.R.C. § 4975(c)(1).

[129] *See* I.R.C. § 4975(c)(1)(C).

[130] I.R.C. § 4975(c) is the subsection that contains the basic litany of all the PTs.

(1) any *loan* made by the plan to a disqualified person who is a participant or beneficiary of the plan *if* such loan—. . .

(2) any contract, or reasonable arrangement, made with a disqualified person for *office space*, or legal, accounting, or other *services* necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor;

(3) any loan to a *leveraged employee stock ownership plan* (as defined in subsection (e)(7)), if— . . .

> (A) such loan is primarily for the benefit of participants and beneficiaries of the plan, and
>
> (B) such loan is at a reasonable rate of interest, and any collateral which is given to a disqualified person by the plan consists only of qualifying employer securities (as defined in subsection (e)(8));

(4) the investment of all or part of a plan's assets in deposits which bear a reasonable interest rate in a bank or similar financial institution supervised by the United States or a State, if such bank or other institution is a fiduciary of such plan and if—

* * * * or

> (B) such investment is expressly authorized by a provision of the plan or by a fiduciary (other than such bank or institution or affiliates thereof) who is expressly empowered by the plan to so instruct the trustee with respect to such investment;

* * * *

(6) *the provision of any ancillary service by a bank or similar financial institution* supervised by the United States or a State, if such service is provided at no more than reasonable compensation, if such bank or other institution is a fiduciary of such plan, and if—. . .

* * * *

(9*) receipt by a disqualified person of any benefit to which he may be entitled as a participant or beneficiary in the plan*,[131] so long as the benefit is computed and paid on a basis which is consistent with the terms of the plan as applied to all other participants and beneficiaries;[132]

If it helps, simply read subsection I.R.C. § 4975(f)(6), quoted *infra* in Part V.C, as saying the exemptions provided in §4975(d) do not apply to "a trust described in section *401(a)* which is part of a plan providing contributions or benefits for employees some or all of whom IRA Owners." I.R.C. § 4975(f)(6).

[131] See ERISA Op. Letter 2009-02A (Sept. 28, 2009), which held that naming a trust as beneficiary of a QP was not a PT, even though the trustees and beneficiaries were DQPs, and the trustee was entitled to a commission.

[132] I.R.C. § 4975(d)(9) is very important theoretically, because it puts a limit on an otherwise potentially boundless I.R.C. § 4975(c)(D)-(E).

(10)[133] receipt by a disqualified person of any *reasonable compensation* for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan, *but no person so serving who already receives full-time pay from an employer* or an association of employers, *whose employees are participants in the plan* or from an employee organization whose members are participants in such plan *shall receive compensation* from such fund, except for reimbursement of expenses properly and actually incurred;[134]

(11) *service* by a disqualified person as a fiduciary in addition to being an officer, employee, agent, or other representative of a disqualified person;[135]

(12) the making by a fiduciary of a distribution of the assets of the trust in accordance with the terms of the plan if such assets are distributed in the same manner as provided under section 4044 of title IV of the Employee Retirement Income Security Act of 1974 (relating to allocation of assets)[136]. . .

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[133] I.R.C. § 4975(f)(6) says that the § 4975(d) exceptions, other than (9) and (12), do not apply to "certain" *401(a) plans* including IRAs, as adumbrated *supra* in Part II.L. Theoretically, I.R.C. § 4975(d)(10) could permit the IRA Owner to receive "*reasonable compensation for services rendered*, or for the reimbursement of expenses properly and actually incurred, *in the performance of his duties with the plan [i.e., IRA]*." I.R.C. § 4975(d)(10) (emphasis added). One question would be whether an IRA Owner can be considered a "person . . . who already receives full-time pay from an employer." An affirmative answer to that question would be undoubtedly wrong. The IRA Owner is not the employer. And we have seen, repeatedly, and most recently in *Rollins v. Comm'r*, T.C. Memo. 2004-260 (2004), the I.R.C. § 4975(e)(2)(C) definition of DQP as including "an employer any of whose employees are covered by the plan," does not apply to the IRA Owner.

[134] This would at least let the IRA trustee or custodian get paid by the plan, if applicable. However, if I.R.C. § 4975(d)(2) and § 4975(d)(10) do not apply to IRAs, how does the trustee or custodian get paid? If § 4975(f)(6) applies to IRAs, then the exemption provided by § 4975(d)(10) does not apply to the extent the plan "directly or indirectly," (as stated in § 4975(f)(6)(A)) "*pays any compensation for personal services rendered to the plan to*" (as stated in § 4975(f)(6)(A)(ii) (emphasis added)), the "*participant or beneficiary* of an [IRA]." § 4975(f)(6)(B)(i)(II) (via a reference to I.R.C. § 7701(a)(37)) (emphasis added). Therefore, it appears that the IRA trustee or custodian can get compensated, but not the participant or beneficiary *if* § 4975(d)(2) and § 4975(d)(10) *do not apply*. Read literally, § 4975(f)(6) does not apply to IRAs that are not a part of a 401(a) plan. *See* § 4975(f)(6). The question is whether someone such as Judge Scalia, who can read a statute and tends to interpret it as it reads, decides this issue, or if someone who thinks the wording of the statute was a mistake, which the courts, rather than the legislature, should correct. *Cf.* Harley v. Minn. Mining and Mfg. Co., 284 F.3d 901 (8th Cir. 2002) (discussed at length *supra* in Part II.K and *infra* in Part VI.D).

[135] This exemption may be for the purpose of avoiding a prohibited transaction as a result of certain dual fiduciary roles that might otherwise create a conflict of interest or a PT *per se*. Now consider that since in the eyes of the IRS an IRA Owner is always a fiduciary, and, hence, a DQP, the IRA Owner will always violate I.R.C. § 4975(c)(1) if the IRA Owner directly or indirectly provides services to the IRA, whether paid for or not, unless I.R.C. § 4975(d)(2), 4975(d)(10) or 4975(d)(11) apply to IRA Owners. The § 4975(f)(6) exceptions to the exemptions, if they apply, would apply in this context only if compensation were paid for the services. If the services are rendered for free, one wonders, as a technical matter, whether anyone is exempted, except as provided in § 4975(d)(11), which implies that the DQP must, in addition, be "an officer, employee, agent, or other representative of a disqualified person." *Id.* This tangled skein is not seamless. In fact, it must have lots of holes; otherwise much of it would be inconceivable as well as incomprehensible.

[136] This subparagraph, along with subparagraph (9), serves as authority for permitting in-kind distributions.

(13) Any transaction which is exempt from section 406 of such Act by reason of section 408(e) of such Act (or which would be so exempt if such section 406 applied to such transaction) or which is exempt from section 406 of such Act by reason of section 408(b)(12) of such Act. [N.B. The cross-references refer to the acquisition by a plan of qualified "qualifying employer securities" and the "acquisition, sale, or lease by plan of qualifying employer real property."][137]

* * * *

(17) Any transaction in connection with the provision of investment advice described in subsection (e)(3)(B) to a participant or beneficiary in a plan that permits such participant or beneficiary to direct the investment of plan assets in an individual account, if—. . .

* * * *

(19) *Any transaction involving the purchase or sale of securities, or other property (as determined by the Secretary of Labor), between a plan and a disqualified person if***—**

(A) the transaction is executed through an electronic communication network, alternative trading system, or similar execution system or trading venue subject to regulation and oversight by

(i) the applicable Federal regulating entity, or

(ii) such foreign regulatory entity as the Secretary of Labor may determine by regulation,

(B) either—

(i) the transaction is effected pursuant to rules designed to match purchases and sales at the best price available through the execution system in accordance with applicable rules of the Securities and Exchange Commission or other relevant governmental authority, or

(ii) neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of trades . . .[and other requirements]

(20) transactions described in subparagraphs (A), (B), and (D) [N.B. not (C) "furnishing of goods, services, or facilities between a plan and a disqualified person"] of subsection (c)(1) between a plan and a person that is a disqualified person other than a fiduciary[138]

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[137] ERISA § 408(e).

[138] This is interesting because the term "fiduciary" is defined by I.R.C. § 4975(e)(3) virtually identically to the fiduciaries excluded from the exemption provided by subparagraph (20):

(3) Fiduciary. For purposes of this section, the term "fiduciary" means any person who—

(A) exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,

(B) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (or an affiliate) who has or exercises any discretionary authority or control with respect to the investment of the plan assets involved in the transaction or renders investment advice (within the meaning of subsection (e)(3)(B)) with respect to those assets, solely by reason of providing services to the plan or solely by reason of a relationship to such a service provider described in subparagraph (F), (G), (H), or (I) of subsection (e)(2), or both, but only if in connection with such transaction the plan receives no less, nor pays no more, than adequate consideration, . . .

* * * *

(22) any transaction described in subsection (c)(1)(A) [sale or exchange, or leasing, of any property between a plan and a disqualified person] involving the purchase and sale of a security between a plan and any other account managed by the same investment manager, if— . . .

* * * *

(C) no brokerage commission, fee (except for customary transfer fees, the fact of which is disclosed pursuant to subparagraph (D)), or other remuneration is paid in connection with the transaction, [and other conditions are met.][139]

SECTION 5.3 EXCEPTIONS TO THE EXEMPTIONS

There are several very important exceptions to some of the exemptions. IRC 4975(d) begins with the clause *"[e]xcept as provided in subsection (f)(6)*, the prohibitions provided in subsection (c) shall not apply to. . . ." IRC § 4975(f)(6), in turn, states "[i]n the case of a trust described in section *401(a)*[140] which is part of a plan providing contributions or benefits for employees some or all of whom are owner-employees" the 4975(d) exemptions (other than (9) and (12)) do not all apply. In a § 401(a) QP that covers owner-employees, as defined, there are certain exemptions that do not apply to the Plan. This much is admitted.

This section begins by saying:

IRC § 4975(f)(6) Exemptions not to apply to certain transactions.

(A) In general. In the case of a trust described in section *401(a)*[141] which is part of a plan providing contributions or benefits for employees some or all of whom are *owner-employees* (as defined in section 401(c)(3)), the exemptions provided by subsection (d)[142] (*other than paragraphs (9) and (12)*) shall not apply to a transaction in which the *plan* directly or indirectly—

(i) lends any part of the corpus or income of the plan to,

(C) has any discretionary authority or discretionary responsibility in the administration of such plan.

Id.

139 All of these paragraphs are part of I.R.C. § 4975(d) (emphasis added).

140 Not an IRA! Is this a drafting error?

141 Again, not an IRA!

142 I.R.C. § 4975(d).

> *(ii)* *pays any compensation for personal services rendered to the plan to,*[143] or
>
> (iii) acquires for the plan any property from, or sells any property to,
>
> any such owner-employee, a member of the family (as defined in section 267(c)(4)[144]) of any such owner-employee, or any corporation in which any such owner-employee owns, directly or indirectly, fifty percent or more of the total combined voting power of all classes of stock entitled to vote or fifty percent or more of the total value of shares of all classes of stock of the corporation.

But an IRA Owner is not an owner-employee anyway. Right? Wrong. Section 4976(f)(6)(B), in a subparagraph entitled "special rule for *shareholder-employees*,[145] provides at § 4975(f)(6)(B)(i), that for "purposes of subparagraph [4975(d)(6)](A), the following shall be treated as *owner-employees . . . .*" Then at § 4975(f)(6)(B)(i)(II)[146] the statute provides, of all things, that the definition of owner-employee includes a "*Participant or beneficiary* of an individual retirement plan (as defined in section 7701(a)(37))," which in turn provides:

> *(37) Individual retirement plan*. The term "individual retirement plan" means—
>
> (A) an individual retirement account described in section 408(a), and
>
> (B) an individual retirement annuity described in section 408(b).

After reading all of the cross-references and fine print we find that an IRA Owner is treated as an owner-employee[147]-but that is only a problem if the IRA is a part of an IRC § 401(a) trust!(?) (Note that the custodian of an IRA is not an IRA Owner, so it need not worry about getting paid.)

SECTION 5.4 AN INDUCTIVE PROBLEM

It is all but axiomatic that an IRA cannot lend money to an IRA Owner.[148] This is just gospel. We know it is the rule, and everyone thinks it is the rule, so it must be the rule. That is the inductive problem. But

[143] But, as has been and will again be noted, Treas. Reg. § 54.4975-6(a)(5)(iii) provides-

> (iii) Services without compensation. If a fiduciary provides services to a plan without the receipt of compensation or other consideration (other than reimbursement of direct expenses properly and actually incurred in the performance of such services within the meaning of paragraph (e)(4) of this section), the provision of such services does not, in and of itself, constitute an act described in section 4975(c)(1)(E) or (F). The allowance of a deduction to an employer under section 162 or 212 for the expense incurred in furnishing office space or services to a plan established or maintained by such employer does not constitute compensation or other consideration. *Id.*

[144] Note that here siblings *are* included. All other cross-references in I.R.C. § 4975 to the I.R.C. § 264(c) constructive ownership rules (of which there are several) substitute the definition of member of the family found in I.R.C. § 4975(e)(6), which excludes siblings.

[145] Note the inconsistent (and misleading) wording: share-holder employees vs. owner-employees.

[146] That is Section 4975, Subsection (f), Paragraph (6), Subparagraph (B), Clause (i), Subclause (II). It is a good thing the statutory organization does not go any deeper, else one would have to stretch to find a name for what would be next. Perhaps Sub-Sub Clause.

[147] I.R.C. §§ 4975(f)(6)(B)(i)(II), 7701(a)(37).

[148] *Cf.* ERISA Op. Letter No. 2011-04A (Feb. 03, 2011).

can we deduce what experience tells us is the answer. If an IRA is not part of a § 401(a) trust, and if, as is here maintained, IRC § 4975(f)(6) does not apply, then the exemption for loans under IRC § 4975(d)(3) would apply, if the conditions set forth therein can be met. This just cannot be right. But it is a conclusion that is all but inescapable. A few observations are worth considering here. For one thing, if a plan is going to allow loans, provisions allowing them have to be in the plan. The IRS prototype IRA Forms 5305 and 5305A certainly do not contain such provisions. Pledging IRA assets as security for a loan results in taxation,[149] so any security would have to be something other than the IRA itself. And certainly foreclosure would be a PT. Perhaps the answer is somewhere in IRC § 72. IRC § 72(p) provides that loans from a "qualified employer plan" will be treated as distributions unless the conditions of IRC § 72(p)(2) apply. But "qualified employer plan" is defined in IRC § 72(p)(4)(A)(i)(I) as being "a plan described in section 401(a) which includes a trust exempt from tax under section 501(a)," and IRC § 403(a) and (b) plans. Would providing security, such as a principal residence[150] be a PT, even though it is apparently not in other cases? No ready answer to this problem comes to mind. Of course, the IRS maintains that no self-dealing transaction gets the benefit of any of the § 4975(d) exceptions from the exemptions. But this position is untenable. It is no more than wishful thinking on the part of the IRS, found in the regulations[151] but not the statute. As mentioned previously, the regulations take the position that the exemptions in 4975(d)(2) do not apply to "acts described in section 4975(c)(1)(E) (relating to fiduciaries dealing with the income or assets of plans in their own interest or for their own account) or acts described in section 4975(c)(1)(F) (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan)."[152] This is important enough to bear the iteration that I have given it. The problem for the IRS is that the first clause of § 4975(d) says "[e]xcept as provided in subsection (f)(6), the prohibitions provided in subsection (c) shall not apply to— . . ." It does not say "except as provided in subsection (f)(6), the prohibitions provided in subsection (c), *other than (c)(1)(E) and (F),* shall not apply to— . . ."

SECTION 5.5 CCA (CHIEF COUNSEL ADVICE) 200952049; THE IRS WOULD SIMPLY IGNORE THE EXEMPTIONS

I.R.S. Chief Counsel Advice 200952049[153] holds that an IRA Owner who causes a corporation owned by the IRA to pay the Owner a salary is engaged in a PT because the IRA Owner has a conflict of interest. In so holding, it goes straight to (and through) the heart of the important issue of whether an IRA Owner can get paid reasonable compensation for services rendered to the IRA. Interestingly, it relies not on § 4975(f)(6)(B), which supports the theory that § 4975(f)(6)(B) does not apply to an IRA that is not part of a § 401(a) Plan(!), but relies instead on an equally spurious theory, with broader application.

I.R.S. Chief Counsel Advice 200952049[154] reads in *toto* [155] as follows:

[149] I.R.C. § 408(e)(4).

[150] See I.R.C. §72(p)(2)(B)(ii) for an example permitting this in the case of a "qualified employer plan."

[151] Treas. Reg. § 54.4975-6(a)(1).

[152] Treas. Reg. § 54.4975-6(a)(1)

[153] I.R.S. Chief Counsel Advice 200952049 (Dec. 24, 2009).

[154] *Id.*

[155] *Id.*

> Yes you are correct *the payment of salary to the IRA Owner, even indirectly by an IRA owned LLC, is a prohibited transaction.* The feeling is although section 4975(d)(10) provides reasonable compensation and reimbursement exception, section 4975(d)(10) or section 4975(d)(2) does not contain an exemption for acts described in section 4975(c)(1)(E) (relating to fiduciaries dealing with the income or assets of plans in their own interest or for their own account) or acts described in section 4975(c)(1)(F) (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan). An IRA Owner has a conflict of interest when he is in a position of authority, control or responsibility to determine how much compensation to pay himself [sic]. See section 54.4975 -6(a) of the regulations.[156]

The CCA does not cite IRC § 4975(f)(6) in order to dismiss the question out of hand, which it could have done if that statute really said that the § 4975(d)(10) exemption does not apply to IRA Owners even if the IRA is not subject to § 401(a). This supports the theory advocated in this article, without actually saying so.

Instead, the CCA reasons that the IRC § 4975(d) exemptions only apply to some of the § 4975(c) PTs. This is a total re-writing of the statute. The first dozen words of the first sentence of 4975(d) say *"[e]xcept as provided in subsection (f)(6)*, § 4975(d) (emphasis added), the prohibitions provided in subsection (c) shall not apply to . . . ." The CCA does not say that its position is that (f)(6) applies here. It says that the prohibitions in subsection (c)(1)(A)-(D), but not (E) and (F), shall not apply**.** IRC § 4975(c)(1)(E) and (F) are prohibitions provided in subsection (c).[157] One is tempted to ask "what is it about the meaning of 'the prohibitions in subsection (c) shall not apply' do you not understand?" The CCA somehow reasons that § 4975(c)(1)(E) and (F) are not part of subsection (c).

What is the authority for the position that § 4975(c)(1)(E) and (F) are not part of § 4975(c)? Unfortunately there is support in the regulations, but the regulations so flagrantly disregard the statute that they are subject to challenge. Anyone who, having merely read the statute, naturally believes that it means what it says, i.e., that § 4975(f)(6) does not apply to IRAs unless the IRA is subject to § 401(a), and who, therefore, believes that an IRA Owner can be compensated for services and can lease office space to an IRA, will want to at least be aware of Treas. Reg. § 54.4975-6, which should be read very carefully. Part of paragraph (a)(1) is reproduced below:

> *[S]ection 4975(d)(2) [which exempts certain transactions from the prohibitions found in § 4975(c)] . . . does not contain an exemption for acts described in section 4975(c)(1)(E)* (relating to fiduciaries dealing with the income or assets of plans in their own interest or for their own account*) or acts described in section 4975(c)(1)(F)* (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan). Such acts are separate transactions not described in section 4975(d)(2). See § 54.4975-6(a)(5) and 54.4975-6(a)(6) for guidance as to whether transactions relating to the furnishing of office space or services by fiduciaries to plans involve acts described in section 4975(c)(1)(E). . . . [158]

[156] *Id.* (emphasis added).

[157] *See id.*

[158] Treas. Reg. § 54.4975-6(a)(1) (emphasis added). This issue is also discussed *supra* in Part III.A. The full text of Treas. Reg. §54.4975-6(a)(5)(i)-(ii) is worth reproducing in full. Not only does this regulation set forth the general outlook of the Treasury regarding conflicts of interest, but it suggests some ways to avoid the problem.

The IRC § 4975(c)(1)(E) and (F) PTs are very important. They are called the fuzzy PT rules in this article, the catch-all rules. They are rules that say even if a DQP is able to avoid all the *per se* rules, the act will still be a PT if there is a direct or indirect

(D) transfer to, or *use by or for the benefit of*, a disqualified person of the income or assets of a plan;

(E) 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

(F) 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.[159]

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(5) Transactions with fiduciaries.

(i) In general. If the furnishing of office space or a service involves an act described in section 4975(c)(1)(E) or (F) (relating to acts involving conflicts of interest by fiduciaries), such as act constitutes a separate transaction which is not exempt under section 4975(d)(2). The prohibitions of sections 4975(c)(1)(E) and (F) supplement the other prohibitions of section 4975(c)(1) by imposing on disqualified persons who are fiduciaries a duty of undivided loyalty to the plans for which they act. These prohibitions are imposed upon fiduciaries to deter them from exercising the authority, control, or responsibility which makes such persons fiduciaries when they have interests which may conflict with the interests of the plans for which they act. In such cases, the fiduciaries have interests in the transactions which may affect the exercise of their best judgment as fiduciaries. Thus, a fiduciary may not use the authority, control, or responsibility which makes such person a fiduciary to cause a plan to pay an additional fee to such fiduciary (or to a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary) to provide a service. Nor may a fiduciary use such authority, control, or responsibility to cause a plan to enter into a transaction involving plan assets whereby such fiduciary (or a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary) will receive consideration from a third party in connection with such transaction.

A person in which a fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary includes, for example, a person who is a disqualified person by reason of a relationship to such fiduciary described in section 4975(e)(2)(E), (F), (G), (H), or (I).

(ii) Transactions not described in section 4975(c)(1)(E). A fiduciary does not engage in an act described in section 4975(c)(1)(E) if the fiduciary does not use any of the authority, control or responsibility which makes such person a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary. This may occur, for example, when one fiduciary is retained on behalf of a plan by a second fiduciary to provide a service for an additional fee. However, because the authority, control or responsibility which makes a person a fiduciary may be exercised "in effect" as well as in form, mere approval of the transaction by a second fiduciary does not mean that the first fiduciary has not used any of the authority, control or responsibility which makes such person a fiduciary to cause the plan to pay the first fiduciary an additional fee for a service. *Id.*

[159] I.R.C. § 4975(c)(1)(D)-(F) (emphasis added).

SECTION 5.6 CONFLATING ERISA WITH THE IRC PROHIBITED TRANSACTION RULES

In I.R.S. Chief Counsel Advice 200952049 the IRS Chief Counsel objected because the payment of compensation to an IRA Owner "was a conflict of interest." This is a very subtle but a very important notion.[160] The IRS is trying to extend a general conflict of interest test, which might be legitimate under ERISA § 404, to IRC § 4975, an income tax statute. For example, ERISA § 404 specifically imposes a general fiduciary responsibility on plan fiduciaries.[161] There are undoubtedly state laws that impose roughly equivalent duties in the case of a non-ERISA plan or an IRA.[162] But plan disqualification for violating such duties is not automatic, as it is if an IRA violates a § 4975(c) PT.

Again, ERISA and the IRC apply to qualified plans, but only the IRC applies to IRAs. One reason for the difference may well be that the IRC imposes an excise tax on QPs in an amount that is computed by reference to the transaction prohibited, which may usually be rectified and the amount involved measured. In the case of an IRA, violation of IRC §4975 results in disqualification rather than an excise tax. But ERISA imposes broader common law fiduciary duties that could be invoked regardless of the application of any excise tax. IRC § 4975 is relatively specific. It could have simply said that all violations of fiduciary duties of loyalty are banned. Nevertheless, it did not do so.

As mentioned *supra* in Part III.A, ERISA § 406(b)(1) and (3) track IRC § 4975(c)(1)(E)-(F) closely. However, ERISA § 406(b)(2) is unique. It provides that

> [a] fiduciary with respect to a plan shall not—. . .
>
> (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries.

This is a general conflict of interest prohibition that is appropriate for a QP. It does not automatically require disqualification, but it could result in disqualification if egregious enough. Furthermore, it is not subject the PT excise tax. This is possibly because the amount involved in such a transaction is not amenable to measurement with enough specificity to warrant the imposition of a tax on the amount involved. But that is only of academic interest. The fact is that it is not found in § 4975 and hence does not apply to IRAs. The Service would like to read § 4975(c)(1)(E) and (F) as prohibiting any transaction where there is a conflict of interest. They might as well read ERISA § 406(b)(1) and (3) in a similar manner, which would make ERISA § 406(b)(2) superfluous.

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[160] Because the IRS is virtually all-powerful, Einstein's quip, distinguishing acts that are subtle from those that are malicious, comes to mind and troubles the will. *See* ABRAHAM PAIS, SUBTLE IS THE LORD: THE SCIENCE AND THE LIFE OF ALBERT EINSTEIN (Oxford University Press 1982).

[161] ERISA § 404(a) provides in part-

> Subject to sections 403(c) and (d) [29 U.S.C. §1103(c) and (d)], 4042 [29 U.S.C. §1342], and 4044 [29 U.S.C. §1344], a fiduciary shall discharge his duties with respect to a plan *solely in the interest* of the participants and beneficiaries and—
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan; . . .

[162] *See, e.g.*, FLA. STAT. § 121.4501 (2011).

ARTICLE 6 PROVIDING SERVICES AND RECEIVING COMPENSATION

A corporate fiduciary who pays itself reasonable compensation is dealing with the assets of the Plan for its own account. True? Of course. Therefore, were it not for the exemption in IRC § 4975(d)(2) and (10), assisted by certain PTEs perhaps, such payment would violate both § 4975(c)(1)(E) and (F).

SECTION 6.1 DOL REGULATIONS PERMITTING THE PAYMENT OF COMPENSATION

DOL Regulation § 2550.408c-2, entitled "Compensation for Services," allows the payment of reasonable compensation for services rendered to a plan subject to ERISA. The regulations include guidelines for determining whether compensation is reasonable.[163]

[163] (a) In general. Section 408(b)(2) of the Employee Retirement Income Security Act of 1974 (the Act) refers to the payment of reasonable compensation by a plan to a party in interest for services rendered to the plan. Section 408(c)(2) of the Act and § 2550.408c-2(b)(1) through 2550.408c-2(b)(4) clarify what constitutes reasonable compensation for such services.

(b)

(1) General rule. Generally, whether compensation is "reasonable" under sections 408(b)(2) and 408(c)(2) of the Act depends on the particular facts and circumstances of each case.

(2) Payments to certain fiduciaries. Under sections 408(b)(2) and 408(c)(2) of the Act, the term "reasonable compensation" does not include any compensation to a fiduciary who is already receiving full-time pay from an employer or association of employers (any of whose employees are participants in the plan) or from an employee organization (any of whose members are participants in the plan), except for the reimbursement of direct expenses properly and actually incurred and not otherwise reimbursed. The restrictions of this paragraph (b)(2) do not apply to a party in interest who is not a fiduciary.

(3) Certain expenses not direct expenses. An expense is not a direct expense to the extent it would have been sustained had the service not been provided or if it represents an allocable portion of overhead costs.

(4) Expense advances. Under sections 408(b)(2) and 408(c)(2) of the Act, the term "reasonable compensation," as applied to a fiduciary or an employee of a plan, includes an advance to such a fiduciary or employee by the plan to cover direct expenses to be properly and actually incurred by such person in the performance of such person's duties with the plan if:

(i) The amount of such advance is reasonable with respect to the amount of the direct expense which is likely to be properly and actually incurred in the immediate future (such as during the next month); and

(ii) The fiduciary or employee accounts to the plan at the end of the period covered by the advance for the expenses properly and actually incurred.

(5) Excessive compensation. Under sections 408(b)(2) and 408(c)(2) of the Act, any compensation which would be considered excessive under 26 C.F.R. 1.162-7 (Income Tax Regulations relating to compensation for personal services which constitutes an ordinary and necessary trade or business expense) will not be "reasonable compensation." Depending upon the facts and circumstances of the particular situation, compensation which is not excessive under 26 C.F.R. 1.162-7 may, nevertheless, not be "reasonable compensation" within the meaning of sections 408(b)(2) and 408 (c)(2) of the Act.

29 C.F.R. § 2550.408c-2; 42 Fed. Reg. 32393 (June 24, 1977); *cf.* 29 C.F.R. § 2550.408b-2 (general statutory exemption for services or office space).

DOL Regulations § 2550.408b-2(c) requires that for compensation to be considered reasonable, an elaborate set of written disclosure materials must first be given to a responsible plan fiduciary.

SECTION 6.2 TREASURY REGULATION § 54.4975-6(A)(5)(I)

Treas. Reg. § 54.4975-6(a)(5)(i) provides that it is a PT for a fiduciary to use its power to cause additional compensation to be paid to it for services rendered to the QRP.[164] For reasons mentioned elsewhere,[165] this position has more legitimacy in the case of an ERISA QRP, because ERISA has a prohibition against conflicts of interest, whereas the IRC has no such blanket rule. As has been frequently mentioned, the IRS regulatory position[166] is to simply ignore this statutory distinction, which position may very well be ultimately insupportable.

SECTION 6.3 TREASURY REGULATION § 54.4975-6(A)(5)(I), EX. 6

The IRS here makes very clear that it does not believe that the statute (§ 4975(d), first sentence) means what it says. What it says is "Except as provided in subsection (f)(6), the prohibitions provided in subsection (c) shall not apply to. . . ." The IRS says that it means "shall not apply to subsections (c)(1)(A)-(D)." The IRS position is clearly that the (c)(1)(E) and (F) are not covered by the exemptions. This is disconcerting, since the regulation clearly contravenes the unambiguous wording of the statute.[167]

> Example (6). A fiduciary of plan P with discretionary authority respecting the management of P, retains S, the son of F, to provide for a fee various kinds of administrative services necessary for the operation of the plan. F has engaged in an act described in section 4975(c)(1)(E), because S is a person in whom F has an interest which may affect the exercise of F's best judgment as a fiduciary. *Such act is not exempt under section 4975(d)(2) irrespective of* whether the provision of the services by S is exempt.[168]

The last sentence may as well have read "*Such act is not exempt under section 4975(d)(2) irrespective of the wording of the § 4975(d),* first sentence."

SECTION 6.4 HARLEY, ET AL. V. MINNESOTA MINING AND MANUFACTURING COMPANY

In *Harley, et al. v. Minnesota Mining and Manufacturing Company*,[169] the beneficiaries brought suit alleging that the trustees of the 3M plan had breached 29 U.S.C. § 1106(b)(1), i.e. ERISA § 406(b)(1), the ERISA equivalent of IRC § 4975(c)(1)(e), which prohibits an "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" because of some conflict of interest, not clearly articulated, but appearing to have something to do with a potential reversion to the employer if the plan were terminated. The beneficiaries were complaining about a performance-based compensation agreement with a hedge fund. Performance-based compensation agreements are often the subject of litigation, and appear to be generally suspect

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[164] To the same effect see 29 C.F.R. §2550.408b-2(e); *cf.* ERISA Op. Letter 2001-10A (Dec. 22, 2001) (applying ERISA § 408(b)(2) and 408(b)(6) to the provision of trustee services to two defined benefit plans sponsored by the trust company and the payment by the plans of trustee fees in connection with said services).

[165] *See, e.g.*, *infra* Part VI.D and accompanying text.

[166] See Treas. Reg. § 54.4975-6(a)(5)(i), the full text of which is quoted in note 153, *supra*.

[167] The 8th Circuit Federal Court of Appeals agrees. *See* Harley v. Minn. Mining and Mfg. Co., 284 F.3d 901 (8th Cir. 2002) (also discussed *supra* in Part II.K).

[168] Treas. Reg. § 54.4975-6(a)(5)(i), Ex. 6 (emphasis added).

[169] 284 F.3d 901.

but not prohibited *per se*. 3M's defense was that the compensation was reasonable and that it was therefore exempted from ERISA 406(b)(1)/IRC § 4975(c)(1)(e) by ERISA 408(b)(2)[170]/IRC § 4975(d)(10). The words of the court are memorable, and directly address the recurring issue of whether the statute means what it says or not:

> Section 1106(b)(1) prohibits a fiduciary from "deal[ing] with the assets of the plan in his own interest or for his own account." However, 29 U.S.C. § 1108(c)(2) provides that "[n]othing in section 1106 of this title shall be construed to prohibit any fiduciary from . . . receiving any reasonable compensation for services rendered . . . in the performance of his duties with the plan." 3M introduced uncontradicted expert testimony that the compensation paid to ACM was reasonable.
>
> Plaintiffs counter this factual showing with a legal argument—that § 1108(c)(2) does not apply to prohibited transactions under § 1106(b) but only clarifies the exemption provided in § 1108(b)(2). Plaintiffs rely for this argument on their interpretation of a regulation, 29 C.F.R. § 2550.408c-2(a). But in this case, the general prohibition in § 1106(b)(1)—that a fiduciary should not deal in plan assets for its own account—is alleged to have been violated when a fiduciary influenced its own compensation for investment services. At least in this situation*, the plain language of § 1108(c)(2)* [the ERISA counterpart to IRC § 4975(d)(10)] *sensibly insulates the fiduciary from liability if the compensation paid was reasonable*. We reject plaintiffs' reading of the *ambiguous regulation because it conflicts with an unambiguous statute*. Moreover, the legislative history of § 1108 does not support the contention that the § 1108(c)(2) exemption merely clarifies § 1108(b)(2). See, for example., H.R. CONF. REP. NO. 93-1280 (1974), reprinted in 1974 U.S.C.C.A.N. 5038, 5092; *Lowen v. Tower Asset Mgmt., Inc.*, 829 F.2d 1209, 1216 and n. 4 (2d Cir. 1987).[171]

SECTION 6.5 NECESSARY SERVICES; ERISA OPINION LETTER 83-45A

In ERISA Opinion Letter 83-45A,[172] issued by the DOL, United Technologies Corporation (UTC) wanted to cause its QRP to invest in commercial real estate. UTC contemplated that a UTC subsidiary would furnish goods and services for the repair and maintenance of the real property acquired by the Plans. The DOL gave a very nuanced, partial "okay" to part of this proposal, but refused to rule on a crucial issue.[173] The DOL was primarily concerned with the conflict of interest question, which should be more of a problem under ERISA than under the IRC, though the IRS does not make this distinction.[174]

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[170] Also codified as 29 U.S.C. §1108(c)(2).

[171] *Harley,* 284 F.3d at 908-09; *but see* Donovan v. Daugherty, 550 F. Supp. 390 (S.D.Ala. 1982).

[172] ERISA Op. Letter 83-45A (Aug. 24, 1983).

[173] *Id.* at 4.

[174] An ERISA opinion letter is similar to a private letter ruling, except instead of being issued by the IRS it is issued by the Department of Labor. This letter comes about as close as anything else to addressing the subject of QRPs compensating fiduciaries for running a business owned by the QRP. The following excerpts are from ERISA Opinion Letter 83-45A (Aug. 24, 1983).

> You further represent that UTC's subsidiaries are engaged in a variety of industries, including the manufacture, installation and servicing of components and equipment used in office and other commercial buildings. You acknowledge that all UTC subsidiaries are parties in interest with respect to the Plans.
>
> On behalf of UTC, you seek the following advisory opinions:

A. The furnishing of goods and services by a UTC subsidiary for the repair and maintenance of real property acquired by the Plans is not prohibited by section 406(a) of ERISA where the arrangements for the goods and services are made by a tenant under an absolute-net lease for the property and where the lease requires the tenant to repair and maintain the property.

B. Services necessary for the maintenance and repair of real property investments that the Plans may acquire qualify as "services necessary for the establishment or operation of the plan..." within the meaning of section 408(b)(2) of ERISA and 29 CFR 2550.408b-2(b).

C. Arrangements made with a UTC subsidiary by a tenant under an absolute-net lease or by an independent property manager for maintenance or repair of real property investments of the Plans are not prohibited by section 406(b) of ERISA.

*   *   *   *

Section 406(a)(1)(A) and (C) of ERISA provide, in pertinent part, that a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he or she knows or should know that such transaction constitutes a direct or indirect sale of property, or a furnishing of goods, services or facilities between the plan and a party in interest with respect to the plan.

In contracting with a UTC subsidiary which is a party in interest defined in section 3(14) or ERISA, for repairs and maintenance, you represent in essence that the tenant under an absolute-net lease with the Plans would not be acting as agent for the landlord (Plans) but rather would simply be fulfilling its obligation under the lease. The tenant will be solely responsible for the maintenance and repair of the property and only the tenant will have enforceable rights under any service contracts it enters into. A transaction for the receipt of services or goods would not be between the Plans and a party in interest with respect to the Plans, but, rather, would be a transaction between a tenant and a provider of the goods or services. Under these circumstances, the furnishing of goods and services by a UTC subsidiary for the repair and maintenance of real property acquired by the Plans would not be prohibited by section 406(a) of ERISA.

With respect to your second question, for those transactions that involve the assets of the Plans, section 408(b)(2) of ERISA exempts from the prohibitions of section 406(a) the payment by a plan to a party in interest, including a fiduciary, for a service (or a combination of services) if: (1) the service is necessary for the establishment or operation of the plan; (2) the service is furnished under a contract or arrangement which is reasonable; and (3) no more than reasonable compensation is paid for the service. Regulations issued by the Department clarify the terms "necessary service" (29 CFR 2550.408b-2(b)), "reasonable contract or arrangement" (29 CFR 2550.408b-2(c)) and "reasonable compensation" (29 CFR 2550.408c-2) as used in section 408(b)(2) of ERISA.

It is the view of the Department that the services necessary for the maintenance and repair of real property investments that the Plans may acquire are services generally encompassed by the statutory exemption contained in section 408(b)(2) of ERISA if the conditions contained therein and in section 2550.408b-2 of the regulations are satisfied. In this connection, questions of what constitutes a (particular) necessary service, reasonable contract or arrangement or reasonable compensation are inherently factual in nature and must be resolved by the trustees or other appropriate fiduciaries of the Plans. Section 5.01 of ERISA Advisory Opinion Procedure (ERISA Proc. 76-1, 41 FR 36281, August 27, 1976) states that the Department generally will not issue advisory opinions on such questions.

Regulation section 29 CFR 2550.408b-2(b) permits a person providing services to a plan to furnish a limited amount of goods which are necessary and incidental to the furnishing of such services. Therefore, the person providing maintenance and repair services in connection with real property investments that the Plans may acquire may furnish goods which would be incidental to such maintenance and repair. *However, section 408(b)(2) of ERISA would not permit a party in interest to furnish (sell) goods to the Plans which would be in the nature of capital improvements to real estate*. However, as you may be aware, the Department recently proposed (47 FR 56945, December 21, 1982) a class exemption under which the

SECTION 6.6 NOT PAYING COMPENSATION TO THE IRA OWNER

Since I.R.S. Chief Counsel Advice 200952049[175] says it would be a violation of the PT rules for an IRA to pay reasonable compensation to the IRA Owner, what if the IRA Owner works on behalf of the IRA for free? The Treasury regulations specifically state that providing services without compensation does not necessarily constitute a PT under IRC § 4975(c)(1)(E) or (F).[176] Treas. Reg. §§ 54.4975-6(a)(5) and ((6) are very important in this context. For our purposes a most interesting part of (a)(5) is subparagraph (iii),[177]

> restrictions of section 406(a)(1)(A) through (D) of ERISA will not apply to a transaction between a party in interest with respect to an employee benefit plan and an investment fund in which the plan has an interest, and which is managed by a qualified professional asset manager (QPAM), subject to certain conditions. In addition, subject to specified conditions, the class exemption would also afford relief under ERISA sections 406(a) and 406(b)(1) so as to permit limited amounts of goods and services to be provided by sponsoring employers and their affiliates.
>
> With respect to your third question, section 406(b) of ERISA provides that a fiduciary with respect to a plan shall not (1) deal with the assets of the plan in his or her own interest or for his or her own account, (2) in his or her individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or (3) receive any consideration for his or her own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.
>
> Regulation provisions under 29 CFR 2550.408b-2(a) indicate that section 408(b)(2) of ERISA does not contain an exemption for an act described in section 406(b) even if such act occurs in connection with a provision of services which is exempt under section 408(b)(2). As explained in regulation 29 CFR 2550.408b -2(e)(1), a fiduciary may not use any of its authority, control or responsibility which makes such person a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which the fiduciary has an interest which may affect the exercise of the fiduciary's best judgment as a fiduciary. A fiduciary would have an interest in a transaction which may affect his best judgment as a fiduciary if, among other things, he is dealing with a person who can terminate his relationship with the plan. See paragraph (f), example 5 of the above regulation. Whether a fiduciary has such an interest general depends on the facts and circumstances of the particular case.
>
> Based on the representations in your letter we have made the following determinations: (1) arrangements made with a UTC subsidiary by a tenant under an absolute net lease in the circumstances you describe would not be a transaction involving a fiduciary dealing with plan assets and therefore would not be prohibited by section 406(b)(1); and (2) whether arrangements made by a property manager with a UTC subsidiary for maintenance and repair in the circumstances you describe constitutes a violation of section 406(b)(1) is a factual question with respect to which we are unable to express an opinion. Specifically, we will not rule as to whether the property manager in such a situation has an interest in the transaction which may affect his judgment as a fiduciary. ERISA Op. Letter 83-45A at 2-5 (emphasis added).

[175] I.R.S. Chief Counsel Advice 200952049 (Dec. 24, 2009) (discussed *supra* in Part V.E).

[176] Treas. Reg. § 54.4975-6(a)(5)(iii).

[177] *Id.*

> (iii) Services without compensation. If a fiduciary provides services to a plan without the receipt of compensation or other consideration (other than reimbursement of direct expenses properly and actually incurred in the performance of such services within the meaning of paragraph (e)(4) of this section), the provision of such services does not, in and of itself, constitute an act described in section 4975(c)(1)(E) or (F). The allowance of a deduction to an employer under section 162 or 212 for the expense incurred in furnishing office space or services to a plan established or maintained by such employer does not constitute compensation or other consideration.

entitled "Services without compensation," which states that "the provision of such services does not, in and of itself, constitute an act described in section 4975(c)(1)(E) or (F)."

Is this blessing limited to the PT Rules or does it apply when the perspective changes? Would the IRS taketh away what it has just given by alleging that working for free would be either an assignment of income or an indirect contribution to the QRP perhaps violating the limits on contributions and benefits under IRC § 415 or an excess contribution to an IRA under IRC § 408(a)(1) via IRC § 219(b)(1)? This would appear to be implicit in Notice 2004-8,[178] so much so that if the uncompensated services are to a Roth-owned company—an incorporated medical practice in one of the examples given in the ruling—the transaction is probably a "listed transaction" and required to be reported as such. On the other hand, surely, where the IRA Owner works all day pouring over Barons and the Wall Street Journal looking for the best investments for his or her IRA, rather than paying an investor advisor to do the same, no one is going to complain. How far can the principle be extended? What if the IRA Owner sets up an office to manage all of the real estate investments owned by the IRA? Treasury Regulation § 54.4975-6-6(a)(5) is a very strong authority for the proposition that this is permissible. Also, everything being done by an IRA Owner on behalf of his or her IRA, where there is no benefit other than as a beneficiary of the IRA, is an instance of the IRA Owner as "a fiduciary acting only as such,"[179] which is not a PT.

There is very little one way or the other on the issue of indirect contributions to a QRP.[180] However, Notice 2004-8[181] discussed at length *infra* in Part XIII, recognizes that a scheme whereby an IRA Owner basically assigns the receipts for his or her services to a Roth IRA-owned corporation is abusive and subject to reporting as a listed transaction.

SECTION 6.7 CLASS PROHIBITED TRANSACTIONS INVOLVING SERVICE PROVIDERS

There are a number of class prohibited transaction exemptions (CPTEs) issued by the DOL allowing broker-dealers, banks, etc. to provide the types of services that are traditionally associated with these institutions.[182] One wonders why a CPTE is necessary in these cases, since there is already a statutory exemption for service providers, if all aspects of the transaction are reasonable. This is not true if goods are being bought and sold between DQPs. In that case reasonableness is insufficient; in fact it is irrelevant. If the buying and selling of goods is involved, an exemption issued by the DOL is the only way the transaction can be permitted.

Query whether effecting a stock transaction is furnishing goods. If so, these CPTEs could be explained on those grounds. On the other hand, even in the case of services, there may be a conflict of interest affecting the judgment of the DQP. Again, a service provider is a DQP and providing services is a PT.

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[178] I.R.S. Notice 2004-8, 2004-4 I.R.B. 333. This Notice is discussed *supra* in Part II.I. and is discussed in greater detail *infra* in Part XIII.

[179] The last sentence of both I.R.C. § 4975(a) and (b) states, "The tax imposed by this subsection shall be paid by any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such)."

[180] The issue did come up, however, in an application for a PT exemption where the DOL expressed concern that a below market sale of equipment to a plan might be an indirect contribution to a QP, in possible violation of the I.R.C. § 415. App. for Indiv. Transaction Exemption d-4124 (on file with author).

[181] I.R.S. Notice 2004-8, 2004-4 I.R.B. 333 (discussed *supra* in Part II.I and at greater length *infra* in Part XIII).

[182] *E.g.,* CPTE 75-1, 40 Fed. Reg. 50845 (Oct. 31, 1975); CPTE 79-13, 44 Fed. Reg. 25533-02 (May 1, 1979); CPTE 81-8, 46 Fed. Reg. 7511 (Jan. 23, 1981), *amended by* 50 Fed. Reg. 14043 (Apr. 8, 1985); CPTE 83-1, 48 Fed. Reg. 895-01 (Jan. 7, 1983); CPTE 91-38, 56 Fed. Reg. 31966-01 (July 12, 1991) (amending CPTE 80-51, 45 Fed. Reg. 49709 (July 25, 1980)).

The IRS and the DOL consider that if there is a conflict of interest, the exemptions otherwise applicable do not apply. Broker dealers probably provide both goods *and* services. If they provide services then they would be DQPs, which would then taint the providing of goods. Perhaps that is the reason for the vast number of CPTEs involving banks and broker-dealers.

SECTION 6.8 PERFORMANCE BASED FEES/VARIABLE FEES

Fees based on a percentage of plan assets under administration or based on a percentage of the gain in the portfolio under management pose special problems. It can be done, but at a minimum there must be no conflict of interest in the arrangement. A good discussion of this issue is found in ERISA Opinion Letter 99-16A.[183]

SUBSECTION 6.8(a) COMPENSATING A DISQUALIFIED PERSON OF AN ESOP

Closely held ESOPs exist. One would assume that the Plan Asset Rules[184] usually apply to them. If so, how do the owners/executives get paid for their services to the corporation? If they are paid, and the Plan Asset Rules apply, would they not be being paid with plan assets? The Plan Asset Rules don't necessarily work that way. The Plan Asset Rules simply make the owners/executives fiduciaries, presumably. Even so, the fiduciary is paying himself or herself compensation. Is there an exemption for this? Perhaps the reasonable compensation for services exemption *applies.* But analysis of the cases, rulings, and IRS and DOL pronouncements lead to a lot of uncertainty for this exemption, and the whole issue is very problematic. Indeed, the IRC § 4975(d) exemptions include allowances for reasonable compensation in certain situations.[185]

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[183] ERISA Op. Letter 99-16A (Dec. 9, 1999); *see* Braden v. Wal-Mart Stores, Inc., 588 F.3d 585 (8th Cir. 2009); Haddock v. Nationwide Fin. Serv. Inc., 419 F. Supp.2d. 156 (D.Conn. 2006); *but see* Hecker v. Deere & Co., 556 F.3d 575 (7th Cir. 2009).

[184] See *infra* Part VII for a discussion of the Plan Asset Rules.

[185]

> Exemptions. Except as provided in subsection (f)(6), the prohibitions provided in subsection (c) shall not apply to—
>
> * * * *
>
> (2) any *contract*, or reasonable arrangement, made with a disqualified person for office space, or *legal, accounting*, or other services necessary for the establishment or operation of the plan, *if no more than reasonable compensation is paid* therefor;
>
> * * * *
>
> (10) receipt by a disqualified person of any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan, but no person so serving who already receives full-time pay from an employer or an association of employers, whose employees are participants in the plan or from an employee organization whose members are participants in such plan shall receive compensation from such fund, except for reimbursement of expenses properly and actually incurred;

I.R.C. § 4975(d) (emphasis added).

SECTION 6.9 ESOP CASES INVOLVING COMPENSATION

There is a concept in the ESOP cases referred to as "procedural prudence."[186] This might require that whoever is setting the salary of the DQP be independent. It is doubtful that this always happens. In a closely held corporation it would be awkward, at least; but it might be necessary in order to avoid a "conflict of interest" which is clearly implied as prohibited under ERISA, though not so clearly under non ERISA QRPs like IRAs. If an ESOP owned more than twenty-five percent of the plan sponsor the Plan Asset Rules might apply; and, if so, the exemptions for reasonable compensation found in § 4975(d)(2) and (10) might permit an independent fiduciary to set the salary of the DQP, although there is an awkward provision in § 4975(d)(10) that prohibits using the exemption in § 4975(d)(10) if the DQP is already receiving full-time pay from the employer. The problem is not being analyzed by the DOL or IRS quite that deeply. In any case, even if the ESOP owns more than twenty-five percent of the equity interests in the employer, the employer is probably an operating company, exempt from the Plan Asset Rules. There could very well be a problem for one reason or another, if the DQP is a fiduciary of a plan that owns employer stock, and the fiduciary is setting his or her own salary.

None of the cases below turns on the question of whether the reasonable compensation exemptions of IRC § 4975(d)(2) and (10) applied, and none discusses the Plan Asset Rules in connection with the compensation issue. Two of the cases, *Bierwirth*[187] and *Delta Star*,[188] are analyzed as conflict of interest cases, but the third, *Eckelkamp*, concluded that setting salary is a corporate function and not controlled by ERISA, even when there is an ESOP that owns a portion of the corporate stock. *Eckelkamp* has been cited often with approval.[189]

Donovan v. Bierwirth. *Donovan v. Bierwirth*[190] is somewhat hoary by now, and is often cited in ESOP cases. The court noted that there were times when the actions of the fiduciaries made to further the best interests of the participants might incidentally benefit the Corporation or the fiduciaries individually as corporate officers.[191]

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[186] *See* DOL Information Letters to Gareth W. Cook (Sept. 12, 1983), 11 Pens. Rep. (BNA) 1494 (Nov. 19, 1984); Charles R. Smith (Nov. 23, 1984 and Nov. 24, 1984), 12 Pens. Rep. (BNA) 52, 53, 59 (Jan. 7, 1985); and Wilson H. Ellis, Jr. (July 30, 1985), 12 Pens. Rep. (BNA) 1182 (Aug. 26, 1985); Andrade v. Parsons Corp., 90 WL 757367 (C.D. Cal. 1990), *aff'd*, 972 F.2d 1336 (9th Cir. 1992).

[187] Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982).

[188] Delta Star v. Patton, 76 F. Supp. 2d 617 (W.D.Pa. 1999).

[189] Johnson v. Couturier, 572 F.3d 1067 (9th Cir. 2009); Barrus v. Dick's Sporting Goods, Inc., 732 F. Supp. 2d 243 (W.D.N.Y. 2010).

[190] *Donovan*, 680 F.2d 263.

[191]

> Although officers of a corporation who are trustees of its pension plan do not violate their duties as trustees by taking action which, after careful and impartial investigation, they reasonably conclude best to promote the interests of participants and beneficiaries simply because it incidentally benefits the corporation or, indeed, themselves, their decisions must be made with an eye single to the interests of the participants and beneficiaries. RESTATEMENT OF TRUSTS 2d § 170 (1959); II SCOTT ON TRUSTS § 170, at 1297-99 (1967) (citing cases and authorities); BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543 (2d ed. 1978). This, in turn, imposes a duty on the trustees to avoid placing themselves in a position where their acts as officers or directors of the corporation will prevent their functioning with the complete loyalty to participants demanded of them as trustees of a pension plan.

Id. at 271.

Delta Star v. Patton. In *Delta Star v. Patton*,[192] an ESOP brought a lawsuit against the owner, director and officer of the ESOP sponsor. One of the claims was that the owner, who was also one of the ESOP trustees, paid himself excessive compensation as an employee of the corporation whose stock was the principal investment of the ESOP.[193] The district court noted:

> Although ERISA does not expressly bar an ESOP trustee from simultaneously serving as director or officer of the sponsoring employer, ERISA does not sanction any derogation from the strict fiduciary requirements imposed upon that ESOP trustee.[194]

The ESOP asserted and the court appeared to agree that-

> 62. Patton breached the fiduciary duties that he owed as an ESOP trustee by failing to recognize the conflict of interest that existed between his duty of loyalty to the participants of the Delta Star ESOP, and his personal financial interest in receiving unreasonable and unauthorized salary increases and bonuses and unreasonable retirement benefits under the BRP and SERP executive compensation plans.[195]

What if Patton had not been a trustee of the ESOP? Perhaps this would have been enough; perhaps not. If the Plan Asset Rules apply, then there can be no self-dealing with the corporate assets,[196] and voting to pay oneself a salary might be considered self-dealing if done by a fiduciary. What if, somehow, someone else, someone independent, were appointed to set the salary of the owner and chief executive? This would probably work. This is probably what happens with large ESOPs, simply by the operation of the corporate norm. Is it the rule or the exception in the case of small ESOPs?

Eckelkamp v. Beste. An issue similar to that discussed above in *Delta Star* arose in *Eckelkamp v. Beste*,[197] but with a result more favorable to the taxpayer. Summary judgment for the complainants was denied. The plaintiffs contended that the executive defendants paid themselves unreasonable salaries resulting in the underpayment of dividends to the ESOP participants.[198]

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[192] *Delta Star,* 76 F. Supp. 2d 617.

[193] The part of the complaint with which we are interested-

> 47. At Count One, the Delta Star ESOP and the current members of the ESOP Board of Trustees claim that Patton breached the fiduciary duties that he owed to the Delta Star ESOP as a member of the ESOP Board of Trustees, in violation of ERISA, 29 U.S.C. § 1104, by voting the shares of Delta Star common stock held by the Delta Star ESOP in favor of his retention as a member of the Delta Star Board, and by failing to take action as a member of the ESOP Board of Trustees to remove himself from the Delta Star Board or otherwise prevent the payment of excessive and unreasonable compensation and retirement benefits to himself.

Id. at 634.

[194] *Id.* at 636.

[195] *Id.* at 637.

[196] *See generally id.* at 638. See also *infra* Part VII.G for a discussion of when the Plan Asset Rules apply.

[197] Beste v. Eckelkamp, 201 F. Supp. 2d 1012 (E.D.Mo. 2002), *aff'd,* 315 F.3d 863 (8th Cir. 2002).

[198] [T]he plaintiffs contend that the Executive Defendants breached their fiduciary duties as trustees of the Melton Machine ESOP by paying themselves (as corporate officers of Melton Machine and Control Company) unreasonable and excessive salaries, bonuses, and other benefits, thereby allegedly causing the

The court first addressed whether the defendants were fiduciaries in setting compensation levels.[199] The court found that in setting corporate salaries, the defendants were not subject to fiduciary duties under ERISA in determining compensation levels for themselves and other employees.[200]

Johnson v. Couturier. *Johnson v. Couturier*[201] involved a company that was 100% owned by an ESOP.[202] A primary allegation was that the President of the corporation was "vastly overcompensated." The 9th Circuit affirmed preliminary injunctions granted by the district court prohibiting the advancement of defense costs, freezing the president's assets and requiring an accounting.[203]

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underpayment of dividends to Melton Machine ESOP participants (including the plaintiffs) and/or the undervaluation of the Melton Machine ESOP's stock in annual appraisals. *Id*. at 1013-14.

199 "The first issue that must be addressed before even considering the existence of any breach by any one or all of the Executive Defendants is whether the Executive Defendants qualify as fiduciaries with respect to the setting of compensation levels." *Eckelkamp*, 201 F. Supp. 2d at 1013.

200 In the instant case, MMCC's by-laws confer the responsibility of setting compensation levels to MMCC's President, subject to the oversight of the Board of Directors. Thus, the financial affairs of MMCC as it relates to salaries is clearly a corporate matter involving the furtherance of the business of MMCC. It does not implicate a fiduciary duty under ERISA. Thus, the Executive Defendants were not acting in their fiduciary capacities when compensation levels were determined for themselves and the other employees of MMCC.

Assuming arguendo that the Executive Defendants determination of compensation levels was conduct governed by ERISA's fiduciary standards (i.e., Executive Defendants were acting as fiduciaries when setting compensation levels), the affirmative evidence before this Court establishes that no breach of fiduciary duty occurred. (*Id.* at 1023.)

201 Johnson v. Couturier, 572 F.3d 1067 (9th Cir. 2009).

202 *See* 29 C.F.R. § 2510.3-101(h)(3) (showing that except in certain cases where the equity is qualifying employer securities, the Plan Asset Rules will always apply where the plan, or a related group of plans, own all of the equity interest, period. This issue is discussed in detail *infra* in Part VII.H).

203 Decisions relating to corporate salaries generally do not fall within ERISA's purview. But where plan assets include the employer's stock, the value of those assets depends on the employer's equity. Employee compensation levels are, of course, one of the many business expenditures reducing the value of the overall equity of any company. On the other hand, "[v]irtually all of an employer's significant business decisions affect the value of its stock, and therefore the benefits that ESOP plan participants will ultimately receive." *Martin v. Feilen*, 965 F.2d 660, 666 (8th Cir. 1992). Taken to its logical conclusion, therefore, this line of thinking would, in the case of an ESOP, extend the application of ERISA to a corporation's annual expenditures on office supplies–clearly an absurd result. The Eighth Circuit has on this basis limited an ERISA fiduciary's duties "to transactions that involve investing the ESOP's assets or administering the plan." *Id*. Setting executive compensation levels does not obviously fall into either category. *See Eckelkamp v. Beste*, 201 F. Supp. 2d 1012, 1023 (E.D.Mo. 2002) (holding that a corporate director is not acting as an ESOP fiduciary in setting compensation levels).

Nonetheless, we conclude that applying ERISA to the instant case does not risk encompassing within its confines any and all day–to–day corporate decisions shielded by the business judgment rule. Where, as here, an ESOP fiduciary also serves as a corporate director or officer, imposing ERISA duties on business decisions from which that individual could directly profit does not to us seem an unworkable rule. To the contrary, our holding merely comports with congressional intent in establishing ERISA fiduciary duties as "the highest known to the law." *Howard v. Shay*, 100 F.3d 1484, 1488 (9th Cir.1996) (quotation omitted). To hold otherwise would protect from ERISA liability obvious self–dealing, as Plaintiffs allege occurred here, to the detriment of the plan beneficiaries. *Johnson*, 572 F.3d at 1077.

ARTICLE 7 WHAT ARE PLAN ASSETS AND WHY DO WE CARE? THE PLAN ASSET RULES

SECTION 7.1 PRELIMINARIES

The Plan Asset Rules,[204] if they apply, impose a look-through principle, under which a plan will be treated as directly owning assets owned by an entity that is owned by the plan.[205] This could conceivably cause persons with management power over the entity's assets to be DQPs so that their dealings with the assets could be PTs, or dealings by the IRA Owner with the entity's assets could be PTs.[206]

DOL Reg. § 2510.3-101(a)(2) states the rule succinctly enough to simply reproduce:

> Generally, when a plan invests in another entity, the plan's assets include its investment, but do not, solely by reason of such investment, include any of the underlying assets of the entity. However, in the case of a plan's investment in an equity interest of an entity that is neither a publicly-offered security nor a security issued by an investment company registered under the Investment Company Act of 1940 its assets include both the equity interest and an undivided interest in each of the underlying assets of the entity, unless it is established that—
>
> (i) The entity is an operating company, or
>
> (ii) Equity participation in the entity by benefit plan investors is not significant.
>
> Therefore, any person who exercises authority or control respecting the management or disposition of such underlying assets, and any person who provides investment advice with respect to such assets for a fee (direct or indirect), is a fiduciary of the investing plan.

It is surprisingly easy to avoid the application of the Plan Asset Rules for businesses that are not investment companies: there is an exception for operating companies, real estate operating companies, publicly-traded stocks and bonds, and venture capital operating companies.

SECTION 7.2 SIGNIFICANT EQUITY OWNERSHIP REQUIREMENT

Under DOL Reg. § 2510.3-101(a)(2), the Plan Asset Rules will not apply if "[e]quity participation in the entity by benefit plan investors is not significant."[207]

Ownership of twenty-five percent or more of *any class* of equity interest in the business is considered for these purposes to be "significant."[208] This is much less than that required for the entity itself to be a DQP.[209]

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[204] Special thanks to Quitman Stephens for reviewing this Part of the article and making suggestions.

[205] 29 C.F.R. § 2510.3-101; *cf.* 29 C.F.R. § 2510.3-102; State St. Bank and Trust Co. v. Salovaara, 326 F.3d 130 (2nd Cir. 2003).

[206] *See infra* Part VII.D.

[207] 29 C.F.R. § 2510.3-101(a)(2)(ii).

[208] Participation by benefit plan investors. (1) Equity participation in an entity by benefit plan investors is "significant" on any date if, immediately after the most recent acquisition of any equity interest in the entity, 25 percent or more of the value of any class of equity interests in the entity is held by benefit plan investors (as defined in paragraph (f)(2)). For purposes of determinations pursuant to this paragraph (f), the value of any equity interests held by a person (other than a benefit plan investor) who has

A problem not to be overlooked is that in determining whether or not the plan owns twenty-five percent of the business is that "the value of any equity interest held by a person (other than such a benefit plan investor) who has discretionary authority or control with respect to the assets of the entity or any person who provides investment advice for a fee (direct or indirect) with respect to such assets, or any affiliate of such a person, shall be **disregarded**."[210] So, if the IRA Owner has a twenty percent interest in a business, and the IRA owns a like amount, the IRA Owner's interest is ignored. This is not helpful, because it means that the IRA is deemed to own twenty-five percent (20/80ths, instead of 20/100ths) of the business.[211]

SECTION 7.3 PURPOSE OF THE RULES

The purpose of the Plan Asset Rules is to determine when assets held by an entity owned by an IRA (or qualified plan) are treated as owned by the IRA (or qualified plan). One effect of a finding that the Plan Asset Rules apply is that "any person who exercises authority or control respecting the management or disposition of such underlying assets, and any person who provides investment advice with respect to such assets for a fee (direct or indirect), is a fiduciary of the investing plan."[212] A fiduciary is always a DQP.

That is not the only consequence, however. The DOL Regulations also state that the regulations are designed to identify "*what constitute assets of a plan with respect to a plan's investment in another entity for purposes of* . . . [the prohibited transaction rules of] section *4975*."[213]

SECTION 7.4 CONSEQUENCES OF THE RULES

For our purposes, we have to consider that not only will all persons who have internal powers of management over the assets in an entity subject to the Plan Asset Rules be fiduciaries, and thus, disqualified persons, but any dealings that those persons have with the assets could easily fall within the class of prohibited transactions. The IRA Owner is usually a fiduciary,[214] so the fact that the IRA Owner is a fiduciary under the Plan Asset Rules is hardly devastating in itself, at least in those cases where the entity is a disqualified person. However, now one must be concerned about that person's activities with the assets of the company owned by the IRA. For example, are those assets being paid to the IRA Owner as compensation, and, if so, is there an exception to the PT rules that will allow that? Even if the entity itself is not a disqualified person, perhaps because the IRA Owner and family have less than fifty percent of the vote, value or capital, any dealings by the IRA Owner with the assets of the entity could

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discretionary authority or control with respect to the assets of the entity or any person who provides investment advice for a fee (direct or indirect) with respect to such assets, or any affiliate of such a person, shall be disregarded. Treas. Reg. § 2510.3-101(f).

See also: (42) the term "plan assets" means plan assets as defined by such regulations as the Secretary may prescribe, except that under such regulations the assets of any entity shall not be treated as plan assets if, immediately after the most recent acquisition of any equity interest in the entity, less than 25 percent of the total value of each class of equity interest in the entity is held by benefit plan investors. ERISA §3(42).

[209] *See supra* Part IV.A (discussing a general fifty percent test).

[210] ERISA § 3(42).

[211] *See* 29 C.F.R. § 2510.3-101(f)(1), 2510.3-101(j), Ex. (4).

[212] 29 C.F.R. § 2510.3-101(a)(2), flush language.

[213] 29 C.F.R.§ 2510.3-101(a); *see also* Treas. Reg. § 54.4975-6.

[214]*See supra* Part IV.D.

nevertheless be prohibited, being treated as a straightforward transaction with the assets of the IRA. This does not necessarily mean that the IRA Owner cannot have a fiduciary role in managing the entity. In fact, under the default laws of most states a fiduciary of a company is not allowed to self-deal anyway, though state law usually permits the default rule to be overridden in the governing documents, and it frequently is.

A manager who is not aware that an IRA has an interest in the entity, or who is unaware of the consequences of that fact, could find him or herself on the wrong side of a prohibited transaction without having a clue that there was a problem.

SECTION 7.5 ERISA OPINION LETTER 2000-10A

ERISA Opinion Letter 2000-10A concluded:

> Moreover, the Department notes that by virtue of the contemplated investment by the IRA in the Partnership, there will be *significant investment* in the Partnership by benefit plan investors. Accordingly, the Partnership will hold *"plan assets"* within the meaning of that term in the Department's regulations at 29 C.F.R. § 2510.3-101. *As a result, any person who exercises discretionary authority or control with respect to assets of the Partnership will be a fiduciary of the IRA* and subject to the restrictions of section 4975(c)(1) of the Code, except to the extent a statutory or administrative exemption applies.[215]

Under the facts of ERISA Opinion Letter 2000-10A, transactions between the partnership and the fiduciary were subject to the list of transactions prohibited by IRC § 4975(c)(1), but *were the partnership assets literally "plan assets" such that assets that an IRA is prohibited from owning under IRC § 408—such as life insurance*[216] *or collectibles*[217]*—cannot be owned by the partnership? The answer should be "no,"* for the reason that the plan assets regulation "describes what constitute assets of a plan with respect to a plan's investment in another entity *for purposes of Subtitle A, and Parts 1 and 4 of Subtitle B, of Title I of the Act and section 4975 of the Internal Revenue Code,"*[218] *and presumably has no application for other purposes, including ERISA § 408.*

SECTION 7.6 HOW CAN THE RULES BE AVOIDED?

If the transaction can be structured so that the Plan Asset Rules do not apply, and if the entity is not a DQP, because, for example, the IRA Owner and family lack the requisite control, then violating the PT rules becomes much more difficult. For that reason, avoiding the Plan Asset Rules " 'tis a consummation devoutly to be wish'd."[219] It can be done, with care, in two broad classes of cases. (a) The Plan Asset Rules do not apply in the case of an operating company, including *a real estate operating company*. (b) In addition, if benefit plan equity participation in the entity is under twenty-five percent, and is thus deemed to be "insignificant," the Plan Asset Rules do not apply.

Of course, even if the Plan Asset Rules apply, one hopes that it does not *per se* prevent the IRA from making the investment; but it does mean, at a minimum, that preventing any inadvertent self-dealing or

[215] ERISA Op. Letter 2000-10A (July 27, 2000) (emphasis added).

[216] *See* ERISA §408(a)(3).

[217] *See* ERISA §408(m).

[218] 29 C.F.R. § 2510.3-101(a).

[219] William Shakespeare, Hamlet, Act 3, Sc. 1.

other violation of the prohibited transaction rules could be a very important as well as a particularly challenging undertaking.

SECTION 7.7 WHAT ARE PLAN ASSETS, IN GENERAL; WHEN DO THE RULES APPLY?

The Plan Asset Rules provide that under certain conditions the assets of an entity are treated as the assets of the IRA for purposes of the prohibited transaction rules (IRC § 4975) among other things.

The Plan Asset Rules do not apply to an equity interest in either a publicly-offered security or a security issued by a Registered Investment Company.[220] Of course, it would be rare for a QRP to own more than twenty-five percent of a publicly-traded corporation. For purposes of this article, the exception just described will rarely be relevant or beneficial.

Importantly, the Plan Asset Rules do not apply to an Operating Company, including a Venture Capital Company or a Real Estate Operating Company. This indicates that the rules are mainly aimed at capital investment companies.

What is an "Operating Company?" "An 'operating company' is an entity that is primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital."[221] An operating company also includes a "venture capital company" or a "real estate operating company."[222]

The definition of an "operating company" in the regulations does not give much guidance. On the other hand, there are elaborate regulations defining a "venture capital operating company" (VCOC) and a "real estate operating company" (REOC). Some hedge funds may be able to qualify under regulations as a VCOC.

If the company is wholly-owned by the QRP, the Plan Asset Rules apply even if the company is an operating company,[223] *unless* all the equity interests in the company are "qualifying employer securities,"[224] owned by eligible individual account plans maintained by the same employer.[225]

What is a "Venture Capital Operating Company? A venture capital operating company is a company that invests most of its assets in "venture capital investments" or "derivative investments," and "the entity, in the ordinary course of its business, actually exercises management rights . . . with respect to one or more of the operating companies in which it invests." [226] More practically speaking a VCOC is an entity that invests at least fifty percent of its assets (other than short-term investments pending long-term commitment), valued at cost on "its initial valuation date"[227] and again on at least one day in each subsequent "annual valuation period,"[228] in "venture capital investments."[229] A "venture capital

[220] 29 C.F.R.§ 2510.3-101(a)(1).

[221] 29 C.F.R. § 2510.3-101(c).

[222] 29 C.F.R. § 2510.3-101 (c)(1).

[223] *See* ERISA Op. Letter 97-23A (Sept. 26, 1997).

[224] ERISA § 407(d)(5).

[225] 29 C.F.R. § 2510.3-101(h)(3).

[226] 29 C.F.R. § 2510.3-101(d).

[227] *Id.*

[228] *Id.*

investment" is an investment in an operating company (including a REOC but excluding a VCOC) over which the investor has "contractual rights directly between the investor and an operating company to substantially participate in, or substantially influence the conduct of, the management of the operating company."[230]

What is a "Real Estate Operating Company?" A real estate operating company is a company that invests at least fifty percent of its assets (other than short-term investments pending long-term commitment) valued at cost on "its initial valuation date"[231] and again on at least one day in each subsequent "annual valuation period"[232]

> in real estate which is managed or developed and with respect to which such entity has the right to substantially participate directly in the management or development activities; and . . . such entity in the ordinary course of its business is engaged directly in real estate management or development activities.[233]

When is Equity Participation in an Entity by Benefit Plan Investors Significant? The Plan Asset Rules will not apply if equity participation by benefit plan investors is not significant.[234] Under the regulations, "[e]quity participation in an entity by benefit plan investors is 'significant' . . . if . . . twenty-five percent or more of the value of any class of equity interests in the entity is held by benefit plan investors."[235] Section 3(42) of ERISA, added by the Pension Protection Act of 2006, now states that

> [T]he assets of any entity shall not be treated as plan assets if, immediately after the most recent acquisition of any equity interest in the entity, less than 25 percent of the total *value of each class* of equity interest in the entity is held by benefit plan investors. . . .[236]

SECTION 7.8 IF THE PLAN OR A RELATED GROUP OF PLANS OWN ALL OF THE EQUITY INTEREST, THE PLAN ASSET LOOK-THROUGH RULES APPLY

A corollary of the "insignificant" equity participation exception is that the Plan Asset Rule applies to the assets of an entity if the plan or a related group of plans "owns all of the outstanding equity interests" in the entity. [237] This means that, except in certain cases where the equity is qualifying employer securities,

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229 *Id.*

230 29 C.F.R. § 2510.3-101(d)(3).

231 29 C.F.R. § 2510.3-101(e).

232 *Id.*

233 *Id.*

234 *See supra* Part VII.B.

235 29 C.F.R. § 2510.3-101(f)(1); *see also* ERISA § 3(42), as amended by the Pension Protection Act of 2006, Pub. L. No. 109–280, 120 Stat. 780.

236 ERISA § 3(42) (emphasis added).

237 (3) When a plan or a related group of plans *owns all of the outstanding equity interests* (other than director's qualifying shares) in an entity, its assets include those equity interests and all of the underlying assets of the entity. *This paragraph (h)(3) does not apply, however, where all of the outstanding equity interests in an entity are qualifying employer securities* described in section 407(d)(5) of the Act, owned by one or more eligible individual account plan(s) (as defined in section 407(d)(3) of the Act) maintained by the same employer, provided that substantially all of the participants in the plan(s) are, or have been, employed by the issuer of such securities or by members of a group of affiliated corporations (as

the plan asset rules will always apply where the plan, or a related group of plans, own all of the equity interest, period.[238]

SECTION 7.9 CONCLUSIONS REGARDING THE APPLICATION OF THE PLAN ASSET RULES

It would appear to be possible in many cases, and not possible in many others, to avoid application of the Plan Asset Rules. If the company is in an active trade or business producing products or services, it should be fairly easy to qualify for an exemption as an Operating Company. Venture Capital Operating Companies and Real Estate Operating Companies are excluded, as are entities where the equity investment by benefit plans in each class of equity in the entity is less than twenty-five percent. Thus avoiding the Rules is definitely achievable and often feasible.

The Plan Asset Rules present problems that are both distinct from and overlap the rules regarding who is and who is not a DQP. If the operating company is a DQP, great care will be called for even if the Plan Asset Rules do not apply. Conversely, even if the entity itself is not a DQP, the Plan Asset Rules could result in dealings between the IRA and the entity or its assets to be prohibited transactions.

SECTION 7.10 INTERPRETIVE BULLETIN 75-2 AND 29 C.F.R. § 2509.75-2

The DOL released Interpretive Bulletin 75-2[239] in early 1975. The purpose of this bulletin was to set forth criteria for determining when a DQP has engaged in a PT where the DQP has engaged in a transaction, not with the QRP itself, but with a business in which the plan has invested.[240] Eleven years later the final plan asset regulations were issued. These replaced part (a) of the Interpretive Bulletin, except for

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> determined under section 407(d)(7) of the Act) of which the issuer is a member. DOL Reg. § 2510.3-101(h)(3) (emphasis added).

[238] This means that, except in certain cases where the equity is qualifying employer securities, the Plan Asset Rules will always apply where the plan, or a related group of plans, own all of the equity interest, period. *Cf.* ERISA Op. Letter 2005-03A*.* ERISA Op. Letter 97-23A (Sept. 26, 1997) states:

> As applicable here, the plan assets regulation provides that, when a plan or a related group of plans owns all of the outstanding equity interests (other than director's qualifying shares) in an entity, the plan's assets include those equity interests and all of the underlying assets of the entity. 29 C.F.R. 2510.3-101(h)(3). As explained in the preamble to the final plan assets regulation, this provision reflects the Department's conclusion that, when a plan is the sole owner of an entity, there is no meaningful difference between the assets of the entity and the assets of the plan. *See* 51 Fed. Reg. 41262, 41276 (Nov. 13, 1986).
>
> In this case, because the Pension Plan will establish and own 100% of the equity interests in Pentegra, the underlying assets of Pentegra will be assets of the Plan. Therefore, transactions between Pentegra and the Plan, including the initial capitalization of Pentegra by the Plan and the transfer of property or services between the Plan and Pentegra, would be considered intra-plan transactions, rather than transactions between the Plan and a party in interest.

[239] 29 C.F.R. § 2509.75-2.

[240] *Id.* Part of first sentence states that the question to be addressed by the regulation was

> with respect to whether a party in interest has engaged in a prohibited transaction with an employee benefit plan where the party in interest has engaged in a transaction with a corporation or partnership (within the meaning of section 7701 of the Internal Revenue Code of 1954) in which the plan has invested.

transactions prior to the final regulations and certain transition rules. However, the rather complicated provisions of subparagraph (c) of 29 C.F.R. § 2509.75-2 are still applicable.[241]

This is sometimes referred to as an anti-log rolling or alter ego rule.[242] Subparagraph (c) of § 2509.75-2 (quoted in the footnote) is a very important pronouncement; however the exceptions -- the various "ifs"-- require careful reading.

SECTION 7.11 CONSEQUENCES OF HOLDING PLAN ASSETS

As stated *supra* in Part VII.C, the main effect of a finding that the Plan Asset Rules apply, according to the DOL, is that "any person who exercises authority or control respecting the management or disposition of such underlying assets, and any person who provides investment advice with respect to such assets for a fee (direct or indirect), is a fiduciary of the investing plan."[243] But the regulations also inform us that they are designed to identify "what constitute assets of a plan with respect to a plan's investment in another entity for purposes of . . . [the prohibited transaction rules of] 4975."[244]

If the entity holds assets that an IRA is not permitted to hold, such as life insurance[245] or collectibles,[246] will the purpose of the rules, as stated by the DOL, be extended to disqualify the IRA by treating those

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241 (c) Applications of the fiduciary responsibility rules. The preceding paragraphs do not mean that an investment of plan assets in a security of a corporation or partnership may not be a prohibited transaction. For example, section 406(a)(1)(D) prohibits the direct or indirect transfer to, or use by or for the benefit of, a party in interest of any assets of the plan and section 406(b)(1) prohibits a fiduciary from dealing with the assets of the plan in his own interest or for his own account. Thus, for example, if there is an arrangement under which a plan invests in, or retains its investment in, an investment company and as part of the arrangement it is expected that the investment company will purchase securities from a party in interest, such arrangement is a prohibited transaction. Similarly, the purchase by a plan of an insurance policy pursuant to an arrangement under which it is expected that the insurance company will make a loan to a party in interest is a prohibited transaction. *Moreover, notwithstanding the foregoing, [1] if a transaction between a party in interest and a plan would be a prohibited transaction, then such a transaction between a party in interest and* <u>*such*</u> *corporation or partnership will ordinarily be a prohibited transaction if the plan may, by itself, require the corporation or partnership to engage in such transaction.* [2] Similarly, if a transaction between a party in interest and a plan would be a prohibited transaction, then such a transaction between a party in interest and such corporation or partnership will ordinarily be a prohibited transaction if such party in interest, together with one or more persons who are parties in interest by reason of such persons' relationship (within the meaning of section 3(14) (E) through (I)) to such party in interest may, *with the aid of the plan but without the aid of any other persons*, require the corporation or partnership to engage in such a transaction. *However, [3] the preceding sentence does not apply if the parties in interest engaging in the transaction, together with one or more persons who are parties in interest by reason of such persons' relationship (within the meaning of section 3(14) (E) through (I)) to such party in interest, may, by themselves, require the corporation or partnership to engage in the transaction.* Further, the Department of Labor emphasizes that it would consider a fiduciary who makes or retains an investment in a corporation or partnership for the purpose of avoiding the application of the fiduciary responsibility provisions of the Act to be in contravention of the provisions of section 404(a) of the Act. *Id.* (emphasis added).

242 *See* Luke Bailey, *Can an IRA Engage in a Transaction if the IRA's Owner Has or Will Have a Direct or Indirect Financial, Business, or Personal Interest in the Transaction Other than the IRA's Investment?*, STATE BAR OF TEX., 12TH ANNUAL ADVANCED ESTATE STRATEGIES COURSE, Ch. 3.4, at 6 (Apr. 6-7, 2006).

243 29 C.F.R. § 2510.3-101(a)(2).

244 29 C.F.R. § 2510.3-101(a)(1).

245 *See* I.R.C. § 408(g).

prohibited assets as "literally" being held by the IRA rather than by the underlying entity? This is not entirely clear, given the focus of the regulations, but the answer would appear to be "no."[247]

What about the rule that plan assets are to be held in trust?[248] Perhaps ERISA is not a concern here, but there is a similar IRC rule that an IRA must have a trustee,[249] and that the assets must not be commingled with other property.[250] This issue has not been raised directly by the IRS, the DOL or the courts; so perhaps the Plan Asset Rules are not meant to act as *per se* prohibition against investing in an entity that would cause the rule to apply. In fact, if holding plan assets under the look-through treatment required by the Plan Asset Rules were a violation of ERISA § 408(a)(2) *per se*, then there are a number of cases as well as ERISA Opinion Letters involving IRAs that could not be explained.

ARTICLE 8 MISCELLANEOUS RULES AND OBSERVATIONS

SECTION 8.1 DISTRIBUTIONS AND CONTRIBUTIONS OF PROPERTY OTHER THAN CASH FROM OR TO AN IRA

Contributions of property other than cash to an IRA are generally prohibited: "Except in the case of a rollover contribution . . . no contribution will be accepted unless it is in cash . . . ."[251]

Any property distributed by a qualified plan (or its proceeds), which are acceptable to the IRA sponsor, may be rolled over, with a few important exceptions. An IRA cannot invest in insurance contracts, for example.

Because there are many investments that the IRA custodian may not be in a position to accept, it is permissible to sell property received in a distribution and reinvest and rollover "an amount equal to any portion of the proceeds."[252] If this is done, no gain or loss on the sale will be recognized; the sales proceeds are treated as part of the distribution.[253]

Although an individual may sell property distributed from a qualified plan and rollover the proceeds, one may not keep the property and rollover equivalent value.[254] Nor may one receive cash, invest in stock, and rollover the stock.[255]

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[246] I.R.C. § 408(m).

[247] *See supra* Part VII.E.

[248] ERISA § 403.

[249] I.R.C. § 408(a)(2).

[250] I.R.C. § 408(a)(5).

[251] I.R.C. § 408(a)(1). "*Except in the case of a rollover contribution* described in subsection (d)(3) in section 402(a)(5), 402(a)(7), 403(a)(4), or 403(b)(8), *no contribution will be accepted unless it is in cash*. . . ." *Id.* (emphasis added).

[252] I.R.C. § 402(c)(6)(A).

[253] I.R.C. § 402(c)(6)(D).

[254] Rev. Rul. 87-77, 1987-2 C.B. 115.

[255] *See* Lemishow v. Comm'r 110 T.C.110 (1998).

Contributions of property are generally prohibited; however, distributions of property are not prohibited. This is because IRC § 4975(d)(9) specifically exempts from the definition of a prohibited transaction the

> (9) receipt by a disqualified person of any benefit to which he may be entitled as a participant or beneficiary in the plan, so long as the benefit is computed and paid on a basis which is consistent with the terms of the plan as applied to all other participants and beneficiaries. . .[256]

Treasury Regulations are explicit regarding how such distributions are to be valued for income tax purposes, viz., at fair market value on date of distribution.[257] Finally, we know that qualified plans can make distributions of property because the rules regarding the rollover of such property or its cash proceeds are detailed and comprehensive.[258]

SECTION 8.2 IRA: CONTRACT, SELF-SETTLED TRUST, GRANTOR TRUST, AGENCY RELATIONSHIP, BANK ACCOUNT, OR WHAT?

It is worth considering just what kind of creature an IRA actually is. Is it a contract? Is it the alter ego of the IRA Owner (though entitled to special income tax treatment)? Is it identical to a bank account?[259] Is it an entity? Is it tangible or intangible property? *Is it a self-settled trust?* Is it a "grantor trust?"

If an IRA is a trust, is it a "grantor trust" under Subpart E of Subchapter J? It would seem to fall squarely under IRC §§ 673, 674 and 677, which would mean that it would be taxed under § 671. However, there is little doubt that taxation is governed by IRC § 408. So, it might be a grantor trust for some purposes, but not for others. One place where the question might be relevant is where the IRA Owner decides to "convey" his or her IRA to a revocable living grantor trust.[260]

Who "owns" the IRA for purposes of the grantor trust rules? Probably the IRA is "owned" by the person who establishes it and contributes property to it, although title may be in the name of a custodial agent or a trustee. If it is a trust, the ownership is beneficial ownership. It is hard to escape the fact that if an IRA is a trust it is a self-settled trust and would be taxed as a grantor trust but for IRC § 408(d)(1).

While these questions are disturbing, on balance, an IRA is simply a self-settled trust (or at least a trusteed IRA is) that is tax exempt. If true, this makes the concept of a partnership between the IRA and the IRA Owner somewhat problematic under Revenue Ruling 85-13[261] and Revenue Ruling 87-61,[262] but there should be no problem with single member LLCs.

Although a trusteed IRA is probably a trust under state law, state trust law as applied to an IRA probably operates in some modified form. The law on this subject is simply not fully developed.

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[256] I.R.C. § 4975(d)(9).

[257] Treas. Reg. § 1.402(a)-1(a)(1)(iii).

[258] I.R.C. § 402(c)(6).

[259] If this is so, can a bank account form a partnership?

[260] See Rev. Rul. 85-13, 1985-1 C.B. 184 and Rev. Rul. 87-61, 1987-2 C.B. 219, which clearly states that all transactions between a grantor and the grantor's trust are ignored for tax purposes. Again, clearly, the grantor trust rules are subservient to I.R.C. § 408, at least if in conflict.

[261] Rev. Rul. 85-13, 1985-1 C.B. 184.

[262] Rev. Rul. 87-61, 1987-2 C.B. 219.

Under IRC § 2652(b), an IRA, even a custodial IRA, is probably considered a trust for GST tax purposes.

SECTION 8.3 CAN AN IRA OR QP FORM A PARTNERSHIP, LLC OR OTHER ENTITY?

Can an IRA form an entity by itself? Is the mere formation of an entity by an IRA a prohibited transaction? Not unless (a) both the IRA and the entity are DQPs, which they would be, at least after formation;[263] and unless (b) formation of the entity is a transaction.[264] Apparently, formation is not a transaction, and the entity is not a DQP until after it has been formed.[265]

Can an IRA form a limited partnership? This would be impossible unless the IRA also formed an entity to act as general partner. Alternatively, could the IRA simply form a single member LLC or other entity? Once the partnership or LLC is formed, could limited partnership or LLC units be distributed by the IRA, in kind, to the IRA Owner or plan Participant? Again, in-kind distributions are, in general, permitted. Would the distribution of LLC units by a single member LLC change the federal tax character of the entity from a sole proprietorship to a partnership? Presumably not, if the IRA is a "grantor trust." Otherwise, one assumes it would, if the independent existence of the IRA Owner and the IRA (a trust in which the IRA Owner has 100% beneficial ownership) is respected. The fact that a single member LLC wholly owned by an IRA, and previously treated for federal income tax purposes as a sole proprietorship,[266] becomes taxable as a partnership upon distribution of any of its units to the IRA Owner is not a relevant event under state law. It seems that a change in tax treatment cannot be a transaction between the IRA and the IRA Owner.

It appears that an IRA can be a partner under the partnership laws of many states, because a "person" can be either a general or a limited partner,[267] and a person includes a trust, custodian and trustee.[268]

Under the law of most states, (1) an IRA can either be a general or limited partner;[269] and (2) an IRA may distribute a partnership interest in kind (unless this independently is an IRC § 4975(c)(1)(D) or (E) violation);[270] provided, in each instance, that the partnership agreement allows for it. An IRA can certainly acquire partnership interests from any unrelated third party, if it can be a partner under state law.

Under state law, one presumes that an IRA could not own all of the partnership interests, without a merger, because it takes two or more persons to form a partnership. The IRA could form a single member LLC, valid under state law but ignored for federal tax purposes. If all partnership or LLC interests were owned solely by the IRA and the IRA Owner, the question of whether the entity would be respected for federal income tax purposes and if so, with what consequences, is an interesting one.

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[263] *See* I.R.C. § 4975. *See also* Swanson v. Comm'r, 106 T.C. 76 (1996).

[264] *See* materials cited *supra* note 258.

[265] Swanson v. Comm'r, 106 T.C. 76 (1996).

[266] *See* Treas. Reg. § 301.7701–2(a).

[267] TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 1.02(4)-(5) (West 2011); TEX. REV. CIV. STAT. ANN. art. 6132b-2.02(a) (West 2011).

[268] *See, e.g.,* TEX. REV. CIV. STAT. ANN. art. 6132a-1 § 1.02(12) (West 2011); TEX. REV. CIV. STAT. ANN. art. § 6132b-1.01(14) (West 2011).

[269] *See, e.g.,* PATRICK W. RICE & WILLIAM MAITLAND, IRA WEALTH: REVOLUTIONARY IRA STRATEGIES FOR REAL ESTATE INVESTMENT 140-175 (Square One Publishers Inc., 2003).

[270] *See, e.g.,* I.R.C. § 4975.

SECTION 8.4 DOL JURISDICTION OVER IRAS

Even though an IRA is not subject to ERISA, and thus is generally exempt from regulation by the Department of Labor (the DOL), the DOL has the specific authority to issue exemptions from the application of the prohibited transaction rules.[271] *Enforcement of the IRA prohibited transaction rules are, however, exclusively within the jurisdiction of the Treasury*.[272] ERISA Opinion Letter 98-03A observes that pursuant to Presidential Reorganization Plan No. 4 of 1978,

> [T]he authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Code, subject to certain exceptions . . . has been transferred to the Secretary of Labor and the Secretary of the Treasury is bound by such interpretations.[273]

ARTICLE 9 SOME ILLUSTRATIVE CASES

SECTION 9.1 SWANSON V. COMMISSIONER (FAVORABLE)[274]

The case that first caught the attention of the tax bar was the favorable *Swanson v. Commissioner*.[275] This case held that the formation of a company by an IRA is not a prohibited transaction, but that after the company is formed it would be a disqualified person.[276] The IRS appears to have informally acquiesced to this notion, because *Swanson* was cited as the basis for a favorable ruling on a similar issue in Field Service Advice 200128011:

> We also consider whether there were prohibited transactions in this case. The issue of prohibited transactions, in circumstances similar to those in this case, was addressed in *Swanson v. Commissioner*, 106 T.C. 76 (1996). In that case, after initially alleging that prohibited transactions had occurred, the Service ultimately conceded the case. The U.S. Tax Court, in awarding litigation costs to the taxpayers under section 7430, held that the Service's position regarding prohibited transactions was not substantially justified.[277]

ERISA Opinion Letter 2000-10A[278] is likewise in accord with *Swanson* on this issue.

Secondly, Swanson held that when the IRA Owner, as director of the 100% IRA-owned business, directed the IRA to pay dividends to the IRA, this was not a prohibited transaction.[279]

The IRS initially argued that the formation of the businesses by the IRAs and the transactions between the IRAs and the IRA Owner were PTs. The taxpayer filed a motion for summary judgment that no PTs had occurred. The IRS did not object.[280]

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[271] Reorganization Plan No. 4 of 1978, 43 F.R. 47713 (1978).

[272] Announcement 79-6, 1979-4 I.R.B. 43 (Jan. 22, 1979).

[273] ERISA Op. Letter 89-03A (Mar. 23, 1989).

[274] In the headings of this Part IX-XII, "favorable" means favorable to the taxpayer. "Unfavorable" means "not so much."

[275] Swanson v. Comm'r, 106 T.C. 76 (1996).

[276] *Id*. at 88.

[277] I.R.S. Field Serv. Advice 200128011 (July 13, 2001).

[278] This opinion letter is discussed in detail *infra* in Part X.B.

[279] *Swanson*, 106 T.C. at 102.

At this point, the validity of the IRS position, if it had been litigated, is not totally clear. However, following the agreed summary judgment, the taxpayer requested *and was granted an award for litigation costs against the government*, on the grounds "that the position of the United States was 'not substantially justified.'"[281]

If *Swanson* is good law, then the formation of an entity, and the simultaneous transfer of IRA assets to the entity, by an IRA, all done at the instigation and direction of an IRA Owner who not only controls the entity but who, after formation, serves as an officer and director of the newly formed entity, is not a prohibited transaction *per se*. In fact, the Tax Court in *Swanson* not only held in favor of the taxpayer on this issue, but went further, and found that the assertion by the IRS that a prohibited transaction existed was so lacking in substantial justification as to justify charging the government with the costs of the litigation![282] Therefore, on the whole, it is safe to say that *Swanson* is a very taxpayer friendly case.

One cause for concern is the statement by the court that the IRS "never suggested that petitioner, acting as a 'fiduciary' or otherwise, ever dealt with the corpus of IRA #1 for his own benefit."[283] This is significant because, even if the taxpayer escapes the net cast by the specific litany of prohibited transactions, there are always the IRC § 4975(c)(1)(D)-(F) catch-all provisions prohibiting a fiduciary from dealing "with the income or assets of a plan in his own interest or for his own account; or . . . [receiving] any consideration for his own personal account . . . in connection with a transaction involving the income or assets of the plan." This issue was easy to resolve because neither Mr. Swanson nor any of his relatives had an interest in the business. The businesses, it is important to note, were owned by the IRA 100%. If the business had not been owned 100% by the IRA, the case in some respects would be closer to the unfavorable case of *Rollins v. Commissioner*,[284] but would also be closer to the favorable case and rulings of *Etter v. J. Pease Construction Co.*,[285] ERISA Opinion Letter 2000-10A,[286] and IRS Field Service Advice 200128011[287] as well. In the cases below, "favorable" means favorable to the taxpayer.

SECTION 9.2 ETTER V. J. PEASE CONSTRUCTION CO. (FAVORABLE)

In Etter v. J. Pease Construction Co.,288 Pease and Miller, acting for their own account, joined by a QP of which they were the trustees, formed Glacier Ponds Venture. Pease personally contributed fifty-six percent of the purchase price (which should have made the venture itself a DQP as a matter of law), Miller seven percent, and the Plan thirty-seven percent. Also, the plan made a loan to a more-than-ten percent business partner of the trustee. The loan was found to be a prohibited transaction per se because under the ERISA equivalent of IRC § 4975(e)(2)(I), a ten percent or more (in capital or

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[280] *Swanson*, 106 T.C. at 78, 79. Petitioners filed a motion for partial summary judgment on March 22, 1993. In their motion, petitioners restated their position, as set forth in their petition, that no prohibited transactions had occurred with respect to IRAs #1 and #2. On July 12, 1993, respondent filed a notice of no objection to petitioners' motion for partial summary judgment, thereby ending the controversy on the DISC and FSC issues.

[281] *Id*. at 89.

[282] *Id.* at 83.

[283] *Id.* at 90.

[284] Rollins v. Comm'r, T.C. Memo. 2004-260 (2004).

[285] Etter v. J. Pease Constr. Co., 963 F.2d 1005 (7th Cir. 1992).

[286] ERISA Op. Letter 2000-10A (July 27, 2000).

[287] I.R.S. Field Serv. Advice 200128011 (July 13, 2001).

[288] *Etter*, 963 F.2d at 1005.

profits)289 partner or joint venturer of a person described in subparagraph (C), (D), (E), or (G) is a disqualified person.290 However, the court noted that "prohibited transactions do not per se mandate a remedy."291 Since the plan made a significant profit, there were no damages to award.

The claimant argued that the joint venture was entered into in order to benefit the trustees personally. The district court found, that by contributing less than 100% of the purchase price, Pease and Miller enabled the Plan to take advantage of a valuable opportunity.292 If this finding were dispositive, motive would be the crucial determinant. It ought not to be in the case of a per se PT, but could be relevant in applying the fuzzy PTs.

The prohibited transaction rules are ordinarily applied without regard to whether or not a plan benefits by a prohibited transaction. One of the main reasons for their existence is so that courts will not have to make ad hoc determinations on questions like this on a case-by-case basis. Etter may be explained and perhaps dismissed by the fact that this was an action by a private litigant. Neither the DOL nor the IRS was a party. A violation of the prohibited transaction rules does not automatically confer a remedy on a plan participant, because, unless only an injunction is being sought, the participant must show damages.293

This is a good example of the joint investment problem that arises frequently. Making a joint investment with a QP or an IRA is a dangerous practice that might or might not be found to be a prohibited transaction. Clearly, Glacier Ponds Venture was a disqualified person with respect to Pease, and Pease was a fiduciary with respect to the plan. The joint purchase seems to have been on the right side of a rather fine line, but the personal guaranty of the note and mortgage by both the plan and the fiduciaries individually, while perhaps benefiting the plan, could possibly have been viewed as an indirect IRC § 4975(c)(1)(B) "lending of money or other extension of credit between a plan and a disqualified person," especially if the Plan Asset Rules were applied, among other potential violations of the prohibited transaction rules.

SECTION 9.3 ROLLINS V. COMMISSIONER (UNFAVORABLE)

Rollins v. Commissioner[294] is a highly fact dependent Tax Court Memorandum decision, but it contains one of the best exegeses of the relevant law and discusses (in dictum) possible limitations on the application of the *fuzzy* PTs.

The case was submitted fully stipulated. The taxpayer caused the 401(k) plan of a company he wholly owned to make loans to various corporations in which he had a minority interest. *None of the borrower companies were disqualified persons (parties in interest) with respect to the plan.* This fact alone precludes application of IRC § 4975(c)(1)(A)-(D); but it does NOT preclude application of IRC § 4975(c)(1)(E)-(F), the *fuzzy* PTs.

[289] Curiously, value is omitted from the test here.

[290] It is not clear which subparagraph applied (C, D, E or G?). Interestingly, a subparagraph (A) "fiduciary" (for example, trustee) is not one of the subparagraphs mentioned.

[291] Etter v. J. Pease Constr. Co., 963 F.2d 1005, 1009 (7th Cir. 1992).

[292] *Id.* at 1010.

[293] *Id.* at 1009-10.

[294] Rollins v. Comm'r, T.C. Memo. 2004-260 (2004). Compare PLR 9208001 (Feb. 21, 1992), a fact situation involving a loan similar to the loans in *Rollins*.

Recall that § 4975(c)(1) prohibits any direct or indirect—

(A) sale or exchange, or leasing, of any property between a plan and a disqualified person;

(B) lending of money or other extension of credit between a plan and a disqualified person;

(C) furnishing of goods, services, or facilities between a plan and a disqualified person;

(D) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;

(E) 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

(F) 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.

The last two enumerated categories (the *fuzzy* PTs) are somewhat vague. The most salient common ground they share is that neither requires that a disqualified person be on both sides of the transaction. Metaphysically, (D) and (E) could mean that anything an IRA Owner does with his or her IRA will be a prohibited transaction if it benefits the IRA Owner, including benefiting from good investments made by self-direction. Obviously, the statute is not meant to be construed so broadly.[295]

Rollins was a disqualified person,[296] but the borrowers were NOT disqualified persons. Nonetheless, by causing the plan to make loans to companies in which Rollins was a “significant part owner,”[297] Rollins was found to have violated IRC § 4975(c)(1)(D).[298] The issue is evidentiary, and the taxpayer had the burden of proof. The court noted: “[I]t is possible that petitioner derived a benefit. However, it also is possible that petitioner did not derive a benefit.”[299] The burden was on the taxpayer to show no benefit, and the taxpayer failed to carry that burden.

Having found a violation of IRC § 4975(c)(1)(D), the court found it unnecessary to determine whether there was also a violation of IRC § 4975(c)(1)(E).[300] The IRS apparently believes that *IRC § 4975(c)(1)(E) can be construed as prohibiting any transaction in which there is conflict of interest or in which there is self-dealing of the type prohibited by common law fiduciary standards.*[301] The Tax Court ventured

[295] The difference between *Etter* and *Rollins* probably comes down to the findings by the trier of fact, which findings will not be set aside on appeal, unless clearly erroneous. So if the trier finds that the “benefit” or “use by” threshold (whatever it may be) has or has not been reached, it is likely that the finding will be respected on appeal.

[296] “Petitioner was a disqualified person with respect to the Plan because (1) he was a fiduciary (sec. 4975(e)(2)(A)), (2) he owned Rollins (sec. 4975(e)(2)(E)), and (redundant in the instant case) (3) he owned at least 10 percent of Rollins (sec. 4975(e)(2)(H)).” *Rollins*, T.C. Memo. 2004-260 at 1570.

[297] *Id.* at 1571.

[298] *Id.* at *11.

[299] *Id.* at *10.

[300] *Id.* at *11.

[301] *Id.* at *11.

considerable skepticism about this, and made the following very cogent observations, albeit made in dictum:

> [A]n analysis of the effect of conflict of interest, without more, as a basis of violation of section 4975(c)(1)(E) should take into account the statutory differences between the ERISA '74 labor law provisions and the tax law provisions. Section 406(b)(1) and (3) of ERISA '74 (codified as 29 U.S.C. 1106(b)(1) and (3)) corresponds to subparagraphs (E) and (F) of section 4975(c)(1). However, the tax law does not have an equivalent of section 406(b)(2) of ERISA '74.[302]
>
> *   *   *   *
>
> *Thus, it appears that a conflict of interest involving a fiduciary's obligations to the other party in a transaction may be actionable under the labor title, but it may be that such a conflict of interest by itself may not be actionable under section 4975(c)(1)(E).*
>
> We shall deal with such matters under section 4975(c)(1)(E) when confronted with a record in which we must decide the matters in order to resolve the case.[303]

The observation that IRC § 4975(c)(1), unlike ERISA § 406(b)(2), does not prohibit a fiduciary

> in his individual or in any other capacity [from acting] in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its Participants or beneficiaries,[304]

could be important. If one assumes that ERISA § 406(b)(2) means something, one would have to conclude that it encompasses some matters that are not covered in IRC § 4975(c)(1). Qualified plans that are covered by ERISA are subject to both statutes; however, it is very rare for an IRA to be subject to ERISA.

SECTION 9.4 GREENLEE V. COMMISSIONER (FAVORABLE)

Greenlee v. Commissioner[305] is very similar to *Rollins*[306] but reached an opposite result. Greenlee was the sole Participant in a plan sponsored by her wholly-owned corporation.[307] Greenlee requested that the

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[302] Excised from the quoted text but included here as a footnote, was the following:

> The statement of managers, H. Conf. Rept. 93-1280, *supra* at 309, 1974-3 C.B. at 470, explains this difference between the labor and tax titles as follows:
>
> > In addition, the labor provisions (but not the tax provisions) prohibit a fiduciary from acting in any transaction involving the plan on behalf of a person (or representing a party) whose interests are adverse to the interests of the plan or of its participants or beneficiaries. This prevents a fiduciary from being put in a position where he has dual loyalties, and, therefore, he cannot act exclusively for the benefit of a plan's participants and beneficiaries. (This prohibition is not included in the tax provisions, because of the difficulty in determining an appropriate measure for an excise tax.) Rollins v. Comm'r, T.C. Memo. 2004-260 at *12 (2004).

[303] *Id.* at 1573.

[304] *Id.*

[305] Greenlee v. Comm'r, T.C. Memo. 1996-378 (1996).

[306] Rollins v. Comm'r, T.C. Memo. 2004-260. *See infra* Part IX.C.

[307] This ordinarily means that ERISA is inapplicable. 29 C.F.R. § 2510.3-2(d).

trustee of her QP make a loan to a company in which she had an eighteen percent interest. The trustee did so. Apparently, this was not a self-directed IRA, because Greenlee was not treated as a fiduciary. This was important and may have been key. Although Greenlee suggested the loan, the trustee independently determined that it was a good investment for the plan and Greenlee did not participate in the trustee's deliberation on this point.

Note that eighteen percent is not a large enough interest to make the company a DQP, which makes the case like *Rollins*. The Commissioner maintained that there was nevertheless a violation of IRC § 4975(c)(1)(D) and (E).[308] The Tax Court disagreed.[309] In order to distinguish this case from *Rollins*, one must assume that the factual details made all the difference, because on the surface the facts are very similar.

SECTION 9.5 BROCK V. CITIZENS BANK OF CLOVIS (FAVORABLE AND UNFAVORABLE)

In *Brock v. Citizens Bank of Clovis*[310] the Tenth Circuit affirmed the district court holding that the bank violated the diversification requirement and the prohibition against party-in-interest transactions by investing over sixty-five percent of the bank pension plan's assets in commercial real estate first mortgages and by allowing parties in interest to make loans of money to the bank's pension plan.[311] However, it refused to hold that the trustee's investment of plan assets in loans to third parties to whom the bank had provided interim financing was a *per se* violation of the ERISA self-dealing rules.[312]

> Alleging the transactions in controversy are inherently suspicious, the Secretary argues around the absence of a specific prohibition in the statute. He states that the public interest in maintaining the integrity of employee retirement plans demands a strict prohibition of any dealings in which doubt may be cast upon the loyalty of the fiduciary. While we do not denigrate the validity of the Secretary's concept of fiduciary responsibility, *we are as unwilling as the district court to translate that concept into a per se violation when Congress has not done so.* We agree with the district court that unless the act complained of falls within the specific list of dealings proscribed by § 1106 (or within the sole dealing provision of § 1104(a)(1)), the transaction does not constitute a per se violation of ERISA.[313]

SECTION 9.6 O'MALLEY V. COMMISSIONER (UNFAVORABLE)

O'Malley v. Commissioner[314] represents an interesting application of the law. This was a teamster's plan, and teamster plans seem to have a disproportionate history of mismanagement and self-dealing. O'Malley was a DQP, but he was not a fiduciary with respect to the PT in question, and he did not personally violate IRC § 4975(c)(1)(D). What did he do?

> Thomas O'Malley was convicted of bribery and fraud in connection with his activities as a trustee of the Central States, Southeast and Southwest Areas Health and Welfare Fund, and the Central States, Southeast and Southwest Areas Pension Fund ("Pension

[308] *Greenlee,* T.C. Memo. 1996-378 at *4.

[309] *Id.* at *5.

[310] Brock v. Citizens Bank of Clovis, 841 F.2d 344 (10th Cir. 1988).

[311] *Id.* at 345.

[312] *Id.*

[313] *Id.* at 347-348 (emphasis added).

[314] 972 F.2d 150 (7th Cir. 1992).

> Fund"). The Pension Fund paid the attorneys' fees and costs for O'Malley's criminal defense.[315]

At issue was the payment of O'Malley's attorney fees by the plan, which was a PT. O'Malley apparently did not participate in this decision but he clearly benefitted from it, and the IRS gave him the bill for the excise tax.[316] O'Malley claimed that he should not owe the tax, since he was not the person who violated the statute giving rise to the tax, even if he was the one who benefited from the violation. The Tax Court disagreed, and so did the Seventh Circuit, which affirmed.[317]

SECTION 9.7 HELLWEG V. COMMISSIONER (FAVORABLE)

Hellweg[318] was a case involving the application of Notice 2004-8[319] and an attempt to impose an IRC § 4973 over-contribution excise tax on the value shifted to Roth IRAs from the taxpayer's controlled corporation. In this case the Roth IRAs of four related taxpayers "each subscribed to 25 percent of the previously unissued stock of ADF International,"[320] a domestic international sales corporation (DISC). This appears to mean that the Roth IRAs formed ADF International, each owning 25% of it. Each of the

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[315] *Id.* at 151.

[316] *Id.*

[317] *Id*. at 154.

> O'Malley contends that because the Secretary of Labor did not find he violated this section, he cannot be subject to § 4975. This argument is specious. As the tax court pointed out,
>
> > the basis for liability of a disqualified person for the excise tax under section 4975(a) and (b), i.e., participation, is not the same as the basis for liability of a fiduciary under section 406(a). A fiduciary is liable under section 406(a), ERISA, if he or she knowingly caused the plan to engage in a transaction which is described in section 406(a)(1), ERISA. Liability under that section is predicated upon a fiduciary's act on behalf of the plan which causes the plan to enter into the transaction and not upon the fiduciary's participation in the transaction itself. . . . Under section 4975(a) and (b), a disqualified person is liable for the excise tax if . . . she participates in the transaction. Participation in section 4975 occurs any time a disqualified person is involved in a transaction *other than as fiduciary acting only as such*.
>
> *O'Malley*, 96 T.C. at 650-51. *See also Pearland Investment Company v. Commissioner*, 62 T.C.M. (CCH) 1221, 1224- 25 (1991) (Section 406 of ERISA prohibits fiduciaries from causing plans to enter into "prohibited transactions.")
>
> …. Because O'Malley did not participate in the approval, he did not breach his fiduciary duty under § 406. *See Schulist v. Blue Cross of Iowa*, 553 F. Supp. 248, 254 (N.D.Ill. 1982), *aff'd* 717 F.2d 1127 (7th Cir. 1983) (explaining that § 406 is "inapposite" when the fiduciary has not caused the Plan to engage in a prohibited transaction).
>
> …. We return then, to the only question presented by the appeal. Did O'Malley's implied request for and receipt of a free defense constitute participation in the prohibited transaction? We believe it did . . . There was at the very least an indirect use of the plan assets for the benefit of a disqualified person. § 4975(c)(1)(D). This is all that is required for the imposition of the tax. As the disqualified person who received the benefit, O'Malley is the proper person to pay the tax. *Id.* at 154-55 (emphasis added).

[318] Hellweg v. Comm'r, T.C. Memo. 2011-58 (2011).

[319] Rev. Proc. 2004-8, 2004-4 I.R.B. 333. *See infra* Part XIII.

[320] *Hellweg*, T.C. Memo. 2011-58 at *2.

Roth IRAs then formed separate C corporations and contributed their stock of ADF International to them. The four taxpayers and eleven other related individuals owned an S Corporation, ADF (not International). *ADF paid commissions to ADF International* on ADF's qualified export sales --why was this not a PT?-- which were then passed through to the four C corporations owned by the Roths. Taxes were paid by the C corporations and the net income was distributed to the Roths. The IRS respected the income tax treatment, but maintained that for excise tax purposes, the "payments from ADF to the C corporations each represented: (1) A distribution from the recipient C corporation to the petitioner whose Roth IRA owned that C corporation and (2) a subsequent contribution by that petitioner to his or her Roth IRA."[321]

It followed from this characterization that the IRC § 4973 6% excise tax on over-contributions to an IRA applied for each year until cured, plus an IRC § 6662A penalty for understating tax relating to involvement in a *reportable transaction* under Notice 2004-8.[322] These conclusions were rejected by Judge Nims on the taxpayer's motion for summary judgment.[323] Among other things, the court cited *Swanson v. Commissioner*[324] for its conclusion that the *acquisition* of ADF International stock by the Roth IRAs was not a PT under IRC § 4975(c)(1)(A)-(C) and that the C corporations' *payment of dividends* to the Roth IRAs was not a PT under IRC § 4975(c)(1)(E)-(F).[325] The court concluded that none of the other events that may cause loss of exempt status under IRC § 408 occurred.[326]

[321] *Id.* *3.

[322] *Id*.

[323] *Id*.

[324] Swanson v. Comm'r, 106 T.C. 76 (1996).

[325] Hellweg v. Comm'r, T.C. Memo. 2011-58 at *10 (2011).

[326] Petitioners . . . conceded that they controlled ADF through direct and indirect ownership.

> Respondent [the IRS] contends that there is an issue as to whether petitioners' purpose in arranging the Transaction was to avoid the limit on IRA contributions. But since respondent has deemed the Transaction valid for income tax purposes (discussed *infra*), he cannot now contend that the Transaction lacked a business purpose.
>
> …
>
> Congress has enumerated the types of transactions, which IRAs are prohibited from making in section 408(e)(2) through (5) and (m). No part of the Transaction here is prohibited under any of those provisions.
>
> Section 408(e)(2)(A) provides that an IRA loses its exempt status if it engages in any transaction prohibited by section 4975. Section 4975(c)(1) prohibits a specific list of self-dealing transactions between a plan and a disqualified person. We have previously held that a similar transaction was not a prohibited transaction under section 4975(c)(1)(A) or (E). *See Swanson v. Commissioner*, 106 T.C. 76, 1996 WL 62615 (1996).
>
> In *Swanson*, the taxpayer was the sole shareholder of an existing S corporation. The taxpayer arranged for the organization of a DISC (Worldwide), and one of his IRAs (IRA #1) subscribed to the DISC's original issue stock. The DISC subsequently received commission payments from the S corporation and paid dividends to the taxpayer's IRA.
>
> We held that the IRA's acquisition of DISC stock could not have been a prohibited transaction under section 4975(c)(1)(A) because the DISC was not a disqualified person at that time. We explained that

The court also concluded that the imposition of an IRC § 4973 excise tax for excess contributions to an IRA was inappropriate because that would be inconsistent with the IRS's acceptance of the transaction for income tax purposes.[327] Judge Nims also rejected the government's contention that the case was analogous to *Hollen v. Commissioner*[328] where Dr. Hollen formed an ESOP out of his dental practice and repaid the loan with money one can only assume would have otherwise been properly allocable to salary.[329] The IRS was successful in that case in having the repayment treated as an excess contribution to the plan in violation of IRC § 415(c).[330]

> The stock acquired in that transaction was newly issued—prior to that point in time, Worldwide had no shares or shareholders. A corporation without shares or shareholders does not fit within the definition of a disqualified person under section 4975(e)(2)(G). It was only *after* Worldwide issued its stock to IRA #1 that petitioner held a beneficial interest in Worldwide's stock, thereby causing Worldwide to become a disqualified person under section 4975(e)(2)(G). *** [*Id*. at 88; fn. refs. omitted.]

We also held that the DISC's payment of dividends to the IRA was not a prohibited transaction under section 4975(c)(1)(E) because "there was no such direct or indirect dealing with the income or assets of a plan, as the dividends paid by Worldwide did not become *income of IRA #1* until unqualifiedly made subject to the demand of IRA #1." *Id.* at 89.

Similarly, the acquisitions of ADF International stock by petitioners' Roth IRAs were also not prohibited transactions under section 4975(c)(1)(A), (B), or (C) because ADF International was not a disqualified person at the time of the stock acquisitions. The C corporations' payment of dividends to the Roth IRAs was not a prohibited transaction under section 4975(c)(1)(D), (E), or (F) because the dividends were not income of the Roth IRAs until they were received by the Roth IRAs.

The Transaction is also not prohibited under section 408(e)(3) because that provision deals with borrowing under or by use of an individual retirement annuity. Section 408(e)(4) is also inapplicable because no petitioner has pledged any portion of a Roth IRA as security for a loan. Section 408(e)(5) is not relevant because no part of any Roth IRA assets has been used to purchase an endowment contract. Section 408(m) does not apply because no Roth IRA invested in a collectible.

Contrary to respondent's contention, the Transaction is not a type of investment that Congress has expressly forbidden. To add it to that list of statutorily prohibited transactions would amount to judicial legislation. *Hellweg*, T.C. Memo. 2011-58 at *4, *10-11.

[327] *Id.* at *9.

[328] Hollen v. Comm'r, T.C. Memo. 2011-2 (2011), *affd,* 437 F. App'x 525 (8th Cir 2011).

[329] *Hellweg*, T.C. Memo. 2011-58 at *9.

[330] Furthermore, even if we were to decide that Congress intended to prohibit this type of transaction, we question whether imposition of the section 4973 excise tax would be appropriate. Participation in one of the above-mentioned statutorily prohibited transactions results in a deemed distribution from the IRA. See sec. 408(e)(2)(B), (3), (4), (5), (m)(1). Such a distribution is included in the taxpayer's gross income and is subject to the section 72(t) 10-percent additional income tax rather than the section 4973 excise tax.

While we are aware that Congress clearly intended to limit the amounts of annual contributions to IRAs by enacting section 4973, our holding here does not negate that limitation. Our decision does not prevent the Service from recharacterizing the Transaction consistently for income tax and excise tax purposes. *[Author's Observation: Perhaps this is the key to this otherwise strange decision.]* Nor does it prevent the Service from asserting that an excess contribution was made when petitioners' Roth IRAs subscribed to the stock of ADF International if that stock had been undervalued. In fact, Notice 2004-8, 2004-1 C.B. at 333, contemplates the possibility that "The acquisition of shares *** [is] not fairly valued."

. . .

[T]he excise tax statute in issue here, section 4973, compels consistent treatment of the Transaction because that statute is intertwined with and inseparable from the income tax regime. . . . [T]he section 4973 excise tax cannot be determined without regard to the taxpayer's income tax because sections 219 and 408A(c)(2) and (3) are income tax provisions and section 408A(c)(3) in particular refers to the taxpayer's adjusted gross income.

The Transaction being valid for income tax purposes, it must also be valid for purposes of section 4973. Since respondent has made no section 482 adjustment which would result in distributions from ADF to petitioners for income tax purposes, the ADF commission payments cannot be treated as distributions to petitioners for purposes of the section 4973 excise tax. Therefore, the ADF commission payments do not constitute excess contributions to petitioners' Roth IRAs.

This case is distinguishable from *Michael C. Hollen, D.D.S., P.C. v. Commissioner*, T.C. Memo. 2011-2 [TC Memo 2011-2], where we sustained the Service's determination that a "dividend" paid by a corporate taxpayer to its employee stock ownership trust (ESOT) represented an excess contribution to the account of a participant in the taxpayer's related employee stock ownership plan (ESOP). There, the taxpayer sought a declaratory judgment that the ESOP and the ESOT were qualified for income tax purposes under section 401(a). The ESOT had borrowed money from the ESOP to purchase stock in the taxpayer. The ESOT then used the proceeds of a $200,000 "dividend" from the taxpayer to partially repay the loan and allocated an equivalent amount of stock to the accounts of the ESOP participants. Most of that stock allocation went to the account of Dr. Hollen, who was the principal shareholder, an employee, and a corporate officer of the taxpayer. Dr. Hollen was also the ESOP's administrator and the ESOT's trustee.

Pursuant to section 1.415-6(b), Income Tax Regs. (which authorizes the Service "in an appropriate case, considering all of the facts and circumstances, [to] treat transactions between the plan and the employee or certain allocations to participants' accounts as giving rise to annual additions"), the Service treated $150,339 of the $200,000 "dividend" as an annual addition to Dr. Hollen's account. We held that the Service did not abuse its discretion to make that recharacterization, because Dr. Hollen used the loan and the associated "dividend" to generate a deduction for the taxpayer for the principal payments on the loans without any corresponding income recognition by either the taxpayer or the ESOT. The resulting tax savings increased the value of the stock held by the ESOT to Dr. Hollen's benefit. Because the annual addition exceeded the section 415(c) contribution limit, we upheld the Service's determination that, for income tax purposes, the ESOP and the ESOT were not qualified trusts under section 401(a) and therefore not tax exempt under section 501(a).

Respondent does not contest the characterization of the Transaction for income tax purposes, and therefore we decide an entirely different and much narrower issue: whether respondent may characterize a transaction inconsistently for excise tax purposes. We have not been asked to and do not decide what the proper treatment of the Transaction is for income tax purposes. Although we held that an excess contribution to a retirement plan had been made in *Hollen*, respondent's approval of the Transaction for income tax purposes compels a different result in the present case. Whereas the Service properly used an income tax regulation to recharacterize the Hollen transaction for income tax purposes, respondent's position that the Transaction is substantive for income tax purposes undermines his attempted use of the substance-over-form doctrine to recharacterize the Transaction for excise tax purposes. *Hellweg*, T.C. Memo. 2011-58 at *9-11 (emphasis added).

Why *Hellweg* was different from *Hollen* based on the facts is not readily apparent. Perhaps the answer is simply that the IRS failed to argue the case the same way as in *Hollen*. This seems to have been an important factor. From the outside, this looks like so much hair splitting, leaving one to wonder what the result would have been if the IRS had simply treated the case as a prohibited transaction inasmuch as a benefit went from a corporation controlled by the taxpayers to a corporation owned by their Roth IRAs. Assets of the taxpayers were indirectly transferred to the Roth. The Roth owned a company that was providing services to the taxpayers' controlled corporation for a fee. Is that generally permissible?

ARTICLE 10 SOME REPRESENTATIVE ERISA OPINION LETTERS

SECTION 10.1 ERISA OPINION LETTER 89-03A (FAVORABLE BUT QUALIFIED)

The IRS and the DOL have joint jurisdiction in prohibited transaction matters, and the DOL has the specific authority to issue exemptions from the application of the prohibited transaction rules,[331] but that the IRA prohibited transaction rules are exclusively within the jurisdiction of the Treasury.[332] What this means in actual practice is unclear, but in ERISA Opinion 89-03A the taxpayers requested the IRS to rule whether the taxpayers could direct their IRAs to purchase stock in a corporation (Rock-Tenn) in which one of the taxpayers was an officer and both taxpayers owned a small interest (less than two percent). The IRS referred the matter to the DOL, and the DOL blessed the purchase in some respects, but withheld an opinion on others.[333]

Although the corporation is not a DQP,[334] the DOL concluded its opinion on a cautionary note that "you may wish to consider whether the purchases of stock involve violations of section 4975(c)(1)(D) or (E) of the Code" in light of the fact that the taxpayers are fiduciaries and in light of their relationship to the corporation.[335]

Like a private letter ruling, an ERISA opinion letter may not be relied upon by third parties.[336]

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[331] Reorganization Plan No. 4 of 1978, 43 F.R. 47713 (1978).

[332] Announcement 79-6, 1979-4, I.R.B. 43 (Jan. 22, 1979).

[333] ERISA Op. Letter 89-03A (Mar. 23, 1989).

[334] The Department of Labor determined that "Rock-Tenn is not a disqualified person with respect to the IRAs under section 4975(e)(2)(G) of the Code by reason of the Bowns' stock ownership in Rock-Tenn." ERISA Op. Letter 89-03A at 3. Note that I.R.C. § 4975(e)(2)(G) requires a more than fifty percent interest, and the percentage involved in this case was well under that.

[335] *We note, however, that this conclusion does not preclude the existence of other prohibited transactions under section 4975 of the Code. Section 4975(c)(1)(D) of the Code prohibits any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan. Section 4975(c)(1)(E) of the Code prohibits a fiduciary from dealing with the income or assets of a plan in his own interest or for his own account.* The Department will generally not issue advisory opinions with respect to inherently factual [citing ERISA Proc. 76-1, §1] matters. We note, however, that Mr. and Mrs. Bowns are fiduciaries with respect to their IRAs. In addition, Mr. Bowns is an officer of Rock-Tenn and the Bowns have stock ownership interests in Rock-Tenn. ERISA Op. Letter 89-03A (emphasis added).

[336] Dep't of Labor, ERISA Procedure 76-1 for ERISA Advisory Opinions § 10 (Aug. 24, 1976) *available at* http://www.dol.gov/ebsa/regs/aos/ao_requests.html (last visited Feb. 29, 2012).

SECTION 10.2 ERISA OPINION LETTER 2000-10A (FAVORABLE); BERNIE MADOFF GETS AWAY WITH IT AGAIN

On the surface ERISA Opinion Letter 2000-10A[337] seems very favorable. It is a short opinion letter, albeit one with mathematically complicated facts. The Fetner Family Partnership was an investment club managed by, of all people, Bernard L. Madoff Investment Securities. A series of complicated transactions were proposed at the culmination of which Mr. Adler's IRA was to purchase a significant interest in a partnership in which Mr. Fetner and his family had an interest. The opinion letter found that there was no *per* se PT because there was no transaction with a DQP.[338]

What is instructive about the opinion is the dicta. Although Mr. Adler received no compensation from the partnership, the opinion notes that a violation of IRC § 4975(c)(1)(D) or (E) could occur if a transaction causes the IRA fiduciaries to have a conflict of interest (including by a subsequent divergence of interests) or if the IRA's participation is necessary for the IRA fiduciary to maintain his share of the investment, but not because the IRA fiduciary merely derives some incidental benefit (with no guidance as to what is a mere "incidental" benefit).[339]

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[337] ERISA Op. Letter 2000-10A (July 27, 2000).

[338] Though not readily apparent, it appears that Adler and his family did not control the partnership prior to its proposed acquisition by his IRA, but afterwards he and his IRA were to end up owning over 50%, directly or by attribution, which is control under I.R.C. § 4975(e)(2)(G)(ii). The DOL ruled that the purchase would not violate 4975(c)(1)(A), a "sale or exchange, or leasing, of any property between a plan and a disqualified person." This suggests that the relevant percentages are to be obtained prior to the transaction, not afterwards, consistent with the approach in *Swanson v. Comm'r*, 106 T.C. 76 (1996), as discussed *supra* in Part IX.A; ERISA Op. Letter 2000-10A.

[339]
> Whether the proposed transaction would violate sections 4975(c)(1)(D) and (E) of the Code raises questions of a factual nature upon which the Department will not issue an opinion. A violation of section 4975(c)(1)(D) and (E) would occur if the transaction was part of an agreement, arrangement or understanding in which the fiduciary caused plan assets to be used in a manner designed to benefit such fiduciary (or any person which such fiduciary had an interest which would affect the exercise of his best judgment as a fiduciary).
>
> In this regard, the Department notes *Mr. Adler does not and will not receive any compensation from the Partnership and will not receive any compensation* by virtue of the IRA's investment in the Partnership. However, the Department further notes that if an IRA fiduciary causes the IRA to enter into a transaction where, by the terms or nature of that transaction, a conflict of interest between the IRA and the fiduciary (or persons in which the fiduciary has an interest) exists or will arise in the future, that transaction would violate either 4975(c)(1)(D) or (E) of the Code. Moreover, the fiduciary must not rely upon and cannot be otherwise dependent upon the participation of the IRA in order for the fiduciary (or persons in which the fiduciary has an interest) to undertake or to continue his or her share of the investment. Furthermore, even if at its inception the transaction did not involve a violation, if a divergence of interests develops between the IRA and the fiduciary (or persons in which the fiduciary has an interest), the fiduciary must take steps to eliminate the conflict of interest in order to avoid engaging in a prohibited transaction. Nonetheless, a violation of section 4975(c)(1)(D) or (E) will not occur merely because the fiduciary derives some incidental benefit from a transaction involving IRA assets.

ERISA Op. Letter 2000-10A (emphasis added). The observation that a conflict of interest may give rise to a PT is the IRS position, but in non-ERISA cases, it is a position on which there is little, if any, statutory authority. It appears to be one way to interpret Treas. Reg. § 54.4975-6(a)(5), however.

Furthermore, the opinion observed that the partnership's assets will be "plan assets," and that anyone who exercises discretion over partnership assets will be an IRA fiduciary subject to the PT rules of IRC § 4975(c)(1).[340]

SECTION 10.3 ERISA OPINION LETTER 93-33A (UNFAVORABLE)

In ERISA Opinion Letter 93-33A,[341] the DOL refused to issue a favorable ruling in a case where an IRA Owner proposed to purchase the land and building on which a school was situated, largely because the school was founded, but not owned, by the IRA Owner's daughter and son-in-law.[342] Interestingly, this opinion letter is a good example of the DOL articulating its broad, and perhaps ill-founded, theory, that if there is a conflict of interest there is a violation of IRC § 4975(c)(1)(E). This issue is far from settled. See the discussion of the Tax Court's dicta in *Rollins*, discussed *supra* in Part IX.C.[343] The DOL appears to note that there is a distinction between plans covered by ERISA and those that are not, but it is not quite ready to formally acknowledge that the difference is important.[344]

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[340] Moreover, the Department notes that by virtue of the contemplated investment by the IRA in the Partnership, there will be significant investment in the Partnership by benefit plan investors. Accordingly, the Partnership will hold *"plan assets"* within the meaning of that term in the Department's regulations at 29 C.F.R. §2510.3-101. As a result, any person who exercises discretionary authority or control with respect to assets of the Partnership will be a fiduciary of the IRA and subject to the restrictions of section 4975(c)(1) of the Code, except to the extent a statutory or administrative exemption applies. ERISA Op.Letter 2000-10A (emphasis added).

[341] ERISA Op. Letter 93-33A (Dec. 16, 1993).

[342] The purchase was to be at fair market value and the taxpayer proposed to lease the land and building back to the school after the purchase. The DOL noted that the IRA Owner was a fiduciary, and hence, a DQP. It was fearful that the transaction was designed to benefit the daughter (a family member of the fiduciary and hence, also a DQP) and the son-in-law (not a DQP). However, benefiting the son-in-law was probably considered to be indirectly benefiting the IRA Owner, and that would be enough under (D). ERISA Op. Letter 93-33A.

[343] Rollins v. Comm'r, T.C. Memo. 2004-260 at 1573 (2004).

[344] The analysis quoted below seems to be beside the point, given that the proposed transaction was with an IRA—

> Moreover, *it is the view of the Department that violations of sections 4975(c)(1)(D) and (E) would occur if a transaction were part of an agreement, arrangement or understanding in which the fiduciary caused plan assets to be used in a manner designed to benefit any person in whom such fiduciary had an interest that would affect the exercise of his or her best judgment as a fiduciary.* For example, Treasury Regulation §54.4975-6(a)(6), Example (6), illustrates that where F, a fiduciary of plan P with discretionary authority respecting the management of P, retains S, the son of F, to provide services necessary to the operation of the plan for a fee, F has engaged in an act described in section 4975(c)(1)(E), because S is a person in whom F has an interest that may affect the exercise of F's best judgment as a fiduciary. Therefore, if you, as fiduciary of the IRA, were to purchase the School property at fair-market value pursuant to an arrangement to lease it back to the School at a rent that is dependent on the School's ability to pay in order to benefit your daughter and son-in-law, the transaction would violate Code section 4975(c)(1)(D) and (E).
>
> * * * *
>
> Finally, to the extent that the IRA is an employee pension benefit plan covered by Title I of ERISA it should be noted that the Department has consistently taken the position that, to act prudently under ERISA, a plan fiduciary must consider, among other factors, the availability, risk, and potential return of alternative investments for the plan. Because the purchase of the School would be an investment selected in preference to alternative investments, the purchase would not be prudent if it provided the IRA with less return, in comparison to risk, than comparable investments available to the plan, or if it involved a greater risk to the security of plan assets than other investments offering a similar return. Similarly, the Department construes

SECTION 10.4 ERISA OPINION LETTER 2001-01A—SETTLOR FUNCTIONS (MIXED)

In analyzing whether the IRA Owner, or anyone else other than the IRA custodian or trustee, is dealing with the IRA or with plan assets, it is helpful to remember that not all activities that affect an IRA or qualified plan are fiduciary in nature. This issue comes up frequently when a plan terminates, and the company seeks to have the plan pay for the termination costs. "Settlor functions" related to the formation, design, and termination of plans are not fiduciary activities governed by ERISA, but expenses related to settlor functions are incurred for the employer's benefit and generally are not reasonable plan expenses.[345]

SECTION 10.5 ERISA OPINION LETTER 2006-01A—PROHIBITED TRANSACTIONS (UNFAVORABLE AND SOMEWHAT CONFUSING); DOUBLE ATTRIBUTION AND AGGREGATION QUESTIONS INVOLVING SECTION 4975(E)(2)(H) DISQUALIFIED PERSONS

Section 4975(e)(2)(H) of the Code defines a disqualified person (an (H) DQP) as including

> (H) an officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10 percent or more shareholder, or a highly compensated employee (earning 10 percent or more of the yearly wages of an employer) of a person described in subparagraph (C), (D), (E), or (G) [e.g. of a closely held business that is itself a disqualified person]. . . .

> the requirements that a fiduciary act solely in the interest, and for the exclusive purpose, of providing benefits to participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. In this regard, a decision to cause an IRA to purchase a property at fair-market value pursuant to an arrangement to lease the property to the seller at a rent that is dependent on the seller's ability to pay would be difficult to reconcile with the prudent person rule under ERISA. ERISA Op. Letter 93-33A (emphasis added).

Presumably this would not be a problem in a normal IRA, because a normal IRA is not subject to ERISA.

[345] With regard to sections 403 and 404 of ERISA, we noted that, as a general rule, reasonable expenses of administering a plan include direct expenses properly and actually incurred in the performance of a fiduciary's duties to the plan. We also noted, however, that the Department has long taken the position that *there is a class of discretionary activities which relate to the formation, rather than the management, of plans, explaining that these so-called "settlor" functions include decisions relating to the establishment, design and termination of plans and, except in the context of multiemployer plans, generally are not fiduciary activities governed by ERISA.* Expenses incurred in connection with the performance of settlor functions would not be reasonable expenses of a plan as they would be incurred for the benefit of the employer and would involve services for which an employer could reasonably be expected to bear the cost in the normal course of its business operations. *However, reasonable expenses incurred in connection with the implementation of a settlor decision would generally be payable by the plan.*

> [I]n the context of tax-qualification activities, fiduciaries must consider, consistent with the principles articulated in earlier letters, *whether the activities are settlor in nature* for purposes of determining whether the expenses attendant thereto may be reasonable expenses of the plan. However, in making this determination, the Department does not believe that a fiduciary must take into account the benefit a plan's tax-qualified status confers on the employer. Any such benefit, in the opinion of the Department, should be viewed as an integral component of the incidental benefits that flow to plan sponsors generally by virtue of offering a plan. ERISA Op. Letter 2001-01A (Jan. 18, 2001) (emphasis added). *See also* Hozier v. Midwest Fasteners, Inc., 908 F.2d 1155 (3d Cir. 1990).

ERISA Opinion Letter 2006-01A[346] addressed a proposed transaction between two entities: an LLC ("LLC") will lease property to an S Corporation ("S Company"). S Company is owned sixty-eight percent by Berry and his wife and thirty-two percent by "G." "R" is an officer of S Company. The LLC would be owned forty-nine percent by Berry's IRA , thirty-one percent by R's IRA, and twenty percent by G.[347] The issue is whether the lease from the LLC to S Company is a PT as to Berry's IRA. The opinion letter concluded that § 4975(c)(1)(A) was violated, apparently under the theory that the lease was tantamount to an (indirect) transaction between Berry's IRA and S Company.[348]

To briefly summarize, (1) Berry is a fiduciary as to his own IRA and therefore a DQP as to his own IRA; (2) S Company is a DQP as to Berry, and therefore as to Berry's IRA;[349] (3) R and G are DQPs as to S Company by reason of § 4975(e)(2)(H) (they are an officer and ten percent shareholder of a company that is a DQP, but that is where confusion starts because S Company is a DQP as to Berry, so does that mean there is attribution to cause R and G to be DQPs as to Berry's IRA?);[350] (4) the LLC is not directly a DQP as to Berry (or therefore his IRA) by reason of Berry's ownership of the LLC (because he does not control it).

Is the LLC a DQP of Berry's IRA that is a forty-nine percent owner? The LLC is a DQP of the IRA only if R and G's interest in the LLC is somehow aggregated with Berry's to cause him to have control of the LLC.

The LLC was carefully structured with intent to keep it from being a DQP. Does it work? Berry through his IRA is going to own only forty-nine percent of the LLC. But R and G will own fifty-one percent. By virtue of § 4975(e)(2)(H), R and G are DQPs with respect to S Company,[351] a company clearly controlled by Berry. Is their interest in the LLC therefore to be aggregated with Berry's, to cause Berry to own by attribution more than his forty-nine percent actual ownership of the LLC?

Such aggregation might conceivably somehow occur under IRC § 4975(e)(2)(H). The opinion concluded, for example, that R, as an officer of S Company, was a DQP as to Berry's IRA.[352] One issue in applying §

[346] ERISA Op. Letter 2006-01A (Jan. 6, 2006).

[347] You represent that Salon Services and Supplies, Inc. is a Washington state "S" Corporation ("S Company") which is 68% owned by Miles and Sydney Berry, a marital community (M). The other 32% is owned by a third-party, George Learned ("G"). Miles Berry *(Berry) proposes to create a limited liability corporation ("LLC") that will purchase land, build a warehouse and lease the property to S Company. The investors in the LLC would be Berry's individual retirement account ("IRA") (49%), Robert Payne's ("R") IRA (31%) and G (20%). R is the comptroller of S Company*. R and G will manage the LLC. You represent that S Company is a disqualified person with respect to Berry's IRA under section 4975(e)(2) of the Code. You represent that R and G are independent of Berry. You also represent that the LLC does not contain plan assets because it is a "real estate operating company" (REOC) as defined by 29 C.F.R. § 2510.3-101(e).

ERISA Op. Letter 2006-01A (emphasis added).

[348] *Id*.

[349] *Id*. S Company is a DQP with respect to Berry because it is controlled by Berry and his family, which makes it a DQP with respect to Berry's IRA. This is fairly straightforward.

[350] *Id*. R and G are tough cases to analyze. Clearly R is a DQP under § 4975(e)(2)(H) with respect to S Company because he is an officer of S Company, and so is G because he is a 10 % or more shareholder of S. Again, S Company is a company controlled by Berry on his own.

[351] *Id*. They are an officer and more than 10% shareholder, respectively.

[352] *Id*. According the opinion,

4975(e)(2)(H) is whether there is cross-attribution/aggregation across entities: Whether or to what extent an (H) DQP can be aggregated with a person in *another* company owned by the same people as the company in which the (H) DQP is a ten percent shareholder.[353] Generally, cross-attribution/aggregation does not seem to apply, but the statutes are very confusing on this issue, especially if the term "indirect" is invoked. The analysis is very trying and hopelessly circular. Simply identifying someone as a DQP is of no moment by itself; the proper question is "a DQP with respect to whom?" R and G are DQPs as to S Company. But is the LLC a DQP with respect to the IRA because it is controlled by Berry and R and G together? The answer should be no.

Section 4975(e)(2)(H) provides that a DQP includes "an officer, [or] . . . a 10 percent or more shareholder . . . of a person described in subparagraph . . . (G)." This subparagraph (G) describes a business controlled by, among other things, "a fiduciary."[354] So, *R is an officer of a business controlled by Berry and G is a ten percent shareholder of a business controlled by Berry, a business which is a DQP with respect to Berry's IRA. Does this make R and G DQPs with respect to Berry's IRA?*[355] However, neither G nor R is a DQP looking at the LLC alone.

Is the LLC a DQP with respect to the IRAs because it is controlled by G, R and Berry? Apparently the DOL did not think so or it would have come out and said it, which would have simplified its analysis considerably. The LLC is controlled by fiduciaries--it is controlled by Berry's IRA and by R's IRA and by G himself, but they are unrelated. One would hope that matters. True, R is an officer of S Company, and G is a more-than-ten percent shareholder of S Company, but that was only indirectly relevant in analyzing the transaction. If the relationship with S Company carried directly over to the LLC, the DOL could simply have called the LLC a DQP and have been done with it. The opinion appears to support that there is not cross attribution/aggregation to another entity to cause it to be a DQP when it would not otherwise be so.[356]

If the LLC is not a DQP in its own right, an assumption that the DOL must have made, can it safely lease to S Company, which is a DQP? This is the ultimate question. A transaction involving only one DQP cannot be a *per se* IRC § 4975(c)(1)(A)-(C) violation; but of course one can never tell for sure whether IRC § 4975(c)(1)(D)-(F) might apply. That is always the case if a DQP has some interest in the company doing business with it, and the DOL concluded that IRC § 4975(c)(1) was violated.[357] It even concluded that IRC § 4975(c)(1)(A) was violated, which is very troubling, but this was apparently under the theory that the lease was tantamount to an (indirect) transaction between Berry's IRA and S Company.[358]

> R, the comptroller of S Company, is a disqualified person with respect to Berry's IRA under section 4975(e)(2)(H) as an officer of S Company. R, as an employee of S Company, a company 68% owned by M, cannot be considered independent of Berry.

[353] *Id.* In order to come under I.R.C. § 4975(e)(2)(H) in our fact pattern, one must first identify a controlled corporation under I.R.C. § 4975(e)(2)(G). S Company is such a corporation, but the LLC is not, unless there is attribution from S.

[354] *See* I.R.C. § 4975(e)(2)(A).

[355] ERISA Op. Letter 2006-01A (Jan. 6, 2006). The opinion doesn't have much to say about G, but G is a 10% shareholder of S Company, so he ought to be a DQP too, with respect to S Company.

[356] *Id*. If the LLC is a DQP in its own right (a dubious assumption), it could not lease property to a company controlled by Berry. That would be a *per se* violation of I.R.C. § 4975(c)(1)(A).

[357] *Id.*

[358] *Id*.

Even though IRC § 4975(e)(2)(H) apparently did not, by cross attribution/aggregation, cause the LLC to be a DQP as to the IRA, the opinion concluded that R is a DQP as to Berry's IRA.[359] While the precise reasoning for the conclusion is not clear, the opinion cited DOL Regulation § 2509.75-2(c).[360] To analyze the application of that difficult regulation, it is important to remember that Berry, R and G each owned minority interests in the LLC, but any two of them together could control decisions of the LLC. Berry's IRA, without R or G, could not cause the lease to S Company to occur. Regulation § 2509.75-2(c), which appears to be highly relevant, is not without ambiguity about just how R or G is to be treated here. The regulation states:

> [1] [I]f a transaction between a party in interest and a plan would be a prohibited transaction,[361] then such a transaction between a party in interest and such corporation or partnership[362] will ordinarily be a prohibited transaction [2] [but only?] *if such party in interest*, *together with one or more persons who are parties in interest by reason of such persons' relationship (within the meaning of section 3(14)(E) through (I)*[363]*) to such party in interest may,*[364] *with the aid of the plan but without the aid of any other persons, require the corporation or partnership to engage in such a transaction.*[365] [3] *However, the preceding sentence does not apply if the parties in interest engaging in the transaction,*[366] *together with one or more persons who are parties in interest by reason of such persons' relationship (within the meaning of section 3(14) (E) through (I)) to such party in interest,*[367] *may, by themselves, require the corporation or partnership to engage in the transaction.*[368]

Post-modernist legal theorists should have a grand time deconstructing those two sentences, both of which are awkwardly worded in the extreme. The footnotes within the quoted regulation apply the various clauses to the facts and are important to understanding these two extremely awkward sentences in this fact situation. These sentences apparently mean that just because Berry has an IRA, and just because Berry and his IRA and his controlled corporation are all DQPs with respect to the IRA, it does not follow that transactions between Berry and his controlled company are PTs, *unless* the transaction could not have been consummated without the aid of the IRA, in which latter case, there is a PT. Getting back to the facts, the lease by the LLC to S company could not have taken place without the

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[359] Again, the opinion letter says "R, the Comptroller of S Company, is a disqualified person with respect to Berry's IRA under section 4975 (e)(2)(H) as an officer of S Company." *Id*.

[360] 29 C.F.R. § 2509.75-2(a) (Interpretative Bulletin 75-2).

[361] Such as (clearly) Berry or S Company and Berry's IRA.

[362] Such as S Company and Berry?! See the "if" (does that mean "only if?") clause that follows in subparagraph [2].

[363] On these facts, I.R.C. § 4975(e)(2)(G) would be the IRC equivalent.

[364] Berry needs the aid of R. R is a DQP under ERISA § 3(14)(H), which lies between (E) and (I).

[365] This is extremely important. The regulation is apparently saying, using the most confusing language imaginable, that a transaction between the owner of a company, who also owns an IRA, and the company the IRA Owner controls, is a PT only if the transaction could not be completed without the aid of the IRA.

[366] Who are the parties in interest engaging in the transaction? Berry for sure.

[367] This brings in R and G, via ERISA § 3(14)(H), because R is an officer of S Company and G a more than 10% shareholder.

[368] 29 C.F.R. §2509.75-2(c) (emphasis added). R and Berry may not, without the aid of their IRAs, cause the LLC to enter into the lease with S Company. Accordingly, the preceding sentence does apply, which says that the plan must be able to engage in the transaction without the aid of any other persons.

participation of Berry's IRA and R's IRA or G, which may be the reason the DOL held the transaction failed. However, the transaction could have taken place without Berry's IRA, *since one imagines that the vote of R's IRA and G could have made it happen*, which would mean that the regulations should not have applied on these facts.

In conclusion, the precise reasoning of the opinion letter is difficult to follow, since it did not explicitly treat the LLC as a DQP. The opinion letter concludes that the lease "would amount" to a two-way transaction between Berry's IRA and Best Company (a DQP) and would constitute a PT under IRC § 4975(c)(1)(A).[369] It reasons that "*a prohibited transaction occurs when a plan invests in a corporation as part of an arrangement or understanding under which it is expected that the corporation will engage in a transaction with a party in interest* (or disqualified person)." The opinion does not rely on the Plan Asset Rules and the exceptions to them.[370]

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[369] ERISA Op.Letter 2006-01A (Jan. 6, 2006).

[370] *Id.* (emphasis added).

> Based upon your representations, it is the opinion of the Department that a lease of property between the LLC and S Company would be a prohibited transaction under Code section 4975, at least as to Berry's IRA. *The lease constitutes a prohibited transaction regardless of whether the LLC qualifies as a REOC under the Department's plan assets regulation.* 29 C.F.R. § 2510.3-101.
>
> The Department's regulation at 29 C.F.R. § 2509.75-2(a) (Interpretative Bulletin 75-2) [(c) is quoted in pertinent part above with copious footnotes applying it to the facts], explains that *a transaction between a party in interest under ERISA (or disqualified person under the Code, in this case S Company) and a corporation in which a plan has invested (i.e., the LLC) does not generally give rise to a prohibited transaction.* However, in some cases it *can* give rise to a prohibited transaction. Regulation section 2509.75-2(c) and Department opinions interpreting it have made clear that *a prohibited transaction occurs when a plan invests in a corporation as part of an arrangement or understanding under which it is expected that the corporation will engage in a transaction with a party in interest* (or disqualified person).
>
> According to your representations, it appears that Berry's IRA will invest in the LLC under an arrangement or understanding that anticipates that the LLC will engage in a lease with S Company, a disqualified person. Therefore, the lease would *amount to* a transaction between Berry's IRA and S Company that Code section 4975(c)(1)(A) and (D) prohibits. *Additionally, the proposed lease, if consummated, may also constitute a violation by Berry, a fiduciary, of Code section 4975(c)(1)(D) and (E).*
>
> Finally, we note the express emphasis in 29 C.F.R. § 2509.75-2(c) that the Department considers "a fiduciary who makes or retains an investment in a corporation or partnership for the purpose of avoiding the application of the fiduciary responsibility provisions of the Act to be in contravention of the provisions of section 404(a) of the Act.
>
> Thus, *the proposed lease,* which *would violate section 4975(c)(1)* of the Code, would also have to be referred to the Internal Revenue Service for a determination as to whether it would consider the transaction a violation of the exclusive benefit rule of section 401(a)(2) of the Code, which is the Code's analogue to the fiduciary responsibility provisions of section 404(a) of ERISA. Because we have concluded that the proposed lease would constitute a prohibited transaction with respect to Berry's IRA, *the issue of whether the Code prohibits the lease as it relates to R's IRA is moot,* and does not need to be addressed.

ARTICLE 11 A COUPLE OF ILLUSTRATIVE PRIVATE LETTER RULINGS

SECTION 11.1 PLR 8717079 (FAVORABLE)

IRS Private Letter Ruling 8717079[371] clearly indicates that the IRS believes that the "employer" mentioned in §4975(e)(2)(C) is the employer with respect to the plan, and not just any employer any of whose employees are covered by any plan. Stated differently, an investment by an IRA in a company that is unrelated to the sponsor of the IRA will not be a PT by reason of a transaction with an "employer." The ruling concluded that for this purpose, *"we consider an employer to be acting in relation to an IRA only when it is involved in maintaining, sponsoring, or contributing directly to the IRA."*[372] This PLR 8717079 is directly on point; and, it is favorable.[373]

In this ruling, N was an employee, less-than-one percent owner, and director of Company M. N had a self-directed IRA, and proposed to cause the IRA to invest in shares of Company M. Presumably, the shares to be owned by the IRA would be attributed to the owner, but the facts recite that after the purchase, N would still own less than one percent of M. The author has been called upon many times to give opinions on similar situations, and generally there is no problem, provided that the employee or officer is under no obligation to have his or her IRA invest in the company, that the investment is not made with job security in mind, or to advance the employee's position in the company by reason of the stock investment. This is not likely to amount to per se self-dealing if the employee is a small stockholder and not related to the other owners. But like all other transactions of this nature, an unqualified opinion can usually not be made, because if the employee is a DQP there is always the fact issue of whether or not the investment was meant to benefit the employee other than as a beneficiary of the QRP.

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[371] PLR 8717079 (Feb. 2, 1987).

[372] *Id*. If an employer is involved in maintaining, sponsoring, or contributing directly to an IRA, that could result in one of those rare instances where the IRA is subject to ERISA.

[373] *Id.* (emphasis added). The ruling noted the following:

> Section 4975(e)(2) of the Code defines, in part, the term "disqualified person" to include an employer any of whose employees are covered by the plan.
>
> There is no further definition of the term "employer" under section 4975 of the Code. Nevertheless, section 3(5) of the Employee Retirement Income Security Act of 1974 (ERISA), which defines the term "employer" for plans within the jurisdiction of Title I, provides, in part, that an employer is any person acting as an employer in relation to an employee benefit plan. *After using this section to help define the term employer for purposes of section 4975 of the Code, we consider an employer to be acting in relation to an IRA only when it is involved in maintaining, sponsoring, or contributing directly to the IRA.* Company M is not, thus, an employer in relation to Individual N's IRA under section 4975(e)(2) because, as the facts indicate, it has no involvement with Individual N's IRA.
>
> Therefore, we conclude that the purchase by the custodian on behalf of Individual N's IRA, and at the direction of Individual N, from Company M of 100 shares of Company M stock will not constitute a prohibited transaction within the meaning of section 4975(c)(1)(A) of the Code.
>
> This conclusion on whether the sale of stock is a prohibited transaction under section 4975(c)(1)(A) would not preclude the possibility of the sale being considered a prohibited transaction under another section 4975(c) depending upon the facts and circumstances.

Various ERISA opinion letters have reached similar conclusions.[374]

SECTION 11.2 PLR 9119002 (UNFAVORABLE)

IRS Private Letter Ruling 9119002[375] involved the qualified plan of a corporation that was wholly owned by the taxpayer's spouse. The taxpayer was co-trustee of the plan. The plan made a loan to a partnership, thirty-nine percent of which was owned by the taxpayer. The taxpayer was a fiduciary, and, hence, a DQP. The partnership was not a DQP. The IRS ruled that this was a PT under IRC § 4975(c)(1)(E); i.e., it was a "direct or indirect 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."

Section 4975(c)(1)(E) is a member of the class of *fuzzy* PTs, described in IRC § 4975(c)(1)(E)-(F),[376] which do not require that a DQP be on both sides of the transaction, and which offer no bright line for taxpayers to follow. An (E)-(F) transaction is therefore very fact dependent; and it is all but impossible to predict in advance where the case will come out. If the IRS is the judge, as in a PLR, including a TAM, one would expect a stricter standard than if the case went before the Tax Court. An (E) violation is seldom a *per se* violation, which an (A)-(C) violation usually is.

The Service quoted its own regulations, which provide that,

> [S]ections 4975(c)(1)(E) and (F) supplement the other prohibitions of § 4975(c)(1) by imposing on disqualified persons who are fiduciaries a duty of undivided loyalty to the plans for which they act . . . . when they have interests which may conflict with the interests of the plans for which they act.[377]

The regulatory position that (E) and (F) prohibit, *per se*, any action by a fiduciary in which the fiduciary has a conflict of interest is very doubtful. Not only does the statute not say this, but there are other provisions in ERISA which do contain such a rule, which would not be necessary if the Service's position were the correct one.[378] In any case, the Service ruled that the loan from the plan to a partnership in

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[374] ERISA Op. Letter 89-03A (Mar. 23, 1989), discussed *supra* in Part X.A, is consistent with PLR 8717079. The Opinion Letter provides as follows:

> Mr. and Mrs. Bowns are fiduciaries and, thus, disqualified persons with respect to their IRAs because of their authority under the IRAs to direct investments. Although section 4975 does not define the term employer, section 3(5) of ERISA provides, in part, that an employer is any person acting as an employer in relation to an employee benefit plan. You have stated that Rock-Tenn has no involvement with the establishment or maintenance of the IRAs. Therefore, it is the opinion of the Department that Rock-Tenn is not a disqualified person with respect to the IRAs under section 4975(e)(2)(C) of the Code. In addition, Rock-Tenn is not a disqualified person with respect to the IRAs under section 4975(e)(2)(G) of the Code by reason of the Bowns' stock ownership in Rock-Tenn. *See also* ERISA Op. Letters 90-20A (Sept. 13, 19) & 88-18A (Dec. 23, 1988).

[375] TAM 9119002 (May 10, 1991).

[376] *See e.g.,* I.R.C. § 4975(c)(1)(E)-(F). The *fuzzy* PTs are discussed in more detail *supra* in Part III.A.

[377] Treas. Reg. § 54.4975-6(a)(5)(i). The prohibitions of sections 4975(c)(1)(E) and (F) supplement the other prohibitions of section 4975(c)(1) by imposing on disqualified persons who are fiduciaries a duty of undivided loyalty to the plans for which they act. These prohibitions are imposed upon fiduciaries to deter them from exercising the authority, control or responsibility with [sic] makes such persons fiduciaries when they have interests which may conflict with the interests of the plans for which they act. In such cases, the fiduciaries have interests in the transactions which may affect the exercise of their best judgment as fiduciaries.

[378] *See* Swanson v. Comm'r, 106 T.C. 76 (1996).

which the individual co-trustee had "a significant ownership interest" was a prohibited transaction, and that the taxpayer was subject to the excise tax.[379]

This TAM was issued prior to *Greenlee v. Commissioner*,[380] which was favorable to the taxpayer on similar facts. As in *Rollins v. Commissioner*,[381] we see the phrase "significant ownership interest" used when the ownership interest is less than that required to make the recipient a DQP, which is a necessary element of an (A)-(C) violation.

ARTICLE 12 FIELD SERVICE ADVICE

SECTION 12.1 FIELD SERVICE ADVICE 665 (1992) (FAVORABLE AND UNFAVORABLE); LIABILITY FOR EXCISE TAX AND WHEN A FIDUCIARY IS ACTING ONLY AS A FIDUCIARY "AS SUCH"

The taxpayer involved in IRS Field Service Advice 665[382] was a highly compensated officer of a company that sponsored a pension plan that permitted him to direct the investments in his account under the plan. He directed the trustee to purchase company stock. The Service held this was a PT, but that the excise tax was not owed by the Participant because he was "a fiduciary acting only as such."[383]

There are special rules and exemptions for investments by a profit sharing plan in employer stock,[384] but the exemptions apparently did not apply here; otherwise the FSA would be inexplicable.[385]

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[379] TAM 9119002 (emphasis added). During the time that Individual A was a fiduciary of Trust B, that trust made a loan to an entity (Partnership Y) in which Individual A had a *significant ownership interest*. There is nothing in the file to refute the assumption that Individual A, as co-trustee of Plan X, participated in the decision to make the loan in question to Partnership Y. Based on this assumption, individual A's simultaneous participation in (a) the decision to make a loan of Plan X assets to Partnership Y, and (b) the subsequent benefit to Partnership Y, constitutes dealing with the assets of Plan X for Individual A's own interest. Therefore, in regard to the transaction in question, Individual A engaged in a "prohibited transaction" within the meaning of Code section 4975(c).

[380] Greenlee v. Comm'r*,* T.C. Memo. 1996-378 (1996).

[381] Rollins v. Comm'r, T.C. Memo. 2004-260 (2004). This case is discussed *supra* in Part IX.C.

[382] I.R.S. Gen. Couns. Mem. 665 (Aug. 18, 1992).

[383] PLR 7915014 (Jan. 9, 1979).

[384] A profit sharing plan is permitted to invest up to 10% of its assets in employer stock, notwithstanding the PT rules. If the plan specifically provides, it can invest 100% of its assets in employer stock. I.R.C. § 4975(d)(13) exempts,

> (13) any transaction which is exempt from section 406 of such Act by reason of section 408(e) of such Act (or which would be so exempt if such section 406 applied to such transaction) or which is exempt from section 406 of such Act by reason of section 408(b)(12) of such Act.

The "Act" referred to is ERISA §408(b)(12), which refers to ERISA §408(e), which provides an exemption for investments in qualified employer stock under certain conditions. ERISA § 408(e) provides,

> (e*) Acquisition or sale by plan of qualifying employer securities; acquisition, sale, or lease by plan of qualifying employer real property.* Sections 406 and 407 [29 USC §§1106 and 1107] shall not apply to the acquisition or sale by a plan of qualifying employer securities (as defined in section 407(d)(5) [29 USC §1107(d)(5)]) or acquisition, sale or lease by a plan of qualifying employer real property (as defined in section 407(d)(4) [29 USC §1107(d)(4)])—

What was interesting about the case was the analysis of who owes the excise tax, and what is meant by the parenthetical phrase found in the last sentence of IRC § 4975(a), the section imposing the PT excise tax, which reads, "The tax imposed by this subsection shall be paid by any disqualified person who participates in the prohibited transaction *(other than a fiduciary acting only as such)*."[386]

The advice to the IRS is very interesting on a number of obscure fronts, but it is neither clear, concise, nor convincing. However, the advice concluded that while the PT excise tax generally "shall be paid by any disqualified person who participates in the prohibited transaction,"[387] the fiduciary is exempt from the excise tax with respect to the *per* se PTs descried in § 4975(c)(1)(A-D) if the person is "a fiduciary acting only as such."[388]

> In the case at issue, the taxpayer's participation in the prohibited transaction was limited to the selection of investment options for his individual account within the parameters of investment choices and procedures set by the Plan and the administrating Committee. Since the taxpayer's investment discretion was controlled and could be limited even more, if so deemed, by the terms of the Plan and the procedures set by the Committee, *it is our interpretation that the taxpayer was participating in the prohibited transaction of the purchases and sales between [redacted text] and the Plan as a "fiduciary acting only as such." Therefore, with respect to such prohibited transaction under I.R.C. section 4975(c)(1)(A), the taxpayer is exempt from the imposition of excise tax under I.R.C. sections 4975(a) and (b)* [redacted text].[389]

Much of the reasoning of the Treasury's position is explained in this Field Service Advice.[390]

> (1) if such acquisition, sale, or lease is for adequate consideration (or in the case of a marketable obligation, at a price not less favorable to the plan than the price determined under Section 407(e)(1) [29 USC §1107(e)(1)]),
>
> (2) if no commission is charged with respect thereto, and
>
> (3) if—
>
> > (A) the plan is an eligible individual account plan (as defined in section 407(d)(3) [29 USC §1107(d)(3)]), or
> >
> > (B) in the case of an acquisition or lease of qualifying employer real property by a plan which is not an eligible individual account plan, or of an acquisition of qualifying employer securities by such a plan, the lease or acquisition is not prohibited by section 407(a) [29 USC §1107(a)].

ERISA § 408(e) (emphasis added).

386 I.R.C. § 4975(a).

387 *Id.*

388 *Id.*

389 I.R.S. Gen. Couns. Mem. 665 (Aug. 18, 1992).

390 Since both [redacted text] and the taxpayer, as a fiduciary, are "disqualified persons" who participated in a prohibited transaction defined under I.R.C. section 4975(c)(1)(A), it initially appears as though [redacted text] and the taxpayer are jointly and severally liable for the excise tax imposed under I.R.C. sections 4975(a) and (b) with respect to such prohibited transaction. See I.R.C. section 4975(f)(1). *However, excise tax under I.R.C. sections 4975(a) and (b) is not imposed upon a disqualified person who participates in a transaction as "a fiduciary acting only as such."* See I.R.C. sections 4975(a) and (b). As stated in *O'Malley, supra*, 96 T.C. at 651, "[p]articipation in section 4975 occurs any time a disqualified person is involved in a transaction in a capacity OTHER THAN as a fiduciary acting only as such."

SECTION 12.2 FIELD SERVICE ADVICE 200128011 (FAVORABLE BUT QUALIFIED)

The facts of IRS Field Service Advice 200128011[391] are briefly summarized as follows:

USCorp was a domestic subchapter S corporation, in which Father owned a majority of the shares. *Father's three minor children ("Children") owned the remaining shares.*

> As stated above, *it is the position of both the Service and the Department of Labor that a plan participant exercising control over the assets in his self-directed individual account is deemed to be a fiduciary of such account.* See I.R.C. section 4975(e)(2)(A); "Participant Directed Individual Account Plans," 56 Fed. Reg. 10724, preamble at 10734 and Prop. Reg. section 2550.404c-1(e)(3) at 10738 (1991) (to be codified at 29 C.F.R. section 2550). The legislative history discussed at pages 20 and 21 of your July 13, 1992, memorandum relates to the fiduciary responsibility requirements set forth in ERISA section 404(c) and not the prohibited transaction requirements of I.R.C. section 4975 which are at issue in the present case. See H. Rept. No. 93-533, 93d Cong., 1st Sess., 11 (Oct. 2, 1973); H. Rept. No. 93-1280, 93d Cong., 2d Sess. 305 (1974). Further, House Report Number 93-533 refers to a bill which preceded ERISA and, thus, does not reflect the final statutory language. *Under Treas. Reg. section 54.4975-9(c)(2), a person shall be deemed to be a fiduciary with respect to a plan if that person has any discretionary control over any portion of the assets of a plan; discretionary control over the entire plan is not required under the definition of "fiduciary" for purposes of I.R.C. section 4975. Therefore, it can be concluded that the taxpayer in the instant case is a fiduciary.*
>
> *A determination as to whether the taxpayer participated in the prohibited transaction as a fiduciary "acting only as such" is less clear.* There have been few interpretations of this language. The Conference Report accompanying I.R.C. section 4975 stated that:
>
> Although fiduciaries are disqualified persons under the tax provisions, they are to be subject to the excise tax only if they act in a prohibited transaction in a capacity other than that of a fiduciary. H.R. CONF. REP. No. 93-1280, 93rd Cong., 2d Sess. 323 (1974).
>
> As noted in your July 13, 1992, memorandum, Private Letter Ruling 7813089 (Dec. 30, 1977) held that an entity which exercised no discretionary authority or control with respect to the disposition of plan assets, but merely responded to the written instructions of the plan's "named fiduciary" was a "fiduciary acting only as such." However, the key consideration in this ruling is that the fiduciary did not engage in transactions prohibited under I.R.C. sections 4975(c)(1)(E) or (F). *Thus, a person or entity acting as a fiduciary with respect to a plan can only be liable for a transaction prohibited under I.R.C. sections 4975(c)(1)(E) or (F).* For transactions prohibited under I.R.C. sections 4975(c)(1)(A), (B), (C), or (D), a person or entity acting only as a fiduciary would be exempt from liability as a fiduciary "acting only as such." For a discussion as to the potential liability in the instant case of the taxpayer, acting as a fiduciary, see the fourth issue, infra.
>
> In the case at issue, the taxpayer's participation in the prohibited transaction was limited to the selection of investment options for his individual account within the parameters of investment choices and procedures set by the Plan and the administrating Committee. Since the taxpayer's investment discretion was controlled and could be limited even more, if so deemed, by the terms of the Plan and the procedures set by the Committee, *it is our interpretation that the taxpayer was participating in the prohibited transaction of the purchases and sales between [redacted text] and the Plan as a "fiduciary acting only as such." Therefore, with respect to such prohibited transaction under I.R.C. section 4975(c)(1)(A), the taxpayer is exempt from the imposition of excise tax under I.R.C. sections 4975(a) and (b)* [redacted text].
>
> For the reasons set forth above, we conclude that the taxpayer is "a fiduciary acting only as such" with respect to the prohibited transactions involving the purchases and sales of debt securities between [redacted text] and the Plan. Therefore, the taxpayer is not jointly and severally liable for excise tax under I.R.C. sections 4975(a) and (b) with respect to these prohibited transactions. I.R.S. Gen. Couns. Mem. 665.

[391] I.R.S. Field Serv. Advice 200128011 (July 13, 2001).

Father and each Child owned separate IRAs. *Each of the four IRAs acquired a twenty-five percent interest in FSC A,* a foreign sales corporation. Even though FSC A was owned in four equal shares by four IRAs owned by family members under IRC §4975(e)(6), the Service advised that FSC A was *not* a DQP with respect to the original issuance of stock to the IRAs. Under the reasoning of *Swanson v. Commissioner*,[392] at the time of the initial issuance of stock to the IRA "the issuing company was not a 'disqualified person' because the newly issued stock was not owned by anyone at the time of the sale." (However, it would be an overstatement to say the FSC A is not a DQP for all purposes, such as if FSC A *subsequently* bought or sold assets from or to any of the IRA beneficiaries.)[393]

USCorp entered into service and commission agreements with FSC A.[394] This would seem to be a PT, unless the reasonable compensation exemption to the PT Rules applied.[395]

FSC A paid dividends to its IRA shareholders "out of earnings and profits derived from foreign trade income relating to USCorp exports."[396] The Advice concluded that the payment of dividends from FSC A to the IRA shareholders was not a PT "because the dividends did not become IRA assets until they were paid."[397]

The Service was very much aware of its loss in *Swanson v. Commissioner*,[398] to which it seems to have informally acquiesced in FSA 200128011. The interpretation of *Swanson* in FSA 200128011 is informative.[399]

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392 Swanson v. Comm'r, 106 T.C. 76, 88 (1996). *See infra* Part IX.A.

393 For example, if Father owned 100% of FSC A (or Father and his three children, for that matter), FSC A would be a corporation more than 50% of which was controlled by DQPs. This issue was addressed *supra* in the introductory section of Part IV.A. As long as the IRAs are just dealing between themselves, the fiduciaries are acting only "as such" and are not benefiting any other DQPs individually. (Increasing the value of one's benefit under a QRP is never, alone, a PT.) However, if FSC A were to buy or sell assets from any of the IRA beneficiaries that would clearly be a PT. That would be a transaction between the IRA and a company controlled by the IRA fiduciary. For that purpose, FSC A would be a DQP. *See supra* Part IV.A.

394 FSC agreed to act as commission agent in connection with export sales made by USCorp, in exchange for commissions based upon the administrative pricing rules applicable to FSCs. USCorp also agreed to perform certain services on behalf of FSC A, such as soliciting and negotiating contracts, for which FSC A would reimburse USCorp its actual costs. I.R.S. Field Serv. Advice 200128011.

395 But I.R.C. § 4975(c)(1)(C) defines a PT as any direct or indirect "(C) furnishing of goods, services, or facilities between a plan and a disqualified person," right? Apparently, one of the exemptions under § 4975(d) might apply:

> (10) receipt by a disqualified person of any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan, but no person so serving who already receives full-time pay from an employer or an association of employers, whose employees are participants in the plan or from an employee organization whose members are participants in such plan shall receive compensation from such fund, except for reimbursement of expenses properly and actually incurred;
>
> (11) service by a disqualified person as a fiduciary in addition to being an officer, employee, agent, or other representative of a disqualified person. . . .

396 I.R.S. Field Serv. Advice 200128011.

397 *Id.* The "until they were paid" analysis seems strange.

398 Swanson v. Comm'r, 106 T.C. 76, 77-78 (1996).

Open questions in this case, and in *Swanson v. Commissioner*,[400] and in a host of others like them, are the following:

1. Are any of these DQP owners performing services for any of these companies?

2. And if so, are they being paid?

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[399] For the years 1985 to 1988, Tool Co. paid commissions to Worldwide DISC with respect to the sale by Tool Co. of export property. In the same years, Mr. Swanson, as president of Worldwide DISC, directed Worldwide DISC to pay dividends to IRA #1. The dividends totaled $593,602 for the four years. Tool Co. stopped paying commissions to Worldwide DISC after December 31, 1988, as Mr. Swanson "no longer considered such payments to be advantageous from a tax planning perspective." *Id.* at 79.

* * * *

The court in Swanson concluded that, *when* the *initial* issuance of DISC (or FSC) stock to the IRA was made, the issuing company was not a "disqualified person" *because the newly issued stock was not owned by anyone at the time of the sale.* Thus, the sale of stock to the IRA was not a sale or exchange of property between a plan (the IRA) and a disqualified person within the meaning of section 4975(c)(1)(A).

The payment of dividends by a DISC (or FSC) to an IRA was held not to be the use of IRA assets for the benefit of a disqualified person within the meaning of section 4975(c)(1)(D) because the dividends did not become IRA assets until they were paid.

* * * *

In light of *Swanson*, we conclude that a prohibited transaction did not occur under section 4975(c)(1)(A) *in the original issuance* of the stock of FSC A to the IRAs in this case. Similarly, we conclude that *payment of dividends by FSC A to the IRAs in this case is not a prohibited transaction* under section 4975(c)(1)(D). We further conclude, considering Swanson, that we should not maintain that the ownership of FSC A stock by the IRAs, together with the payment of dividends by FSC A to the IRAs, constitutes a prohibited transaction under section 4975(c)(1)(E).

Accordingly, this case should not be pursued as one involving prohibited transactions. *We note, however, that similar transactions may be prohibited under section 4975,* based upon the particular facts of such transactions. For example, while *FSC A in this case is not a disqualified person, the owners of the IRAs are disqualified persons as fiduciaries with respect their IRAs and USCorp is a disqualified person with respect to the IRA owned by Individual A, the majority shareholder of USCorp.* Thus, if a transaction is made for the purpose of benefiting USCorp, the IRA Owners would violate section 4795(c)(1)(D). *Also, if the facts were such that the IRA Owners' interests in the transaction because of their ownership of USCorp affected their best judgments as fiduciaries of the IRAs, the transaction would violate section 4975(c)(1)(E).* I.R.S. Field Serv. Advice 200128011 (July 13, 2001).

The caveat about I.R.C. § 4795(c)(1)(D) is always there and these administrative opinions and rulings virtually always point this out and refuse to rule on what is perhaps the most important question involved.

The last sentence quoted is a baleful warning, which turned out to be prescient, a shot across the bow, which almost struck home in *Rollins v. Commissioner*, T.C. Memo. 2004-260 (2004), discussed *infra* in Part IX.C. However, the *Rollins* court, noting the difference between the ERISA and the IRC definitions of prohibited transactions, declined to rule on the question of whether or not (c)(1)(E) can be construed to prohibit all conflict of interest transactions, as discussed *infra* in Parts V.E and IX.C. The IRS was successful, however, in making I.R.C. § 4975(c)(1)(D), a close cousin to § 4975(c)(1)(E), stick in *Rollins*, thus making it unnecessary for the court to take a position on the interpretation of (c)(1)(E) being advocated by the IRS in *Rollins* and by the DOL in ERISA Opinion Letter 2000-10A and in the quoted material of the FSA in this footnote.

[400] *Swanson*, 106 T.C. at 88-89.

3. And if they are being paid, is that a PT, and if not, why not?

ARTICLE 13 NOTICE 2004-8: CERTAIN IRAS ARE LISTED TRANSACTIONS

SECTION 13.1 A SHOT ACROSS THE BOW?

Certain transactions that are related to the type of transaction under discussion, but which we hope are not substantially similar, have been added to the IRA index *prohibitorum* of "listed transactions." The "Headnote" says-,

> The Internal Revenue Service and the Treasury Department are aware of a type of transaction, described below, that taxpayers are using to avoid the limitations on contributions to Roth IRAs. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, *as well as substantially similar transactions*, as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations [disclosure requirements] and §§ 301.6111-2(b)(2) [tax shelter registration] and 301.6112-1(b)(2) of the Procedure and Administration Regulations [list maintenance requirements]. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.[401]

SECTION 13.2 THE HOLDING

The technical holding was as follows:

> *The following transactions are identified as "listed transactions"* for purposes of § 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2) effective December 31, 2003, the date this document is released to the public: *arrangements in which an individual, related persons described in § 267(b) or 707(b), or a business controlled by such individual or related persons, engage in one or more transactions with a corporation, including contributions of property to such corporation, substantially all the shares of which are owned by one or more Roth IRAs maintained for the benefit of the individual, related persons described in § 267(b)(1), or both.* The transactions are listed transactions with respect to the individuals for whom the Roth IRAs are maintained, the business (if not a sole proprietorship) that is a party to the transaction, and the corporation substantially all the shares of which are owned by the Roth IRAs. Independent of their classification as "listed transactions," these transactions may already be subject to the disclosure requirements of § 6011 (§ 1.6011-4), the tax shelter registration requirements of § 6111 (§§ 301.6111-1T and 301.6111-2), or the list maintenance requirements of § 6112 (§ 301.6112-1).
>
> Substantially similar transactions include transactions that attempt to use a single structure with the intent of achieving the same or substantially same tax effect for multiple taxpayers. For example, if the Roth IRA Corporation is owned by multiple taxpayers' Roth IRAs, a substantially similar transaction occurs whenever that Roth IRA Corporation enters into a transaction with a business of any of the taxpayers if distributions from the Roth IRA Corporation are made to that taxpayer's Roth IRA based on the purported business transactions done with that taxpayer's business or otherwise based on the value shifted from that taxpayer's business to the Roth IRA Corporation.[402]

[401] I.R.S. Notice 2004-8, 2004-4 I.R.B. 333 (emphasis added).

[402] *Id*. (emphasis added).

SECTION 13.3 TARGETED TRANSACTIONS

The Notice targets transactions transferring assets for less than full value from an individual's pre-existing business to a corporation the shares of which are owned or acquired by the individual's Roth IRA.[403] *The crucial fact that makes this Notice generally inapplicable to anything being discussed in this outline is that the Roth is acquiring assets that are not fairly valued.* But even fairly valued transfers are covered by the Notice, and are still "listed transactions," nevertheless.[404]

SECTION 13.4 IRS ANALYSIS REGARDING § 4975

After threatening taxation under IRC §§ 311(b), 482, and 4973(f), the Notice says that "*the Service may take the position in appropriate cases that the transaction gives rise to one or more prohibited transactions* between a Roth IRA and a disqualified person described in § 4975(e)(2)."[405] The analysis observes that "*the Department of Labor has advised the Service that, if a transaction between a disqualified person and the Roth IRA would be a prohibited transaction, then a transaction between that disqualified person and the Roth IRA Corporation would be a prohibited transaction if* the Roth IRA may, by itself, require the Roth IRA Corporation to enter into the transaction."[406]

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[403] *Id*. The "Facts" portion of the opinion reads:

> In general, these transactions involve the following parties: (1) an individual (the Taxpayer) who owns a *pre-existing business* such as a corporation or a sole proprietorship (*the Business*), (2) a *Roth IRA* within the meaning of § 408A that is maintained for the Taxpayer, and (3) *a corporation (the Roth IRA Corporation), substantially all the shares of which are owned or acquired by the Roth IRA*. The Business and the Roth IRA Corporation enter into transactions as described below. The acquisition of shares, the transactions or both are *not fairly valued* and thus have the effect of shifting value into the Roth IRA.
>
> Examples include transactions in which *the Roth IRA Corporation acquires property, such as accounts receivable, from the Business for less than fair market value*, contributions of property, including intangible property, by a person other than the Roth IRA, without a commensurate receipt of stock ownership, or any other arrangement between the Roth IRA Corporation and the Taxpayer, a related party described in § 267(b) or 707(b), or the Business that has the effect of transferring value to the Roth IRA Corporation comparable to a contribution to the Roth IRA.

[404] *Id.* If the Roth IRA Corporation acquires property from the Business, one must wonder why this is not a *per se* violation of I.R.C. § 4975(c)(1)(A) whether the price paid was fair or not.

[405] I.R.S. Notice 2004-8, 2004-4 I.R.B. 333.

[406] The full analysis regarding I.R.C. §§ 408(e)(2)(A) and 4975(c)(1)(C) provides:

> Moreover, under §408(e)(2)(A), *the Service may take the position in appropriate cases that the transaction gives rise to one or more prohibited transactions* between a Roth IRA and a disqualified person described in § 4975(e)(2). For example, the Department of Labor has advised the Service that, to the extent that the Roth IRA Corporation constitutes a plan asset under the Department of Labor's plan asset regulation (29 C.F.R. § 2510.3-101), the provision of services by the Roth IRA Corporation to the Taxpayer's Business (which is a disqualified person with respect to the Roth IRA under § 4975(e)(2)) would constitute a prohibited transaction under *§4975(c)(1)(C).* [Note that §4975(c)(1)(C) prohibits *"furnishing of goods, services, or facilities between a plan and a disqualified person."*] Further, *the Department of Labor has advised the Service that, if a transaction between a disqualified person and the Roth IRA would be a prohibited transaction, then a transaction between that disqualified person and the Roth IRA Corporation would be a prohibited transaction if* the Roth IRA may, by itself, require the Roth IRA Corporation to enter into the transaction.

Notice 2004-8, 2004-4 I.R.B. 333 (emphasis added). This analysis contains an omitted citation to C.F.R. § 2509.75-2(c), discussed *supra* in Part VII.J and in Part X.E. at footnote 365, *supra*.

Why the IRS needed the DOL to advise it on this subject is curious. The conclusion seems rather straightforwardly evident. What is even more interesting is that IRC § 4975 is mentioned almost as an afterthought — "the Service may take the position in appropriate cases" — after having first threatened taxation under IRC §§ 311(b), 482, and 4973(f). The Notice's analysis of IRC § 4975 also invokes the Department of Labor's plan asset regulation.[407]

SECTION 13.5 EXAMPLE INVOLVING COMPENSATION

The IRS gave two examples of what it thinks is an abusive transaction being addressed by the Notice. These are not found in the Notice itself, but are found on the IRS Website for Abusive Tax Shelters, Special Edition.[408] The first involved a sale of accounts receivable from a dentist to a corporation 100% owned by his Roth IRA for less than fair market value (FMV). The Notice did not even mention that this would be a clear PT on its face. Instead the concern was that the sale was for less than FMV.[409] It noted that in appropriate cases there were a host of positions it could take,[410] only one of which was a PT. This

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[407] Footnote 2 to the Notice's discussion of § 4975 reads-

> For the Roth IRA Corporation to be considered as holding plan assets under the Department of Labor's plan asset regulation, the Roth IRA's investment in the Roth IRA Corporation must be an equity interest, the Roth IRA Corporation's securities must not be publicly-offered securities, and the Roth IRA's investment in the Roth IRA Corporation must be significant. 29 C.F.R. §§ 2510.3-101(a)(2), 2510.3-101(b)(1), 2510.3-101(b)(2), and 2510.3-101(f). Although the Roth IRA Corporation would not be treated as holding plan assets if the Roth IRA Corporation constituted an operating company within the meaning of 29 C.F.R. § 2510.3 -101(c), given the context of the examples described in this notice, it is unlikely that the Roth IRA Corporation would qualify as an operating company. *Id.*

[408] *Employee Plans News*, *supra* note 66.

[409] *Id.* at 2.

[410] The Notice said-

> Depending on the facts of the specific case, the Service may apply § 482 to allocate income from the Roth IRA Corporation to the Taxpayer, Business, or other entities under the control of the Taxpayer. Section 482 provides the Secretary with authority to allocate gross income, deductions, credits or allowances among persons owned or controlled directly or indirectly by the same interests, if such allocation is necessary to prevent evasion of taxes or clearly to reflect income. The § 482 regulations provide that the standard to be applied is that of a person dealing at arm's length with an uncontrolled person. See generally § 1.482-1(b) of the Income Tax Regulations. To the extent that the consideration paid or received in transactions between the Business and the Roth IRA Corporation is not in accordance with the arm's length standard, the Service may apply § 482 as necessary to prevent evasion of taxes or clearly to reflect income. In the event of a § 482 allocation between the Roth IRA Corporation and the Business or other parties, correlative allocations and other conforming adjustments would be made pursuant to § 1.482-1(g). Also see Rev. Rul. 78-83, 1978-1 C.B. 79.
>
> In addition to any other tax consequences that may be present, the amount treated as a contribution as described above is subject to the excise tax described in § 4973 to the extent that it is an excess contribution within the meaning of § 4973(f). This is an annual tax that is imposed until the excess amount is eliminated.
>
> Moreover, under § 408(e)(2)(A), the Service may take the position in appropriate cases that the transaction gives rise to one or more prohibited transactions between a Roth IRA and a disqualified person described in § 4975(e)(2). For example, the Department of Labor has advised the Service that, to the extent that the Roth IRA Corporation constitutes a plan asset under the Department of Labor's plan asset regulation (29 C.F.R. § 2510.3-101), the provision of services by the Roth IRA Corporation to the Taxpayer's Business (which is a disqualified person with respect to the Roth IRA under § 4975(e)(2)) would constitute a prohibited transaction under § 4975(c)(1)(C). Further, the Department of Labor has advised

is baffling. One would think that automatic disqualification of the IRA would be a slam-dunk, even if the sale had been for FMV.

The second example is relevant to the concern about how compensation is to be handled when an IRA owns a business that the IRA Owner helps to manage. Under the example a doctor opens a Roth IRA, which acquires all of the stock of a new corporation, and the doctor enters into a services agreement with the new corporation in which she is paid $50,000, but the corporation actually received payments of $200,000 for her services. The low compensation paid to the doctor qualifies her to make a contribution to the Roth IRA in the following year; if she had earned $200,000 she could not have done so.[411]

What if the doctor had been paid her full normal salary? I.R.S. Chief Counsel Advice (CCA) 200952049 says that if an IRA pays compensation to the IRA Owner (despite the exemption of IRC § 4975(d)(2) for reasonable compensation), it is a prohibited transaction.[412] Apparently, if the IRA Owner does not pay reasonable compensation it is an abusive transaction. Interestingly, Treas. Reg. §54.4975(a)(5)(iii) says that a fiduciary who provides services to a plan without receiving compensation does not trigger a PT under IRC § 4975(c)(1)(E) or (F):

> *(iii) Services without compensation*. If a fiduciary provides services to a plan without the receipt of compensation or other consideration (other than reimbursement of direct expenses properly and actually incurred in the performance of such services within the meaning of paragraph (e)(4) of this section), the provision of such services does not, in and of itself, constitute an act described in section 4975(c)(1)(E) or (F). The allowance of a deduction to an employer under section 162 or 212 for the expense incurred in furnishing office space or services to a plan

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> the Service that, if a transaction between a disqualified person and the Roth IRA would be a prohibited transaction, then a transaction between that disqualified person and the Roth IRA Corporation would be a prohibited transaction if the Roth IRA may, by itself, require the Roth IRA Corporation to enter into the transaction.

I.R.S. Notice 2004-8, 2004-4 I.R.B. 333.

[411] Illustration 2: MJ is a doctor who has operated her medical practice as a solely-owned corporation for several years. In Year 1, MJ opened a Roth IRA and contributed $1,000 to the account. Shortly after the contribution was made, the Roth IRA acquired 100% of the stock of a newly-formed corporation. In Year 2, MJ and the corporation entered into an agreement which provided that MJ would provide the same services to the new corporation as she had provided to the solely-owned corporation, with the new corporation receiving payment for MJ's services. The agreement provided that MJ would be paid $50,000 per year, although she had earned $200,000 per year for such services in each of the two prior years. In Year 2, in accordance with the agreement, MJ performed the same services she had performed in prior years, and received $50,000 from the newly-formed corporation, while the new corporation retained $150,000 of the $200,000 received in connection with MJ's services. The amounts received in Year 3 by the new corporation were distributed to the Roth IRA as the sole shareholder. If MJ had received the $200,000 as earnings in Year 3, she could not have made a contribution to the Roth IRA. *The amounts received by the new corporation were taxed to the corporation at its corporate rate,* but no tax was paid on the distribution to the Roth IRA, and MJ paid taxes only on the $50,000 she received for her services. MJ anticipates receiving a tax-free distribution of the proceeds from the Roth IRA in a later year. The IRS said that this is an abusive transaction and is one type the IRS has targeted in. *See Employee Plans News*, *supra* note 66, at 2; Notice 2004-8, 2004-4 I.R.B. 333.

[412] I.R.S. Chief Counsel Advice 200952049 (Dec. 24, 2009).

established or maintained by such employer does not constitute compensation or other consideration.[413]

This sounds like services to the doctor's patients, using a now acceptable corporate format, making it services to the corporation (or professional association). If the services are to the corporation, and the corporation is wholly owned by the QRP, is this not services to the QRP? To put this in relief, could any of this be done without a corporate intermediary? What if is the services at issue are merely investment services, rendered by the IRA Owner either directly to the IRA (directing the custodian what to buy and sell) or to an LLC wholly owned by the IRA? This seems a lot less abusive than a doctor working for her IRA, though the theoretical basis for the distinction is not readily apparent. Managing assets is something everyone with assets to manage does, and it does not pose an assignment of income problem. But if a doctor (or lawyer) works for free for a professional corporation, assignment of income is always an issue.

SECTION 13.6 CONSEQUENCES

The Notice reminds taxpayers of the consequences of a transaction making the abusive tax shelter list, including penalties for failure to register tax shelters and for failure to maintain lists of investors, as well as penalties on participants, return preparers, and promoters.[414]

SECTION 13.7 OBSERVATIONS

The Service seems to be focusing on transactions in which a Roth IRA forms a business and acquires stock or other property from *another* business owned by the IRA Owner at less than fair market value.[415] Such a transfer would clearly be a prohibited transaction, even if the Roth IRA pays full fair market value. Perhaps disqualification of the Roth IRA is not enough, since, unlike a traditional IRA, the taxpayer would not immediately recognize income on 100% of the January 1 value of the IRA, since it is a Roth IRA after all. Perhaps the additional penalties or consequences make the transaction even more onerous. The point is that if a Roth IRA Owner causes his IRA to purchase anything from the Owner, at FMV or otherwise, the transaction is an out-and-out clear violation of IRC § 4975(c)(1)(A) without need of further analysis, and against which no defense is imaginable. The trustee of the Roth IRA is a disqualified person, the Roth IRA Owner is a disqualified person, and if the business is a disqualified person, which it

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[413] Treas. Reg. §54.4975-6(a)(5)(iii) (emphasis added).

[414] Persons required to register these tax shelters under § 6111 who have failed to do so may be subject to the penalty under § 6707(a). Persons required to maintain lists of investors under § 6112 who have failed to do so (or who fail to provide such lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this transaction or substantially similar transactions, including the accuracy-related penalty under § 6662, and as applicable, persons who participate in the reporting of this transaction or substantially similar transactions, including the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this notice. These taxpayers should consult with a tax advisor to ensure that their transactions are disclosed properly and to take appropriate corrective action. I.R.S. Notice 2004-8, 2004-4 I.R.B. 333.

[415] The Notice gives examples of targeted transactions, including "transactions in which *the Roth IRA Corporation acquires property, such as accounts receivable, from the Business for less than fair market value* . . . that has the effect of transferring value to the Roth IRA Corporation comparable to a contribution to the Roth IRA." *Id*. (emphasis added).

probably will be, then virtually any transaction between any of them is going to be a prohibited transaction. End of story.

ARTICLE 14 QUALIFIED PLANS THAT INVEST IN QUALIFYING EMPLOYER SECURITIES

SECTION 14.1 NOT JUST ESOPS

What is said in this Part is not necessarily, or even primarily, about ESOPs, though much in it will apply to an ESOP as well. The main focus is in any Eligible Individual Account Plan (EIAP) that takes advantage of the exemption provided by the IRC and ERISA that allows such plans to invest in qualifying employer securities under certain circumstances. This exemption is by no means limited to ESOPs, though the leveraging and front-loading opportunities offered by ESOPs make ESOPs the most well-known of the various species of EIAPs.

SECTION 14.2 GENERAL REMARKS

An eligible individual account plan (EIAP) can invest in qualified employer stock without violating the prohibited transaction rules. This offers many benefits, including being a source of financing for a middle aged entrepreneur who has just retired with a large pension benefit that he or she rolls over to the profit sharing plan of a closely held start-up company, recently formed by the retiree.

Although investing in the stock of the employer sounds like a prohibited transaction, and would be if it were not for an exemption, the law has permitted such investments for as long as companies have provided retirement plans, and a specific exception has been in the law from the date ERISA was enacted in 1974. And why not? If an employer is not required by law to provide for the retirement of its employees—and in the United States it is not—then why prohibit what is voluntary anyway? Well, the truth is that the law prohibits a lot of things that arguably could be similarly analyzed. The reason for such prohibitions is that self-dealing and the like can lead to such conflicts of interest and abuses that, given the tax benefits afforded qualified plans, the government has a right to place limits on such behavior and has a clear interest in protecting assets that are designed to provide for an employee's retirement. Nevertheless, ERISA § 408(b) specifically permits certain non-pension defined contribution, or individual account, plans subject to Title I of ERISA to invest in "qualifying employer securities" and "qualifying employer real property."

Interestingly, the type of plan that receives the greatest legislative subsidy in the form of tax breaks is the Employee Stock Ownership Plan, or ESOP. An ESOP is simply a company profit-sharing plan that permits, and in some cases requires, investment in company stock. But the plan does not have to be an ESOP to be able to invest in employer securities. The employer can invest up to ten percent of the assets of your typical profit-sharing or 401(k) plan with no special plan language permitting such investments, *and the employer is free to invest up to 100% of employer non-elective contributions in employer stock if the plan so provides.*

SECTION 14.3 "ROBS:" A NEW TERM FOR AN OLD CONCEPT

The IRS has recently noted that EIAPs using rollover funds may, in a particular case, be abusive. It has indicated that these arrangements will be subject to scrutiny in the future.[416] It calls these arrangements ROBS, for "Rollovers as Business Start-Ups."

ROBS create an arrangement in which prospective business owners use their retirement funds to pay for new business start-up costs. ROBS plans, while not considered an abusive tax avoidance transaction, are questionable because they may solely benefit one individual – the individual who rolls over his or her existing retirement funds to the ROBS plan in a tax-free transaction. The ROBS plan then uses the rollover assets to purchase the stock of the new business.

Promoters aggressively market ROBS arrangements to prospective business owners. In many cases, the company will apply to the IRS for a favorable Determination Letter ("DL") as a way to assure their clients that the IRS approves the ROBS arrangement. The IRS issues a DL based on the plan's terms meeting Internal Revenue Code requirements. DLs do not give plan sponsors protection from incorrectly applying the plan's terms or from operating the plan in a discriminatory manner. When a plan sponsor administers a plan in a way that results in prohibited discrimination or engages in prohibited transactions, it can result in plan disqualification and adverse tax consequences to the plan's sponsor and its participants.

The IRS notes the following special problem situations with ROBS:

- After the ROBS plan sponsor purchases the new company's employer stock with the rollover funds, the sponsor amends the plan to prevent other participants from purchasing stock.
- If the sponsor amends the plan to prevent other employees from participating after the DL is issued, this may violate the Code qualification requirements. These types of amendments tend to result in problems with coverage, discrimination and potentially result in violations of benefits, rights and features requirements.
- Promoter fees
- Valuation of assets
- Failure to issue a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., when the assets are rolled over into the ROBS plan.[417]

These problems are well-known, or should be. Anyone practicing in this area will have paid particular attention to the valuation of the stock. The practitioner will also make sure that the option to invest in

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[416] Internal Revenue Service*, Rollovers as Business Start-Ups Compliance Project*, Retirement News For Employers, Fall 2010 Edition, http://www.irs.gov/retirement/article/0,,id=231594,00.html (Aug. 2, 2011) (last visited Feb. 29, 2012).

[417] *Id*.

employer stock is open to all plan employees, and does not otherwise violate IRC § 401(a)(4), which prohibits providing any benefits, rights, and features in a discriminatory manner.[418]

SECTION 14.4 THE LAW AND QUESTIONS ABOUT IT

What is the relationship between the IRC § 4975(d)(13), and ERISA §§ 406-408, which alternatively prohibit and except investments in "qualifying employer securities," and the "exclusive benefit" rule, found in IRC § 401(a), and its close kindred found in § 404(a)(1)-(2) of ERISA? This is a very troubling question, to which there is no clear or easy answer.

IRC § 4975(d)(13) provides that, except as provided in subsection (f)(6), the prohibitions provided in subsection (c) shall not apply to

> (13) any transaction which is exempt from section 406 of such Act by reason of section 408(e) of such Act (or which would be so exempt if such section 406 applied to such transaction) or which is exempt from section 406 of such Act by reason of section 408(b)(12) of such Act.

Note that ERISA §§ 408(e), and 408(b)(12) are not the only exceptions addressing investments in "qualifying employer securities" found in ERISA. Various provisions of ERISA § 407 and § 404(a)(2) also address these investments.[419]

The very first sentence to IRC § 401 states the basic "exclusive benefit" rule:

> A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer *for the exclusive benefit of his employees or their beneficiaries* shall constitute a qualified trust under this section . . . [if, if, if and more ifs].[420]

ERISA has an "exclusive benefit" discussion as well.[421]

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418 (3) Nondiscriminatory availability of benefits, rights, and features. All benefits, rights, and features provided under the plan must be made available in the plan in a nondiscriminatory manner. Rules for determining whether this requirement is satisfied are set forth in §1.401(a)(4)-4. Treas. Reg. §1.401(a)(4)-1(b)(3).

419 I.R.M. 4.72.11.2 (Nov. 1, 2010).

420 I.R.C. § 401(a) (emphasis added).

421 ERISA § 404(a)(1)-(2).

(1) Subject to sections 403(c) and (d) [29 USC §1103(c) and (d)], 4042 [29 USC §1342], and 4044 [29 USC §1344], a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

The IRS Manual actually discusses the relationship between the exclusive benefit rule and the exemptions, at § 4.72.11.1.2(2). The PT rules and the exclusive benefit rules generally apply independently of each other. The Manual makes clear that a transaction may violate both rules, in which event the sanctions of IRS § 4975 and possible revocation of the plan's exempt status would both apply. Conversely, even if there is an exemption that applies under IRC § 4975, the "*transaction must still meet the exclusive benefit and the assignment or alienation requirements*."[422]

SECTION 14.5 CASES: *EAVES V. PENN* AND ITS PROGENY

In *Eaves v. Penn*[423] an individual purchased a company by converting an existing profit sharing plan into an ESOP and using the ESOP as his main source of financing for the purchase. Under the facts, which indicated that the transaction was done to benefit the purchaser individually, the attempted conversion of the profit sharing plan into an ESOP was a PT.[424]

> ESOP fiduciaries are subject to the same fiduciary standards as any other fiduciary except to the extent that the standards require diversification of investments. Therefore, we hold that Penn's activities as trustee and sponsor of the employee stock ownership plan were subject to both the "solely in the interest" and prudence tests of § 404(a)(1)(A) and (B).[425]

Eaves v. Penn has been cited dozens of times since the Tenth Circuit first published the case, and can be considered settled law.[426]

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title [and title IV].

(2) In the case of an eligible individual account plan (as defined in section 407(d)(3) [29 USC §1107(d)(3)]), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of qualifying employer real property or qualifying employer securities (as defined in section 407(d)(4) and (5) [29 USC §1107(d)(4) and (5)).

[422] I.R.M. 4.72.11.1.2 (emphasis added).

> (1) The exclusive benefit rule of IRC 401(a) does not conflict with the prohibited transaction provisions of IRC 4975. A disqualified person may engage in a prohibited transaction and at the same time cause a violation of the exclusive benefit rule. Thus, a trust officer, etc., cannot take the position that the imposition of an IRC 4975 excise tax precludes the application of the exclusive benefit rule.
>
> a. If a transaction violates the exclusive benefit rule, revocation of the qualified status of the trust should be considered.
>
> b. If revocation is invoked, the prohibitions and sanctions of IRC 4975 continue to apply to the disqualified plan. See also, guidelines on Plan Revocation procedures. See IRM 4.72.12.
>
> (2) Generally any transaction described in IRC 4975(c) between the plan and the employer or other persons related to the plan or the employer, i.e., a disqualified person, will constitute a prohibited transaction under IRC 4975. *In some cases such transactions may be exempt from the sanctions imposed by IRC 4975 as a result of a statutory or an administrative exemption. However, even though a transaction may be exempt from the sanctions imposed by IRC 4975, that transaction must still meet the exclusive benefit and the assignment or alienation requirements.*

[423] Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978).

[424] *Id.* at 460-62.

[425] *Id.* at 460.

[426] *See, e.g.*, Marshall v. Snyder, No. 77 C 116, 1979 U.S. Dist. LEXIS 15377, at *3 (E.D.N.Y. Aug. 21, 1979), Van Orman v. Am. Ins. Co., No. 75-2007, 1980 U.S. Dist. LEXIS 17400, at *116 (D.N.J. Oct. 23, 1980), Mohler v. Unger,

The point to note is that aside from diversification as an element of prudence, the prudence requirement is not excepted, and, it would appear that neither the "solely in the interest" requirement nor the "exclusive purpose" rule is affected by the employer stock exception at all.

This is very troubling. It is clear that ESOPs are seldom intended to be for the metaphysically "exclusive" benefit of the employees, as such. They are often intended, at least in part, to benefit the owners and company. This is a rather *fuzzy* area.

In analyzing the exemptions, judgment calls must be made in light of the *Eaves v. Penn* limitations*.*

SECTION 14.6 SPECIAL EXEMPTION FROM PROHIBITED TRANSACTION RULES FOR QUALIFYING EMPLOYER SECURITIES

Can an IRA be a source to finance a new business venture of the IRA Owner? That was the subject of this article, and it should now be clear that although it might be possible it is very hazardous. However, the statutes bless investment in company stock under certain circumstances. (Take Enron for example?) Clearly ESOPs can invest in company stock. That is the whole point of ESOPs. In addition, any *profit sharing plan can legally acquire securities from the company that sponsors it, if certain conditions are met.* (Planning opportunity: This should be true, even if IRA rollover money from a profit sharing plan is used for this purpose(?(!))) If what actually commonly happens in ESOPs is legal, it makes no difference that the DQP is benefiting from the transaction in a manner that would otherwise have violated IRC § 4975(c)(1), particularly the vague (D)-(F) violations that trouble IRA fiduciaries dealing with unrelated parties.[427] This is, however a conclusion derived more by induction than deduction, which provides less than full comfort.

Investing in employer stock, particularly if acquired from a disqualified person, could conceivably violate ERISA § 406 (self-dealing), perhaps ERISA § 407 (diversification) if the investment was sufficiently disproportionate, and also IRC § 4975(c). Nevertheless, there is an exception under ERISA and under the IRC that allows certain eligible individual account plans to invest up to 100% of the trust fund in "qualifying employer securities." What is a "Qualifying Employer Security?" The ERISA definition is found in ERISA §407.[428] The IRC definition is found in IRC § 409(l) via § 4975(e)(8). Why not just one definition?

No. C-3-90-284, 1994 U.S. Dist. LEXIS 21697, at *52 (S.D.Ohio Aug. 26, 1994), Landro v. Glendenning Motorways, Inc., No. 3-77-384, 1979 U.S. Dist. LEXIS 11202, at *2-3 (D.Minn. July 6, 1979), Marshall v. Kelly, No. CIV-78-0070-E, 1978 U.S. Dist. LEXIS 6950, at *18 (W.D.Okla. Dec. 29, 1978), *In re* Fairchild Indus., No. MDL-822, 1993 U.S. Dist. LEXIS 14265, at *40 (N.D.Fla. Sept. 9, 1993).

[427] *See supra* Parts II.E & X.E.

[428] ERISA § 407(d)(5) (emphasis added).

> The term *"qualifying employer security"* means an employer security which is-
>
> (A) *stock*,
>
> (B) a *marketable obligation* (as defined in subsection (e) . . .), *or*
>
> (C) an interest in a *publicly traded partnership* (as defined in section 7704(b)) of the Internal Revenue Code of 1986), but only if such partnership is an existing partnership as defined in section 10211(c)(2)(A) of the Revenue Act of 1987 (Public Law 100-203).

ERISA § 407(e) (emphasis added).

> *Marketable obligations.* For purposes of subsection (d)(5), the term *"marketable obligation"* means a bond, debenture, note, or certificate, or other evidence of indebtedness (hereinafter in this subsection referred to as "obligation") if --

That is not clear, but apparently both must be met. A profit sharing plan (but not an IRA or SEP or money purchase plan)[429] can be an eligible individual account plan if it expressly allows for the investment in qualifying employer securities in excess of the ten percent limitation otherwise applicable.[430] The exception under ERISA is found in § 408(e), and the exception under the IRC is found at § 4975(d)(13), which cross references ERISA.

In relying on these exemptions, make sure to meet the threshold requirements, which include, inter alia "adequate consideration"[431] and "no commissions."[432] Adequate consideration means the value has to be correct, and since valuation is more of an art than a science no matter what the appraisers say, —a fact that is demonstrably and empirically provable by the fact that in a double blind experiment no three will ever, ever, arrive at the same value— one can never be 100% sure whether *either* too much or too little was paid.

Can the statutory exemption be relied on and taken literally, considering the cautionary notes in this article? *ERISA Opinion Letter No. 75-89 gives every indication that the statute means exactly what it says.*[433] Note however that neither the exclusive benefit nor the solely in the interest rules are even mentioned in that Opinion Letter.

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(1) such obligation is acquired --

(A) on the market, either (i) at the price of the obligation prevailing on a national securities exchange which is registered with the Securities and Exchange Commission, or (ii) if the obligation is not traded on such a national securities exchange, at a price not less favorable to the plan than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer;

(B) from an underwriter, at a price (i) not in excess of the public offering price for the obligation as set forth in a prospectus or offering circular filed with the Securities and Exchange Commission, and (ii) at which a substantial portion of the same issue is acquired by persons independent of the issuer; or

(C) *directly from the issuer*, at a price not less favorable to the plan than the price paid currently for a substantial portion of the same issue by persons independent of the issuer;

(2) immediately following acquisition of such obligation --

(A) not more than 25 percent of the aggregate amount of obligations issued in such issue and outstanding at the time of acquisition is held by the plan, and

(B) at least 50 percent of the aggregate amount referred to in subparagraph (A) is held by persons independent of the issuer; and

(3) immediately following acquisition of the obligation, not more than 25 percent of the assets of the plan is invested in obligations of the employer or an affiliate of the employer.

[429] ERISA § 407(d)(3)(A)-(C).

[430] *Id.*

[431] I.R.C. § 4975(d)(5).

[432] I.R.C. § 4975(d)(16)(E).

[433] ERISA Op. Letter 75-89 (Oct. 14, 1975).

Dear _____:

This is in reply to your letters of July 23 and August 5, 1975, concerning the application of the provisions of sections 404, 406, 407 and 408(e) of the Employee Retirement Income Security Act of 1974 (the Act) to profit-sharing plans which propose to acquire either employer securities or preferred stock issued by corporations that own 100 percent of the outstanding shares of employers whose employees are covered by such profit-sharing plans. Your letters request confirmation of your opinion that, by reason of section 407(b)(1), such acquisitions are not subject to the 10 percent limitation set forth in section 407(a) of the Act, and that such purchases and sales of such securities by such profit-sharing plans are exempt from the restrictions of section 406 and 407 of the Act by reason of section 408(e) of the Act.

You have also requested confirmation of your opinion that the diversification requirements of section 404(a)(1) of the Act do not apply to the acquisition and holding of such securities by profit-sharing plans. Finally, you have requested our views regarding the impact of the exercise by a participant of control over the assets in his individual account, within the meaning of section 404(c), upon the purchase and sale of qualifying employer securities and the availability of the exemption provided in section 408(e) of the Act with respect to such transactions.

Section 407(b)(1) of the Act exempts plans from the 10 percent limitations on the acquisition and holding of qualifying employer securities and real property set forth in section 407(a) of the Act, if such plans are eligible individual accounts plans. Under section 407(d)(3)(A)(i) of the Act, an individual account plan (as defined in section 3(34) of the Act) is an eligible individual account plan if it is, among other things, a profit-sharing plan or a stock bonus plan. Under section 407 (d)(3)(B), such a plan will be treated as an eligible individual account plan only if the terms of the plan explicitly provide for the acquisition and holding of qualifying employer securities or real property. Therefore, if the profit-sharing plans to which you refer in your letters are amended in accordance with section 407 (d)(3)(B) of the Act, they will be treated as eligible individual account plans and the exemption under section 407(b)(1) would be available for such plans. Further, an exemption is provided from the requirements of section 407(d)(3)(B) until January 1, 1976 for plans in existence on September 2, 1974.

We also note in this regard that although your letters refer to the securities that certain profit-sharing plans might purchase from parent corporations of employers whose employees are covered by such plans as preferred stock (which would meet the definition of “qualifying employer security” set forth in section 407(d)(5) of the Act since such parent corporations, as you have described them, would be “affiliates” of employers within the meaning of section 407(d)(7) of the Act), your letters do not provide sufficient information for us to determine whether the securities purchases by such plans which are issued directly by employers whose employees are covered by the plans would come within the definition of “qualifying employer securities.”

In addition to the restrictions of section 407 of the Act, sections 406(a)(1)(E) and 406(a)(2) prohibit plan fiduciaries from knowingly causing plans to acquire or hold employer securities or real property in violation of section 407(a). Thus, acquisitions or holdings of employer securities by an eligible individual account plan would not be prohibited under either section 406(a)(1)(B) or section 406(a)(2) of the Act, provided that such employer securities are qualifying employer securities. However, acquisitions and sales of qualifying employer securities by eligible individual account plans as well as other plans might nevertheless constitute prohibited transactions under other provisions of the Act. For example, section 406(a)(1)(A) prohibits the sale or exchange of any property between a plan and a party in interest, which, as defined in section 3(14) of the Act, includes an employer any of whose employees are covered by the plan and any person which owns a 50 percent or more interest in such an employer.

However, section 408(e) of the Act provides an exemption from the restrictions of sections 406 and 407 for the acquisition or sale by a plan or qualifying employer securities or real property if, as here relevant, (1) such acquisition is for adequate consideration, (2) no commission is charged with respect thereto, and (3) the plan is an eligible individual account plan. In this regard, your letters represent that no commission would be charged with respect to any acquisition of qualifying employer securities by such plans (nor, presumably, would any commission be charged with respect to any sales of such securities), and that the plans under consideration are eligible individual account plans.

SECTION 14.7 APPLICATION OF THE SECURITIES LAWS TO EMPLOYER STOCK

This article does not address securities laws. It is particularly relevant, however, that the antifraud provisions of the federal securities laws and regulations apply to ERISA plans. [434] It is also noteworthy that ERISA § 512 states that ERISA does not preempt state laws regulating securities.

> With regard, however, to whether such transactions are for "adequate consideration," section 3(18) defines that term, when used in part 4 of subtitle B, to mean, in the case of a security for which there is a generally recognized market, either the price of the security prevailing on a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934, or if the security is not traded on such an exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any party in interest; and in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor. In this connection, you have not provided sufficient information to enable us to determine whether transactions in qualifying employer securities to which you refer would be for adequate consideration for purposes of section 408(e) of the Act.
>
> As noted above, your letter requests our confirmation of your opinion that the diversification requirement of section 404(a)(1)(C) of the Act and the prudence requirement of section 404(a)(a)(B), insofar as it requires diversification, is not applicable to the acquisition or holding of qualifying employer securities by an eligible individual account plan. Pursuant to the provisions of section 404(a)(2) of the Act, is our view that your opinion in this regard is accurate.
>
> Finally, you have inquired whether the exemption provided in section 408(e) of the Act from sections 406 and 407 (a) of the Act, as it applies to eligible individual account plans, would be available if the acquisition or sale of qualifying employer securities is at the direction of a participant or beneficiary exercising control over the assets in his individual account within the meaning of section 404(c) of the Act. In this regard, the exemption provided in section 408(e) is available with respect to an eligible individual account plan only if the conditions set forth in that section are met; the exemption is not affected by the exercise of control by a participant or beneficiary over the assets in his individual account. We further note that a determination of whether a participant or beneficiary exercises control over the assets in his individual account for purposes of section 404(c) can only be made in accordance with regulations issued by the Secretary of Labor. At this time, such regulations have not been adopted or proposed for adoption.
>
> It is hoped that the above is helpful to you.

[434] *See* Santa Fe Indus. v. Green, 430 U.S. 462 (1977) (holding Section 10(b) and Rule 10b-5 inapplicable where no deceptive or manipulative conduct alleged), Ventimiglia v. Gruntal & Co., 1989 US Dist. LEXIS 12910, at *4 (S.D.N.Y. 1989).

> In the present case, plaintiffs have alleged specific instances of deceptive conduct on the part of defendants which, if proven, would go beyond mere breach of fiduciary duty. This type of conduct is among those that the Act was designed to address. Thus, the Court declines to hold that these claims should be dismissed on preemption grounds.

Id. at *11.