Anatomy of a Prohibited Transaction

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• ERISA §404: Fiduciary Duty. What a fiduciary shall do.

• ERISA §406: Prohibited Transactions. What a fiduciary shall not do (unless exempted).
ERISA § 404: Fiduciary Duties

- ERISA has five general guidelines concerning the conduct of plan fiduciaries.
- Fiduciaries are required to:
  1) Act solely in the interest of plan participants and beneficiaries;
  2) Hold and deal with plan assets for the exclusive purpose of paying benefits and defraying reasonable costs of plan administration;
  3) Act prudently;
  4) Diversify plan investments; and
  5) Act in accordance with plan documents, but only to the extent that the plan documents are consistent with ERISA § 404(a)(1).

ERISA § 403(c)(1) and 404(a); ERISA § 404(a)(1)(B); 29 CFR § 2509.75-9; H.R. Rep. 93-1280, 93d Cong., 2d Sess. P. 304.
Prohibited Transactions

Congress adopted stringent provisions in ERISA §406 barring the plan or its fiduciaries from involvement in transaction defined as prohibited transactions. The Internal Revenue Code imposes a tax on such persons called “disqualified persons” under the IRC, for engaging in such conduct. The prohibited transaction rules apply regardless of whether the transaction may actually benefit the participants.

Underlying Theory:
That certain transactions are so ripe for abuse that they must be avoided unless an exemption applies. **Two major categories:**

- ERISA §406(a): Party in Interest Transactions
- ERISA §406(b): Self-Dealing
### Key Differences Between Breach of Fiduciary Duty and Prohibited Transactions

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<thead>
<tr>
<th>Fiduciary Duty</th>
<th>Prohibited Transactions</th>
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<td>Prudency: Ultimately determined by court/finder of fact based on totality of circumstances</td>
<td>These are per se violations.</td>
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<td>Damages: To prove claim, damages must have been sustained.</td>
<td>Damages: No proof of damages necessary.</td>
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<td>Remedies: Range of remedies including compensatory damages, attorney fees/interest</td>
<td>Remedies: correction of transaction + two tier excise tax* and ERISA civil penalties**</td>
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<td>Insurance Coverage: Generally provides coverage</td>
<td>Insurance Coverage: watch for exclusions (specifically, penalties)</td>
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*First tier is percent of the “amount involved” in the transaction. If the transaction is not corrected with the taxable period, the IRS assess a second tier tax equal to 100 percent of the amount involved. IRC §4975. The amount involved is the amount of money and the FMV of the property given or received. In the case of service providers, the amount involved is equal to the excess compensation received. To correct a transaction means to put the plan in a financial position that is as good as it would have been had the disqualified person acted under the highest fiduciary standards. Both tiers of taxes are to be paid by the persons who committed the transaction.

**ERISA Civil Penalties may not exceed 5% of amount involved in each such transaction for each year and penalty can increase to 100% of the amount involved if not corrected within 90 days after notice. ERISA §502(i).
Common Transactions

- Collections
- Payment of bills
- Trustee expense reimbursement
- Sharing of office space
- Employment of relatives
- Retention of service providers for additional work
- Maintenance of facilities by contributing employers
- Transactions between related plans with common trustees
- Trustees who are also plan participants
- Union “gifting” property to fund
- Transferring participant contributions to third party, i.e., PAC.
Defining the “Type” of Prohibited Transaction

1. “Party in Interest” Transactions
   prohibition on certain transactions between the plan and a party in interest.

2. “Self Dealing” Transactions
“Party in Interest”
Transactions
Step One: Define the Party

- ERISA’s goal is to identify persons with a relationship to the plan and regulate their conduct in relation to the plan and its assets.

- ERISA/IRC:
  - ERISA: “Parties in Interest” vs. Internal Revenue Code: “Disqualified Persons”
  - ERISA rules encompass broader range of individuals. IRC does not include fiduciaries who did not participate in Transaction.
  - IRC: Two tier excise tax
  - ERISA: Civil penalties
Step One: Define the Party (continued)

- Defined by ERISA § 3(14).
  The term “party in interest” means, as to an employee benefit plan—
  (A) Any fiduciary (including, but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of such employee benefit plan;
  (B) A person providing services to such plan;
  (C) An employer any of whose employees are covered by such plan;
  (D) An employee organization any of whose members are covered by such plan;
  (E) Substantial owner of employer or employee organization. Substantial owner is one who owns 50% or more of the stock or interest in the entity;
  (F) Family member of any individual or any individual of any person described above;
  (G) An entity which 50% or more of the stock or interest is owned by any person or entity described above;
  (H) Officers, directors or highly compensation employees (one who owns 10% of wages paid by his/her employer) of entities described in C, D, E, and G, above.
  (I) A partner of entities described in C, D, E, and G above.
Step One: Define the Party (continued)

- Not a party in interest = no prohibited transaction
- Penalties:
  - IRC: Two tier excise tax
  - ERISA: Civil penalties
Step Two: Define the Transaction

Five Categories of Party in Interest Transactions:

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

(2) Any lending of money or other extension of credit between the plan and a party in interest (ERISA §406(a)(1)(B));

(3) Any furnishing of goods, services, or facilities between the plan and a party in interest (ERISA §406(a)(1)(C));

(4) Any transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan (ERISA §406(a)(1)(D)); or

(5) Any acquisition, on behalf of the plan, of any employer security or employer real property in violation of ERISA §407 (ERISA §406(a)(1)(E)).
Self Dealing Transactions
Step One: Defining the Party

• Fiduciaries. These can be named fiduciaries and—
• Any person who:
  (A) Exercises any discretionary authority or control respecting management of plan, or exercises any authority or control respecting management or disposition of the assets;
  (B) Renders investment advice for a fee or other compensation for any plan assets, or has authority or responsibility to do so; or
  (C) Has any discretionary authority or responsibility in the administration of the Plan

ERISA §3(21) and IRC §4975(c)(1)(E)-(F)
Step Two: Defining the Transaction

- ERI SA §406(b)
- Dealing with the assets of the plan in the fiduciaries own interest or for his own account.
- Acting in a transaction involving the plan on behalf of a party whose interest are adverse to the interest of the plan or the interests of its participants/beneficiaries
- Receiving consideration for fiduciaries own account from any party dealing with such plan in connection with a transaction involving the assets of the plan.
“Safe” Transactions

- Certain transactions are exempt from the prohibited transactions rule:
  - Statutory exemption in ERISA
  - Class exemption issued by the DOL
  - DOL has granted an individual exemption
  - Legal fictions—every plan will engage in some of these, i.e., necessary to operation of plan.
Statutory Exemptions
Under ERISA

• Rely upon these enumerated exemptions if certain conditions are met
• Sampling of exemptions:
  – Participant loans
  – Contracting or making reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment or operating of the plan, if no more than reasonable compensation is paid therefore.
  – Mergers of multiemployer plan
  – Service providers (transactions with non-fiduciary service providers if adequate consideration is received)
  – Securities transaction corrected in 14 days (unless the transaction was known or should have been known)
Administrative/Class Exemptions

- “Blanket” exemptions
- In order to grant administrative exemption the DOL must make three determinations:
  1. The exemption must be administratively feasible;
  2. In the interest of the plan and its participants and beneficiaries; and
  3. Protective of the rights of the plan participants and beneficiaries.

ERISA §408(a); IRC §4975(c)(2)
Administrative/ Class Exemptions Examples

• Payment agreements: Extended payment schedule or accepting less than the full amount of money owed by a delinquent employer. (PTE 76-1)
• Furnishing of Office Space, Administrative Services, and Goods Involving Multiple Employer Plans. (PTE 76-1)
• Purchase or sale by an employee benefit plan of shares of a mutual fund when an investment adviser to the Fund, other than the Plan Sponsor, also is a fiduciary for the Plan (PTE 77-15)
Transfers of individual life insurance contracts between plans and their participants (PTEs 92-15 and 92-6)

Interest Free Loans made by plans to their sponsoring employers (PTE 80-26)

Receipt of certain services at reduced or no cost by an IRA/Keogh Plan beneficiary from a bank (PTE 93-33)

Short Term Debt Instrument: Plan may invest in short-term investments that involve parties in interest if the parties in interest do not have discretionary authority or control with respect to the investment. (PTE 81-8)
Administrative/Class Exemptions Examples (continued)

- Securities lending: the plan may enter into certain securities lending transaction with broker-dealers who are parties in interest with respect to the plan. (PTE 81-6)
- Sale of Insurance from the Plan: Plan may sell a life insurance policy to the participant insured by the policy, to a relative of the insured participant, the employer to another employee benefit plan. (PTE 92-6).
- Certain transactions ordered by Court or DOL: A transaction authorized by court order or the DOL prior to the occurrence of such transaction in order to remedy a violation of ERISA (e.g. settlement of DOL investigation) is exempted from the prohibited transaction rules. PTE 79-15, 94-71.
QPAMs: Term originated in PTE 84-14. Exemption permits parties in interest to engage in a real transaction involving plan assets if, among other conditions. The plan assets are managed by person defined by the exemption as qualified professional asset managers. Hiring a QPAM allows the pension plan to engage in certain transactions that may otherwise be prohibited under ERISA.

- QPAM is essentially an investment manager as defined in ERISA §3(38) who meets the requirements of PTE 84-14.
Individual Exemptions

- Case-by-case determination.
- Apply to applicant only. Other plans cannot rely on this exemption even if all conditions are met.
- Applications are handled by the Administration’s Office of Exemption Determination (OED)
Exemption Procedure

- 29 CFR 2570.30 – 2570.52
- Burden is on applicant to demonstrative that they should be granted exemptive relief
- Important to ensure that applications are completed and that all material facts and legal analyses needed to justify the request are included.
- DOL suggests that applicants considered relief previously provided by the Department.
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