DOL Proposes Class Exemption to Resolve PT Problems With IRAs for Securities Firms and Others

Securities and brokerage firms have written many of their account opening documents so that an individual opening a new investment account agrees that if he or she owes money with respect to anyone of his or her accounts that the security company has the right to withdraw the amount owed from a different account. This is generally called a cross-collateralization agreement. In order for a person (or an IRA) to be able to engaged in short sales, margin transactions, options and futures the securities firm wants to be assured of getting paid and so imposes a cross-collateralization agreement or an indemnification agreement.

The securities and brokerage firms have rightfully concluded that there needs to be a prohibited transaction class exemption granted by the DOL/EBSA or many firms will suffer adverse tax and financial consequences because of their account agreements. One does wonder why the securities firms have been so stubborn and so stubborn for so long in requiring individuals setting up an IRA to furnish a cross-collateralization.

As discussed in the previous article, this is a prohibited transaction. The securities industry has been brazen to think it is not a prohibited transaction or try to argue it is not. IRA custodians have known since the 1970'sand 1980's that they could not have a person's IRA serve as collateral for any personal loan or investment. Nevertheless, it is 2013 and the securities industry wants to keep doing what they have been doing. The securities industry has requested of the DOL/EBSA that prohibited class exemption (PTE) 80-26 be amended on a prospective basis to allow an individual in the future to be able to use his or her IRA to cover debts of other non-IRA accounts.

In general, the DOL/EBSA is not granting the request on a prospective basis, but is granting limited relief on a retroactive basis if certain conditions are met. The securities industry should be ecstatic as they have ignored a basic tax rule for over 30 years.

In October of 2009, the DOL/EBSA in Advisory Opinion 2009-03A made clear that the grant by an IRA owner to a broker of a security interest in the IRA owner's non-IRA accounts in order to cover indebtedness of, or arising from, the IRA would be an impermissible extension of credit under Code section 4975. In October of 2011, the DOL issued Advisory Opinion 2011-09A and made clear the exemption provided by PTE 80-26 granting class PTE exemption for certain interest free credit would not apply to the cross-collateralization situations.

Independent auditors are apparently discussing this cross-collaterization topic in their public audit reports. In some situations the financial consequences could be so adverse as to materially impact the securities firm's financial condition.

Remember when a prohibited transaction (PT) occurs as a result of an individual with respect to an IRA, that the IRA is either considered totally taxable since a deemed distribution takes place on the first day of the tax year, or if the PT occurs as a result of the IRA custodian, then the financial institution will need to pay a tax equal to 15% times the total value of the involved IRAs.

The possible adverse tax consequences are very large.

The DOL/EBSA has concluded that its proposed regulatory action of amending PTE 80-26 is not so "significant" that the Office of Budget and Management(OBM) must first review the proposal before it was submitted to the general public. The OBM is supposed to review a regulatory proposal if on an annual basis the proposal will have an impact on the economy of $100 million or more. Considering that IRAs have a value of4.7 trillion and that over 75% of IRAs are with Securities firms, it is almost a certainty that taxing such IRAs would amount to more than $100 million. And there certainly would be lawsuits by individuals against the security and brokerage firms.

Consequently, the Securities Industry and Financial Markets Association (SIFMA) has requested the DOL/EBSA issue the proposed amendment to PTE 80-26 and code section 4975. The proposed amendment, if adopted, would give temporary and retroactive exemptive relief for certain guarantees of the payment of debts to plan investment accounts (including IRAs) by parties in interest to such plans as well as certain loans and loan repayments made pursuant to such guarantees. If adopted, the proposed amendment will be effective from January 1, 1975, until the date that is 6months after the date on which an adopted amendment is published in the Federal Register.

That is, the prohibited transaction exemption (PTE) is to be retroactive. It may be that a person who has had to pay the income tax penalties associated with a PT will be able to seek a refund. It will certainly mean that large tax amounts currently owed will not need to be paid. This is a nice “settlement” for the securities industry. The DOL/EBSA does not discuss whether it has considered or could consider having the security industry pay a monetary penalty.

At the present time, the DOL/EBSA proposal is to forgive any tax amount owing as long as the conditions set forth in the proposed exemption are satisfied.

Even though SIMFA did not request any relief where a business and its 401(k) plan might have executed across-collateralization agreement, the DOL/EBSA on its own has pointed that such agreements may also need to be revised and that retroactive relief is also available by the same deadline.

The DOL/EBSA has proposed a 6 month time period during which the securities and brokerage firms must replace all of the existing account opening agreements. Any cross-collateralization or indemnification provisions must be removed from the account opening form. In some cases there may need to be refunds of various fees.

The DOL/EBSA did not adopt a 12 month correction period as requested by SIFMA. The DOL/EBSA said that12 months was unreasonable considering the DOL/EBSA had put the industry on notice in 2009 that such provisions result in a prohibited transaction.

And the DOL/EBSA is unwilling to grant the UNLIMITED exemption requested by SIFMA on a prospective basis. However, if the new conditions of the revised exemption are satisfied, then there will be exemptive relief.The DOL/EBSA has set July 23, 2013, as the deadline to submit a request for a public hearing and to submit written comments.

The DOL/EBSA must receive such on or before July 23, 2013 (i.e. 60 days after the proposal on May 23, 2013).

To read sections IV-VI of the propose class exemption, go to www.pension-specialists/dolebsa.pdf. Once the 6month period has expired (sometime in 2014) the general exemption will apply if the general prospective requirements are met.