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Annuities and IRAs - Possible PT Problems

The purpose of this article is to discuss whether or not the purchase of an insurance company annuity by or for an IRA might be a prohibited transaction (PT). We realize that today many financial institutions or their "controlled" affiliates sell annuities, and in many cases these annuities are sold to IRAs. We feel there is a real concern about PTs in certain annuity/IRA situations.

We believe that it is very likely that prohibited transactions do occur in some annuity sale situations. We hope to make you are aware of situations in which there might be prohibited transaction concerns, so that you will consult with your legal counsel when warranted.

A financial institution must always be vigilant for possible PTs because the tax consequences are so harsh, and the accountholder will look to the IRA custodian to share all or some of the "pain."

In addition to your legal counsel, you may want to direct questions to the insurance company with which you have chosen to do business for annuities, to ask for its opinion as to whether or not a prohibited transaction might occur in a specific situation.

A Basic Definition of PTs

What is a prohibited transaction, and what are the undesirable consequences when one occurs?

In simplest terms, a prohibited transaction is any direct or indirect transaction (buying , selling, leasing, renting, loaning, etc.) between an IRA and the IRA custodian/trustee, or the IRA accountholder or certain family members. The intent of the law is to prohibit transactions where there is a conflict of interest. The law takes the approach that it

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Two Key Compliance Deadlines Approaching

Those who deal with IRAs and certain qualified plans are reminded that there are two rapidly approaching compliance responsibilities that must be met.

FDIC Notice

A required Notice of changes in FDIC insurance coverage on IRAs, self-directed Keoghs, self-directed defined contribution plans and certain other retirement plan accounts must be sent to all customers having such accounts no later than Oct. 10, 1993. Effective Dec. 19, 1993, insurance coverage on such plans will be AGGREGATED to reach the $100,000 maximum within any one insured institution. Before that time, each account has a separate $100,000 limit per institution. The net effect for some customers may be significantly reduced coverage.

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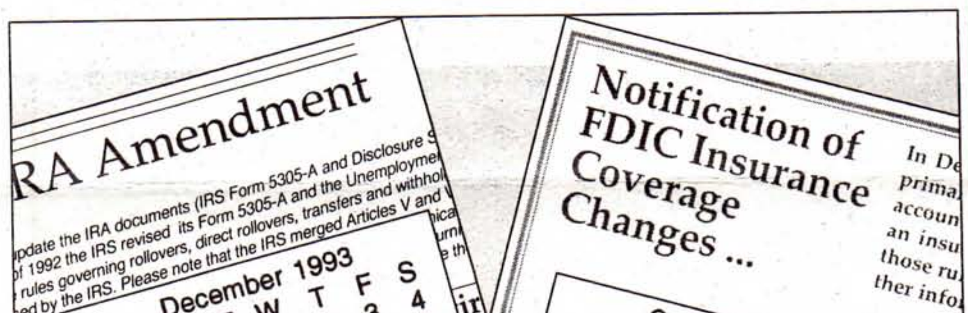

Revisiting PT Class Exemption 77-9

From time to time the Department of Labor will issue a prohibited transaction (PT) exemption. An exemption is a ruling which in essence says that, even though a PT has occurred or will occur, the DOL will not impose on the plan the negative consequences which normally are imposed when a PT occurs.

The DOL may issue individual exemptions on a case-by-case basis or it may issue a class exemption. The DOL issues class exemptions to ease their administrative burden and to assist the general public. Any party who meets the conditions of the class exemption is assured that the DOL will not impose the usual negative consequences.

PT Class Exemption 77-9 exempts certain transactions (six types) involving employee benefit plans and insurance agents and brokers, pension consultants, insurance companies, investment companies and investment company principal underwriters. The exemptions is for, or in connection with, the purchase of insurance or annuity contracts and the purchase or sale of securities issued by an investment company, if certain conditions are met.

These conditions are discussed in this article. But because of the complexity of the subject your institution's counsel has hopefully reviewed the proposed transactions (sale of annuities, sales of securities) prior to their occurrence.

PT Exemption 77-9 clearly applies to transactions of funds of a qualified plan. It is less clear if this exemption applies to transactions involving IRAs. Although we need not answer that question for purposes of this article, your attorney might.

What Are the Six Types of Transactions Which May Receive an Exemption?

1. The receipt of a sales commission by an insurance agent, broker or pension consultant from an insurance company in connection with the purchase with plan assets of an insurance or annuity contract.

2. The receipt of a sales commission by a principal underwriter for an investment company in connection with the purchase with plan assets of securities issued by an investment company.

3. The effecting by an insurance agent, broker, pension consultant or principal underwriter of a transaction for the purchase with plan assets of an insurance or annuity contract, or securities issued by an investment company.

4. The purchase with plan assets of an insurance or annuity contract from an insurance company.

5. The purchase with plan assets of an insurance or annuity contract from an insurance company which is a fiduciary or a service provider (or both) with respect to the plan, solely by reason of sponsorship of a master or a prototype plan.

6. The purchase with plan assets of securities issued by an investment company from, or the sale of such securities to, an investment company or an investment company principal underwriter, when such investment company, principal underwriter or the investment company investment adviser is a fiduciary or a service provider, or both, solely by reason of: (1) the sponsorship of a master or prototype plan; (2) the provision of nondiscretionary trust services to the plan; or (3) both (1) and (2).

PT Exemption 77-9 clearly applies to transactions of funds of a qualified plan. It is less clear if this exemption applies to transactions involving IRAs.

Before discussing the conditions which must be met, it is important to understand how broad the rules are. One cannot escape having to meet the conditions or risk creating a PT by having an affiliate perform the transaction on your behalf. The PT rules define the terms "insurance agent or broker", "pension consultant," "insurance company", "investment company" and "principal underwriter" to mean such persons and any affiliates thereof.

Obviously, the intent of the definition is to define affiliate very broadly. An affiliate is any of the following:

1. Any person directly or indirectly controlling, controlled by, or under common control with such person.

Control means the power to exercise a controlling influence over the management or policies of "a person other than an individual" (other than the controlling individual).

2. Any officer, director, employee (including in the case of a principal underwriter, any registered representative thereof, whether or not such person is a common law employee of such principal underwriter) or relative of any such person or any partner of such person.

A relative is a spouse, ancestor, lineal descendant, any spouse of a lineal descendant, a brother, sister or a spouse of a brother or sister.

3. Any corporation or partnership of which such person is an officer, director or employee, or in which such person is a partner.

In order to gain the relief provided by the exemption, certain conditions must be satisfied. There are two categories of conditions: those which must be met by all six transaction types (i.e. universal) and those which must be met by only the first four types.

Universal Conditions Applying to All Six Transactions

1. The transaction must be effected in the ordinary course of such person's business (insurance agent, broker, etc.)

2. The transaction is on terms at least as favorable to the plan as an "arm's length" transaction with an unrelated party would be.

3. The combined total of all fees paid to the insurance agent, broker, etc. for the provision of services and in connection with the purchase of the insurance contract or annuity or securities must not be in excess of "reasonable compensation" within the statutory definition of that term. If the total of the compensation was in excess of the reasonable amount, then the excess amount (total minus reasonable) would be used to determine the civil penalties under ERISA and the excise taxes under the tax code.

Conditions Which Apply Only to the First Four Types of Transactions

1. The agent, broker, etc. cannot be: (1) a plan trustee (other than nondiscretionary trustee who does not render any investment advice with respect to plan assets); (2) a plan administrator; (3) a fiduciary who is authorized in writing to manage, acquire or dispose of assets on a discretionary basis; or (4) an employer, any of whose employees are covered by the plan for those transactions of the first four types.

2. With respect to an insurance transaction (types 1, 3, 4 or 5), the insurance agent, broker or pension consultant must, prior to the execution of the transaction, provide to an INDEPENDENT FIDUCIARY with respect to the plan the following information in writing and in a form calculated to be

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understood by a plan fiduciary who has no special expertise in insurance or investment matters:

A. The nature of any affiliation between the agent and the insurance company and the nature of any limitations placed on the agent by the insurance company.

B. The sales commission, expressed as a percentage of gross annual premium payments for the first year and for each of the succeeding renewal years that will be paid by the insurance company to the agent in connection with the purchase of the recommended contract.

C. A description of any charges, fees, discounts, penalties or adjustments which may be imposed under the recommended contract in connection with the purchase, holding, exchange, termination or sale of such contract.

3. Following the receipt of this disclosure information, the independent fiduciary must acknowledge in writing the receipt of such information and approve the transaction on behalf of the plan. Such fiduciary may not receive, directly or indirectly (e.g. through an affiliate) any compensation or other consideration for his or her own personal account from any party dealing with the plan in connection with the transaction. Such fiduciary may be an employer of employees covered by the plan but may not be an insurance agent or broker, pension consultant or insurance company involved in the transaction.

4. With respect to a securities transaction (type 2, 3 or 6), the investment company principal underwriter must, prior to the execution of the transaction, provide to an INDEPENDENT FIDUCIARY with respect to the plan the following information in writing and in a form calculated to be understood by a plan fiduciary who has no special expertise in insurance or investment matters:

A. The name of a principal underwriter of the investment company whose securities are being recommended, the nature of such relationship and of any limitation it places on its ability to recommend investment company securities.

B. The sales commission, expressed as a percentage of the dollar amount of the plan's gross payment and of the amount actually invested, that will be received by the principal underwriter in connection with the purchase of the recommended securities issued by the investment company.

C. A description of any charges, fees, discounts, penalties or adjustments which may be imposed under the recommended securities in connection with the purchase, holding, exchange, termination or sale of such securities.

D. Following the receipt of this disclosure information, the independent fiduciary must approve the transaction on behalf of the plan. Unless the facts or circumstances indicate the contrary, such approval may be presumed if the fiduciary permits the transaction to proceed after receipt of the written disclosure.

Note that approval may be presumed for a securities transaction but not for insurance situations.

Such fiduciary may not receive, directly or indirectly (e.g. through an affiliate) any compensation or other consideration for his or her own personal account from any party dealing with the plan in connection with the transaction. Such fiduciary may be an employer of employees covered by the plan but may not be an insurance agent or broker, pension consultant or insurance company involved in the transaction.

Further Disclosure Duties?

What duty exists to furnish subsequent disclosures for additional purchases of insurance or annuity contracts or securities issued by an investment company?

There is no need to repeat a disclosure unless: (1) more than three years have passed since such disclosure was made with respect to the same kind of contract or security and (2) the contract or security being recommended for purchase, or the commission with respect thereto, is materially different from the prior one.

In addition to the above conditions, there are some administrative conditions. The person involved in the transaction must retain or cause to retain for a period of six years from the date of such transaction the following: (1) the actual disclosure furnished, (2) any additional information or documents provided to the fiduciary and (3) a copy of the written acknowledgement from the fiduciary. And, such records must be unconditionally available for examination during normal business hours by duly authorized employees of the IRS or the DOL, and plan participants, beneficiaries, an employer of plan participants, and any employee organization any of whose members are covered by the plan.

In summary, there are many conditions to be met to qualify to use this exemption. If all conditions are not met, then a prohibited transaction will have occurred. If your institution offers self-directed IRAs which allow the purchase of insurance contracts and securities, your counsel should have made a determination that a PT would not result from these transactions. Either a PT must not occur, or there must be a PT exemption available. PD

Deadlines

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Later Deadline for Some Customers

For some customers the financial institution may be able to send the required Notice AFTER Oct. 10. This applies to accounts that contain time deposits and would not otherwise receive a regular monthly or quarterly account statement before Oct. 10, 1993. (IRAs would be included since they typically do not receive such regularly scheduled statements.) In such cases, the Notice may be sent by the LATER of:

1. 60 days before the first maturity date of that time deposit, or

2. Oct. 10, 1993.

For example, if an account had a time deposit maturing on Jan. 10, 1994, the Notice would have to be sent 60 days prior, or Nov. 11, 1993.

Individual Savings, Checking Accounts Are Not Affected

These new rules do not apply to typical individual accounts such as checking or savings, which will continue to be insured separately from retirement plan accounts.

Notices, Informational Brochures Are Available from CWF

If you have questions about who must receive this Notice, we encourage you to contact our Customer Service department. A short form and a longer version that also amends the insuring language of certain IRA plan documents, are available from CWF.

We also have informational brochures for your customers that will help them understand both the new FDIC insuring rules and other existing coverage provisions. Call CWF at 1-800-346-3961.

IRA Amending

Although the amending of all existing IRA plans required by IRS Announcement 93-8 may seem like old news, some financial institutions have not yet completed this mandatory amending process.

For those who have not completed their amending, the deadline is Dec. 31, 1993. Model amendment language is available from the IRS, but it is not comprehensive or cumulative to include prior amending changes, and therefore IRA account-holders may find it difficult to understand all the provisions that will now apply to their plans. Several pension vendors provide better amendments.

Contact the CWF Customer Service department if you have questions about which amendments are best for your customers. PD

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3. Following the receipt of this disclosure information, the independent fiduciary must acknowledge in writing the receipt of such information and approve the transaction on behalf of the plan. Such fiduciary may not receive, directly or indirectly (e.g. through an affiliate) any compensation or other consideration for his or her own personal account from any party dealing with the plan in connection with the transaction. Such fiduciary may be an employer of employees covered by the plan but may not be an insurance agent or broker, pension consultant or insurance company involved in the transaction.

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