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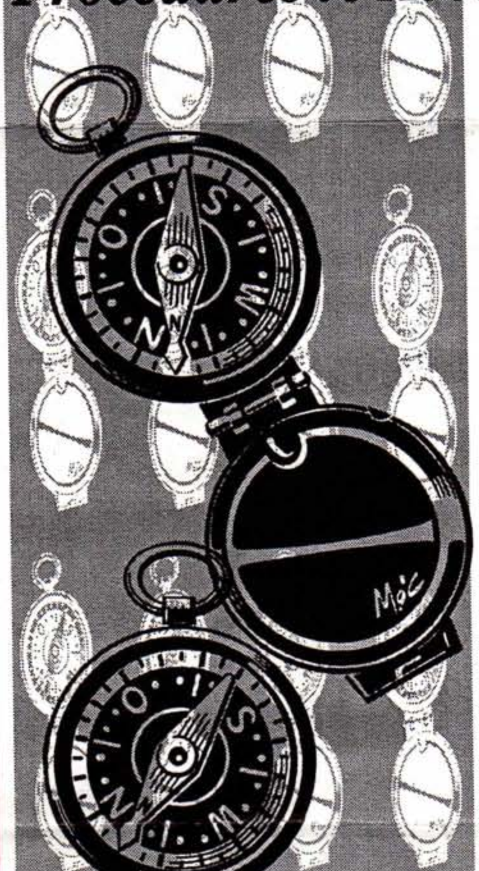
IRA Annuity, Securities Investments – Directing Your Procedures to Avoid Prohibited Transactions



This is the third installment in our recent newsletter coverage of IRA investments that may result in prohibited transactions. We have extensively covered annuities, but have said comparatively less about securities investments.

In this month's coverage we will discuss means by which financial institutions may possibly find relief from potential prohibited transactions, via the PTE, or Prohibited Transaction Exemption.

But first, for those who may not have seen the past two issues, a very brief recap.

At issue is whether or not a financial institution acting as custodian/trustee for an IRA, can receive commissions for the movement of IRA funds from a typical time deposit, money market or CD-based IRA investment, into an annuity or a securities investment, when the insurance company or securities firm is not controlled by the bank or a holding company entity. This is an increasingly common practice.

Is this allowable, in light of the Internal Revenue Code section 4975 prohibition against "...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 institution is by definition a fiduciary, even if it does not direct plan investments. In this case, "receipt of any consideration" includes commissions. As we have pointed out in past discussion, if an institution receives a commission for such an exchange, **it appears clear that this is a prohibited transaction**.

The Prohibited Transaction Exemption Concept

It must be understood that a prohibited transaction is a class of transactions between the IRA and certain parties that have been "disqualified." These are transactions that have potential for "short-changing" the IRA, such as transactions between the IRA and an accountholder's family or relatives, between the plan and a fiduciary, etc.

Rather than deal with such transactions on a case-by-case basis, the IRS chose, for administrative simplicity, to simply prohibit a class of transactions that have potential for mismanagement.

But there are exceptions. Where warranted, exemptions have been granted when an otherwise prohibited transaction has been shown to be both common, and harmless to the interests of the IRA. The blanket exemptions are called PTEs, or Prohibited Transaction Exemptions. When the conditions of a PTE are met, no adverse consequences will occur for the IRA, or the parties to an IRA transaction.

Given the fact that receipt of a commission in an IRA annuity/security purchase situation falls under this definition, the only way that such a transaction would be allowable would be if it would fall under a Prohibited Transaction Exemption.

Who are institutions accountable to? Who issues exemptions for such otherwise-prohibited transactions?

Most who work with IRAs expect to be accountable to the IRS for meeting administrative and compliance responsibilities. However, in the area of issuing

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exemptions to prohibited transaction rules, that authority was passed from the IRS to the Department of Labor (DOL) in 1978 under a reorganization plan.

Are there exemptions that would allow this practice of buying an annuity or securities with IRA funds?

There are exemptions that have been written for other types of "employee benefit plans" that allow investment in annuities or securities. These were originally issued for traditional "QPs," or employer-sponsored qualified retirement plans.

Are IRAs included in such exemptions? Possible Guidance From a DOL Advisory Opinion

Are IRAs included under the definition "employee benefit plans" for the prohibited transaction exemptions (PTEs) written by the IRS before the transfer of this responsibility to the DOL?

This is not clear from any all-encompassing directives from the DOL. However, we can sometimes take direction from actions between the DOL and individual banking entities, in the form of Advisory Opinions. These are issued to a specific organization for a specific situation, rather than being issued as broad conclusions or advice to the financial industry at-large. As valuable as such Opinions may be, however, be aware that both the DOL and IRS typically advise that they will not be held to such terms or decisions beyond the scope of the case for which that opinion is issued.

The SunTrust Case: DOL Advisory Opinion 93-26A & PTE 77-4

Advisory Opinion 93-26A was issued by the DOL after SunTrust Banks, Inc. requested an individual exemption from the prohibited transaction rules, to allow IRA accounts to purchase mutual fund shares of an investment company owned by SunTrust.

SunTrust's request for an individual exemption for such transactions was turned down by the DOL. SunTrust then requested that the DOL rule that SunTrust would remain in compliance if such transactions complied with Prohibited Transaction Exemption 77-4 (which had been originally written to provide relief for "employee benefit plans"). PTE 77-4 had made no mentioned of IRAs.

The DOL responded with the following conditions:

1. DOL told SunTrust that it had concluded after consulting with the IRS that PTE 77-4 does apply to IRAs, even though the term "employee benefit plan" was not defined expressly to include IRAs.

2. DOL also told SunTrust that it was making no determination as to whether the proposed (mutual fund) transactions would satisfy the conditions of 77-4. In other words, SunTrust could expect prohibited transaction relief only if each transaction met the conditions of PTE 77-4.

3. DOL made it clear that the inclusion of IRAs under 77-4 did not necessarily mean that other PTEs would be revised to cover IRAs.

PTE 77-4: Compliance Requirements

Here, briefly, are the conditions that must be met to comply with PTE 77-4, for the purpose (in SunTrust's case) of allowing an IRA to purchase securities:

1. No sales commission may be paid.

2. A redemption fee may not be paid unless it is paid only to the investment company, and is disclosed in the securities prospectus at the time of the sale.

3. The IRA must not pay an investment management, management, or advisory fee. The mutual fund itself may pay various fees, however, and the IRA pay a pro rata portion.

4. A second fiduciary who is independent must receive certain disclosures and approve the transactions, without compensation (by definition, this fiduciary cannot qualify as independent if it receives compensation).

This latter provision (4) may be the most difficult to satisfy in the case of an IRA. This would not be typical of most IRA relationships between the accountholder and the custodian/trustee institution, which traditionally is the sole fiduciary to the relationship.

Unless all these requirements are met, a prohibited transaction is the result. But financial institutions should not be complacent in the fact that an exemption exists, unless past practices have been in compliance with this PTE.

Annuities, Securities and PTE 77-9

In the course of our recent discussion on the issue of annuities, securities and IRAs, we have also examined another Prohibited Transaction Exemption, PTE 77-9.

Like PTE 77-4, this Prohibited Transaction Exemption was also written for qualified plans, applying to transactions involving employee benefit plans and insurance agents/companies, brokers, pension consultants, and investment companies and their principal underwriters. The exemption applies to the purchase of insurance or annuity contracts, and the purchase or sale of securities issued by an investment company.

We found no evidence that this PTE expressly applied to IRAs. (Remember that when the DOL advised SunTrust that PTE 77-4 applied to IRAs, it indicated that this inclusion of IRAs did not necessarily extend to other PT Exemptions that had been issued, such as PTE 77-9.)

However, in recent private and informal conversations with a DOL staff member, we were told that in all likelihood PTE 77-9 would apply to self-directed IRAs. The question of non-self-directed IRAs was less certain, but we were given the impression that these would be covered as well.

In this context, a "SELF-DIRECTED" IRA transaction would be one in which the IRA account buys an annuity or securities, while the financial institution remains the custodian/trustee, but does not take responsibility for directing the IRA investments.

A "NON-SELF-DIRECTED" IRA would be one in which a financial institution time deposit is transferred to a brokerage firm – if a security – or an insurance company – if an annuity – and that entity becomes the new custodian/trustee. The financial institution which transferred the IRA receives a commission for the transaction from the brokerage firm or insurance company.

PTE 77-9: Compliance Requirements

See the September 1993, *Pension Digest* for a complete discussion of the provisions of PTE 77-9. But here, in brief, are the requirements for PT exemption:

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1. The transaction must be an "ordinary course of business" transaction for the agent or broker (in this case the agent/broker would be the financial institution acting as an intermediary between the accountholder and the insurance company or securities firm).

2. It must be as favorable as any "arm's length" (with full disclosure and fairness) transaction would be.

3. The total of all fees paid to the agent/broker (institution) must not exceed "reasonable compensation" within its statutory meaning.

Additional requirements apply in cases where the insurance company or securities firm is not a fiduciary or service provider to the plan. This would be the most common situation for most financial institutions.

The requirements are:

1. The agent (institution) cannot be more than a nondiscretionary trustee, in other words, the agent cannot render investment advice or management services.

2. In the case of an annuity, a **disclosure must be made to an independent fiduciary** of the terms of the sale, **including commissions, fees, penalties, and the relationship between insurance company and agent** (institution).

3. In the case of a securities transaction, similar information must also be provided to an **independent fiduciary. This information includes the sales commission, and any other charges or fees** which may be imposed in connection with purchase, exchange, termination, etc. Also required is the name of the investment company's principal underwriter, and the relationship between his/her firm and the custodian/trustee institution.

This, as we noted under PTE 77-4, may be the most difficult compliance task facing an institution acting as custodian/trustee for an IRA. **This independent fiduciary may not receive compensation** from any party to the transaction.

Remember, however, that despite verbal comments concerning the applicability of PTE 77-9 to IRAs, this has not been officially announced. But even if or when it should be, as we stated under our discussion of PTE 77-4, unless the above PTE requirements are met, a prohibited transaction exists.

Are Keogh plans included in these PTEs?

Though not specifically addressed, it was indicated to us that Keogh plans would also be included under PTE 77-9.

Can an institution structure the annuity/security transaction so that it receives a fee rather than a commission, and thereby avoid PT concerns?

Yes, it may. A fee paid by the accountholder could be imposed, rather than a commission being received from the insurance or securities firm. But this fee would have to be included in the IRA plan's financial disclosure at the time of plan opening. Or, the plan could be amended with the consent of the accountholder to allow this. Use of a fee rather than commission would keep the transaction in compliance.

Summary

As difficult as the above requirements may be to comply with, they are complicated by the fact that no blanket class exemptions or guidelines covering IRAs and annuity/security transactions have been issued.

It should be an objective of the banking industry to seek such definitive guidance from the Department of Labor, perhaps through an umbrella organization such as the American Banking Association.

IN THE MEANTIME, an institution may choose one of two courses:

1. Charge no commissions for annuity/securities transactions with an IRA, and properly impose fees instead via a plan document (or amendment) that allows this. Or...

2. Rely on the Prohibited Transaction Exemptions described above, and adhere rigidly to their requirements **(with special attention given to disclosure)**, as difficult as they may be.

(CWF is developing disclosure forms to handle these situations. It is our hope that standard forms will in some cases suffice. However, in other cases, custom disclosure forms may well be the answer.) PD

Introduction of New Tax Bill: Tax Simplification and Technical Corrections

On November 1, 1993, Rep. Dan Rostenkowski (D-IL) introduced in the House of Representatives Bill H.R. 3419. As with most recent tax bills, it is labeled a simplification bill when in fact it contains substantial revenue-raising provisions. There are some favorable provisions in this bill for employers who sponsor 401(k) plans. Unless stated otherwise, the changes summarized below would be effective for tax years beginning after December 31, 1993.

Many Keogh participants may wish to consult with their tax advisors to make a determination whether or not they should take a lump-sum distribution to take advantage of five-year averaging while it is still available. (Five-year averaging is a method of easing the tax impact of a lump-sum distribution.) The odds are that this time there could well be a repeal of five-year averaging. Although this may not be good for Keogh customers, it will be good for custodian/trustee institutions, which will receive more IRA rollovers.

The following changes would be made if this bill were enacted:

1. There would be a repeal of five-year income averaging for lump-sum distributions. It is not clear if the bill would also eliminate 10-year averaging for those who were "grandfathered" in under TRA (Tax Reform Act) 86.

2. There would be a repeal of the $5,000 death benefit exclusion as authorized by Code section 101. (The Death Benefit Exclusion allows $5,000 to be received by a deceased plan participant's beneficiary, tax-free.)

3. There would be created a new simplified method for taxing annuity payments from a qualified employer retirement plan. The term "employer retirement plan" includes IRAs, 403(b) tax sheltered annuities and qualified plans.

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The amount of a monthly annuity payment which would not be included in income would be the monthly payment amount multiplied by a ratio. The numerator of this ratio would be the person's investment in the contract. See Table "A" to obtain the denominator.

Table A

IF THE AGE OF THE PRIMARY ANNUITANT ON THE ANNUITY STARTING DATE IS:	THE NUMBER OF ANTICIPATED PAYMENTS IS:	
Not more than 55	300	denominator
More than 55 but not more than 60	260	denominator
More than 60 but not more than 65	240	denominator
More than 65 but not more than 70	170	denominator
More than 70	120	denominator

4. The required minimum distribution rules would be changed in two ways. A non-5% percent business owner would not be required to commence his or her RMDs until April 1st of the later of: (1) the year following the calendar year in which he or she attains age 70-1/2; or (2) the calendar year in which the employee retires. (The proposed new rule restores the old rule in effect prior to TRA 86.)

The second change is that a person who is a 5% owner (as defined in Code section 416), with respect to the plan year ending in the calendar year in which he or she attains age 70-1/2, could not use the retirement option (#2). Under the new proposed rule there is no lookback period as there is under current law. This is a simplification move.

5. The reporting penalty provisions of Code sections 6721, 6722 and 6724 would be extended to apply to IRAs and other pension distributions.

This is a major change. Under current law, an IRA custodian is fined by the IRS only for failing to **complete** a form, not for incorrect preparation. Under the new law the graduated fines under sections 6721, 6722 and 6724 would apply to incorrect IRA form preparation.

A qualified plan administrator who fails to furnish the 402(f) notice (describing an employee's distribution options and withholding requirements) would be subject to a penalty of $100 per failure rather than $10, and the maximum annual penalty would be increased from $5,000 to $50,000. Apparently, the IRS does not feel the $10 penalty created a sufficient incentive for employers to furnish a 402(f) notice. The increase in penalty should make employers serious about furnishing the 402(f) notice.

A Form 1099-R would not need to be generated unless the amount distributed was $10 or more.

The above changes apply to any report or statement due after 12-31-93. That is, to 1993 reports due in 1994.

6. There are a number of proposed salary reduction SEP (Simplified Employee Pension) changes.

A. Under current law, salary reduction SEPs are only available if an employer has less than 25 employees who would meet the age and service requirement. The proposal would increase this to 100. More small businesses would, therefore, be eligible for salary-reduction SEPs.

B. Under current law 50% of the employees who are eligible must choose to participate in order for there to be a salary-reduction SEP. This requirement would be repealed.

7. The 401(k) rules would be amended to allow tax exempt organizations to sponsor 401(k) plans. Such plans would still be impermissible for state or local governments or political subdivisions thereof.

8. The IRS would be given various areas of authority with respect to certain sponsors of prototype plans.

9. There would be a revised definition of the term, "highly-compensated employee." The definition would be simplified to include two categories. (1) A highly-compensated employee would mean any employee who was a 5% owner at any time during the current or preceding year, or (2) who had compensation during the previous year from the employer in excess of $50,000 (this $50,000 will be indexed). The family member rules would be repealed.

10. The participation rule found in Code section 401(a)(26) would be changed so that it only applies to defined benefit pension plans. It would not apply to defined contribution plans.

11. There would be new safe harbors created for 401(k) plans. That is, there would be new alternative methods for meeting the nondiscrimination tests. An employer could choose to contribute 3% of each nonhighly-compensated employee's compensation. Or, the employer could choose to make a matching contribution on behalf of each nonhighly-compensated employee equal to 100% of his or her elective deferrals (but not to exceed 3% of compensation) and 50% of the elective deferrals to the extent that such deferrals do exceed 3%, but do not exceed 5%, of the employee's compensation. Thus, an employer would be in compliance by contributing a maximum of 4% for each nonhighly-compensated employee.

12. There would be new rules dealing with the full-funding limitation of multiemployer plans and a new alternative full-funding limitation.

13. There would be new rules governing the treatment of governmental plans under section 415.

14. Plan amendments would not be required to be made before the first day of the first plan year beginning on or after January 1, 1995, if the plan is operated in accordance with the law changes, and such plan amendments apply retroactively once adopted. PD

THE Pension Digest EXTRA

A supplement to your monthly pension newsletter

DOL Advisory Opinion 93-26A

Following is the text of Department of Labor (DOL) Advisory Opinion 93-26A. It was issued to SunTrust Banks, Inc., in response to their attempt to resolve a potential Prohibited Transaction situation with respect to their IRA plans. It is reprinted here because it is referred to in the story beginning on page one of this month's Pension Digest newsletter.

SEP 9 1993

Donald S. Kohla, Esq.
King & Spalding
191 Peachtree Streets
Atlanta, Georgia 30303-1763

Re: SunTrust Banks, Inc. (SunTrust) Exemption Application No. D-9424

Dear Mr. Kohla:

This is in response to the above referenced application requesting an exemption from the prohibitions of section 406 of the Employee Retirement Income Security Act of 1974 (ERISA or the Act) and from the sanctions resulting from the application of section 4975 of the Internal Revenue Code of 1986 (the Code).

Your application sets forth the following facts and representations. SunTrust proposes to offer shares of the STI Classic Funds (the Funds), a series of open-end investment companies registered under the Investment Company Act of 1940, to individual retirement accounts (IRAs) for which SunTrust acts as a trustee with investment management responsibility. Sun Bank Capital Management and Trusco Capital Management, affiliates of SunTrust, serve as investment advisers for the Funds and receive fees for their services from the Funds. You represent that SunTrust will not charge the IRAs any investment management fees for assets that are invested in the Funds.

At the conference regarding your exemption request on August 19, 1993, you stated that, as an alternative to obtaining an individual exemption for the proposed transactions, SunTrust would be willing to structure the arrangement to comply with Prohibited Transaction Exemption (PTE) 77-4 (42 FR 18732, April 8, 1977) if that exemption is available for IRAs.

Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) the authority to issue rulings under section 4975 of the Code has been transferred, with certain exceptions, to the Secretary of Labor. Therefore, the references in this letter to specific sections of ERISA refer also to corresponding sections of the Code.

PTE 77-4 provides that the restrictions of section 406 of the Act, and the taxes imposed by section 4975(a) and (b) of the code, shall not apply to the purchase and sale by an employee benefit plan of shares of an open-end investment company registered under the Investment Company Act of 1940, the investment adviser for which is also a fiduciary with respect to the plan (or an affiliate of such fiduciary), and is not an employer of employees covered by the plan,provided certain conditions are met.

Although PTE 77-4 does not define the term "employee benefit plan" the Department of Labor (the Department) is of the view that the exemption is applicable not only to transactions involving employee benefit plans covered under Title I of ERISA, but also to transactions involving IRAs and H.R. 10 plans which are not covered by Title I of ERISA but which are subject to the provisions of section 4975 of the Code. We have conferred with representatives of the Internal Revenue Service and they concur in the view that plans described in code section 4975(e)(1) are included within the scope of PTE 77-4.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 and is issued subject to the provisions of that procedure, including section 10, relating to the effect of advisory opinions. This opinion relates only to the specific issue addressed herein. For example, the Department is not providing an opinion as to whether the particular arrangement described in your exemption application would satisfy the conditions imposed by PTE 77-4. Nor is the Department providing an opinion as to the definition of the term "employee benefit plan" in any exemption other than PTE 77-4.

If you have any further questions, please contact Mr. E.F. Williams, Department of Labor.

Sincerely,
Ivan L. Strasfeld
Director
Office of Exemption Determinations