Basics of Prohibited Transactions

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The Traditional IRA Life Span

**Contributions**
- Deductible
- Non-Deductible

**Rollovers**
- Transfers

**Investments and Prohibited Transactions**
- Custodial or Trust Account Earnings within Account are not Taxed

**Distributions**
- Accountholder
  - Before Age 59½
  - Age 59½ to 70½
  - And older

**Beneficiaries**
- Original
- Subsequent

In general, the accountholder or beneficiary will include the distribution in income and pay tax.
The Roth IRA Life Span

- **Contributions**: Non-Deductible
- **Custodial or Trust Account Earnings Within Account are not Taxed**
- **Investments and Prohibited Transactions**
- **Distributions**
  - **Accountholder**
    - Before Age 59½
    - Age 59½ to 70½
    - And older
  - **Beneficiaries**
    - Original
    - Subsequent
    - In general, the accountholder or beneficiary will not include the distribution in income and pay tax
What Investments May be Bought and Sold by an IRA?

IRA contributions may be invested in almost any type of investment except as described below and except when the transaction would be a prohibited transaction. IRA funds may be invested in stocks, bonds, mutual funds, real estate, mortgages, etc. However, many IRA funds with financial institutions are still invested in savings accounts and time deposits.
What Investments Are Not Permissible for an IRA?

Article III of IRS Model 5305-A reads as follows

**Article III**

1. No part of the custodial funds may be invested in life insurance contracts, nor may the assets of the custodial account be commingled with other property except in a common trust funds or common investment funds (within the meaning of section 408(a)(5)).

2. No part of the custodial funds may be invested in collectibles (within the meaning of section 408(m)) except as otherwise permitted by section 408(m)(3) which provides an exception for certain gold, silver, and platinum coins, coins issued under the laws of any state and certain bullion.

An IRA may not own any life insurance, including viatical contracts, and any collectibles. A collectible is any type of tangible personal property such as antiques, cars, oriental rugs, jewelry, art, etc. However, IRA funds may be invested in certain gold and silver coins issued by the U.S., or in any coin issued under the laws of any state after November 10, 1988, and certain coins grandfathered in prior to the law which prohibited investment in collectibles.

In addition, IRA funds cannot be combined with non-IRA funds. Exception – IRA funds can be combined with other IRA funds if done within a common trust or investment fund.
Basics of Prohibited Transactions

Self-Directed and/or Trust Investments

General rules

A. Regular, annual contributions to the IRA must be in cash, not property. The accountholder cannot contribute property he or she already owns to the self-directed IRA. Rollovers and transfers from existing IRAs and QPs can be in cash and/or property.

B. Life insurance is not a permissible IRA investment. Annuities can be IRA investments but not regular life insurance contracts.

C. The assets of the IRA may not be commingled with any other property except in a common trust or investment fund. Before attempting to establish a common trust or investment fund, consult with legal counsel as the Securities and Exchange Commission imposed stringent requirements on these funds. Assets purchased in blocks using a nominee name is permitted.
Basics of Prohibited Transactions

Self-Directed and/or Trust Investments

General rules – continued

D. Margin accounts may be used in the IRA. The law does not prohibit the use of margin within an IRA. However, the prohibited transaction rules must be complied with. Buying on margin brings into play the unrelated business income tax rules as debt exists since margin, by definition involves the extending of credit. We strongly suggest that an IRA custodian or trustee very clearly communicate to the party extending credit (i.e. the margin) to the IRA that it is only the IRA assets which can be looked to satisfy any margin call. The individual or the IRA custodian/trustee are not legally liable or permitted to make up any “shortage” amount. Any type of guaranty, direct or indirect, would be a prohibited transactions.

E. Collectibles are generally prohibited. Collectibles include art, antiques, gems, most coins, precious metals, stamps, alcoholic beverages and any other tangible property specified by the Secretary of the Treasury.
Basics of Prohibited Transactions

Self-Directed and/or Trust Investments

General rules – continued

F. The Investments must not constitute a prohibited transaction. An IRA can be subject to severe penalties, even disqualification, if it engages in a prohibited transaction. The prohibited transaction rules basically exist to prevent a transaction where there could be a conflict of interest between the IRA and the accountholder or certain people or entities related to the accountholder.

Whenever you are dealing with self-directed investment directions from an IRA accountholder protect your financial institution by documenting his or her instructions in writing. A form such as CWF Form # 54-SD provides clear instructions from the accountholder and places responsibility for the transaction on the accountholder. It also sets out exactly how the transaction will take place. The form serves as documentation for the custodian/trustee, thereby providing protection for the financial institution.
Overview # 1

Prohibited Transactions

Generally, a prohibited transaction is any improper use of your traditional IRA account or annuity by you, your beneficiary, or any disqualified person.

Disqualified persons include your fiduciary and members of your family (spouse, ancestor, lineal descendant, and any spouse of lineal descendant).

The following are examples of prohibited transactions with a traditional IRA.

• Borrowing money from it
• Selling property to it
• Receiving unreasonable compensation for managing it.
• Using it as security for a loan.
• Buying property for personal use (present or future) with funds.
Overview # 1

You will note that the discussion covers traditional IRAs, but not Roth IRAs. Roth IRAs became available in 1998. The IRS certainly could have added by now a section discussing the PT’s in the Roth IRA section of Publication 590 if it had wanted to do so. The IRS must have a reason for not doing so. For whatever reason, the IRS has chosen to not explain as fully as the IRS should the consequence(s) of having a PT occur with respect to a Roth IRA. It may be that the IRS feels the rules are so easy to understand and apply that a separate discussion should not be necessary.

We at CWF disagree. We believe the IRS should try to assist individuals and IRA/Roth IRA custodians/trustees as much as possible. Some guidance is better than no guidance. The IRS needs to explain the PT rules for Roth IRAs since there will be some differences from traditional IRAs. Roth IRA custodians/trustees will want to be vigilant to make sure they do not participate or assist with a PT transaction for Roth IRAs. As with any PT situation, the individual may well harbor ill-feelings because of their “tax losses” even though he or she wanted to do the investment.
Definition – Prohibited Transactions

A 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. Transfers 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 income or assets of a plan 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 Terms “plan” and “disqualified person” are defined in Code section 4975(e) as set forth later. These terms certainly cover the IRA plan and accountholder.

Thus, it would be impermissible for a person to sell any personal investments to the IRA and it would be impermissible for the person to rent or use any of the assets of the IRA.
Basics of Prohibited Transactions

Definition – Prohibited Transactions – continued

E. Definitions

1. Plan. For purposes of this section, the term “plan” means –
   a. A trusts described in section 401(a) which forms a part of the plan, or a plan described in section 403(a), which trust or plan is exempt from tax under section 501(a).
   b. An individual retirement account described in section 408(a)
   c. An individual retirement account described in section 408(b)
   d. An Archer MSA described in section 220(d)
   e. A health savings account described in section 223(d)
   f. A Coverdell education savings account described in section 530, or
   g. A trust, plan, account, or annuity which, at any time, has been determined by the Secretary to be described in any preceding subparagraph of this paragraph.
Basics of Prohibited Transactions

Definition – Prohibited Transactions – continued

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 50 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 if 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 a family (as defined in paragraph (6)) of any individual described in subparagraph (A), (B), (C), or (E);
Definition – Prohibited Transactions – continued

**g.** A corporation, partnership, or trust or estate of which (or in which) 50 percent or more of –

1. 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,

2. The capital interest or profits interest of such partnership, or

3. The beneficial interest of such trust or estate, is allowed 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 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); or

**i.** A 10 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 50 percent for subparagraphs (E) and (G) and lower than 10 percent for Subparagraphs (H) and (I).
Definition – Prohibited Transactions – continued

3. Fiduciary. For purposes of this section, the term “fiduciary” means a 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 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.

4. Stockholdings. For purposes of paragraphs (2)(E)(i) and (G)(i) 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 the members of the family of an individual are the members within the meaning of paragraph(6).
Definition – Prohibited Transactions – continued

5. **Partnerships; trusts.** For purposes of paragraphs (2)(e)(ii) and (iii), (G)(ii) and (iii) and (I) the ownership of profits or beneficial interests shall be determined in accordance with the rules for constructive ownership of stock provided in section 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,

*CWF Comment.* Both IRS and DOL have written that siblings will also be family members for purposes of the PT rules.
Most Common Prohibited Transactions

- The accountholder sells or buys something from his or her IRA. For example, the IRA account holds 1,000 shares of AT&T and the individual pays the IRA for these shares. Even if the fair market value is paid, this is a prohibited transaction.
- The accountholder pledges his or her IRA as collateral for a personal loan.
- The accountholder’s IRA owns real estate which is leased to a relative or controlled business.
- The financial institution which is the IRA trustee sells investments which it owns to the IRA.
Basics of Prohibited Transactions

The Statute – Internal Revenue Code Section 4975 – 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).

(c) Prohibited Transaction

(i) General Rule

(3) 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.
Basics of Prohibited Transactions

The Traditional IRA Life Span

Contributions
- Deductible
- Non-Deductible

Rollovers
- Transfers

Custodial or Trust Account Earnings Within Account are not Taxed

Distributions
- Accountholder
  - Before Age 59½
  - Age 59½ to 70½
  - And older

Beneficiaries
- Original
- Subsequent

In general, the accountholder or beneficiary will include the distribution in income and pay tax.

If a PT occurs, the IRA is deemed distributed as of the first day of the year. Generally, the individual will include the distribution in his or her income, pay income tax, and the 10% pre-59½ tax, if applicable.
Basics of Prohibited Transactions

The Roth IRA Life Span

Contributions
Non-Deductible

Rollovers
Transfers

Custodial or Trust Account Earnings Within Account are not Taxed

Distributions
Accountholder

Before Age 59½
Age 59½ to 70½
And older

Beneficiaries
Original
Subsequent

In general, the accountholder or beneficiary will not include the distribution in income and pay tax.

If a PT occurs, the Roth IRA is deemed distributed as of the first day of the year. Such distribution may or may not be taxable. However, such funds will no longer have the opportunity to earn tax-free income.
Overview # 2

Federal law defines certain transactions as being prohibited. Example, a person cannot sell an asset he or she owns personally to their IRA. Adverse tax consequences occur when there is a prohibited transaction. There is a 15%/100% excise tax which is owed if a prohibited transaction occurs with respect to a 401(k) or other pension plan. An IRA is deemed distributed if a prohibited transaction is caused by the IRA Accountholder.

Federal law does provide for some exemptions. That is, even though the transaction is a prohibited transaction it will permitted if certain rules are met.

An IRA custodian must adopt policies and procedures where an individual must obtain a legal opinion from their attorney that a proposed investment or other transaction will not result in or has not resulted in a prohibited transaction.

* No Correction program exists for IRAs. Tax consequences are extremely harsh.
Overview # 2

The federal and state laws governing conflicts of interest are very complex. A trustee is to act in the best interest of the beneficiary whether he or she be a 401(k) or pension plan participant or an IRA accountholder. A trustee must be acting to maximize the growth of the pension and/or account and not benefit the individual on a personal (*non-pension or non-IRA*) basis or benefit the financial institution.

In order to simplify the tax administration of IRA and pension investments, the federal law has been written, in general, to provide that the IRA accountholder cannot have any business deals with his or her IRA. And the same is true for 401(k) and other pension plans – neither a participant or an employer is to benefit personally, all earnings must be allocated or earned by the IRA or the 401(k) plan.
Prohibited Transaction Exemptions

Certain PTs are given exceptions called exemptions. These transactions are permissible under the law even though they do constitute a PT. Sufficient safeguards are considered to exist. There are really three types of exemptions under the law:

a. Statutory exemptions
b. Class exemptions
c. Individual exemptions

The statutory exemptions are set forth in Code section 4975(d).

Most of these exemptions do not apply to IRAs.
Prohibited Transaction Exemption Procedure

It is possible to ask the Secretary of the Treasury or the Secretary of Labor for an exemption for a single transaction, for a class of transactions, or for a class of disqualified persons.

Before granting such an exemption, the Secretary must determine that this is:

• Administratively feasible
• In the interests of the plan and of its participants and beneficiaries
• Protective of the rights of participants and beneficiaries under the plan
DOL vs. IRS

The DOL has the authority to issue administrative exemptions under both ERISA and the Internal Revenue Code. The DOL may conditionally or unconditionally exempt any fiduciary or transaction, or class of fiduciaries or transactions, from all or part of the prohibited transaction rules.

Normally, an exemption is granted on a prospective basis. In limited situations, an exemption will be granted on a retroactive basis.

What surprises many people is the fact that there is no filing fee to be paid in order to have DOL process a request for a PT exemption.
Basics of Prohibited Transactions

Statutory Exemptions - 4975

1. Any loan made by the plan to a disqualified person who is a participant or beneficiary of the plan if such loan –
   a. Is available to all such participants or beneficiaries on a reasonable equivalent basis,
   b. Is not made available to highly compensated employees (within the meaning of section 414(q)) in an amount greater than the amount made available to other employees.
   c. Is made in accordance with specific provisions regarding such loans set forth in the plan
   d. Bears a reasonable rate of interest
   e. Is adequately secured

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 therefore;
Basics of Prohibited Transactions

Statutory Exemptions – 4975 – continued

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

   a. The plan covers only employees of such bank or other institution and employees of affiliates of such bank or other institution, 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 not more than reasonable compensation, if such bank or other institution is a fiduciary of such plan, and if –

a. Such bank or similar financial institution has adopted adequate internal safeguards which assure that the provision of such ancillary service is consistent with sound banking and financial practice, as determined by Federal or State supervisory authority, and

b. The extent to which such ancillary is provided is subject to specific guidelines issued by such bank or similar financial institution (as determined by the Secretary after consultation with Federal and State supervisory authority), and under such guidelines the bank or similar financial institution does not provide such ancillary service –

i. In an excessive or unreasonable manner, and

ii. In a manner that would be inconsistent with the best interests of participants and beneficiaries of employee benefit plans;
7. The exercise of a privilege to convert securities to the extent provided in regulations of the Secretary but only if the plan receives no less than adequate consideration pursuant to such conversion;

8. Any transaction between a plan and a common or collective trust fund or pooled investment fund maintained by a disqualified person which is a bank or trust company supervised by a State of Federal agency or between a plan and a pooled investment fund of an insurance company qualified to do business in a State if –

   a. The transaction is a sale or a purchase of an interest in the fund,

   b. The bank, trust company, or insurance company receives not more than a reasonable compensation, and

   c. Such transaction is expressly permitted by the instrument under which the plan is maintained, or a fiduciary \((other\ than\ the\ bank,\ trust\ company,\ or\ insurance\ company,\ or\ an\ affiliate\ thereof)\ who\ has\ authority\ to\ manage\ and\ control\ the\ assets\ of\ the\ plan;\)
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 participants and beneficiaries.

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;
Basics of Prohibited Transactions

The Statutory Class Exemptions

Bank’s Own Time Deposit

Express IRA Provision

You may also instruct us in writing to invest your traditional IRA into one or more of the savings or time deposit instruments which we are offering at that time. You expressly authorize this even though we are acting as the IRA trustee of your IRA. Our name is set forth on the IRA application. Such deposit account must bear a reasonable rate of interest as determined by the terms of the deposit instruments and the short and long term economic conditions. The terms of any such accounts are incorporated by reference into this agreement.
Basics of Prohibited Transactions

Certain PT Class Exemptions For the IRA Custodian/Trustee

Prohibited Transaction Class Exemption 93-1

Officially Allows Incentive Premiums to IRA and Keogh Accountholders

The use of incentives to generate business for financial institutions is a longstanding practice. Everything from stadium blankets to toasters, calculators to television sets have been used at one time or another.

In the mid-70s the DOL examined the practice of financial entities offering various premiums for opening or contributing to IRA and Keogh plans and initially found to be violation of prohibited transaction (PT) rules. The regulatory objection to offering retirement plan deposit incentives is the potential for diminished benefits or earnings within the plan, because of the cost of benefits (premiums) offered outside the plan.

But the fact of numerous requests for prohibited transaction exemptions, the DOL in 1983 made a decision to consider the granting of a “class exemption” allowing limited offerings of premiums, retroactive to January 1, 1975. It took 10 years – until February 11, 1993 – to finalize the exemption, known as PTE 93-1. Prior to this, Announcement 90-1 had granted temporary reliefe from the prohibited transaction rules. PTE-93-1 applies to IRA and Keogh plans but not to multiple participant SEP-IRA plans, whereas PTE/93-1 does.
Certain PT Class Exemptions For the IRA Custodian/Trustee

Here are the PTE 93-1’s Provisions:

The IRA and Keogh plan associated with the payment of cash, property or other consideration, must be established solely to benefit the participant, his or her spouse and their beneficiaries.

The special cash, property or other consideration is to be given only in connection with the initial embellishment of the plan, or the making of additional contributions, including the transfer of assets from another plan into an IRA or Keogh.

During any given tax year, the total fair market value of the cash, property or other considerations given to an IRA accountholder of Keogh plan participant may not exceed (1) $10 for deposits of less than $5,000 or (2) $20 for deposits of $5,000 or more.
Certain PT Class Exemptions For the IRA Custodian/Trustee

Some Pertinent Definitions:

“Taxable year” means the taxable year of the individual. In the case of transfers of assets from previously established plans, then the calendar year in which the transfer was received into the new plan is considered to be the taxable year.

“Fair market value”, as used in determining the allowable value of a premium or other consideration, may be the cost to the financial institution, rather than an item’s so-called “street-value” or average purchase price by an individual.

The term “members of his or her family” refers to the beneficiaries of the individual for whose benefit the plan was established as the term “family” is defined in Code Section 4975(e)(6), or brother, sister or spouse of a brother or sister.
Certain PT Class Exemptions For the IRA Custodian/Trustee

Prohibited Transaction Class Exemption 93-33 – Linked Accounts

The history of the Department of Labor’s opinions and actions concerning “relationship banking” programs and pension plans is an extended and complicated one. It began in 1989, when DOL took the position that – with respect to IRAs and Keogh plans – relationship banking programs (the linking of free or reduced costs services to he establishing or funding of a plan) often constituted a prohibited transaction. (PT)

This harsh PT position could potentially have caused many IRA and Keogh plans that were opened or funded under financial institution incentive programs to lose their tax-deferred status – to be “deemed distributed” – in most cases resulting in an added tax burden on the accountholder or plan participant.

In the wake of strong protests from the American Bankers Association, state banking associations, and many private banks and holding companies, the IRS issued temporary relief from the DOL advisory opinion, with Announcement 90-1, January 8, 1990. These rules were to be in effect while a request for “administrative exemption” was considered.

Nearly three years later, that request for exemption having been considered, the IRS issued Prohibited Transaction Class Exemption 93-33 – PTE 933-33 for short. It took effect May 11, 1993.
Certain PT Class Exemptions For the IRA Custodian/Trustee

Summary of PTE 93-33 Exemption for Certain Services

The rules under 93-33 are quite specific.

A financial institution may offer certain services *(at no cost of a reduced cost)* to its IRA/Keogh accountholders without having a prohibited transaction result if certain conditions are met. Simply put, the deposit balance in an IRA or Keogh may be taken into account for purposes of determining if the person for whom the IRA or Keogh is established is eligible to receive services *(outside of the IRA/Keogh)* at reduced or not cost they comply with certain rules.

Condition/Rule # 1.

For the IRA or Keogh plan, the deposit balance which will be considered in determining eligibility for the service must be established or maintained for the exclusive benefit of the participant covered under the IRA or Keogh, his or her spouse or their beneficiaries. By definition, an IRA or Keogh should meet this rule.
Certain PT Class Exemptions For the IRA Custodian/Trustee

Summary of PTE 93-33 Exemption for Certain Services

The rules under 93-33 are quite specific.

Condition/Rule # 2.

The services to be received by the accountholder must be of a type which the financial institution itself could offer. Thus, services offered by a controlled non-bank affiliate or a third party would not be covered (e.g. brokerage services). However, service is defined to encompass incidental products of a de minimis value if provided by a third person pursuant to an arrangement with the financial institution, and if these services are customary services. For example, many financial institutions contract with vendors of checks to provide checkbooks. Such are permitted.
Certain PT Class Exemptions For the IRA Custodian/Trustee

Summary of PTE 93-33 Exemption for Certain Services

The rules under 93-33 are quite specific.

Condition/Rule # 3.

The services (provided by the financial institution or an affiliate) to the IRA/Keogh account holder must also be offered to depositors who do not maintain IRAs or Keoghs with the financial institution. Why? The DOL does not want any service programs designed just to favor IRA/Keogh account holders. And, the DOL does not want the financial institution to offer the person who has the IRA or Keogh, rewards outside of the IRA/Keogh at the expense of paying earnings to the IRA/Keogh itself.

This rule precludes the furnishing of services as an incentive only for establishing or maintaining an IRA/Keogh.

Condition/Rule# 4.

In the eligibility determination, the deposit balance required by the financial institution for the IRA or Keogh account holder to receive the service must be equal to (or less than) the lowest balance required for any other type of account receiving the same service.
Certain PT Class Exemptions For the IRA Custodian/Trustee

Summary of PTE 93-33 Exemption for Certain Services

The rules under 93-33 are quite specific.

Condition/Rule # 5.

The rate of return on the IRA/Keogh investment must not be less than the rate of return on an identical investment that could have been made at the same time at the same branch by a depositor who is not eligible for, or who does not receive, the reduced or no cost services.

The DOL has stated its belief that this rule will assure that the financial institution will offer to IRAs and Keoghs the same investment opportunities which are available to other accountholders of the bank who do not receive reduced or no cost services. Special services will not mean reduced earnings or opportunities for IRA and Keogh accounts.

The financial institution will need to make sure it has such identical investments available if it adopts a service program.

This rule does not prevent a financial institution from offering a more favorable rate of return on an IRA or Keogh plan investment which is otherwise identical to an investment available to other depositors. This is true whether or not there is participation in a relationship banking program. IRAs and Keoghs may be favored. They may not be discriminated against.
Basics of Prohibited Transactions

Certain PT Class Exemptions For the IRA Custodian/Trustee

Administrative Procedures

If you believe that proposed investment may be a PT – exercise prudence! The rules are vague, difficult to apply, and sometimes interpreted more broadly by the DOL than would seem warranted. Because of the complexity of this area, protect your financial institution and involve legal counsel before the PT occurs.

Prohibited transactions can certainly have adverse affects on an accountholder’s self-directed IRA. Therefore, procedures should be in place and followed properly in order to avoid financial institution liability.

If an IRA accountholder wants to self-direct his or her IRA assets into any type of non-liquid/market type of investment, require that the IRA accountholder have his or her attorney provide the custodian/trustee with a written opinion that the proposed investment transaction would not be a prohibited transaction as defined in Code Section 4975. The procedure would be prudent for the following reasons:

a. Code section 408(a)(2) requires that an IRA have a financial institution as the IRA custodian/Trustee. IRA laws to not contain any express statutory provisions that remove fiduciary liabilities for self-directed IRAs as is the case of qualified plans. Therefore it is doubtful whether the custodian/trustee of an IRA can eliminate or transfer all of its responsibilities as custodian/trustee by giving those responsibilities to the accountholder.
Certain PT Class Exemptions For the IRA Custodian/Trustee

Administrative Procedures – continued

b. If a prohibited transaction occurs, the financial institution is required to file the Form 1099-R.

c. Many times the transaction that is proposed by an accountholder is changed and something else actually happens. Accountholders very often do not understand how fact-specific a prohibited transaction analysis can be – changing one fact may change the conclusion. Therefore, by requiring a written opinion from legal counsel they are made aware of the complicated nature of the transaction.

d. After receiving the written opinion from your IRA accountholder’s attorney, have your attorney review the written opinion. Your attorney is merely reviewing the opinion to ascertain whether it would be prudent for the financial institution to rely on it, not to determine whether the written opinion is right or wrong.
Basics of Prohibited Transactions

Certain PT Class Exemptions For the IRA Custodian/Trustee

Administrative Procedures – continued

Additional guidelines to follow when dealing with potential prohibited transactions:

- Review the appropriate forms and paperwork with your IRA accountholder, including his or her signature and (tactfully) the reference of Article VIII (traditional IRA) or Article IX (Roth IRA), Section 1.4 to your financial institution’s responsibility only for savings and time deposit transactions.

- Ensure that you receive your IRA accountholder’s written instructions regarding self-directed investments.

- Consider having your IRA accountholder sign a “hold harmless” agreement regarding the self-directed investment.

- Consider informing all IRA accountholder of potential PTs, alerting them to the risk by an example (no names). This will serve as proof of your proactive concern for your IRA accountholder’s best interest.

- If at all possible, it is best to have each (questionable) self-directed asset in a separate IRA. PT penalties can disqualify the entire IRA, so having each asset in a separate IRA, meaning a separate plan agreement, will not jeopardize the entire IRA, just the asset in question, should a prohibited transaction occur.
Certain PT Class Exemptions For the IRA Custodian/Trustee

Administrative Procedures – continued

Hold Harmless Documents

While it is always best to have clear-cut answers to a particular IRA question or situation, not all questions have a clear answer. In some cases your financial institution may find itself dealing with a situation that is not clearly prohibited or allowed by the Code or regulations. In these types of situations it should be required that the IRA accountholder consult his or her legal counsel or guidance. A further requirement may be that the accountholder furnish the custodian/trustee a written opinion prepared by his or her own legal counsel that states the transaction can in that attorney’s opinion be done. The last step should be to have the accountholder execute a “hold harmless”. A hold harmless document is a written statement wherein the accountholder releases another party, i.e. the custodian/trustee, from liability in connection with a specific transaction or event. Any hold harmless document, however, should be drafted by the custodian/trustee’s own legal counsel to insure compliance with state law and appropriateness for the specific situation.
Certain PT Class Exemptions For the IRA Custodian/Trustee

A personal Guarantee to an IRA Investment Must be Avoided

Banks and security firms almost always seek a personal guaranty for loans and many investments. This may be what is best for the bank or the securities firm, but it will cause major problems when an IRA is involved. The individual and possibly the bank or securities firms will learn a tax lesson the hard way.

Example. John Doe has $300,000 in his IRA. He instructs his IRA trustee to purchase a parcel of real estate for $350,000 on a contract for deed and his initial payment is $200,000 with the remaining $150,000 to be paid in 18 months. The IRA is purchasing the real estate from another bank which acquired the property by foreclosure. The bank selling the property wants a personal guaranty because that is its standard practice. If with respect to the IRA’s purchase John Doe gives his personal guaranty, that act will constitute a prohibited transaction and whatever balance was in his IRA as of January 1 is considered distributed. No one likes to pay income tax on $300,000.

In summary, a cardinal rule for a self-directed IRA or trust IRA is that the individual must never personally guaranty an investment within his or her IRA, be it a traditional, Roth, SIMPLE or SEP. Furnishing a personal guarantee is always a prohibited transaction unless the DOL would grant a special exemption.
Basics of Prohibited Transactions

Certain PT Class Exemptions For the IRA Custodian/Trustee

A personal Guarantee to an IRA Investment Must be Avoided - continued

See the following newsletter article discussing the special relief the DOL is making available to individuals who furnished guarantees when they signed the “standard” forms of many security firms. The DOS has chosen to grant relief to both the individuals and the securities forms. Without such relief the securities forms would be facing unhappy customers and their lawsuits.
Financial Institution Officers or Directors Owning Stock With their IRA

A PT Concern?

Yes. For some time the IRS and the DOL have stated their belief that is very likely a PT occurs when a senior officer or director invests in his or her own financial institution stock via his or her self-directed IRA. The following summarized their analysis:

IRA owners who have discretion regarding investments of IRA’s are fiduciaries of the IRAs under Code section 4975(e)(2)(A). Therefore, the purchase and holding of employer stock or parent stock by self-directed IRAs of officers and directors of a financial institution raise questions under Code Section 4975(c)(1)(D) and (E) because the officers and directors may have interests in the transactions which affect their best judgment as fiduciaries.

The IRS’ and DOL’s position may not be a strong position. You will want those officers and directors who decide to make these investments to acknowledge in writing that the law is not settled and he or she assumes full responsibility.
Basics of Prohibited Transactions

Real Estate as an IRA Investment

Real estate in an IRA raises some concerns not often found with other types of IRA investments

- Title the real estate in the name of the IRA, with the financial institution listed as the IRA custodian/trustee.

  "ABC Financial Institution as Custodian/Trustee for John Jones (traditional/Roth/SEP/SIMPLE) IRA."

- Watch out for prohibited transactions. The accountholder, his family, and his business may not use real estate held by the IRA. Additionally, be careful of how the real estate is financed.

- Any expenses associated with the real estate must be paid out of the IRA. They cannot be paid by the accountholder. If expenses cannot be paid out of the IRA, the real estate should be sold.

- Any earnings the real estate generates, such as rent, must be paid directly to the IRA. They cannot go directly to the accountholder.

- The real estate must be appraised each year for the December 31 fair market value reporting. The IRA must pay for this appraisal. This appraisal should be done by an independent appraiser.

With real estate, the trustee or custodian has the responsibility to manage the property while it is held in the IRA. Many IRA custodians or trustees do not want this responsibility. It is possible to hire a real estate manager.
Participant Loans, Including IRAs

A nice feature of an employer sponsored plan is that an employer may choose to allow the participants to take a loan from the plan based on his or her account balance.

Question # 1

Does the plan authorize loans for participants?

Many 401(k) plans and profit sharing plans do authorize loans to participants, but an employer is not required to include this special feature in its plan.

Loans from any type of IRA, including SEP-IRAs and SIMPLE IRAs cannot be made to the IRA accountholder or any related family member. To make such a loan would be a prohibited transaction.
Participant Loans, Including IRAs – continued

Question # 2

If the plan authorizes loans, the plan document must contain provisions defining:

1. Who is eligible to receive a loan;
2. What needs to be done for a person to apply for the loan;
3. The maximum amount which may be borrowed, such limit cannot exceed $50,000; and
4. The loan terms;
   - interest rate,
   - term of loan, generally five years or less
   - method of payment, a loan may be written to require repayment by an authorization to deduct payments from a participant’s paycheck
   - whether the individual will have to provide any collateral in addition to his or her account balance, and whether or not repayment of the loan will be accelerated if the participant separates from service, and
5. An explanation of what happens if the borrower defaults on repaying the loan.

In general, if a participant defaults on his or her loan, the individual will be required to include the loan amount in his or her income for the default year. The plan will prepare and furnish him or her with a Form 1099-R (Distributions From Pensions, Annuities, Retirement or Profit-sharing Plans, IRAs, Insurance Contracts, etc). The individual will also owe the 10% additional pre-59½ tax unless he or she would qualify for one of the exceptions.
A Promissory Note as a Self-Directed IRA Investment

CWF recently had a self-directed IRA custodian pose the following question. How long should a non-performing or delinquent loan remain in an IRA. This IRA could either be a trust IRA of a self-directed custodial IRA.

Here are CWF’s general thoughts on promissory notes as an IRA investment.

1. The most conservative approach is to always keep the loan in the IRA even if the loan has been in default for a long time. Unless the debtor has gone through bankruptcy, there would always be a legal claim to seek repayment. Situations change. In most cases there is no need to rush to eliminated the note from the list of IRA assets unless administrative fees for such note would induce one to eliminate the note. If the loan has no value, the IRA custodian will use zero as the fair market value in its accounting and determination of fair market value of the entire IRA. An IRA may need to have a special fee for “defaulted loans”.

Basics of Prohibited Transactions
2. If an asset decreases significantly in value, it can be advantageous from a tax planning standpoint to distribute the asset in-kind to the IRA accountholder. This is especially true if the individual believes the value of the asset will increase after being distributed.

The fair market value of the asset at the time of the in-kind distribution will be required to be included in the individual’s taxable income. There is the “valuing” issue. We are not sure if there are loan appraisers, but a good faith effort should be made by an accountant or bank personnel to determine the current discounted value of a loan which might not be repaid. There should be a write-up setting forth the determination of the value. Under the federal tax rules, we believe the IRA custodian has the primary duty to determine FMV and this duty cannot be delegated to another party.

The IRA custodian wants to be careful in the situation involving the in-kind distribution of a loan. A taxpayer could easily try to abuse the situation to his or her personal benefit. It is unclear if the IRS will look to the IRA custodian to try to limit such abuse. We expect the IRS will adopt the approach of expecting the IRA custodian to have procedures to limit such abuse. For example, an IRA accountholder has $100,000 of fully taxable funds within a traditional IRA. He loans $90,000 to a third party in early 2008. The third party defaults on the loan in 2009, such loan is distributed in-kind in December of 2009 with a zero or $1.00 value, but the borrower ends up repaying the loan in 2011.
A Promissory Note as a Self-Directed IRA Investment – continued

Note the individual would include in his or her 2009 taxable income the amount of $0 or $1.00. How will the individual reflect the repayment of the $90,000 loan amount and the payment of the accrued income of his or her 2011 tax return?

We will need to do research to determine the tax consequences – is the repayment of the loan amount non-taxable, might the entire payment qualify as capital gain income or might the entire amount be taxed as ordinary income?
A Promissory Note as a Self-Directed IRA Investment – continued

3. An IRA custodian and an IRA accountholder need to have a written understanding covering all subjects with respect to the promissory notes. This topic needs to be covered by a special addendum to the plan agreement. Some of the subjects to be covered:

   a. What percentage of the IRA may be used to make such loans;
   b. What loan documents will be used;
   c. What collateral will be given for a loan by the borrower;
   d. What interest rate will apply;
   e. What is a default defined to occur so that the collection action will commence;
   f. When will collection action be deferred or suspended and for what reasons;
   g. The IRA custodian should be authorized to hire an attorney to collect the delinquent debt.

We have heard that many IRA custodians of self-directed IRAs require the use of a Note Servicing Agent. Does the Service Agent have the duty to collect with respect to a defaulted note?

Some IRA self-directed custodians have adopted a business model where they want severely limit their collection activity and may try to contractually remove themselves from performing this duty.
A Promissory Note as a Self-Directed IRA Investment – continued

The other approach is to have the IRA custodian perform the collection duty by having the IRA plan agreement or addendum expressly authorize the hiring of a collection attorney and the paying of his or her fee.

There is one more issue to be mentioned. Under federal income tax laws, income arises when one party forgives or cancels a legal debt. We have paraphrased an IRS summary on this issue. The tax impact of debt forgiveness or cancellation depends on the facts and circumstances of each particular situation. Generally, if a person or party borrows money from a commercial lender and the lender later forgives the debt, the person or party most likely will need to include the cancelled amount in income for tax purposes. The lender is usually required to report the amount of the cancelled debt to the third party and the IRS on Form 1099-C, Cancellation of Debt. In some limited situations, the amount forgiven is not required to be included as income.

The IRA, as a lender, most likely will be required to prepare the Form 1099-C in a defaulted note situation. There could also be prohibited transaction issues arising from the loan forgiveness situation if the IRA accountholder would personally benefit from the forgiveness.

In summary, a self-directed IRA may certainly have as an investment, a loan or loans to third parties. There are special concerns and tasks with loans.
IRAs as a Lender – A Possible PT Concern

IRA Loans

IRA accountholders are increasingly directing plan assets into a growing array of different types of investments. Often this is done with the hope of increasing the rate of return on the retirement dollars. Other times, however, this investment direction may be selected for a different reason, that being to help out a family member. This section will focus on a particular type of IRA investment, a loan from an IRA to an individual or business.

There is nothing in the Internal Revenue Code or ERISA that prohibits a loan as an investment, per se, if it is handled correctly. There are, however, dangers that must be avoided at all costs or a prohibited transaction will result. The result of a prohibited transaction in an IRA is a total disqualification of the IRA, subjecting all the funds to taxation and penalties.

What types of loans would result in a prohibited transaction? To begin with, Internal Revenue Code section 4975 and ERISA section 406 both prohibit any loan between a plan and a disqualified person. The IRA accountholder is a disqualified person as defined in the bodies of law. Any business of which the accountholder or participant controls 50% or more is also defined as a disqualified person. As such, a loan by the IRA accountholder could not be made to the individual IRA accountholder or an entity controlled by that individual. These sections also prohibit the IRA accountholder from guaranteeing any loan made by the plan.
IRAs as a Lender – A Possible PT Concern - Continued

IRA Loans

What about other entities with which the individual does not control but is involved? It is also evident from a number of IRS and Department of Labor rulings that loans to these entities would be prohibited. Private Letter Ruling #9119002 provides ample evidence of this. In this situation, a QRP participant had a loan made from his QRP account to a partnership of which he owned 39%. While this partnership technically did not qualify as a disqualified person, the IRS ruling was that a prohibited transaction had occurred. Their rationale is one they use often. This loan benefitted the accountholder outside of the QRP. They stated that this type of transaction constituted dealing with plan assets in the accountholder’s own interest. A prohibited transaction was the result. This situation illustrates that even in situations where it may first appear from the Code that a prohibited did not occur, the IRS and DOL can still rule in the opposite manner, using the position that if the person receives a benefit, direct or indirect, outside of the plan because of a transaction, a prohibited transaction has occurred.
IRA Loans

Certain family members of the IRA account holder are also classified as disqualified persons. The problem normally confronted today is determining which family members these are. Both the Internal Revenue Code and ERISA define family members as any spouse, ancestor, lineal descendant, or spouse of a lineal descendant. It is very clear then that there can be no loan made by the IRA to the spouse, parents, children, grandparents, grandchildren or spouses of these individuals by the account holder’s IRA. Neither section, however makes any mention of siblings of his or her spouses. Does this then mean that an IRA could make a loan to the individual’s brother-in-law, sister, or a business controlled by one of these persons, for example? It would appear that it does not. In a number of written documents, the IRS and Department of Labor (DOL) appear to have extended the statutory definition of a “family member” to include siblings and spouses. In a number of DOL Advisory Opinions, in Prohibited Transaction Exemption 93-1, and in the IRS Internal Audit Manual, the statement is made that both the DOL and the IRS will use Code 267 to determine who are family members when applying the prohibited-transaction rules. Code section 267 does include siblings and spouses as family members. As such, it appears that both agencies intend to include these people as disqualified persons under the prohibited-transaction rules. This would mean that any loan by the plan to such an individual would result in a prohibited transaction.
Basics of Prohibited Transactions

IRAs as a Lender – A Possible PT Concern - Continued

IRA Loans

The question now becomes, “Does the IRS and DOL have the authority to make this extension?” At first glance it would appear they do not. Both IRC 4975 and ERISA 406 have very definite definitions of family members that do not include siblings or their spouses. It would appear Congress did not intend for siblings and their spouses to be included in the definition of a disqualified person. As such, an argument could be made that the IRS and DOL cannot extend these rules to these types of family members. This is an argument that an IRA accountholder would probably be forced to make in court as it apparent the IRS and DOL intend to enforce the rules under the stated position. These agencies’ argument will be that IRC section 4975 contains numerous references to IRC section 267. In every situation, except for the definition of a disqualified person, section 267’s definition of the term “family member” is used then applying the prohibited transaction rules under 4975. The IRS and DOL will argue that this was simply an oversight and 267’s definition is the one Congress intended. They will also argue that any loan to a sibling or sibling’s spouse results in a direct or indirect benefit to the accountholder or results in the accountholder using plan assets in his or her own interests. Again the result would be a prohibited transaction.
IRAs as a Lender – A Possible PT Concern - Continued

IRA Loans

With this confusion, what should an IRA custodian/trustee do if an accountholder wants to have the IRA make such a loan? The safest course of action is to not permit it. It is very apparent that the IRS and DOL would rule the loan prohibited and force the accountholder into court to fight the ruling. If the accountholder insists upon making such a loan, a number of steps should be taken;

1. The accountholder’s own legal counsel should prepare a written opinion that states they do not feel this transaction is prohibited.

2. The accountholder should sign a direction of investment document, directing the loan to be made. This document should contain a “hold harmless” provision where the accountholder releases the custodian/trustee from liability for the transaction and agrees to take total responsibility for it.

3. If the loan is made, it needs to be treated as any other loan. Proper loan documentation and disclosures are required. It must be secured with collateral. All loan payments are to be made to the plan’s custodian/trustee, not the individual. The accountholder may not guarantee the loan. Additionally, the interest rate on the loan must be equivalent to the prevailing market rate in that area for a similar type of loan.

4. If it is an IRA, establish a new IRA with a separate IRA plan agreement just for the loan. The only asset in that IRA is the loan. This will help should the loan be deemed a prohibited transaction. It will help because the only IRA disqualified will the one with the loan in it.
IRAs as a Lender – A Possible PT Concern - Continued

IRA Loans

Our recommendation at this time is to not permit loans to these family members. While there may be an argument that the IRS and DOL should not rule as they have been, it will be an expensive argument for the accountholder to make.
Basics of Prohibited Transactions

Coins and Bullion

A financial institution is allowed to offer “limited” self-directed IRAs. A financial institution is not required to offer its IRA accountholders every investment opportunity. They can choose to limit the investments which are made available to the “self-directed” accounts. Some financial institutions have chosen to act as the IRA custodian/trustee for those IRA accountholders wanting to invest the IRA funds in certain coins and bullion.

Why would a financial institution consider doing so?

The primary reason is the special fees such IRA accountholders are willing to pay.

Service Fees Associated with Coins and Bullion

The IRA custodian/trustee will often assess an annual administrative fee in the range of ($150.00-$200.00) per year and then also impose a per-transaction fee ($25-$50.00) per purchase or sale.

General Rules

Code section 408(m) sets fort the general rule that the acquisition of a collectible by an IRA or a self-directed 401(k) plan or similar plan, is to be treated as a distribution in an amount equal to the cost of the collectible.

In general, coins and other tangible personal property are defined to be collectibles. Therefore. The purchase of a coin for the amount of $800 will generally be considered to be a distribution from the IRA in the amount of $800.
Coins and Bullion - continued

A Special Rule

Code section 408(m)(3) creates an exception for certain coins and bullion. No distribution will be considered to have taken place if the following coins or bullion are purchased.

1. Any coin described in paragraphs (7), (8), (9) or (10) of section 5112(a) of title 31 of the United States Code
   a. Paragraph 7 provides – A fifty-dollar gold coin that is 32.7 millimeters in diameter, weighs 33.931 grams, and contains one troy ounce of fine gold.
   b. Paragraph 8 provides – A twenty-five dollar gold coin that is 2.0 millimeters in diameter, weighs 16.966 grams, and contains one-half troy ounce of fine gold.
   c. Paragraph 9 provides – A ten dollar gold coin that is 22.0 millimeters in diameter, weighs 8.483 grams, and contains one-fourth troy ounce of fine gold.
   d. Paragraph 10 provides – A five-dollar gold coin that is 16.5 millimeters in diameter, weighs 3.393 grams, and contains one-tenth troy ounce of fine gold.

In general, the above coins are called, “Gold American Eagle” coins. These coins must also meet the following requirements.
   a. The Secretary of the treasury will have the discretion to decide the design of the five-dollar, ten-dollar and twenty-five dollar coins.
Coins and Bullion - continued

A Special Rule

b. The fifty-dollar gold coin shall have the following design elements:
   1. Symbolic of liberty on the obverse (front) side;
   2. A family of eagles on the reverse side with a male carrying an olive branch and flying above a nest containing a female eagle and hatchlings;
   3. Have inscriptions of the denominations, the weight of the fine gold content, the year of minting or issuance, and the words “Liberty”, “In God We Trust”, “United States of America”, and “E Pluribus Unum”, and;
   4. Have reeded edges;

2. A silver coin described in section 5112(e) – such coin must meet the following requirements:
   a. Be 40.6 millimeters in diameter and weigh 31.103 grams;
   b. Contain .9990 fine silver;
   c. Have a design (1) symbolic of Liberty on the obverse (front) side; and (2) of an eagle on the reverse side;
   d. Have inscriptions of the year of minting and issuance, and the words “Liberty”, “In God We Trust”, “United States of America”, “1 Oz. Fine Silver”, E Pluribus Unum”, “One Dollar”; and
   e. Have reeded edges.

This coin is called the American Silver eagle. Note that this coin is limited to the on-dollar coin (i.e. the silver dollar).
A Special Rule

3. A platinum coin described in section

This subsection provides that the Secretary may mint and issue platinum coins and proof platinum coins in accordance with specifications, designs, varieties, quantities, denominations and inscriptions as the Secretary, in the Secretary’s discretion, may prescribe from time to time. It appears that the Secretary has authorized the coining of American Platinum Eagle coins.

4. A Coin issued under the laws of any state, or

5. Any gold, silver, platinum or palladium bullion –

Of a fineness equal to or exceeding the minimum fineness that a contract market (as described in section 7 of the Exchange Act, 7. U.S.C) requires for metals which may be delivered in satisfaction of a regulated futures contract, if such bullion is in the physical possession of an IRA custodian or trustee.

In general, the gold bullion musts be .9950 pure, the silver must be .9990 pure, the platinum bullion must be .9995 pure, and the palladium bullion must be .9995 pure.

It appears that certain coins may be considered to be bullion. A number of foreign governments mint coins of silver, gold, platinum or palladium, with the fineness to meet the above standards of purity. However, the IRS has not yet given specific written guidance saying that such coins qualify as bullion.
Basics of Prohibited Transactions

Status of DOL’s Fiduciary Rules

DOL Fiduciary Rule Vacated

On March 15, 2018, the U.S. Court of Appeals for the Fifth Circuit vacated the DOL’s Fiduciary Rule.

The case is, Chamber of Commerce of the USA, et al v. U.S. Department of Labor, Case 17-10238, Document 00514388699.

This case is the first victory for opponents of the Fiduciary Rule who argued the DOL exceeded its authority in issuing its new regulation defining various IRA service providers to be a fiduciary investment adviser and any one participating in a rollover transaction to be a fiduciary. Other circuit courts have ruled the DOL had the authority to adopt the regulatory changes it made.

The DOL has announced it will be reviewing the Fifth Circuit’s ruling. In the mean time it will not seek to enforce its Fiduciary regulation and related exemptions, including the Best Interest Contract exemption. The new definition of a fiduciary investment adviser had become effective on June 9, 2017. There are interim rules in effect with respect to the Best Interest Contract exemption and the other related exemptions.

The ruling of this case is not effective until May 7, 2018, because the ruling could be stayed if the case would be reheard by all of the judges of the Fifth Circuit. The DOL has 45 days from entry of the judgment to request a rehearing of the case before all of the Fifth Circuit judges. The DOL will need to decide if it will seek a rehearing or if it will appeal the case to the U.S. Supreme Court. The DOL might decide to do neither and let the Fiduciary Rule cease to exist. When a rule is vacated, it means the regulation is treated as if it had never gone into effect. The 5-part 1975 regulation of a fiduciary investment adviser (a fiduciary) would again apply.

This fiduciary topic has been highly political since the Obama administration first proposed its change in 2010. We at CWF hope Congress will decide it should be the branch of government making such new laws and act accordingly. Why is the Department of Labor involved? Very few employers offer any type of employer sponsored IRA programs. IRAs are a tax subject and the IRS (and not the DOL) should be providing better administration. However, we will not be surprised if the DOL proposes some course of action which we would keep it involved with IRAs in addition to its continuing to issue individual prohibited transaction exemptions.

We suggest an IRA custodian/trustee continue with its current approach until more is learned. In general, this means an IRA custodian/trustee should not accept any compensation from third parties regarding its IRA products and services. Most financial institutions did not do so prior to the DOL Fiduciary Rule and most do not do so today. Most financial institutions charge reasonable fees as the law has always permitted. Rollover contributions should continue to be sought.
Temporary Enforcement Policy

Accordingly, for the period from June 9, 2017, until after regulations or exemptions or other administrative guidance has been issued, the department will not pursue prohibited transaction claims against investment advice fiduciaries who are working diligently and in good faith to comply with the impartial conduct standards for transactions that would have been exempted in the BIC Exemption and Principal Transaction Exemption, or treat such fiduciaries as violating the applicable prohibited transaction rules. Of course, investment advice fiduciaries may also choose to rely upon other available exemptions to the extent applicable after the Fifth Circuit’s decision, but the Department will not treat and adviser’s failure to rely upon such other exemptions as resulting in a violation of the prohibited transaction rules if the adviser meets the terms of this enforcement policy.

The Department is evaluating the need for other temporary or permanent prohibited transaction relief for investment advice fiduciaries, including possible prospective and retroactive prohibited transaction relief. The Department will, of course, consider any applications for additional relief.

This Bulleting is an expression of the Department’s temporary enforcement policy, and it does not address the rights and obligations of other parties.
Basics of Prohibited Transactions

Status of DOL’s Fiduciary Rules
DOL Fiduciary Rule Vacated

DOL Field Assistance Bulletin NO. 2018-02  May 7. 2018

On or about May 7, 2018, the United States Court of Appeals for the Fifth Circuit is expected to issue a mandate effectuating its opinion vacating the entire fiduciary rule, the BIC Exemption, the Principal Transaction Exemption, and related amendments to existing PTEs. The Department understands that financial institutions, advisers, and retirement investors may have questions regarding the investment advice fiduciary definition and related exemptive relief following the court’s order. The Department intends to provide appropriate guidance in the future. At this point, however, the Department is aware that some financial institutions may be uncertain as to the breadth of the prohibited transaction exemptions that remain available for investment advice fiduciaries following the court’s order. The uncertainty about fiduciary obligations and the scope of exemptive relief could disrupt existing investment advice arrangements to the detriment of retirement plans, retirement investors, and financial institutions. Further, some financial institutions have devoted significant resources to comply with the BIC Exemption and the Principal Transaction Exemption and may prefer to continue to rely upon the new compliance structures.
Basics of Prohibited Transactions

Status of DOL’s Fiduciary Rules
DOL Fiduciary Rule Vacated

DOL Field Assistance Bulletin NO. 2018-02  May 7. 2018

Temporary Enforcement Policy – IRS

On March 28, 2017, the Treasury Department and the IRS issued IRS Announcement 2017-4 stating that the IRS will not apply § 4975 (which provides excise taxes relating to prohibited transactions) and related reporting obligations with respect to any transaction agreement to which the Labor Department’s temporary policy described in FAB 2017-01, or other subsequent related enforcement guidance, would apply. The Treasury Department and the IRS have confirmed that, for purposes of applying the IRS Announcement 2017-4, this FAB 2018-02 constitutes “other subsequent related enforcement guidance.”
DOL Actions – Fiduciary & Conflict of Interest Rules

**DOL’s Old Definition of Fiduciary**

1975 regulation provided for a five-part test to determine if a person was a fiduciary. Under this rule a person is a fiduciary only if he or she:

1. makes recommendations on investing in, purchasing or selling securities or other property; or gives advice as to their value;
2. on a regular basis;
3. pursuant to a mutual understanding that the advice
4. will serve as a primary basis for investment decisions; and
5. will be individualized to the particular needs of the IRA or plan.

A person who did not meet all five conditions was and is not a fiduciary. The current EBSA believes there are situations where a person should be a fiduciary even though they are not one under existing law. One example, an investment representative selling an investment product to an IRA owner making a rollover contribution is not a fiduciary since he or she most likely is not performing services on a “regular basis”. So, the new rule has been proposed with the goal to make many more individual fiduciaries.
Status of DOL’s Fiduciary Rules

New Definition of Fiduciary in effect – June 10, 2017

Extension of Transition Periods

Appellate Court Cases

5th Circuit - Fiduciary Rule Vacated

10th Circuit – Fiduciary Rule – Partially Upheld

11th Circuit - Withdrawn
Basics of Prohibited Transactions

DOL Actions – Fiduciary & Conflict of Interest Rules

- Final Regulation – Definition of Fiduciary
- Best Interest Contract Exemption
- Rollovers & Transfers
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DOL Actions – Fiduciary & Conflict of Interest Rules

DOL’s **New** Definition of Fiduciary  In effect 6-10-2017

Sec. 2510.3-21 Definition of “Fiduciary”

(A) Investment Advice. For purposes of section 3(21)(A)(ii) of the Employee Retirement Income Security act of 1974 (Act) and section 4975(e)(3)(B) of the Internal Revenue Code (Code), except as provided in paragraph (b) of this section, a person renders investment advice with respect to moneys or other property of a plan or IRA described in paragraph (f)(2) of this section if —
Basics of Prohibited Transactions

DOL Actions – Fiduciary & Conflict of Interest Rules

DOL’s **New** Definition of Fiduciary

Such person provides, directly to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner

(1) Following types of advice in exchange for a fee or other compensation, whether direct or indirect.

(i) A recommendation as to the advisability of acquiring, holding, disposing or exchanging securities or other property, including a recommendation to take a distribution of benefits or a recommendation as to the investment of securities or other property to be rolled over or otherwise distributed from the plan or IRA.

(ii) A recommendation as to the management of securities or other property, including recommendations as to the management of securities or other property to be rolled over or otherwise distributed from the plan or IRA;
DOL’s *New* Definition of Fiduciary

(iii) An appraisal. Fairness opinion, or similar statement whether verbal or written concerning the value of securities or other property if provided in connection with a specific transaction or transactions involving the acquisition, disposition, or exchange, of such securities or other property by the plan or IRA;

(iv) A recommendation of a person who is also going to receive a fee or other compensation for providing any of the types if advice described in paragraphs (i) through (iii); and
DOL’s New Definition of Fiduciary

2) Such person, either directly or indirectly (e.g., through or together with any affiliate), --

   (i) Represents or acknowledges that it is acting as a fiduciary within the meaning of the Act with respect to the advice described in paragraph (a)(1) of this section; or

   (ii) Renders the advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is individualized to, or that such advice is specifically directed to, the advice recipient for consideration in making investment or management decisions with respect to securities or other property of the plan or IRA.
Best Interest Contract Exemption (BICE)

The exemption requires Financial Institutions to acknowledge their fiduciary status and the fiduciary status of their Advisers in writing. The Financial Institution and Advisers must adhere to enforceable standards of fiduciary conduct and fair dealing with respect to their advice. In the case of IRAs and non-ERISA plans, the exemption requires that the standards be set forth in an enforceable contract with the Retirement Investor. Under the exemption’s terms, Financial Institutions are not required to enter into a contract with ERISA plan investors, but they are obligated to adhere to these same standards of fiduciary conduct, which the investors can effectively enforce pursuant to ERISA section 502(a)(2) and (3). Likewise, “Level Fee” Fiduciaries that, with their Affiliates, receive only a Level Fee in connection with advisory or investment management services, do not have to enter into a contract with Retirement Investors, but they must provide a written statement of fiduciary status, adhere to standards of fiduciary conduct, and prepare a written documentation of the reasons for the recommendation.
Basics of Prohibited Transactions

DOL Actions – Fiduciary & Conflict of Interest Rules

Best Interest Contract Exemption (BICE)

In order to protect the interests of the plan participants and beneficiaries, IRA owners and plan fiduciaries, the exemption requires the Financial Institution to acknowledge fiduciary status for itself and its Advisers. The Financial Institutions and Advisers must adhere to basic standards of impartial conduct. In particular, under this standards-based approach, the Adviser and Financial Institution must give prudent advice that is in the customer’s best interest, avoid misleading statements, and receive no more than reasonable compensation. Additionally, Financial Institutions generally must adopt policies and procedures reasonably designed to mitigate any harmful impact if conflicts of interest, and disclose basic information about their conflicts of interest and the cost of their advise.
UBIT - Real Potential For Causing Problems For An IRA Trustee

UBIT is the acronym for unrelated business income tax. An IRA trustee of a trust IRA or an IRA custodian of a self-directed IRA has the responsibility to determine if the IRA is required to file Form 990-T and pay any applicable tax liability. The title of Form 990-T is Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e)).

If an IRA holds certain IRA investments and has related income of $1,000 or more from such investments, then there is a duty to file the Form 1099-T. The fact the Form 990-T must be filed does not necessarily mean there is a tax liability. There is a tax liability only if there is taxable income from the business activity.

Code sections 511-514 (the unrelated business taxable income tax rules) were enacted in 1950 long before the IRA tax laws were enacted in 1974. The IRA laws did not set forth any discussion how the unrelated business income tax laws applied to IRAs, if at all. Therefore, the IRS adopted an administrative position to explain how the two laws interrelated. The IRS ruled there are times when an IRA or a 401(k) plan will be subject to the unrelated business income tax laws. In general, if the IRA investment is a passive investment such laws do not apply. However, if the IRA investment is an operating business or there is debt financing such laws will apply and the IRA must pay taxes on this businesses’ taxable income.
With the growth in self-directed IRAs and hard to value IRAs more questions are arising regarding the unrelated business income rules. The IRS, of course, is always looking for tax areas where it can collect additional income tax revenue.

It is the IRA trustee who must decide if an IRA has unrelated business income, if the Form 990-T must be prepared and filed and must pay any tax which is owed. The IRA trustee may ask the individual and the individual’s accountant for assistance, but the IRA trustee should have its own staff or accountant perform the required tasks. An IRA trustee should charge reasonable fees for doing these tasks.

The IRA trustee must make the determination on an annual basis whether an IRA has any unrelated business income. Often it is not clear if an IRA has unrelated business income. The IRS position is, an IRA investment activity produces unrelated business income if it meets three requirements:
1. it is a trade or business,
2. it is regularly carried on, and
3. it is not substantially related to furthering the exempt purpose of the organization.
The Internal Revenue Service has defined the owning of any active trade or business as being unrelated to the IRA’s tax exempt purpose. The following types of income when paid to an IRA will generally not be unrelated business income:

1. Dividends,
2. Interest,
3. Royalties,
4. Rent from real estate, and
5. Sales proceeds from the sale of real estate as long as the facts do not show that there is a pattern of selling real estate.

The bank as the IRA trustee is in a difficult situation because there will be times when it is not clear if there is unrelated business income so the Form 990-T must be filed.

The conservative approach for the bank/IRA trustee is to prepare the Form 990-T (or partially prepare it) and attach a note to the tax return explaining why the IRA trustee believes there is no unrelated business income and request that the IRS make the determination that no tax is owed because there is no UBIT.

Another possible course of action, have the IRA owner furnish an opinion letter from an attorney or an accountant (and acknowledged by the individual) stating the law is unclear and that if the IRS would conclude otherwise that the IRA trustee is authorized to pay from the IRA the tax liability plus any interest and penalties.
A primary purpose of an IRA or a 401(k) plan is to have the plan assets earn income. The goal is to prudently maximize earnings. The more income earned means there will be more funds to be used for retirement purposes. The IRS’ argument that an IRA which owns a business is not substantially related to furthering the exempt purpose of the IRA is not a strong argument.
This concludes this Webinar. We thank you for attending.

If you have any questions regarding the subject covered in this Webinar please feel free to

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