

Are Prohibited Transactions for Real?

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ERISA Creates the Legislation

- Basically, everything is prohibited unless an exemption applies
- ERISA describes very broad prohibited transaction rules
- Statute and Department of Labor provide exemption relief

Two Types of Prohibited Transactions

- “Party-in-Interest”
- “Self-dealing”

“Party-in-Interest Transactions”

- Section 406(a) of ERISA prohibits fiduciaries of ERISA plans from entering into certain transactions with parties in interest.
- ERISA Section 406(a) states that a fiduciary with respect to a plan shall not cause the plan to engage in a transaction if he knows or should know that such transaction constitutes a direct or indirect
 - sale or exchange, or leasing, of property between the plan and a party in interest;
 - lending of money or other extension of credit between the plan and a party in interest;

“Party-in-Interest” Transactions (cont.)

- furnishing goods, services, or facilities between the plan and a party in interest; or
- transfer to, or use by or for the benefit of, a party in interest of any assets of the plan.

No fiduciary that has authority or discretion to control or manage the assets of a plan may permit the plan to hold any employer security or employer real property if he knows or should know that holding such security or real property violates ERISA Section 407(a).

“Parties-in-Interest” Defined

- Section 3(14) of ERISA defines a party in interest to include
 - plan fiduciaries or employees of the plan
 - any person who provides services to the plan
 - an employer whose employees are covered by the plan
 - an employee organization whose members are covered by the plan
 - officers and relatives of parties-in-interest

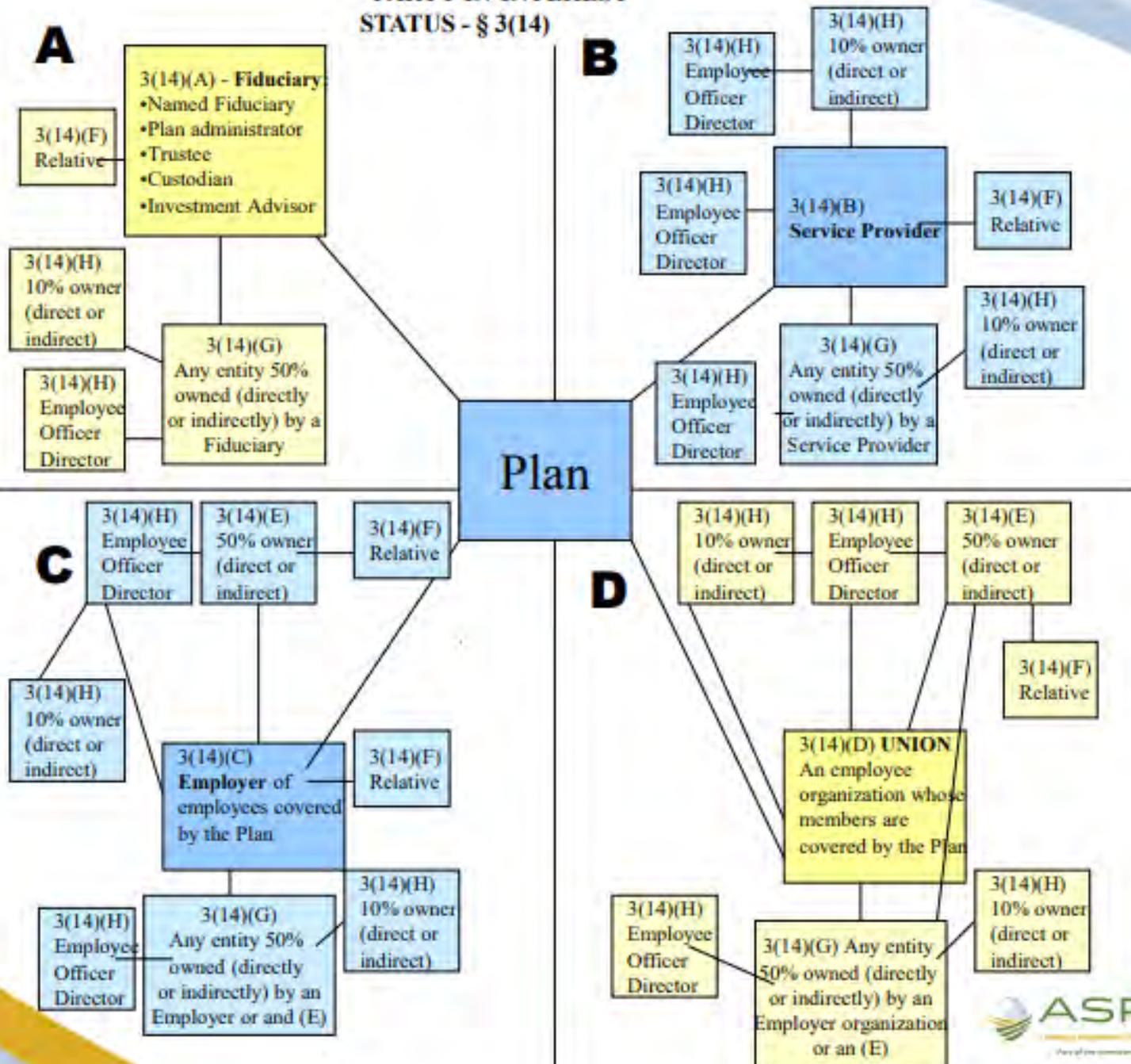
“Parties-in-Interest” Defined

- a person who owns 50 percent or more of such an employer or employee organization, or relatives of such persons just mentioned
 - (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 or 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);

ERISA 406(b) “Self-Dealing” Prohibited Transactions

- ERISA Section 406(b) prohibits fiduciaries from self-dealing in three areas. A fiduciary shall not:
 - deal with plan assets in his own interest or for his account;
 - in any capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries; or
 - receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving plan assets.
- Examples of prohibited transactions under ERISA are similar to those that would occur under the Internal Revenue Code.

**"PARTY-IN-INTEREST"
STATUS - § 3(14)**



Examples of Prohibited Transactions

- **Sale or exchange or leasing of any property**
 - *Example* - The owner decides to purchase a limited partnership interest of an investment owned by the plan. The transaction would be prohibited even if it is properly appraised or beneficial to the plan.
 - This includes direct or indirect transactions, even if the transaction is conducted under fair market value.
- **Lending money or extending credit**
 - *Example:* The plan lend money to the owner or the plan makes indirect loans to a third party to lend to the owner.
- **Use of Plan Assets by Disqualified Person**
 - *Example:* Failure to transmit participant contributions on a timely basis.
 - This is considered an indirect loan to the employer. The employer has effectively borrowed the assets from the plan which makes this a prohibited transaction.

Penalties for Prohibited Transactions

- Prohibited transactions may trigger civil monetary penalties under ERISA section 502(i)
- DOL has authority to assess a penalty against a party in interest of up to 5 percent of the amount involved for each year or part thereof during which a prohibited transaction continues.

Penalties for Prohibited Transactions

- Internal Revenue Code Section 4975 imposes a 15 percent excise tax against disqualified persons, which are substantially similar to ERISA parties in interest, who engage in prohibited transactions with qualified pension and profit sharing plan assets
- A second tier tax of 100 percent of the amount involved is imposed if the transaction is not timely corrected.
- A prohibited transaction may also violate the exclusive benefit rule in IRC section 401(a) potentially resulting in the plan trust losing its tax-exempt status.
- Therefore, disqualified persons engaged in prohibited transactions with qualified pension or profit-sharing plans are subject to the IRC section 4975 excise tax, while parties in interest that are engaged in prohibited transactions with health and welfare plans are subject to the ERISA section 502(i) civil penalty.
- File Form 5330 to pay penalty

Exempt Transactions

- ERISA section 408(a) contains specific exemptions whereby plans may engage in certain transactions with parties in interest otherwise prohibited by law.
- For example, the statutory exemptions include:
 - Loans to plan participants or beneficiaries;
 - The provision of services necessary for the operation of a plan for no more than reasonable compensation;
 - Loans to employee stock ownership plans;
 - Deposits in certain financial institutions;
 - Contracts for life insurance, health insurance, or annuities with one or more insurers;

Exempt Transactions

- Providing of any ancillary service by a bank or similar financial institution;
- exercise of a privilege to convert securities;
- Transaction between a plan and a common or collective trust fund or pooled investment fund, or transaction between a plan and a pooled investment fund of an insurance company;
- Distribution of the assets of the plan in accordance with the terms of the plan; and
- Providing certain investment advice to a participant or beneficiary of an individual account plan that permits such participant or beneficiary to direct the investment of assets in their individual account.

Class Exemptions

- Class exemptions granted by the DOL are listed on the DOL Employee Benefit Security Administration's (EBSA) website at <http://www.dol.gov/ebsa/Regs/ClassExemptions/main.html>.
 - Parties in interest to make unsecured interest-free loans to plans for plan operating expenses.
 - Various transactions involving employee benefit plans whose assets are managed by in-house managers
 - Transfer of individual life insurance policies by plans to participants, relatives of participants, plan sponsors or another plan.
 - Insurance company pooled separate accounts, in which plans invest in, to engage in certain transactions with parties in interest and to hold employer securities or employer real property.
 - Purchases and sales of open-end mutual fund shares by a plan when a plan fiduciary is also the investment adviser for the investment company marketing the mutual fund.

Reporting and Correcting Non-Exempt Transactions

- Non-exempt transactions must be reported on the Form 5500. ERISA and DOL regulations require transactions with parties in interest (excluding any transactions exempted from prohibited transaction rules) to be reported on schedules to the Form 5500 Annual Return/Report
- The failure to timely remit participant contributions must be reported on Form 5500, Schedule H and the Supplemental Schedule of Delinquent Participant Contributions. Other prohibited transactions must be disclosed on Form 5500; Schedule G. Additional disclosures may also be required in accordance with the Form 5500 instructions.
- Under ERISA section 502(c)(2), the DOL may assess a daily penalty against a plan administrator who fails or refuses to comply with the annual reporting requirements.

Prohibited Transactions Under IRC Section 4975

- IRC Section 4975 (c) states that generally a prohibited transaction is any direct or indirect
 - sale, exchange, or leasing of property between a plan and a disqualified person
 - lending of money, or extending credit between a plan and a disqualified person
 - furnishing goods, services, or facilities between a plan and a disqualified person
 - a transfer of plan income or assets to use by or for the benefit of, a disqualified person
 - act by a plan fiduciary whereby plan assets or plan income are used for his or her own interest
 - receipt for consideration by a fiduciary for his or her own personal account from any party dealing with the plan in a transaction that involves plan income or assets

Who is a Disqualified Person?

- a fiduciary of the plan
- a person providing services to the plan
- an employer, any of whose employees are covered by the plan
- an employee organization, any of whose employees are covered by the plan
- a 50 percent owner of items above
- a family member of above (family members include spouse, ancestor, lineal descendant, and any spouse of lineal descendant, but not brother or sister)
- a 50 percent or more ownership (or control) in a corporation, partnership, trust or estate owned by the above individuals
- an officer, director, or 10 percent or more shareholder, or highly compensated employee of any of the above individuals
- (l) a 10 percent or more partner or joint venture of a person described above

Bottom Line

- Entering into a prohibited transaction may result in an ERISA plan becoming disqualified
- The plan's trust loses its tax-exempt status and must file Form 1041, U.S. Income Tax Return for Estates and and pay income tax on trust earnings.
- A distribution from a plan that has been disqualified is not an eligible rollover distribution and can't be rolled over to either another eligible retirement plan or to an IRA rollover account.
- When a disqualified plan distributes benefits, they are subject to taxation.

QUESTIONS?