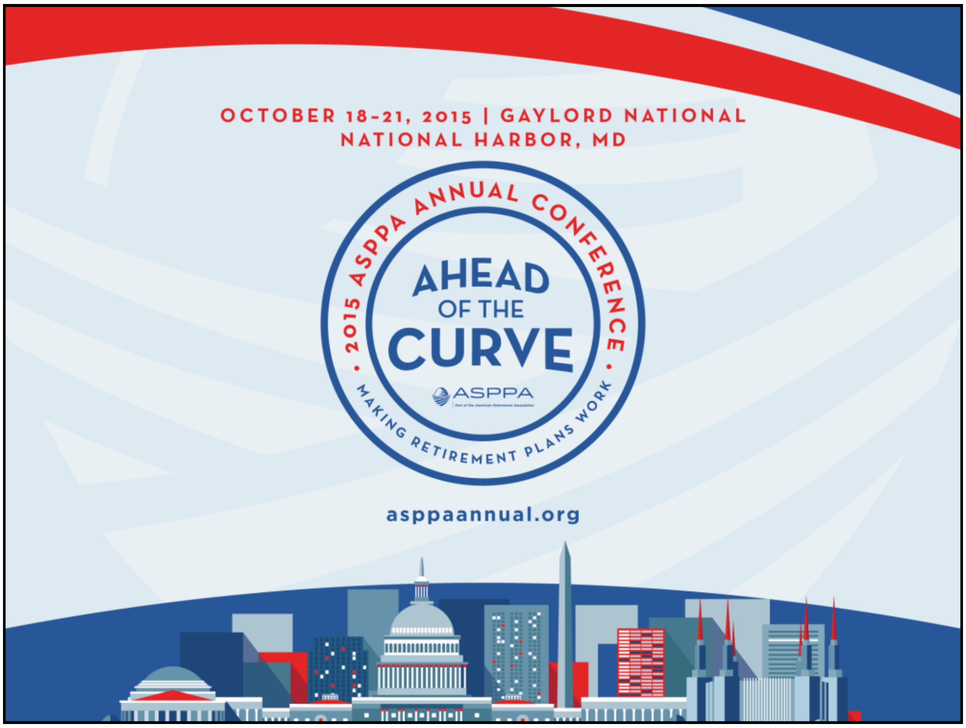

It Pays to Know Your PT Exemptions

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What Should Get From This Session?

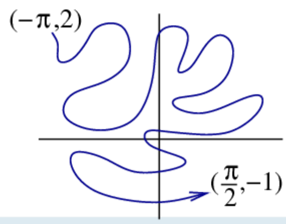
- Understanding of prohibited transaction rules
  - Who are the “bad guys”?
  - What is proscribed?
  - How do these rules work?
  - Why do we have them?
  - And what are the exemptions?
  - And what do we “pay” if we don’t abide the exemptions?

Why Do We Have PT Rules?

- Adoption of ERISA
  - Jimmy Hoffa
  - Concert with fiduciary duties
  - Both ERISA and Code

The First Step: Identification of the Proscribed Parties

- Much of the difficulty in comprehending the structure of IRS § 4975(e) [disqualified person] and ERISA § 3(14) [party in interest] is understanding the statutory subsetting of subsets of sets of implicated parties



Proscribed Parties

- IRS side vs. DOL side
  - IRS: excise tax on <u>disqualified persons</u> (IRC 4975)
  - DOL: fiduciary breach – possible sanctions against fiduciary who authorized (ERISA 406, 408)
    - <u>party-in-interest</u> is a broader definition
    - 5500 reporting uses this term

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Code Focus

- Transactions between a plan and a disqualified person

ERISA Focus

- The duty of fiduciaries not to allow a prohibited transaction to occur between a plan and a party in interest and not to engage in self-dealing

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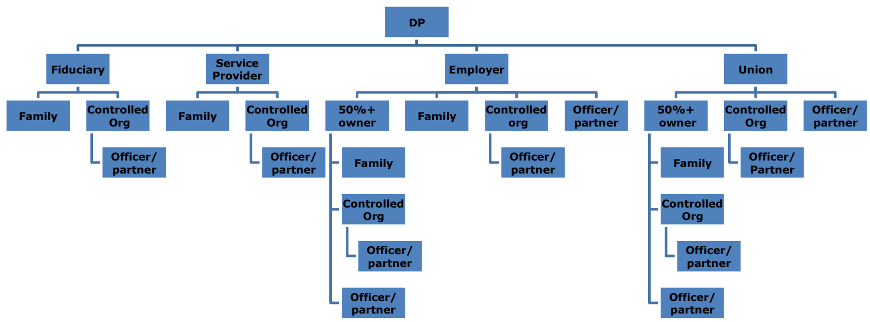
Disqualified Person



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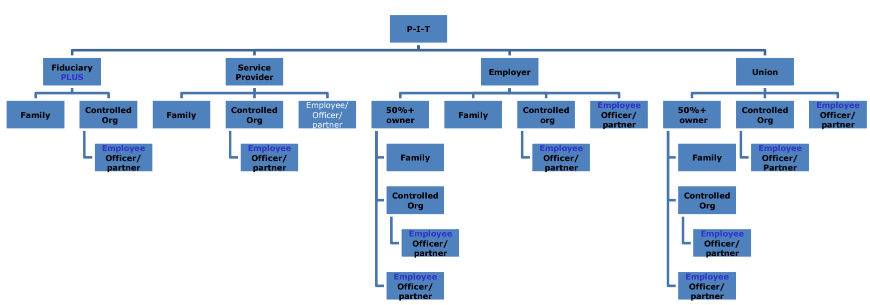
Party-in-interest



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The Second Step: Identifying Proscribed Transactions

- The general rule is very broad and may be interpreted this way:
  - In no event, either directly or indirectly, can a "bad guy" do anything with a plan or its assets

Statutes Make it Clear that There Can Be No Direct or Indirect -

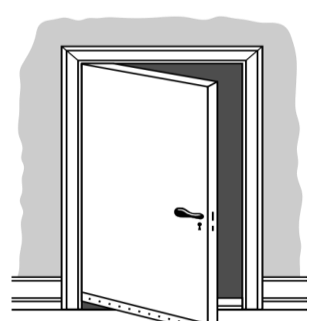
- sale, exchange or lease of property
- lending of money
- extension of credit
- furnishing of goods, services or facilities
- transfer of plan assets
- receipt of any consideration personally by a fiduciary from any party dealing with a plan
- **It could be said that ERISA plans and IRAs cannot function!**

Direct Prohibited Transactions

- Generally, once the status of the parties to a transaction as disqualified persons and/or parties in interest is established, it is relatively easy to identify a direct prohibited transaction
  - First, did any prohibited conduct occur between a “bad guy” and a plan or its assets?
  - Second, if yes, check to see if an exemption applies

Indirect Prohibited Transactions

- These are much more difficult to identify and often require a detailed determination of “bad guy” status
- Use of plan assets for the benefit, albeit indirect, of a party in interest
- Going through the back door



The Third Step: Determining if an Exemption Applies

- How does a plan function?
  - By exemption
- Exemption might be statutory, class or individual

There Are Three Categories of Exemptions

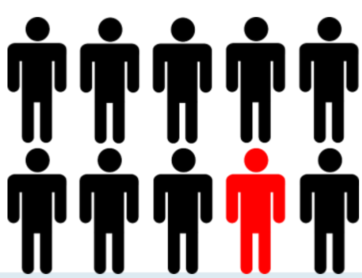
- First is Statutory
  - For Example:
    - Participant loans
    - Contracting for office space and services including, among others, legal and accounting, for reasonable compensation
    - Exempt ESOP loans

Class Exemptions

- Second category is class exemptions
  - The Secretary of Labor is authorized to grant exemptions to the PT rules for certain classes of transactions and to certain classes of otherwise proscribed parties in interest and disqualified persons

Individual Exemptions

- The third category is private exemptions
  - The Secretary of Labor can provide an exemption to a specific party in interest or disqualified person for a specific transaction



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Prohibited Transaction Statutory Exemption

Statutory exemption examples—specifically listed in ERISA—apply to a number of transactions such as those relating to:

- plan loans
- office space
- ESOP loans
- certain insurance or annuity contracts
- securities conversions
- certain aspects of multiemployer benefit plan mergers, and
- certain transfers of excess pension assets to fund retiree health liabilities

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Statutory Exemptions for Loans to Plans

- ERISA exempts any loans made by the plan to parties in interest who are participants or beneficiaries of the plan if
  - the loans are available to all participants and beneficiaries on a reasonably equivalent basis
  - are not made available to HCEs in an amount greater than made available to NHCEs
  - are made under specific provisions in the plan
  - bear a reasonable rate of interest
  - and are adequately secured

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Statutory Exemptions for Office Space

- Plans may contract with or make reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment and operation of the plan
- These contracts will not be prohibited transactions if no more than "reasonable compensation" is paid

Statutory Exemptions for ESOP Loans

- A loan to an ESOP is not a prohibited transaction if the loan is primarily for the benefit of participants and beneficiaries and bears a reasonable interest rate
- The rules are complex

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Statutory Exemptions for Bank Deposits

- Plans may hold assets in bank accounts bearing reasonable rates of interest where the bank is a plan fiduciary, if the plan covers only bank employees or affiliates, or if the plan document or named fiduciary expressly provides for the investment

Statutory Exemptions for Insurance Contracts

- Plans may contract for life insurance, health insurance, or annuities with insurers (qualified by the state), if the plan pays no more than adequate consideration and if the insurer is either the employer maintaining the plan or is a party-in-interest owned by the employer maintaining the plan
- The premiums or annuities written to the employer by the plan cannot exceed 5 percent of the total premiums and annuities written for all lines of insurance

Statutory Exemptions for Ancillary Bank Services

- A bank or financial institution that is a plan fiduciary may provide ancillary services, such as cash management programs, to the plan if the bank has adopted adequate internal safeguards
- The ancillary service must be provided through specific guidelines that preclude the bank from providing services in an excessive or unreasonable manner that is inconsistent with the best interests of plan participants and beneficiaries

Statutory Exemptions for Conversion of Securities

- A plan may exercise its privilege to "convert" securities from one type of stock to another, but only if the plan receives adequate consideration
- And uses a prudent process to establish adequate consideration

Statutory Exemptions for Common Trust Funds

- Certain plan transactions with trust funds or pooled investment funds maintained by a party in interest that is a regulated bank, trust or insurance company are exempt if:
  - the transaction is a sale or purchase of an interest in the fund;
  - the bank, trust company, or insurance company receives reasonable compensation; and
  - the transaction is expressly permitted by the plan document or by a fiduciary (other than the bank or trust company) who has the authority to manage and control plan assets

Statutory Exemption for Receipt of Benefits

- The PT rules do not prohibit a fiduciary from:
  - receiving any benefit as a participant or beneficiary in the plan, so long as the benefit is computed and paid on the same terms as the benefits of others in the plan

Statutory Exemption for Compensation

- The PT rules do not prohibit a fiduciary from:
  - receiving any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred (although reimbursement is unavailable for a person receiving full-time pay from an employer or union whose employees or members are participating in the plan)

Statutory Exemption for Wearing Two Hats

- The PT rules do not prohibit a fiduciary from:
  - serving as a fiduciary in addition to being an officer, employee, agent, or representative of a party in interest

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Statutory Exemptions for Termination Distribution

- A transaction is not prohibited where a plan fiduciary distributes the assets of a terminated plan in accordance with the terms of the plan as long as the assets are allocated according to ERISA rules

PPA Additional Statutory Exemptions

- Block Trading
- Cross Trading
- Foreign Exchange Transactions
  - All with complex requirements

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No Statutory Exemptions for Owner-Employees

- Statutory exemptions do not exist for owner-employees and shareholder-employees who take plan loans, receive compensation from the plan for services rendered, or buy property from or sell it to the plan

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Prohibited Transaction Class Exemptions

- The DOL provides prohibited transaction exemptions to “classes” of transactions, as long as members of the class meet prescribed conditions

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Particular Industries are Targeted in Some Class Exemptions

- For example:
  - securities industries (Prohibited Transaction Exemptions 75-1 and 86-128)
  - plan investment in mutual funds (PTEs 77-3 and 77-4)
  - plan investments in insurance company products (PTEs 81-82 and 90-1)
  - collective investment funds maintained by banks (PTE 80-51)
  - individual account plan investments in real estate investment trusts (REITs) that operate in business trust form (PTE 2004–07)

Certain Types of Transactions are Treated as Class Exempt

- Plan purchases of employer customer notes (PTEs 79-9 and 85-68)
- The use of proceeds from the sale of securities to reduce or retire debt (PTE 80-83)
- Securities lending (PTEs 81-6 and 82-63)
- Short-term investments (PTE 81-8)
- Investments in mortgages or mortgage pools (PTEs 83-1 and 88-59)
- Service provider offering additional services to plans for extra commission (PTE 84-24
- Release of claims and extensions of credit in connection with litigation (PTE 2003–39)

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Some Special Items are Class Exempt

- Multiemployer plans (PTEs 76-1, 77-10, and 78-5)
- Large plan investment using qualified professional asset managers (PTE 84-14)

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The Proposed "Advice" Regulation Amends Certain PTEs

- PTEs 75-1, 77-4, 80-83, 83-1, 84-24 and 86-128

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Limited Relief Offered by Class Exemptions

- The relief offered by class exemptions is limited to the transaction described in the exemption and is available only when certain conditions are met

Individual Exemption

- While a class exemption applies to any party in interest within the class, individual exemptions apply only to the specific party in interest named or defined in the exemption
- Either the plan or the party in interest may apply for exemptions
- Difficult standards

Additional Requirements for Individual Exemptions

- In addition to typical identifying information, the applicant must advise the DOL:
  - whether the transaction has been made or will be made only if the exemption is granted;
  - if the transaction already has been made, the circumstances which resulted in plan fiduciaries causing the plan to enter the transaction without an exemption, whether the transaction has been terminated, whether it has been corrected, whether IRS Form 5330, Return of Excise Taxes Related To Employee Benefit Plans, has been filed with IRS and whether any excise taxes have been paid

More Additional Requirements

- the name of every person with investment discretion over plan assets involved in the transaction, and their relationships to the party in interest requesting the transaction;
- whether the plan assets are invested in loans, leases, or employer securities to the parties in interest, identifying the type of investment, aggregate fair market value, percentage of plan's investment in this type, and any statutory or administrative exemptions covering these investments

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And Still More Additional Requirements

- the approximate aggregate fair market value of the total assets of each affected plan;
- the person who will bear the costs of the exemption application and of notifying interested persons; and
- whether an independent fiduciary will be involved in the transaction and, if so, who will pay the fee to the fiduciary

EXPRO

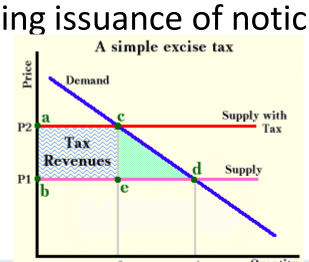
- In 2002, DOL began a program to expedite filings for individual prohibited transaction exemptions
- EXPRO allows applicants for individual exemptions to cite either 2 individual exemptions granted by DOL within the past 5 years that are substantially similar to the applicant's situation, or 1 individual exemption that has been granted within the past 10 years plus 1 exemption that has been "authorized" under EXPRO within the past five years
- This can then lead to an expedited determination and grant of an individual exemption

EXPRO Listing

- DOL maintains a list of EXPRO exemptions at http://www.dol.gov/ebsa/regs/expro_exemptions.html
- The DOL web-based locator index to individual exemptions that DOL has granted since 1996 can be found at http://www.dol.gov/ebsa/regs/masterindex.html, and is updated periodically

The Excise Tax

- One of the main purposes of the prohibited transactions excise tax is to bring about the correction of the transaction
- Two-tiered and pyramided excise tax
  - 15% per year until corrected - pyramid
  - 100% following issuance of notice of deficiency



First Tier Tax

- 15% of the amount involved in the transaction
- Imposed for each year or portion thereof that is within the taxable period
  - The taxable period begins on the date of the prohibited transaction and ends on the earlier of:
    - the date the notice of deficiency is mailed;
    - the date when the prohibited transaction was completely corrected; or
    - the date when the initial tax was assessed

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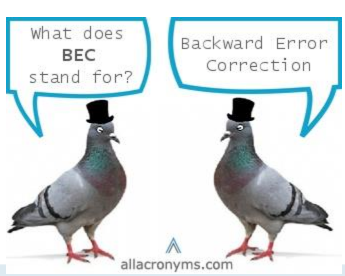
Second Tier Tax

- The second excise tax is 100% of the amount involved in the prohibited transaction
  - It will be imposed only if the prohibited transaction is not corrected within a specified time (the "correction period")



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Imposing The Excise Tax

- The imposition of the 15% and 100% excise taxes is based on the amount involved in each prohibited transaction
- Only imposed on the disqualified person

Amount Involved

- Generally, the amount involved in a prohibited transaction is the greater of:
  - the amount of money and the fair market value of property given by a disqualified person; or
  - the amount of money and the fair market value of property received by the disqualified person

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Loan Amount Involved

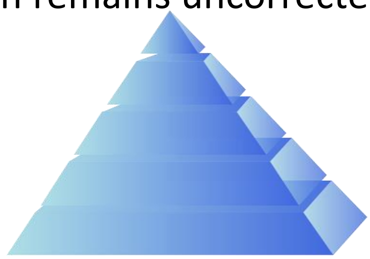
- In the case of a loan that is a prohibited transaction, the amount involved is the greater of the amount paid for such use (the interest rate on the loan) or the fair market value of such use (the going interest rate) for the period which the money is used
- The amount involved in a prohibited lending transaction is based on the interest, not the principal

Correction Values

- For purposes of the 15% tax, property is valued as of the date of the transaction
- In the case of the 100% tax, the value of property will be the highest market value during the "taxable period"

Pyramid

- Continuing prohibited transactions, such as leases or loans, will be treated as separate events, and are subject to the excise tax for each additional tax year in which the transaction remains uncorrected



Reporting The Excise Tax

- Every disqualified person who is liable for the initial 15% excise tax on prohibited transactions is required to report the transactions that are subject to the tax on Form 5330
  – The form must be filed with respect to each prohibited transaction and for each taxable year (or part thereof) of the disqualified person that falls within the taxable period beginning on the date that the prohibited transaction occurred
  – The prohibited transactions excise taxes are due on the last day of the 7th month after the end of the tax year of the filer

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Statute of Limitations

- Filing of Form 5500 starts running of the statute of limitations
- Form 5330 is filed to pay the taxes, but does not start the running of the statute of limitations

Thanks for Your Attention

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