FAQs REGARDING PLAN INVESTMENTS

These frequently asked questions and answers are provided for general information only and should not be cited as any type of legal authority. They are designed to provide the user with information required to respond to general inquiries. Due to the uniqueness and complexities of Federal tax law, it is imperative to ensure a full understanding of the specific question presented, and to perform the requisite research to ensure a correct response is provided.

1. **Are there special limits on the type of investments available to retirement plans?**
2. **What is a prohibited transaction?**
3. **What is a disqualified person for purposes of the prohibited transaction rules?**
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5. **How is a prohibited transaction corrected?**
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1. Are there special limits on the type of investments available to retirement plans?

Although there is no list of approved investments for retirement plans, there are special rules contained in the Employee Retirement Income Security Act of 1974 (ERISA) that apply to retirement plan investments. In general, a plan sponsor or plan administrator of a qualified plan who acts in a fiduciary capacity is required, in investing plan assets, to exercise the judgment that a prudent investor would use in investing for his or her own retirement. (ERISA § 404) In addition, certain rules apply to specific plan types. For example, there are different limits on the amount of employer stock and employer real property that a qualified plan can hold, depending on whether the plan is a defined benefit plan, a 401(k) plan, or another kind of qualified plan. (ERISA §407) Certain plans, such as 401(k) plans, that permit participant-directed investment can avoid some fiduciary responsibilities if participants are offered at least three diversified options for investment, each with different risk/return factors. (Labor Reg. §2550.404c-1)

In addition, under the Code, both participant-directed accounts and IRAs cannot invest in collectibles, such as art, antiques, gems, coins, or alcoholic beverages, and they can invest in certain precious metals only if they meet specific requirements. (Code §408(m))

Individual retirement accounts also are not permitted to invest in life insurance. (Code §408(a)(3))

Finally, certain transactions between a plan and a “disqualified person” are specifically prohibited by law; see Q&A-2. Similar rules apply to transactions between an IRA and its owner or beneficiary or between an IRA and a “disqualified person”.

2. What is a prohibited transaction?

A prohibited transaction is a transaction between a plan and a disqualified person that is prohibited by law.

Prohibited transactions generally include the following transactions: a transfer of plan income or assets to, or use of them by or for the benefit of, a disqualified person; any act of a fiduciary by which plan income or assets are used for his or her own interest; the receipt of consideration by a fiduciary for his or her own account from any party dealing with the plan in a transaction that involves plan income or assets; the sale, exchange, or lease of property between a plan and a disqualified person; lending money or extending credit between a plan and a disqualified person; and furnishing goods, services, or facilities between a plan and a disqualified person.

Certain transactions are exempt from being treated as prohibited transactions. For example, a prohibited transaction does not take place if a disqualified person receives a benefit to which he or she is entitled as a plan participant or beneficiary. However, the benefit must be figured and paid under the same terms as for all other participants and beneficiaries.

The Department of Labor (DOL) has granted class exemptions for certain types of investments under conditions that protect the safety and security of the plan assets. In addition, a plan sponsor may apply to the DOL to obtain an administrative exemption for a particular proposed transaction that would otherwise be a prohibited transaction.

3. What is a disqualified person for purposes of the prohibited transaction rules?

A disqualified person is any of the following:

(1) A fiduciary of the plan;
(2) A person providing services to the plan;
(3) An employer, any of whose employees are covered by the plan;
(4) An employee organization, any of whose members are covered by the plan;
(5) Any direct or indirect owner of 50% or more of any of the following: 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 that is an employer or employee organization described in (3) or (4); the capital interest or profits interest of a partnership that is an employer or employee organization described in (3) or (4); or the beneficial interest of a trust or unincorporated enterprise that is an employer or an employee organization described in (3) or (4);
(6) A member of the family of any individual described in (1), (2), (3), or (4) (i.e., the individual's spouse, ancestor, lineal descendant, or any spouse of a lineal descendant);
(7) A corporation, partnership, trust, or estate of which (or in which) any direct or indirect owner described in (1) through (5) holds 50% or more of any of the following: 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; the capital interest or profits interest of a partnership; or the beneficial interest of a trust or estate;
(8) An officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10% or more shareholder, or highly compensated employee (earning 10% or more of the yearly wages of an employer) of a person described in (3), (4), (5), or (7);
(9) A 10% or more (in capital or profits) partner or joint venture of a person described in (3), (4), (5), or (7); or
(10) Any disqualified person, as described in (1) through (9) above, who is a disqualified person with respect to any plan to which a multiemployer plan trust is permitted to make payments under section 4223 of ERISA.

4. What are the consequences of participating in a prohibited transaction?

A disqualified person who takes part in a prohibited transaction must correct the transaction and must pay an excise tax based on the amount involved in the transaction. The initial tax on a prohibited transaction is 15% of the amount involved for each year (or part of a year) in the taxable period. If the transaction is not corrected within the taxable period, an additional tax of 100% of the amount involved is imposed. Both taxes are payable by any disqualified person who participated in the transaction (other than a fiduciary acting only as such). If more than one person takes part in the transaction, each person can be jointly and severally liable for the entire tax.

The amount involved in a prohibited transaction is the greater of the following amounts: the money and fair market value of any property given; and the money and fair market value of any property received.
If services are performed, the amount involved is any excess compensation given or received. The taxable period starts on the transaction date and ends on the earliest of the following days: the day the IRS mails a notice of deficiency for the tax; the day the IRS assesses the tax; and the day the correction of the transaction is completed. The tax is paid with Form 5330.

5. How is a prohibited transaction corrected?

A disqualified person who participated in a prohibited transaction can avoid the 100% tax by correcting the transaction as soon as possible. Correcting the transaction means undoing it as much as possible without putting the plan in a worse financial position than if the disqualified person had acted under the highest fiduciary standards.

If the prohibited transaction is not corrected during the taxable period, the disqualified person usually has an additional 90 days after the day the IRS mails a notice of deficiency for the 100% tax to correct the transaction. This correction period (the taxable period plus the 90 days) can be extended if either of the following occurs: the IRS grants reasonable time needed to correct the transaction; or the disqualified person petitions the Tax Court.

If the transaction is corrected within this period, the IRS will abate, credit, or refund the 100% tax.

6. How do the prohibited transactions rules apply to IRAs?

A prohibited transaction with respect to an IRA occurs if the owner or beneficiary of the IRA engages in any of the transactions described in Q&A-2. However, in this case, with an individual retirement account, instead of imposing an excise tax on the parties to the transaction, the Code provides that the account is no longer an individual retirement account, and it is treated as if the assets were distributed on the first day of the taxable year in which the prohibited transaction occurred. (Code §408(e)(2))

A prohibited transaction can also occur between an IRA and a disqualified person other than the IRA owner or beneficiary, such as a relative of the owner or beneficiary or a fiduciary. If a prohibited transaction with respect to an IRA involves a disqualified person other than the IRA owner or beneficiary, then that other person is subject to the prohibited transactions excise tax.