What are Prohibited Transactions in Retirement Plans?

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When the Employee Retirement Income Security Act (ERISA) was enacted in 1974 the main purpose was to ensure that plan assets were not mismanaged and participants would receive promised benefits. The basic concept was that every transaction is prohibited unless the transaction meets one of the few exemptions. Over the years there has been more and more guidance from the Department of Labor as well as changes in the ERISA statutory language to help determine what transactions receives exemptive relief. If the transaction does not meet one of the exemptions, then it can result in excise taxes or breach of fiduciary duties and could lead to disqualification of the plan if it is also in violation of the exclusive benefit rule.

So, what exactly is a prohibited transaction? In order to answer that question, we have to determine who a party-in- interest/disqualified person may be. A person is a party-in-interest or disqualified person if they are:

- Named Fiduciary
- Employees of the Plan
- Plan administrator
- Service Provider (including Third Party Administrators and Plan Auditors)
- Trustee
- Custodian
- Investment Advisor/Managers
- Legal Counsel
- Owner(s)
- Family member of one of the above
- Officers, Directors, Highly Compensated Employee

A transaction between the qualified plan and anyone listed above is considered a prohibited transaction unless there is a statutory exemption allowing for the transaction to occur.

For example, the plan may not sell, exchange or lease property to a disqualified person, nor may a disqualified person sell, exchange or lease property to the plan. This includes direct or indirect transactions such as, a sale of property by the plan to a nonrelated person, who in turn sells the property to a disqualified person. A sale, exchange or lease between the plan and a disqualified person is a prohibited transaction, even if the sale is for fair market value or the lease is for fair rental value.

The plan may not lend money or otherwise extend credit to a party-in-interest, nor may a party-in-interest loan money or otherwise extend credit to the plan. This includes direct or indirect transactions.

What about investments (i.e., sales and purchases of securities, mutual fund shares, insurance contracts and the like)? If an investment trade involves the plan and a disqualified person, it could be a prohibited transaction. Even if the participant directs the investments in a self-directed brokerage account. Those transactions can also be subject to prohibited transaction rules.

One of the statutory exemptions involves Employer Securities. A company may contribute employer securities or purchase employer securities from a party-in-interest without it being prohibited under limited circumstances. The sale of qualifying employer securities to or from the plan, and the leasing of qualifying employer real property by the plan are also not considered prohibited transaction under a different exemption.

A qualified plan may also purchase life insurance. The plan may sell a life insurance policy or individual annuity contract to the individual participant, relative of the insured participant, employer or another employee benefit plan. The exemption is not available unless the plan is going to surrender the policy if it is not purchased under the exemption.

Participant loans are allowed because the participant receiving the loan is doing so in the capacity as a plan participant, if certain conditions are met. The plan document will specify the conditions in order to meet this exemption.

So, what happens if a prohibited transaction occurs? A fiduciary is personally liable for any losses to plan arising from the violation. Profit earned by a fiduciary in connection with violation will be subject to excise taxes owed to IRS. The excise tax may be 15% of the amount involved per year up to 100% of the amount involved. Even if the prohibited transaction is done by another fiduciary all fiduciaries may be liable for the action if they participate in another fiduciary's breach or have knowledge of a breach by another fiduciary and fail to take reasonable steps to remedy it. The fiduciary must make good any losses to the plan, restore any profits earned by the fiduciary through the use of plan assets or any other equitable or remedial relief as a "court may deem appropriate, including removal of such fiduciary". This can be a very serious issue for a qualified plan. The solution is to hire providers that are well versed in prohibited transactions so they can help you keep your plan in compliance. If you are thinking about executing a transaction that you are not sure is exempt, you should consult with qualified service providers.

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