Prohibited Transactions

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A prohibited transaction is a transaction between a plan and a disqualified person that is prohibited by law. That Law is primarily **26 USC 4975**.

That is the primary focus of this white paper, but it also covers **26 USC 408** and **Plan Asset Rules**.

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Prohibited Transactions

Prohibited transactions include the following:

(1) A transfer of plan income or assets to, or use of them by or for the benefit of, a disqualified person

(2) Any act of a fiduciary by which he or she deals with plan income or assets in his or her own interest

(3) 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

(4) Any of the following acts between the plan and a disqualified person: selling, exchanging or leasing property; lending money or extending credit; or furnishing goods, services or facilities

Due Diligence

Before making any investment decision, please consult with legal, tax and accounting professionals.

Disqualified persons include 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 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 as described above, the capital interest or profits interest of a partnership that is an employer or employee organization as described above, or the beneficial interest of a trust or unincorporated enterprise that is an employer or employee organization as described above

(6) A family member of any individual described above, defined as a spouse, ancestor (or lineal antecedent, which would be a mother, father, grandparent, great-grandparent and so on forever), lineal descendant (daughter, son, grandchild, great-grandchild and so on forever) or any spouse of a lineal descendant

(7) A corporation, limited partnership, trust or estate of which, or in which, any direct or indirect owner as described above holds 50% or more of the following: the combined voting power of all classes of stock entitled to vote or the total value of the shares of all classes of stock of a corporation, the capital interest or profits of a limited 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 above

(9) A 10% or more in capital or profits partner or joint venturer of a person described above

Regarding the **consequences** of prohibited transactions, the tax 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% is imposed. Both taxes are payable by any disqualified person who participated in the transaction. If more than one disqualified person takes part in the transaction, each person can be held jointly and severally liable for the entire tax.

The amount involved is the greater of 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 begins on the date the prohibited transaction occurs and ends on the earliest of the following:

(1) The date the IRS mails a notice of deficiency for the tax
(2) The date the IRS assesses the tax
(3) The date the correction of the transaction is completed

Correcting a Prohibited Transaction

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

If the prohibited transaction is not corrected during the taxable period, you usually have an additional 90 days following the day the IRS mails a notice of deficiency for the 100% tax to correct the transaction. This period can be extended if the IRS grants reasonable time needed to correct the transaction *or* you petition the Tax Court.

26 USC 408 (e)(2) provides that where a prohibited transaction is entered into by an account owner or a beneficiary, the IRS does not impose the excise tax but instead disqualifies the account and treats the assets of the account as if they had been distributed as of the first day of the year in which the prohibited transaction occurred.

For a Traditional IRA, the result is the entire amount is immediately taxable as ordinary income and, if the owner is under 59 1/2, the early withdrawal penalty of 10% applies.

If the prohibited transaction is performed by a disqualified person other than the account owner or a beneficiary, that disqualified person is subject to and liable for the 15% excise tax for each year or part of a year during the taxable period. That person may also be liable for the 100% if the IRS deems the person to be recalcitrant.

Plan Asset Rules

IRAs and other retirement plans are a major source of capital for private equity funds and other pooled investment vehicles. If investments by retirement plans exceed 25% of the fund, all of the fund assets can be deemed assets of the plans.

If all of the fund assets are deemed "plan assets," the law requires that fund managers manage in a way that avoids prohibited transactions and complies with ERISA fiduciary standards of conduct.

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