

U.S. Department of Labor

Pension and Welfare Benefits Administration
Washington, D.C. 20210



DEC 16 1993

93-33a
INTERNAL REVENUE CODE
4975(c)(1)

Mr. Roberto Faith
1101 S.W. 102 Court
Miami, Florida 33174

Dear Mr. Faith:

Your letter to the Internal Revenue Service (the Service) has been forwarded to this Office for our consideration and response with respect to the first of the two rulings you requested. You request guidance concerning the application of the prohibited transaction provisions of the Internal Revenue Code (the Code) to a proposed purchase and lease-back of a tax-exempt school's land and building by a self-directed Individual Retirement Account (the IRA). Specifically, you ask whether the purchase and lease-back of the school would result in a prohibited transaction under section 4975 of the Code, and if so, whether the prohibited transaction would result in a deemed distribution from the IRA under section 408(e)(2) of the Code.

You represent that you have discretionary control over the IRA's assets. You propose to cause the IRA to purchase the land and building of Harkness Road High School Ltd. (the School), a high school founded by your daughter and son-in-law, who are the sole directors and officers of the School. The purchase would be made at fair market value. Subsequently, the IRA would lease the land and building to the School at a fair-market rent or below market rent, depending on the School's ability to pay.

Pursuant to regulations promulgated by the Department of Labor (the Department), at 29 C.F.R. §2510.3-2(d), an IRA as described in the regulation is not an employee pension benefit plan. The Department does not have jurisdiction under Title I of the Employee Retirement Security Act of 1974 (ERISA) over IRAs that are not employee pension plans.¹

Nevertheless, under Presidential Reorganization Plan No. 4 of 1978, effective December 31, 1978, the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Code has been transferred, with certain exceptions such as section 4975(c)(3) of the Code, to the Secretary of Labor.

The Department's authority to issue interpretations involving certain prohibited transaction provisions of section 4975 of the Code extends to transactions involving individual retirement accounts which are not plans and over which the Department would not normally have any jurisdiction. The Department, therefore, can address your first inquiry concerning the purchase and lease-back regardless of whether your IRA is a plan under ERISA. While your second inquiry, which asks whether the purchase and lease-back would result in a deemed distribution, turns on the resolution of the prohibited transaction inquiry, it involves a section of the Code over which the Department has no jurisdiction. Accordingly, we are referring this part of your request back to the Service for their response.

¹ You have not indicated whether the IRA is an "employee pension benefit plan" within the meaning of section 3(2) of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). To the extent there is also Title I jurisdiction over the IRA, the fiduciary provisions of Title I would apply and references to the Code in this letter should be deemed to also refer to the corresponding sections of ERISA.

The Code prohibits certain transactions between a plan and a disqualified person with respect to the plan. Code section 4975(e)(1) defines a plan to include an IRA described in Code section 408(a). Code section 4975(a) imposes a tax on each prohibited transaction as that term is defined in section 4975(c). Specifically, section 4975(c)(1) prohibits any direct or indirect sale or exchange, or leasing, of any property between a plan and a disqualified person (4975(c)(1)(A)); any lending of money or other extension of credit between a plan and a disqualified person (4975(c)(1)(B)); any transfer to, or use by or for the benefit, of a disqualified person of the income or assets of a plan (4975(c)(1)(D)); and any act by a disqualified person who is a fiduciary whereby he or she deals with the income or assets of a plan in the fiduciary's own interest or for his or her own account (4975(c)(1)(E)).

Section 4975(e)(2)(A) defines the term "disqualified person" to include a plan fiduciary. Section 4975(e)(3)(A) of the Code defines the term "fiduciary," in part, to include any person who exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control regarding management or disposition of its assets. As a person with investment discretion over the assets in the IRA, you are a fiduciary with respect to the IRA, and, therefore, a disqualified person under section 4975(e)(2) of the Code.

Section 4975(e)(2)(F) of the Code defines a "disqualified person" to include a family member of a plan fiduciary. Section 4975(e)(6) defines a family member to include a lineal descendant and any spouse of a lineal descendant. Therefore, your daughter and son-in-law would be disqualified persons with respect to the plan. Accordingly, the sale and lease-back arrangement, described above, between the plan and the School would constitute a use of plan assets for the benefit of disqualified persons in violation of section 4975(c)(1)(D) of the Code.²

Moreover, it is the view of the Department that violations of sections 4975(c)(1)(D) and (E) would occur if a transaction were part of an agreement, arrangement or understanding in which the fiduciary caused plan assets to be used in a manner designed to benefit any person in whom such fiduciary had an interest that would affect the exercise of his or her best judgement as a fiduciary. For example, Treasury Regulation § 54.4975-6(a)(6), Example (6), illustrates that where F, a fiduciary of plan P with discretionary authority respecting the management of P, retains S, the son of F, to provide services necessary to the operation of the plan for a fee, F has engaged in an act described in section 4975(c)(1)(E), because S is a person in whom F has an interest that may affect the exercise of F's best judgment as a fiduciary. Therefore, if you, as fiduciary of the IRA, were to purchase the School property at fair-market value pursuant to an arrangement to lease it back to the School at a rent that is dependent on the School's ability to pay in order to benefit your daughter and son-in-law, the transaction would violate Code section 4975(c)(1)(D) and (E).

The Department notes that section 4975(c)(3) of the Code, over which the Secretary of the Treasury retains jurisdiction to issue interpretations, provides, in part, for an exemption from the excise tax on prohibited transactions that would otherwise be imposed if the account ceases to be an individual retirement account by reason of the application of section 408(e)(2)(A) of the Code and is treated as distributing all its assets. However, because the Service retains jurisdiction to issue interpretations concerning section 4975(c)(3) of the Code, we are referring this portion of your inquiry back to the Service.

Finally, to the extent that the IRA is an employee pension benefit plan covered by Title I of ERISA, it should be noted that the Department has consistently taken the position that, to act prudently under ERISA, a plan fiduciary must consider, among other factors, the availability, risk, and potential return of alternative investments for the plan. Because the purchase of the School would be an investment selected in preference to alternative investments, the purchase would not be prudent if it provided the IRA with less return, in comparison to risk, than comparable

² You have not provided facts in your submission concerning ownership interests in the School. In consequence, this opinion does not address how Code section 4975 would apply if your daughter or son-in-law had any ownership interest in the School.

investments available to the plan, or if it involved a greater risk to the security of plan assets than other investments offering a similar return. Similarly, the Department construes the requirements that a fiduciary act solely in the interest, and for the exclusive purpose, of providing benefits to participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. In this regard, a decision to cause an IRA to purchase a property at fair-market value pursuant to an arrangement to lease the property to the seller at a rent that is dependent on the seller's ability to pay would be difficult to reconcile with the prudent person rule under ERISA.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 (41 Fed. Reg. 36281, Aug. 27, 1976). Section 10 of the Procedure explains the effect of advisory opinions.

Sincerely,

ROBERT J. DOYLE
Director of Regulations and Interpretations