Advisory Opinion

January 6, 2006
Debra C. Buchanan, Esq.
Guidant Legal Group, PLLC
225 Commerce Street, Suite 450
Tacoma, WA 98402

2006-01A
ERISA Sec. 29 CFR 2509.75-2

Dear Ms. Buchanan,

This is in response to your request for an advisory opinion as to whether the following proposed transaction would be prohibited under section 4975 of the Internal Revenue Code (the "Code"), 26 U.S.C. § 4975.[1]

You represent that Salon Services and Supplies, Inc. is a Washington state "S" Corporation ("S Company") which is 68% owned by Miles and Sydney Berry, a marital community (M). The other 32% is owned by a third-party, George Learned ("G"). Miles Berry (Berry) proposes to create a limited liability corporation ("LLC") that will purchase land, build a warehouse and lease the property to S Company. The investors in the LLC would be Berry's individual retirement account ("IRA") (49%), Robert Payne's ("R") IRA (31%) and G (20%). R is the comptroller of S Company. R and G will manage the LLC. You represent that S Company is a disqualified person with respect to Berry's IRA under section 4975(e)(2) of the Code. You represent that R and G are independent of Berry. You also represent that the LLC does not contain plan assets because it is a "real estate operating company" (REOC) as defined by 29 C.F.R. § 2510.3-101(e).

You state that an independent qualified commercial real estate appraiser has appraised the rental value of the lease and has found that the terms of the lease are not less favorable to the LLC and its IRA investors than those obtainable in an arm's length transaction between unrelated parties. Finally, the custodian for Berry's and R's IRAs has reviewed the LLC operating agreement and has approved the investment for those two self-directed IRAs.

Section 4975(c)(1)(A) of the Code prohibits any direct or indirect sale, exchange or leasing of any property between a plan and a "disqualified person." Section 4975(c)(1)(D) of the Code prohibits any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan. A "disqualified person" is defined under section 4975(e)(2)(A) of the Code to include a person who is a fiduciary. Code section 4975(e)(3) defines the term "fiduciary" to include, in pertinent part, any person who exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets. Section 4975(c)(1)(E) prohibits a fiduciary from dealing with the income or assets of a plan in the fiduciary's own interest or for his or her own account. Section 4975(e)(1)(B) of the Code defines the term "plan" to include an individual retirement account described in Code section 408(a).

We first address the proposed lease as it relates to Berry's IRA. Berry is a fiduciary to his own IRA because he exercises authority or control over its assets and management. 26 U.S.C. § 4975(e)(3). As a fiduciary, Berry is a disqualified person under section 4975(e)(2)(A) of the Code. You represent that S Company is a disqualified person under section 4975(e)(2) of the Code. R, the comptroller of S Company, is a disqualified person with respect to Berry's IRA under section 4975(e)(2)(H) as an officer of S Company. R, as an employee of S Company, a company 68% owned by M, cannot be considered independent of Berry.

Based upon your representations, it is the opinion of the Department that a lease of property between the LLC and S Company would be a prohibited transaction under Code section 4975, at least as to Berry's IRA. The lease constitutes a prohibited transaction regardless of whether the LLC qualifies as a REOC under the Department's plan assets regulation. 29 C.F.R. § 2510.3-101.

The Department's regulation at 29 C.F.R. § 2509.75-2(a) (Interpretative Bulletin 75-2), explains that a transaction between a party in interest under ERISA[2] (or disqualified person under the Code, in this case S Company) and a corporation in which a plan has invested (i.e., the LLC) does not generally give rise to a prohibited transaction. However, in some cases it can give rise to a prohibited transaction. Regulation section 2509.75-2(c) and Department opinions interpreting it have made clear that a prohibited transaction occurs when a plan invests in a corporation as part of an arrangement or understanding under which it is expected that the corporation will engage in a transaction with a party in interest (or disqualified person).[3]

According to your representations, it appears that Berry's IRA will invest in the LLC under an arrangement or understanding that anticipates that the LLC will engage in a lease with S Company, a disqualified person. Therefore, the lease would amount to a transaction between Berry's IRA and S Company that Code section 4975(c)(1)(A) and (D) prohibits. Additionally, the proposed lease, if consummated, may also constitute a violation by Berry, a fiduciary, of Code section 4975(c)(1)(D) and (E).

Finally, we note the express emphasis in 29 C.F.R. § 2509.75-2(c) that the Department considers "a fiduciary who makes or retains an investment in a corporation or partnership for the purpose of avoiding the application of the fiduciary responsibility provisions of the Act to be in contravention of the provisions of section 404(a) of the Act."

Thus, the proposed lease, which would violate section 4975(c)(1) of the Code, would also have to be referred to the Internal Revenue Service for a determination as to whether it would consider the transaction a violation of the exclusive benefit rule of section 401(a)(2) of the Code, which is the Code's analogue to the fiduciary responsibility provisions of section 404(a) of ERISA.

Because we have concluded that the proposed lease would constitute a prohibited transaction with respect to Berry's IRA, the issue of whether the Code prohibits the lease as it relates to R's IRA is moot, and does not need to be addressed.

This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (1976). Accordingly, this letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,
Louis J. Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Footnotes

1. Under Reorganization Plan No. 4 of 1978, effective December 31, 1978 [5 U.S.C. App. at 214 (2000 ed.)], the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Code was transferred, with certain exceptions not here relevant, to the Secretary of Labor. As a result, citations to section 406 of the Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1001 et seq. and applicable regulations also refer to the parallel citations of section 4975 of the Code.

2. Section 3(14) of ERISA defines the term "party in interest" for purposes of Title I of ERISA, including the prohibited transaction provisions of ERISA section 406.

3. *See* 29 C.F.R. § 2509.75-2(c); Opinion No. 75-103 (Oct. 22, 1975); 1978 WL 170764 (June 13, 1978). Further, prior to the promulgation of the Department's plan assets regulation, 29 C.F.R. § 2510.3-101, the Department had issued Interpretive Bulletin 75-2 which discusses certain prohibited transactions under section 406 of ERISA or section 4975 or the Code. As indicated in the preamble to the plan assets regulation, part of Interpretive Bulletin 75-2 was revised to coordinate it with the final regulation (51 Fed. Reg. 41278). The remainder of the Interpretive Bulletin 75-2, published at 29 C.F.R. § 2509.75-2(c), remains in force and was not affected by the plan assets regulation. Regulation section 2509.75-2(c) sets forth that a transaction between a party in interest and a corporation in which a plan has invested may constitute a prohibited transaction under certain circumstances. Such transactions are prohibited regardless of whether or not they meet the plan assets regulation.