OVERVIEW OF PRESENT LAW

RELATING TO THE

INVESTMENT OF PENSION PLAN ASSETS

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON OVERSIGHT

of the

COMMITTEE ON WAYS AND MEANS

on July 12, 1988

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a brief overview of the rules in the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code relating to the investment of assets of pension plans.

The Subcommittee on Oversight of the House Ways and Means Committee has scheduled a hearing on July 12, 1988, to examine the enforcement of the present-law rules by the Department of Labor and the Internal Revenue Service and to review the impact of recent fluctuations in the stock market on the financial stability and investment practices of pension plans.

The first part of the document is a summary. The second part discusses ERISA requirements, including general fiduciary rules, prohibited transactions, and remedies for breach of fiduciary duty. The third part discusses requirements of the Internal Revenue Code, including the exclusive benefit rule, diversification requirements, and prohibited transactions under the Code.

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[1] This document may be cited as follows: Joint Committee on Taxation, Overview of Present Law Relating to the Investment of Pension Plan Assets (JCX-14-88), July 7, 1988.

I. SUMMARY

The Employee Retirement Income Security Act of 1974 (ERISA) contains rules governing the conduct of fiduciaries of employee benefit plans. ERISA has general rules relating to the standard of conduct of plan fiduciaries, and also specific rules prohibiting certain transactions between a plan and parties in interest with respect to the plan, such as a plan fiduciary. Plan participants as well as the Department of Labor may bring suit to enforce the fiduciary rules. Plan fiduciaries are personally liable under ERISA for any losses to a plan resulting from a breach of fiduciary duty. A court may also impose whatever equitable or remedial relief it deems appropriate for a violation of the fiduciary standards.

The Internal Revenue Code contains qualification requirements for plans of deferred compensation. Plans that satisfy these rules receive favorable tax treatment. The employer maintaining the plan is entitled to a current deduction (within limits) for contributions to a qualified plan. However, employees do not include benefits in income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable.

The Internal Revenue Service (IRS) has the authority to audit plans to determine if they are in compliance with the qualification rules. Such audits may also involve prohibited transaction issues (discussed below). The IRS also monitors compliance with the qualification rules through the determination letter process. Through this process, an employer may request a determination from the IRS that the plan document meets the qualification requirements. A plan can receive a favorable determination and still fail to be qualified if there is a failure to comply with the qualification rules in the operation of the plan.

The Code does not provide extensive fiduciary rules. However, in order for a plan to be qualified under the Code, a plan is required to provide that the assets of the plan be used for the exclusive benefit of employees and their beneficiaries. In addition, the Code contains rules prohibiting transactions between a plan and disqualified persons with respect to a plan that are similar to the prohibited transaction rules under ERISA. Both the Code and ERISA provisions are designed to prevent certain parties related to a plan from misusing plan assets or engaging in transactions with the plan that are detrimental to plan participants. The prohibited transaction rules are not a plan qualification requirement. Rather, the Code imposes excise taxes on a disqualified person who engages in a prohibited transaction. Both the excise tax and the sanctions for violations of the fiduciary responsibility rules under ERISA may be imposed with respect to a prohibited transaction. The Department of Labor has authority to issue exemptions from the prohibited transaction rules. The Department of Treasury is responsible for enforcing the excise tax.

Employee benefit plans are required to file annual reports with the IRS and the Department of Labor. This report is generally made on IRS Form 5500 Annual Return/Report of Employee Benefit Plan (with 100 or more participants). Similar forms are filed for smaller plans. Information regarding the investments of the plan, including investments involving parties in interest, is required to be reported on Form 5500.

II. ERISA REQUIREMENTS

A. General Fiduciary Rules

Exclusive purpose rule; prudence standard

The general fiduciary standard under ERISA requires that a plan fiduciary discharge his or her duties with respect to a plan (1) solely in the interest of the plan participants and beneficiaries, (2) for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable administrative expenses of the plan, (3) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, and (4) in accordance with the documents and instruments governing the plan to the extent such documents and instruments are consistent with ERISA.

The prudence requirement is the basic rule governing the standard of conduct of plan fiduciaries, and it is against this rule that actions of plan fiduciaries are generally tested. The prudence standard charges fiduciaries with a high degree of knowledge. The standard measures the decisions of plan fiduciaries against the decisions that would be made by experienced investment advisers. For this reason, many plan fiduciaries hire professional asset managers to invest plan assets.

Diversification

ERISA also requires that plan fiduciaries diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. The diversification requirement is relaxed in the case of eligible individual account plans. Such plans are not treated as violating the diversification rules by the acquisition of qualifying employer real property or qualifying employer securities.

An eligible individual account plan is an individual account plan that is a profit-sharing, stock bonus, thrift, savings, or employee stock ownership plan (ESOP), or a pre-ERISA money purchase pension plan. Under the Pension Protection Act, the term eligible individual account plan does not include an individual account plan that is part of a floor-offset arrangement.

Qualifying employer securities are stock or marketable obligations issued by the employer of employees covered by the plan or an affiliate of such employer. Qualifying employer real property is real property that is leased to an employer of employees covered by the plan or to an affiliate of the employer and that meets certain requirements.

This exception to the diversification rule permits eligible individual account plans to acquire and hold securities of the employer and to lease property to the employer even though such investments would not otherwise be sufficiently diversified to protect the plan from large losses. That is, the exception permits such plans to hold up to 100 percent of their assets in qualifying employer real property or qualifying employer securities.

Ten-percent limitation on the acquisition and holding of employer securities and employer real property by certain plans

Plans other than eligible individual account plans, such as defined benefit plans and plans that are part of floor-offset arrangements, may not acquire qualifying employer securities or qualifying employer real property if, after the acquisition, the aggregate fair market value of employer securities and employer real property held by the plan exceeds 10 percent of the fair market value of the assets of the plan. This 10-percent limitation is designed to protect the plan against losses and provide additional benefit security for plan participants.

Participant directed accounts

If an individual account plan permits a participant or beneficiary to exercise control over the assets in his or her account and the participant or beneficiary exercises such control, then a person who would otherwise be a fiduciary under the plan is not responsible for any loss that results from the exercise of control by the participant or beneficiary. Thus, plan fiduciaries are not responsible for the results of carrying out the instructions of plan participants. The degree of participant control necessary for this provision to apply is to be determined pursuant to Department of Labor regulations.

B. Prohibited Transaction Rules

General rules

In order to prevent persons with a close relationship to a plan from using that relationship to the detriment of plan participants and beneficiaries, ERISA prohibits certain transactions between a plan and a party in interest. A party in interest includes any fiduciary, a person providing services to the plan, an employer any of whose employees are covered by the plan, an employee organization any of whose members are covered by the plan, and certain persons related to such parties in interest.

Transactions prohibited include (1) the sale or exchange, or leasing of property between the plan and a party in interest, (2) the lending of money or other extension of credit between the plan and a party in interest, (3) the furnishing of goods, services, or facilities between the plan and a party in interest, (4) the transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan, or (5) the acquisition, on behalf of the plan, of any employer security or employer real property that is not a qualifying employer security or qualifying real property or that violates the 10-percent limitation on acquisition of such securities and property.

It is a breach of fiduciary duty for a fiduciary to cause a plan to engage in a transaction if the fiduciary knows or should know that the transaction is a prohibited transaction.

<u>Exemptions from prohibited transaction rules</u>

ERISA contains a number of statutory exemptions to the prohibited transaction rules. For example, ERISA permits a plan to make loans to participants and beneficiaries if certain requirements are satisfied and permits a party in interest to make a loan to an employee stock ownership plan under certain circumstances.

ERISA also permits the Secretary of Labor to grant exemptions from the prohibited transaction rules on a case-by-case basis. The Secretary may grant an exemption for a particular transaction, for example where a plan wishes to acquire a particular building from the employer sponsoring the plan, or may grant an exemption for a class of transactions that has certain common characteristics.

The Secretary of Labor may not grant an exemption from the prohibited transaction rules unless he or she finds that the exemption is administratively feasible, is in the interests of the plan and its participants and beneficiaries, and is protective of the rights of participants and beneficiaries of the plan. The Secretary may grant conditional exemptions. For example, the Secretary could require, as a condition of the granting of an exemption, that the proposed transaction be approved by an independent fiduciary.

<u>Self-dealing</u>

ERISA also has specific rules designed to prevent a fiduciary from self-dealing with respect to plan assets. Thus, a fiduciary may not (1) deal with plan assets in his or her own interest or for his or her own account, (2) in any capacity act in any transaction involving the plan on behalf of a party or represent a party whose interests are adverse to the interests of the plan or plan participants and beneficiaries, or (3) receive any consideration from any party dealing with a plan in connection with a transaction involving plan assets. A prohibited transaction exemption granted by the Secretary of Labor does not exempt a fiduciary from complying with these rules.

C. Remedies for Breach of Fiduciary Duty

The Secretary of Labor, a participant, a beneficiary, or a fiduciary may bring an action under ERISA for a violation of fiduciary duty. A fiduciary that breaches any of the duties imposed on fiduciaries by ERISA is personally liable to the plan for any losses resulting from the breach. A fiduciary may be required to restore to the plan any profits the fiduciary made through use of plan assets. A court may impose whatever additional equitable or remedial relief it deems appropriate, including removal of the fiduciary.

III. REQUIREMENTS OF THE INTERNAL REVENUE CODE

A. Exclusive Benefit Rule

The Internal Revenue Code does not have extensive rules regarding investment plan assets. The Code does require, however, that, prior to the termination of a qualified plan, no part of the assets of the plan may be used for or diverted to purposes other than for the exclusive benefit of the employees covered by the plan and their beneficiaries. This provision prohibits all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or beneficiaries covered by the plan.

In 1978, the Administration issued Reorganization Plan No. 4 (the ERISA Reorganization Plan), which address areas, such as the exclusive benefit rule and the prohibited transaction rules, in which both the Treasury Department and the Labor Department have jurisdiction under ERISA. The purpose of the Reorganization Plan is to clarify the jurisdiction of each Department in order to avoid administrative delays and to facilitate the enforcement of ERISA.

Under Reorganization Plan No. 4, the Secretary of the Treasury is required to notify the Department of Labor before issuing a notice of intent to disqualify a plan for violation of the exclusive benefit rule. The Secretary of the Treasury is not to disqualify a plan for violation of the rule unless, within 90 days of such notification, the Secretary of Labor certifies that he or she has no objection to the disqualification or fails to respond to the notice.

B. Diversification Requirement

The Tax Reform Act of 1986 added a requirement that a qualified employee stock ownership plan offer qualified participants the opportunity to diversify up to 25 percent (and, in some cases, 50 percent) of the individual's account balance. In general, a qualified participant is a participant who has at least 10 years of service and has attained age 55. The purpose of the diversification rules is to permit employees who are nearing retirement to elect, if they so desire, to protect their retirement benefits by investing them in more diversified investments than securities of the employer.

C. Prohibited Transactions

In general

The Code contains prohibited transaction provisions that are very similar, although not identical, to the prohibited transaction rules of ERISA. The Code provisions prohibit certain transactions between a plan and a disqualified person. The definition of a disqualified person is generally the same as the definition of a party in interest under ERISA. Similarly, the transactions prohibited under the Code are generally the same as the transactions prohibited under ERISA. The Code gives the Secretary of the Treasury the authority to grant exemptions from the Code's prohibited transaction rules in accordance with the same guidelines that apply to exemptions granted by the Secretary of Labor.

Under Reorganization Plan No. 4, the Department of Labor generally has the authority to grant prohibited transaction exemptions with respect to the prohibited transaction rules of both the Code and ERISA. Thus, the Department of Labor generally has significant administrative authority with respect to such provisions.

Excise taxes

The Code imposes a two-tier excise tax on prohibited transactions. The initial level tax is equal to 5 percent of the amount involved with respect to the transaction. In any case in which the initial tax is imposed and the prohibited transaction is not corrected within a certain period, a tax equal to 100 percent of the amount involved may be imposed. Each disqualified person engaging in the prohibited transaction (other than a fiduciary acting as such) is jointly and severally liable for the excise taxes. The Secretary of the Treasury has authority to waive the second-level tax.

For purposes of determining the amount of the excise tax, the amount involved means the greater of the amount of money and the fair market value of other property given or the amount of money and the fair market value of other property received. For example, if a disqualified person obtains a one-year loan from a plan at an interest rate of 6 percent, and the fair market value of the use of the funds is 10 percent, the amount involved is 10 percent times the amount of the loan.

To correct a prohibited transaction means to undo the transaction to the extent possible. In any event, the plan must be placed in a financial position not worse than that in which it would be in if the disqualified person acted under the highest fiduciary standards.

Before sending a notice of deficiency with respect to either the first- or second-tier excise tax, the Secretary of the Treasury is to notify the Secretary of Labor to afford the Secretary of Labor a chance to comment on the imposition of the excise tax and provide the Secretary of Labor with the opportunity to seek correction of the prohibited transaction. Reorganization Plan No. 4 does not limit the ability of the Secretary of the Treasury to enforce the excise taxes on prohibited transactions.