AMERICAN BENEFITS COUNCIL

January 8, 2016

J. Mark Iwry
Senior Advisor to the Secretary
Deputy Assistant Secretary
(Retirement & Health Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Victoria Judson
Associate Chief Counsel
Tax Exempt & Government Entities
Internal Revenue Service
1111 Constitution Avenue, NW, 4306 IR
Washington, DC 20224

Robert Choi
Director, Employee Plans
Internal Revenue Service
1111 Constitution Avenue, NW, NCA 614
Washington, DC 20224

Dear Mark, Vicki, and Robert:

On behalf of the American Benefits Council (the "Council"), I am writing to seek clarification on whether the prohibited transaction excise tax regime described in Internal Revenue Code Section 4975 could apply to states that sponsor payroll deduction IRA arrangements for private sector employees, even where such arrangements are exempt from ERISA.

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans. We have a significant interest in clarity around the application of the prohibited transaction rules because our members either voluntarily maintain or service ERISA and tax qualified plans in multiple states and would be affected by state legislation.

Specifically, we are seeking clarification on two important questions:

- First, a state may select a private sector service provider to administer such

payroll deduction IRA arrangements. In this context, if a state monitors and approves the actions of such service provider, including an action that constitutes a prohibited transaction, would the state be treated as having "participated" in the prohibited transaction for purposes of Section 4975, thus potentially triggering state liability for an excise tax? As discussed further below, under Reorganization Plan No. 4 of 1978, this question is exclusively within Treasury's jurisdiction, not the Department of Labor's.

- Second, if the answer to the first question is yes, would states be exempt from the application of Section 4975 excise taxes in this situation? Briefly, there does not appear to be any exemption for states in this situation, either under Section 4975 or more generally.

We believe that all parties would benefit from clarity on these issues. As states move toward performing retirement functions currently performed exclusively by the private sector, it would be helpful for all stakeholders to understand whether states will be provided with special exemptions from rules universally applicable to the private sector. And states need to know their potential liabilities. In addition, participants in these arrangements, who would no longer have the protections of ERISA under proposed regulations issued by the Department of Labor, need to know if the Code's protections will be fully applicable. And service providers participating in the state programs need to understand what potential liabilities could arise.

BACKGROUND & DISCUSSION

Section 4975 imposes a two-tiered excise tax on "any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such)." At the first level, Section 4975(a) imposes a tax equal to 15 percent of the amount involved in the prohibited transaction. At the second level, Section 4975(b) imposes a tax equal to 100 percent of the amount involved in the prohibited transaction if it is not corrected within the taxable period with respect to the prohibited transaction.

Generally, the Code's prohibited transaction rules prohibit "disqualified persons" from using plan assets in transactions that involve a disqualified person or otherwise benefit a disqualified person, unless a specific exemption applies. If a prohibited transaction occurs, as noted, Section 4975 provides that the excise tax will be paid by "*any disqualified person who participates in the prohibited transaction* (other than a fiduciary acting only as such)" (emphasis added).

Disqualified persons include plan fiduciaries and persons who provide services to the plan. For the purposes of Section 4975, the term "fiduciary" includes any person who (1) exercises any discretionary authority or discretionary control respecting management of plan assets, (2) provides investment advice for a fee, or (3) has any discretionary authority or discretionary responsibility in the administration of such plan. Accordingly, states that establish payroll deduction IRA arrangements for

private sector employees will be fiduciaries by reason of their ultimate authority over, for example, (1) the selection and retention of service providers, and (2) operational and investment issues (even if those operational and investment issues are being handled by a service provider subject to the state's oversight). This is especially true because, under the state programs, the participating employers are required by law to continue participating in the state program and could not leave the program by reason of a program-related decision made by the state, even if the state were to give the employer advance notice of such decision.

What constitutes participation in a prohibited transaction (other than as a fiduciary acting only as such)?

For purposes of this letter, we assume that states do not take actions that directly benefit themselves in a way that would violate the prohibited transaction rules. For example, a state would clearly be engaging in a prohibited transaction if it selected a service provider to run its payroll deduction IRA program in exchange for receiving discounted services from the same service provider for other state operations.

Our question relates to a different type of prohibited transaction. Specifically, states will have the authority to select and monitor service providers, and to oversee and approve specific actions of those service providers, including, for example, (1) the solicitation of rollovers from the state IRAs, (2) the provision of a menu of investment options for the IRA owners, and (3) the selection of a default investment for IRA owners who are automatically enrolled. Under the proposed DOL fiduciary rules, all of these actions of the service providers could be prohibited transactions.

Assume that a state oversees and approves -- either by action or inaction -- service provider activities that constitute a prohibited transaction. Does the approval by the state (as a fiduciary) of a prohibited transaction constitute "participation" in the prohibited transaction? Or could the state avoid tax liability by claiming to be "a fiduciary acting only as such"?

Approval of a prohibited transaction would logically be participation in such transaction, and it would not seem that the parenthetical regarding a fiduciary acting only as such would excuse a fiduciary who approves a prohibited transaction. But we are not aware of any authority directly on these questions, and would appreciate clarification. Clarification of these points would of course apply without regard to whether a state is involved, since these issues relate to the underlying interpretation of Section 4975.

As noted above, under Reorganization Plan No. 4 of 1978, this issue is exclusively under the jurisdiction of the Treasury Department. The issue in question is not whether a prohibited transaction has occurred, which is generally within the jurisdiction of the Department of Labor. The issue is: if a prohibited transaction occurs, which entities are considered to have "participated in the prohibited transaction (other than a fiduciary acting only as such)" and thus are liable for the excise tax under Code Section 4975?

This issue arises solely under subsections (a) and (b) of Section 4975. Under the Reorganization Plan, those subsections are exclusively within Treasury's jurisdiction.

State Immunity from the Prohibited Transaction Excise Tax?

If the activities described above can constitute participation in a prohibited transaction, the next question is whether states could be subject to excise taxes under Section 4975. This issue has two parts.

First, is there anything in Section 4975 that would exempt the states from excise taxes in this situation? The answer is clearly no. Governmental plans are exempt from Section 4975 but governmental plans are plans that cover government employees, and the arrangements at issue involve IRAs that cover private sector employees.

Second, is there any basis outside of Section 4975 that would provide states that have participated in a prohibited transaction with immunity from the excise taxes? Briefly, although Federal taxation of states is not done frequently, it is done and there is no bar on such taxation. That is especially true in situations like this where states would be performing a private sector function.

These issues are also exclusively within the jurisdiction of the Treasury Department.

CONCLUSION

Answers to the questions posed above are very much needed. Especially in light of the DOL's proposal to remove ERISA protections in this area, there is a need to understand the relevant law regarding the liabilities and protections under the Code. If you have any questions, please feel free to contact me at (202) 289-6700 or at ldudley@abcstaff.org.

Sincerely,

Lynn D. Dudley
Senior Vice President,
Global Retirement and Compensation Policy

cc: Kyle Brown
Dominic DeMatties
William Evans
Robert Neis
Harlan Weller