Who Cares About the BIC Exemption for IRAs – “Reasonable Compensation” is Already Exempt ... Isn’t It?

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As a long-time ERISA practitioner with a special interest in individual retirement accounts (IRAs), I am familiar with the “exemption” set out in Internal Revenue Code (Code) section 4975(d)(10) for “receipt by a disqualified person of any reasonable compensation for services rendered.” Over the years I have seen numerous articles referencing it, have received letters from counsel citing it, and have even been personally attacked for my ignorance in failing to grasp its plain meaning: that it unequivocally exempts the receipt of reasonable compensation for IRA services by any person, including the IRA owner, family member, or fiduciary adviser.

Yet, if it is true that section 4975(d)(10) provides all the relief needed for a fiduciary to receive reasonable compensation for IRA services, why did the Department of Labor (DOL) spend more than 5 years working on its massive fiduciary proposal and corresponding “Best Interest Contract” (BIC) Exemption, and why of the more than 3,000 comments filed did no one (at least to my knowledge), point out this obvious fact? Of course, the question is rhetorical; section 4975(d)(10) does not exempt fiduciary self-dealing...or does it?

First, a bit of technical background. Code section 4975(c)(1)(E) prohibits an IRA fiduciary from acting in his/her own interest or for the benefit of his/her own account. An IRA owner is a fiduciary with respect to his/her own IRA. Under current law, a fiduciary also includes anyone who manages money on a discretionary basis and anyone who provides investment advice for a fee under the so-called “five-part test.” A fee-based adviser usually will be a fiduciary and, despite protests to the contrary, even today a broker may be a fiduciary if he/she regularly advises clients on what to buy or sell – “incidental” advice is still advice.1

Self-dealing occurs when a fiduciary exercises the “authority, control, or responsibility which makes such person a fiduciary to cause a plan to pay an additional fee to such fiduciary (or to a person in which such fiduciary has an interest which may affect the exercise of such fiduciary’s best judgment as a fiduciary) to provide a service.”2 A person in which a fiduciary has an interest which may affect the exercise of such fiduciary’s best judgment as a fiduciary includes (but is not limited to) any disqualified person including a family member.3

Thus, under the IRS regulation, an IRA owner engages in an act of self-dealing when hiring a family member as a financial adviser or broker.4 Whether the

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1 This is not to suggest that the typical broker representative acts as a fiduciary when recommending “suitable” investments to clients; however, many brokers all but exercise full discretion when it comes to family member IRAs (and certainly do for their own IRAs).

2 26 C.F.R. § 54.4975-6(a)(5). Note that “causation” in this context does not necessarily mean exercising discretion; giving fiduciary advice is sufficient if that advice is followed.

3 Id.

4 We are only speaking here of situations where the financial adviser is compensated, directly or indirectly, from IRA assets. Separate rules permit the provision of services at no charge, or if payment
adviser or broker is also a fiduciary is not relevant to this conclusion (though if the adviser/broker is a fiduciary, then exercising discretion in a way that causes the adviser/broker to receive additional compensation may involve a separate act of self-dealing).

Similarly, if a financial adviser is a fiduciary, and recommends specific investments that cause the adviser to receive additional compensation, the adviser has engaged in self-dealing (“conflicted advice,” in DOL parlance). The purpose of the DOL’s proposed rule is to make more people fiduciaries in this context.

Assuming there is a prohibited transaction, the next question is whether an exemption is available. As relevant here, Code section 4975(d) provides that the prohibitions of subsection (c) shall not apply to –

(2) any contract, or reasonable arrangement, made with a disqualified person for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor;

* * *

(10) receipt by a disqualified person of any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan, but no person so serving who already receives full-time pay from an employer or an association of employers, whose employees are participants in the plan or from an employee organization whose members are participants in such plan shall receive compensation from such fund, except for reimbursement of expenses properly and actually incurred;

[Emphasis added.] So, there appear to be two separate but similarly worded exemptions for the payment of reasonable compensation to a disqualified person.

The Treasury regulations (and parallel regulations under ERISA section 408) make it clear that, in the view of the IRS (and DOL), the first of these exemptions, section 4975(d)(2), does not cover self-dealing:

However, section 4975(d)(2) does not contain an exemption for acts described in section 4975(c)(1)(E) (relating to fiduciaries dealing with the income or assets of plans in their own interest or for their own account) or acts described in section 4975(c)(1)(F) (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan). Such acts are separate transactions not described in section 4975(d)(2). See §§ 54.4975-6(a)(5) and 54.4975-6(a)(6) for guidance as to whether transactions relating to the furnishing of office space or services by fiduciaries to plans involve acts described in section 4975(c)(1)(E).

26 C.F.R. section 54.4975-6(a)(1) [emphasis added].

Interestingly, these regulations refer only to subsection (d)(2). What about subsection (d)(10)? Apparently, many people have seized on this very noticeable

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is made from the IRA owner’s personal (after-tax) assets, though in some cases paying compensation from after-tax assets can constitute a constructive contribution to the IRA.

5 Code section 4975(c)(1)(F) – prohibited “kickbacks” – may also be implicated.
omission as evidence that (d)(10) is to be read differently, as allowing self-dealing. However, neither the IRS nor DOL agree. Treasury regulation section 54.4975-6(e)
indicates that (d)(2) and (d)(10) are to be read together, as a single exemption:

(e) Compensation for services

(1) In general. Section 4975(d)(2) refers to the payment of reasonable compensation by a plan to a disqualified person for services rendered to the plan. Section 4975(d)(10) and §§ 54.4975-6(e)(2) through 54.4975-6(e)(5) clarify what constitutes reasonable compensation for such services. [Emphasis added.]

Thus, although section 4975(d)(10) is styled as an exemption, the IRS does not view it as such; rather, it is considered a clarification or limitation on subsection (d)(2), rather than as a separate and distinct exemption in its own right. This is clearer if one understands that section 4975(d)(2) is the analogue of section 408(b)(2) of the Employee Retirement Income Security Act of 1974, as amended (ERISA), and section 4975(d)(10) is the analogue of ERISA section 408(c)(2); the ERISA and Treasury regulations were adopted simultaneously and are more or less identical in their wording.6

There is extensive authority under ERISA section 408(c)(2). In general, most courts have agreed with the DOL regulatory position that section 408(c)(2) does not afford relief from self-dealing, see, e.g., Patelco Credit Union v. Sahni, 262 F.3d 897, 910-11 (9th Cir. 2001), reviewing cases that discuss whether ERISA section 408(c)(2) is a distinct exemption in its own right, and ultimately concluding that, regardless, “the reasonable compensation provision does not apply to fiduciary self-dealing . . . .” But, see, Harley v. Minn. Mining and Mfg. Co., 284 F.3d 901 (8th Cir. 2002), cert. denied 123 S.Ct. 872 (2003) (“Harley” or “3M”), and subsequent cases in the 8th Circuit, which generally reach a contrary conclusion.8

In contrast, after 40 years there is almost no case law separately addressing section 4975(d)(10); the recent case of Ellis v. Comm., 787 F.3d 1213 (8th Cir. 2015), may be the sole exception. In that case, taxpayers argued that 4975(d)(10) exempted their receipt of salaries from a business owned by their IRAs. In its appellate brief, the IRS stated as follows:

Finally, even if the payments had met the language of I.R.C. § 4975(d)(2) and (10), at best, they would be exempt from violations of § 4975(c)(1)(A) through (D) only. Department of Labor regulations make clear that these provisions

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6 Note, however, that ERISA section 408(c)(2) and Code section 4975(d)(10) are not in fact identical; the latter is styled on its face as an “exemption,” whereas the former is written more as a qualification to the ERISA prohibitions (“Nothing in section 406 shall be construed to prohibit any fiduciary from ... receiving any reasonable compensation for services rendered....”). Could this mean, as some have suggested, that the rules really are different for IRAs than for ERISA plans?

7 I.e., is it an exemption or merely a “clarification” as the DOL and IRS regulations indicate? At least in the 9th Circuit, the question seems to be irrelevant.

8 DOL strongly objected to this conclusion in its amicus curiae brief in Harley. In Nat’l Sec.Sys., Inc. v. Iola, 700 F.3d 65 (3rd Cir. 2012), the court extensively reviewed the case law, including Harley, and concluded that although section 408(c)(2) arguably was ambiguous, it ultimately must give deference to DOL’s reading.
do not exempt a fiduciary’s use of plan assets in his own interest or for his own account under § 4975(c)(1)(E). See 29 C.F.R. § 2550.408b-2(b) (“section 408(b)(2) [counterpart to I.R.C. § 4975(d)(2)] does not contain an exemption from acts described in section 406(b)(1) [counterpart to I.R.C. § 4975(c)(1)(E)]”); see also 29 C.F.R. § 2550.408c-2(a) (ERISA § 408(c)(2) [counterpart to I.R.C. § 4975(d)(10)] clarifies what constitutes “reasonable compensation” under ERISA § 408(b)(2) [counterpart to I.R.C. § 4975(d)(2)]).

In short, there is no exemption for fiduciary self-dealing. [Emphasis added.]

This paragraph makes the IRS’ position clear: section 4975(d)(10), whether characterized as an exemption in its own right or merely a “clarification” of (d)(2), does not exempt self-dealing. However, the Ellis court did not find it necessary to address the IRS argument, because it concluded that the salaries in question were not exempt for a different reason, i.e., they were not for services rendered in connection with the performance of plan duties (but, rather, for running the business) and thus did not on their face satisfy the terms of that section.9

By coincidence, Ellis was an 8th Circuit decision, so it is possible that – consistent with its conclusion in Harley – that court might disagree with the IRS. Thus – arguably – anyone giving investment advice to IRAs in the Dakotas, Minnesota, Iowa, Missouri, Nebraska or Arkansas will not need to comply with the BIC Exemption, if and when it is promulgated (at least until the Supreme Court weighs in). Unfortunately, most other courts seem to have sided with DOL and the IRS.

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9 A similar conclusion was reached in Lowen v. Tower AssetMgmt., Inc., 829 F.2d 1209 (2nd Cir. 1987) regarding an investment manager’s receipt of compensation from companies in which it invested plan assets; it also found that payments must come directly from the plan. The court did not address self-dealing – its silence has been construed by some as standing for the proposition that ERISA section 408(c)(2) would exempt self-dealing involving actual plan services. However, in its brief in Harley, DOL disputed that the court’s silence had any meaning.