MANUAL TRANSMITTAL

Department of the Treasury
Internal Revenue Service

4.72.11

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PURPOSE

This transmits complete reprint with changes for IRM 4.72.11, Employee Plans Technical Guidance, Prohibited Transactions.

BACKGROUND

This IRM provides guidance on what constitutes a prohibited transaction, including the computation of the applicable excise taxes, as well as certain exclusive benefit requirements under IRC 401(a), and assignment and alienation provisions under IRC 401(a)(13).

NATURE OF CHANGES

This transmittal reissues existing procedures in the new IRM format. IRM 4.72.11 replaces IRM 7.7.1 Chapter 11 using the same catalog number. These procedures have also been updated to include recent legislative and regulatory changes up to and including the Taxpayer Relief Act of 1997.

EFFECT ON OTHER DOCUMENTS

IRM HB 7.7.1 CH. 11 is obsolete.

INTENDED AUDIENCE

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Distribution: IRM 4.72.11

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4.72.11.1 (06-14-2002)
Overview

(1) Guidance is provided on the prohibited transactions, requirements, including the—

a. applicable excise taxes,
b. exclusive benefit requirements under IRC 401(a), and
c. assignment and alienation provisions under IRC 401(a)(13).

4.72.11.1.1 (06-14-2002)
Technical Overview

(1) IRC 4975 imposes a nondeductible excise tax on the amount involved with respect to a prohibited transaction which occurs in a tax year to be paid by the disqualified person who participated in the prohibited transaction. See IRC 4975(a)(1).

a. The term “prohibited transaction,” is described in IRC 4975 while temporary Reg. 141.4975–13 (temporary Pension Excise Tax Regulations) refers to Reg. 53.4941(e)–1 (Private Foundation Excise Tax Regulations) with respect to certain terms that appear in both sections of the Code, e.g., amount involved and correction.

(2) The legislative history to the Employee Retirement Income Security Act of 1974 (ERISA) indicates that Congress felt that the sanction of an excise tax in lieu of disqualification under the prohibited transaction rules of IRC 503 was desirable in many instances.

a. IRC 503(b) governs whether a transaction that was entered into prior to 1/1/75 constitutes a prohibited transaction.
b. IRC 503(b) continues to apply to governmental plans within the meaning of IRC 414(d) and to those church plans that do not make an election under IRC 410(d) to be covered by ERISA.

(3) IRC 401(a)(2) provides that in order for a plan to be qualified (and the related trust tax-exempt) at any time prior to the satisfaction of all liabilities with respect to its employees and their beneficiaries, it must be impossible to divert the trust’s corpus or income other than for the exclusive benefit of the employees and their beneficiaries.

a. A proposed disqualification on a plan involving fiduciary action within the meaning of Part 4 of Subtitle B of Title I of ERISA is subject to mandatory technical advice, and pursuant to section 103 of Reorganization Plan No. 4 of 1978, 1979–1 C.B. 480, review by the Department of Labor (DOL).
b. There are special rules with respect to multiemployer plans. See 4.72.14.3.10.

(4) IRC 401(a)(13) provides that a trust will not constitute a qualified trust under IRC 401 unless the plan of which the trust is a part provides that benefits under the plan may not be assigned or alienated.

4.72.11.1.2 (06-14-2002)
Relationship Between Exclusive Benefit and Prohibited Transaction

(1) The exclusive benefit rule of IRC 401(a) does not conflict with the prohibited transaction provisions of IRC 4975. A disqualified person may engage in a prohibited transaction and at the same time cause a violation of the exclusive benefit rule. Thus, a trust officer, etc., cannot take the position that the imposition of an IRC 4975 excise tax precludes the application of the exclusive benefit rule.

a. If a transaction violates the exclusive benefit rule, revocation of the qualified status of the trust should be considered.
b. If revocation is invoked, the prohibitions and sanctions of IRC 4975 continue to apply to the disqualified plan. See also, guidelines on Plan Revocation procedures. See IRM 4.72.12.

(2) Generally any transaction described in IRC 4975(c) between the plan and the employer or other persons related to the plan or the employer, i.e., a disqualified person, will constitute a prohibited transaction under IRC 4975. In some cases such transactions may be exempt from the sanctions imposed by IRC 4975 as a result of a statutory or an administrative exemption. However, even though a transaction may be exempt from the sanctions imposed by IRC 4975 that transaction must still meet the exclusive benefit and the assignment or alienation requirements.

4.72.11.1.3 (06-14-2002)
Exclusive Benefit Rules

(1) The fact that a trust's investment policies must be for the exclusive benefit of the employer's employees or their beneficiaries is a criterion for qualification under IRC 401(a). Four criteria are set forth in Rev. Rul. 69–494, 1969–2 C.B. 88, and were incorporated into ERISA 404 and its legislative history.

(2) The factors to consider are:

a. The cost of an investment must not exceed its fair market value (FMV) at the time of its purchase;
b. A fair return commensurate with the prevailing rate must be provided;
c. Sufficient liquidity must be maintained to permit distributions in accordance with the terms of the plan; and
d. The safeguards and diversity that a prudent investor would adhere to must be present.

(3) Other investment considerations include the use or diversion of the trust's corpus or income and whether there is a reversion of the trust's corpus or income to the employer. For purposes of IRC 401(a), a custodial account within the meaning of IRC 401(f) is treated as if it were a trust and custodian is treated as a trustee.

4.72.11.1.4 (06-14-2002)
Relationship Between Assignment or Alienation and Prohibited Transaction

(1) The assignment or alienation rule of IRC 401(a)(13) does not conflict with the prohibited transaction provisions of IRC 4975. As a result it can not be argued that the imposition of the IRC 4975 excise tax precludes the application of the assignment or alienation provisions of IRC 401(a)(13).

(2) There are several exceptions to the general rule. See Reg. 1.401(a)–13(b)(2). For example, IRC 401(a)(13) may not be violated if–

a. not more than 10% of any benefit payment made by any participant who is receiving benefits under the plan is made for the purpose of defraying plan administration costs;
b. there is a qualified domestic relations order as described in IRC 414(p);
c. a loan meets the requirements of IRC 4975(d)(1); or
d. there is a federal tax levy or a federal tax lien.

4.72.11.1.5 (06-14-2002)
Examination Steps

(1) Inspect the Form 5500 series return to determine the nature of investments. Also inspect the actual balance sheet and statement of receipts and disbursements of the trust to ascertain that the amounts reflected in such statements agree with the amounts shown on the Form 5500 series return.

(2) If the employer establishes in the trust instrument the powers and duties to be exercised by the trustees with respect to investments, determine whether the trustees are giving effect to the trust instrument.

(3) If the trust instrument is silent as to investment powers or in situations that go beyond the instrument, determine whether the investments meet the law governing investments by employee trusts.

Note: For all plans covered by Title I of ERISA as described in DOL Reg. 2510.3–3, State law does not apply after 1/1/75. Plans not covered by Title I, such as, Keogh plans covering only (i) sole proprietors and their spouses, or (ii) partners and their spouses as well as corporate plans where the corporation is wholly owned by an individual or his spouse and the plan covers only the owner and the owner's spouse, continue to be subject to state trust investment law.

(4) Inspect the receipts and disbursements records of the trust to detect disbursements of funds that are contrary to IRC 401(a)(2).

(5) During any examination of a Form 5500 series return, be alert to the diversion of corpus or income of the trust for purposes other than for the exclusive benefit of the employees for whom the funds were originally allocated.

(6) Inspect the disbursements records of the trust to detect payments made to the employer-creator. Review the plan and/or trust provisions approved by the Service and, during the examination of the records, be alert for payments made to the employer-creator that violate the plan and/or trust provisions.

4.72.11.2 (06-14-2002)
Identifying Prohibited Transactions

(1) A prohibited transaction means any direct or indirect transaction described in IRC 4975(c)(1) between the plan and a disqualified person.

(2) If a prohibited transaction falls within one of the statutory exemptions under IRC 4975(d), the excise tax may not apply. See 11.3. In addition, there are two types of administrative exemptions that may be granted under IRC 4975(c)(2)—

- individual exemptions and
- class exemptions.

(3) The statutory exemptions under IRC 4975(d) (other than IRC 4975(d)(9) and (12)) do not apply to certain types of transactions involving owner-employees (as defined in IRC 401(c)(3)) and persons or entities deemed to be owner-employees. These transactions are described in IRC 4975(f)(6) and include any direct or indirect acquisition of property for the plan from, or sale of plan property to a(n):

a. Owner-employee;
b. Participant or beneficiary of an individual retirement account or annuity;
c. Shareholder-employee (as defined in IRC 4975(f)(6)(C));
d. Member of the family (as defined in IRC 267(c)(4)) of the owner-employee, etc., or
e. Corporation at least 50% of which is directly or indirectly controlled by a person mentioned in a., b. or c.

4.72.11.2.1 (06-14-2002)
Disqualified Person

(1) Disqualified persons are those who, by virtue of their relationship to the plan, may be in a position to self-deal.

(2) The term “disqualified person” as defined in IRC 4975(e)(2) covers a range of people including employers, unions and their officials, fiduciaries, and persons providing services to a plan such as lawyers and accountants. Also included are persons whose relationship to the plan is not immediately apparent and who will require more diligent investigation to detect. This includes—

- a service provider,
- the employer or employee organization involved,
- persons who have a 50% or more interest (see IRC 4975(e)(2)(E) and (G)),
- a member of the family of a fiduciary of any of these persons, or individuals with a 10% or more interest (see IRC 4975(e)(2)(H) and (I)).

(3) For example, the sale, exchange or leasing of property, directly or indirectly, between a disqualified person and the plan constitutes a prohibited transaction whether the transaction was made from the disqualified person to the plan or from the plan to the disqualified person. If a disqualified person transfers real or personal property to a plan, that transfer constitutes a sale or exchange such as to make the transfer a prohibited transaction if:

a. the real or personal property transferred by a disqualified person to a plan is subject to a mortgage or lien which the plan assumes; or
b. the plan takes the property subject to a mortgage or similar lien which was placed on the property by a disqualified person within 10 years prior to the transfer. See IRC 4975(f)(3). Such a transfer of real or personal property will most often arise in the context of a contribution of property other than cash by the employer.

4.72.11.2.1.1 (06-14-2002)
Examination Steps

(1) If a transaction described in IRC 4975(c)(1) has occurred, ascertain whether such transaction took place directly or indirectly between the plan and a person (entity) described in IRC 4975(e)(2). See Exhibits 4.72.11–2 and 4.72.11–3 which show the relationships described in IRC 4975(e)(2).

Note: The term “fiduciary” is specifically defined in IRC 4975(e)(3) and includes persons not previously covered under traditional trust law.

(2) Ascertain whether a transaction described in IRC 4975(c)(1) has occurred between the plan and any person who:

a. exercises any discretionary authority or control in managing the plan;
b. exercises any authority or control over the trust’s assets;
c. renders investment advise concerning plan assets for which he/she receives direct or indirect compensation; or
d. has any discretionary authority or responsibility for plan administration.

(3) Inspect the plan records to ascertain if any of the transactions described in (2) have taken place directly or indirectly between the plan and a disqualified person.

4.72.11.2.2 (06-14-2002)
Application of IRC 4975

(1) The following plans are the type to which the IRC 4975 excise tax provisions apply:

a. A tax-exempt trust under IRC 401(a) (which is part of a plan).
b. A tax-exempt plan under IRC 403(a).
c. An IRC 408(a), Individual Retirement Account, or an IRC 408(b), Individual Retirement Annuity (collectively, an IRA). However, if the individual for whom the IRA was established or the IRA’s beneficiary engages in a prohibited transaction with respect to the IRA, the sanction is the loss of the tax-exempt status of the IRA as of the first day of the taxable year in which the prohibited transaction occurs. See IRC 408(e)(2)(A) and IRC 408(e)(4).
d. Any of the above, even after they cease to be qualified. See IRC 4975(e)(1)(F).

Note: In the late 1990’s Congress in different statutes added Archer medical savings accounts described in IRC 220(d) and education IRAs described in IRC 530 to the plans described in IRC 4975(e)(2). Both IRC

220(e)(2) and IRC 530(e) state that rules similar to those under IRC 408(e) will be applied in the instance of these plans. This is also described at IRC 4975(c)(4) and (5).

(2) The excise tax provisions of IRC 4975 do not apply to—

a. a governmental plan within the meaning of IRC 414(d), or
b. those church plans that do not make an election under IRC 410(d) to be covered by ERISA. See 4.72.11.1.1(2)b.

4.72.11.2.2.1 (06-14-2002)
Examination Steps

(1) Due to the complexity of the area, use an analytical approach to ascertain whether a prohibited transaction has occurred for which the excise tax applies. A suggested approach to developing such an issue is as follows:

a. Determine whether there has been a prohibited transaction as described in IRC 4975(c)(1).
b. If a prohibited transaction has occurred, ascertain whether the trust or a disqualified person has received an administrative exemption as set forth in IRC 4975(c)(2).
c. If a prohibited transaction has occurred and the exemption under b. has not been granted, ascertain whether the prohibited transaction falls within the purview of statutory exemptions set forth in IRC 4975(d) or IRC 4975(f)(6)(B)(ii).
d. If a prohibited transaction has occurred and one of the exemption areas outlined in b. or c. is applicable, do not pursue the prohibited transaction issue. (However, ascertain whether the transaction complies with the exclusive benefit requirements; the assignment and alienation requirements and/or the IRC 72(p) loan provisions.)
e. If a prohibited transaction has occurred and none of the exemption areas outlined in b. or c. is applicable, pursue the issue to its conclusion.

(2) This is only a suggested approach to developing an issue concerning prohibited transactions. See 4.72.11.3 for guidance on issues commonly encountered during an examination.

4.72.11.3 (06-14-2002)
Prohibited Transactions

(1) The following transactions (whether direct or indirect) between a plan and a disqualified person result in a prohibited transaction subject to the sanctions of IRC 4975 unless there is an applicable statutory or administrative exemption.

a. Sale, exchange or lease of any property
b. Loans or extensions of credit
c. Furnishing goods, services or facilities
d. Transfer to, or use by or for the benefit of, a disqualified person of any income or assets of the plan
e. Dealings by a fiduciary with the income or assets of the plan for his/her own interest or account

f. Receipt by a fiduciary of any consideration, from a party dealing with the plan in connection with a transaction involving income or assets of the plan
g. Acquisition and holding of employer securities or employer real property in excess of the ERISA 407 limits

4.72.11.3.1 (06-14-2002)
Sale or Exchange

(1) The sale, exchange or leasing of property, directly or indirectly, between a disqualified person and the plan constitutes a prohibited transaction whether the transaction was made from the disqualified person to the plan or from the plan to the disqualified person.

Note: An administrative exemption may be granted by DOL for a sale, exchange or lease of property which falls within the purview of IRC 4975(c)(1)(A).

(2) If a disqualified person transfers real or personal property to a plan, that transfer constitutes a sale or exchange such as to make the transfer a prohibited transaction if:

a. the property is subject to a mortgage or lien which the plan assumes, or
b. the plan takes the property subject to a mortgage or similar lien which was placed on the property by a disqualified person within 10 years prior to the transfer. IRC 4975(f)(3).

(3) Such a transfer of real or personal property will most often arise in the context of a contribution of property other than cash by the employer.

a. With respect to a contribution of unencumbered property, in Commissioner v. Keystone Consolidated Industries, Inc., 508 U.S. 152 (1993), the U.S. Supreme Court held that an employer's contribution of unencumbered property to a defined benefit plan to satisfy the employer's funding obligation to that plan is a sale or exchange within the meaning of IRC 4975(c)(1)(A) and, therefore, a prohibited transaction.

(4) An ordinary blind purchase or sale of securities does not constitute a prohibited transaction where neither the buyer nor the seller nor the agent of either knows the identity of the other parties.

(5) If a prohibited transaction falls within one of the following, the excise tax may not be applicable:

a. If securities held by the plan are subject to a privilege to convert those securities to other securities (e.g., from bonds to stock), the plan may exercise that privilege (to the extent provided in Treasury and Labor Regulations) so long as the plan receives adequate consideration under the conversion. See IRC 4975(d)(7).
b. Pooled Investments. A plan may purchase or sell an interest in a common or collective trust fund or a pooled investment fund maintained by a disqualified person which is a bank or trust company supervised by a State or federal agency or between a plan and a

pooled investment fund of an insurance company qualified to do business in a State so long as the bank, etc., receives no more than reasonable compensation for the purchase or sale or for the investment management of the pooled fund. Further, the transaction must be expressly permitted by the plan instrument or by a plan fiduciary, independent of the bank, trust company, or insurance company, who has authority to manage and control the plan assets. See IRC 4975(d)(8).

c. A plan may acquire, sell or lease qualifying employer securities or qualifying employer real property, under certain conditions. See IRC 4975(d)(13).

4.72.11.3.1.1 (06-14-2002)
Sales, Transfers and Leases of Property

(1) The direct leasing of any property other than qualifying employer real property between a plan and a disqualified person is prohibited.

(2) IRC 4975(d)(2) provides, in part, that any contract, or reasonable arrangement, made with a disqualified person for office space which is deemed necessary for establishing or operating a plan may be statutorily exempt from the prohibited transaction excise taxes if no more than reasonable compensation is paid for such lease.

4.72.11.3.1.2 (06-14-2002)
Examination Step

(1) Inspect the plan records to ascertain whether there have been any sales, exchanges or leases of property. If such a transaction has occurred, request back-up documents to determine if the transaction is prohibited. Documents which might be examined to ascertain whether a prohibited transaction has occurred include, but are not limited to:

- purchase-sales agreements
- mortgages
- land contracts
- liens
- deeds
- lease and rental agreements
- brokerage statements

(2) If expensive equipment is used in the employer’s business, check to see whether the plan owns the equipment and leases it to the employer.

(3) A common transaction is a sale-leaseback. In that situation there is a sale of property by a disqualified person to the plan followed by a lease of the property by the plan to the disqualified person. If an equipment lease to the employer is discovered, determine how the plan acquired the equipment. Generally, a sale (including a sale-leaseback) between the plan and a disqualified person, in the absence of an administrative exemption, constitutes one or more prohibited transactions.

(4) If the plan leases office space from a disqualified person, the arrangement must meet the conditions of IRC 4975(d)(2) for there to be a statutory exemption.

a. The terms of the lease must be as favorable to the plan as the plan might have obtained in an arms length transaction with an unrelated third person. Compare the leased space with any commercially leased space in the same building or obtain comparability data on similar office space from the local board of realtors.
b. The length of the lease must be reasonable (especially in relationship to leases on similar property).
c. The lease must be necessary for the establishment or operation of the plan.

(5) Check for the existence of an administrative exemption if a prohibited lease is discovered.

Note: There are two class exemptions pertaining to leases. However, they deal with multiple employer and multi-employer plans only. See 4.72.14 for an in-depth discussion of multi-employer plans.

4.72.11.3.2 (06-14-2002)

Loans Between Plan and Disqualified Person Who Is a Participant or Beneficiary

(1) A loan to a disqualified person is a prohibited transaction unless it is a loan to a participant or beneficiary that meets the conditions of the statutory exemption for such loans or is a loan for which the DOL has granted an administrative exemption.

(2) IRC 4975(d)(1) permits loans to plan participants and beneficiaries who are disqualified persons that:

a. are adequately secured
b. are available on a reasonably equivalent basis to all participants or beneficiaries in the plan
c. bear a reasonable rate of interest
d. are not made available to highly compensated employees in greater amounts than other employees
e. are made in accordance with specific plan provisions governing such transactions.

(3) IRC 72(p) and IRC 72(t) may also apply. See Treas. Reg. section 1.72(p)-1, Q & A – 11, Notice 82–22, 1982–2, C.B. 751, and Notice 87–13, 1987–1 C.B. 432, 441. For example,

a. Plans which take the participant's account balance as security for a loan to the participant may simply offset that amount where the participant defaults on his obligation to repay the loan. Such an offset could result in a distribution not permitted in a pension plan.
b. Where the account balance is less than the loan, it might not represent adequate security.
c. Offsets in a profit-sharing plan or a stock bonus plan may be permissible if the plan permits early distribution. However, evaluate all distributions for proper reporting of Forms 1099–R as to the total amount of the distribution and the taxable amount.

(4) ESOP Loans. See ESOP Examination Guideline which covers this exemption.

4.72.11.3.2.1 (06-14-2002)
Loans to Owner-Employees

(1) If two corporations adopt the same qualified plan and if an individual is a shareholder-employee of the first corporation which is a Subchapter S corporation, a shareholder of the second corporation, and a disqualified person within the meaning of IRC 4975(e)(2), the individual cannot obtain a loan based on the individual's assets in the qualified plan of the second corporation without it being a prohibited transaction.

4.72.11.3.2.1.1 (06-14-2002)
Examination Steps

(1) Determine whether loans are made in accordance with specific provisions governing such transactions.

(2) Ascertain whether loans to participants are adequately secured, usually by the participant's vested accrued benefit. In addition, there must be a reasonable rate of interest. To determine if the interest rate is reasonable:

a. Determine whether the rate of interest and other conditions of the plan's loans to participants are comparable to the terms of similar commercial loans in the relevant community.
b. When a large percentage of plan assets is invested in participant loans, one possible indication of an unreasonable rate of interest is the overall rate of return on the plan's investments.

Example 1: F Company's defined contribution plan lists participant loans amounting to 90% of the plan's assets. The remaining assets are invested in U.S. Government securities. The earnings from all of the plan's investments are less than 2%. Thus, it would appear that the plan is not charging a reasonable rate of interest on participant loans.

(3) To ascertain whether loans are available on a reasonably equivalent basis to all participants in the plan, determine whether the loan amount to one person is a substantial portion of plan assets. If so, it may indicate that loans may not have been made available on a reasonably equivalent basis to other employees. See Esfandiar Kadivar v. Commissioner, T.C. Memo. 1989–404.

(4) Make certain that loans to highly compensated employees do not exceed any specific plan limits on participant loans.

(5) Determine whether loans were made available to highly compensated employees more frequently than to nonhighly compensated employees.

a. Check whether loans to highly compensated employees are made from plan assets in amounts greater than the amounts made available to other employees. See Kadivar.
b. Inquire about administrative practices regarding the loan program, including how participants are informed about the program and the history of loan applications and their disposition.

Example 2: E Company's defined contribution plan authorizes participant loans and the use of an employee's vested accrued account balance as collateral. The plan's most recent Form 5500 reports loans totalling $125,000 to the five most highly compensated employees of the employer in the prohibited transactions section of the Form 5500. Because the only loans reported on the Form 5500's statement of assets are participant loans totalling $125,000, it would appear that loans may be made available to highly compensated employees more frequently than to nonhighly compensated employees.

(6) Ascertain whether an extension of the term of a loan to a disqualified person was granted. An extension on a loan is a separate transaction that must, in itself, meet the criteria for an exemption. An extension on a loan which is not exempt is a second prohibited transaction occurring at the time the loan was due and the extension granted.

4.72.11.3.2.2 (06-14-2002)

Loans From Plan to Disqualified Person (Other than Participant Loans)

(1) IRC 4975(c)(1)(B) prohibits direct or indirect loans or other extensions of credit between the plan and a disqualified person.

(2) IRC 4975(d)(13) provides an exemption for transactions which are exempt from ERISA 406 by reason of ERISA 408(e). ERISA 406 is the Title I equivalent of IRC 4975(c)(1).

a. ERISA 408(e), as pertinent, exempts the acquisition by a plan of qualifying employer securities if the conditions set forth in the exemption are met.

(3) ERISA 407(d)(5) defines qualifying employer securities as stock or marketable obligations as defined in ERISA 407(e). DOL Reg. 2550.407d–5 provides further guidance with respect to the definition of qualifying employer security and marketable obligation. If the employer security is not stock it must be a marketable obligation.

(4) A marketable obligation is a bond, debenture, note, or certificate, or other evidence of indebtedness that meets certain requirements that insure that:

a. the obligation is acquired at a price that is not unfavorable to the plan,
b. immediately following the acquisition not more than 25% of the issue is held by the plan and at least 50% is held by persons independent of the issuer, and
c. immediately following the acquisition not more than 25% of the plan's assets is invested in obligations of the employer or an affiliate.

4.72.11.3.2.2.1 (06-14-2002)

Examination Steps

(1) If the employer is experiencing financial difficulties or if the employer's business is in a recessionary industry or region, consider the potential for nonexempt prohibited loans. The Form 5500 series identifies party-in-interest investments in corporate debt instruments, mortgages, and other loans.

(2) A plan's purchase of a disqualified person's debt securities that does not meet the definitions of a marketable obligation or a qualifying employer security or which causes the plan to exceed any applicable limits on

holding qualifying employer securities under ERISA 407(a) is a prohibited transaction that is not exempt under IRC 4975(d)(13).

(3) The DOL grants numerous individual administrative exemptions each year, and many of them are for loan transactions. If a prohibited loan is discovered, therefore, check for the existence of an exemption. If there is an exemption, make sure it covers the transaction and that all of the conditions of the exemption are met.

(4) Inspect the plan's records to ascertain whether loans between disqualified persons and the plan have occurred. If yes, (either directly or indirectly), scrutinize a copy of the loan agreement to identify the parties to the loan.

4.72.11.3.3 (06-14-2002)
Furnishing Goods or Services or Usage of Facilities

(1) IRC 4975(c)(1)(C) prohibits the direct or indirect furnishing of goods, services, or facilities between a plan and a disqualified person.

Note: An administrative exemption may be granted by DOL under IRC 4975(c)(1)(C).

(2) If the plan enters into a contract or reasonable arrangement with a disqualified person for office space or legal, accounting or other services necessary to establish or operate the plan, and no more than reasonable compensation is involved for such office space or service, the excise tax is not applicable. See IRC 4975(d)(2) and Reg. 54.4975–6 for further guidance on issues relating to multiple services.

(3) A bank or other financial institution which is acting as a plan fiduciary may provide additional banking services to the plan if it charges no more than reasonable compensation for the additional services, and it has adopted adequate internal safeguards to insure the services are provided in accordance with sound banking practice. See IRC 4975(d)(6).

(4) A disqualified person may serve as a fiduciary to the plan in addition to serving as an officer, employee, agent or other representative of a disqualified person (e.g., the employer which sponsors the plan), without being liable for the excise tax. See IRC 4975(d)(11).

(5) The excise tax is not applicable when a fiduciary receives reasonable compensation for services rendered to the plan if the services are necessary to establish and/or operate the plan. See IRC 4975(d)(10).

Note: The fiduciary cannot receive double compensation, i.e., a fiduciary cannot receive full-time pay from the employer or union sponsoring the plan and also receive additional compensation from the plan for providing such fiduciary services to the plan. A fiduciary may receive reasonable reimbursement for expenses actually incurred while providing services to the plan.

4.72.11.3.3.1 (06-14-2002)
Examination Step

(1) Inspect plan records to ascertain whether there has been any furnishing of goods or services or the use of facilities (directly or indirectly) between a disqualified person and the plan. Inspect both receipts and disbursements because it does not matter in which direction the goods, services or facility usage takes place.

(2) Inspect the balance sheet to see if the plan owns any property which might be involved in this type of prohibited transaction. If it is discovered the plan owns real or personal property, verify this property is not being occupied or used by a disqualified person.

4.72.11.3.4 (06-14-2002)
Transfer to, or Use By or For

(1) IRC 4975(c)(1)(D) prohibits the direct or indirect transfer to, or use by or for the benefit of, a disqualified person, of the income or assets of a plan.

- An example of an indirect benefit which would constitute a prohibited transaction is the purchase or sale of securities by a plan to manipulate the price of the security in a manner advantageous to a disqualified person.

(2) However, IRC 4975(d) grants certain statutory exemptions for the transfer to, or use by or for a disqualified person of income or assets of a plan. If a prohibited transaction falls within one of the following, the excise tax is not applicable.

a. If a disqualified person is a participant in the plan, he/she may receive plan benefits as long as the benefits are computed and paid in a manner consistent with the provisions of the plan as applied to all other participants and beneficiaries. See IRC 4975(d)(9).
b. If a plan terminates, distributions may be made to all plan participants (some of whom may be disqualified persons) without being a prohibited transaction if distributions are made in accordance with plan provisions and the asset allocation rules in ERISA 4044 are not violated. Also, excess assets caused by actuarial surplus may revert to the employer if the conditions set forth in ERISA 4044(b) are not violated. See IRC 4975(d)(12).

4.72.11.3.4.1 (06-14-2002)
Examination Step

(1) Inspect the plan receipts and disbursements journal to ascertain whether any income or assets of the plan have been transferred to, or used by or for the benefit of, a disqualified person.

(2) If the result is yes, examine source documents (checks, loan agreements, security buy-sell statements, stock quotations, etc.) to verify the nature, circumstances and ultimate effect of the transaction.

4.72.11.3.5 (06-14-2002)
Fiduciary Self Dealing

(1) IRC 4975(c)(1)(E) prohibits an act by a fiduciary whereby he deals with the income or assets of the plan in his own interest or for his own account.

(2) IRC 4975(d)(2) provides a statutory exemption for 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.

a. The regulations interpreting this exemption at Reg. 54.4975–6 explain that fiduciaries and other disqualified persons may provide services to the plan if the arrangement meets the requirements of the exemption.
b. The exemption, however, does not apply to exempt a fiduciary's exercise of authority, control or responsibility to cause the plan to pay the fiduciary additional fees for services. See 4.72.11.3.5.3.

(3) Under ERISA the definition of fiduciary goes beyond those persons traditionally recognized as plan fiduciaries, such as the trustees of the plan.

(4) The term "fiduciary" includes any person who exercises any authority or control regarding management or disposition of plan assets, or has or exercises discretionary authority, control or responsibility for plan administration, or renders investment advice to the plan for a fee or any other direct or indirect compensation.

- For example, persons who give advisory or consulting services to the plan, such as insurance agents or stockbrokers, may be fiduciaries to the plan although not formally named as such.

(5) Included within the concept of indirect benefit to a fiduciary is a benefit to someone in whom that fiduciary has an interest that would affect his/her fiduciary judgement.

- An example would be the retention by a fiduciary of his/her son to provide administrative services to the plan for a fee. Although the son's providing of services to the plan would be a prohibited transaction in and of itself, it may be exempt from excise tax if it meets the conditions of IRC 4975(d)(2). However, the fiduciary's action in causing the plan to pay a fee to his/her son is a separate prohibited transaction under IRC 4975(c)(1)(E) which would not be exempt under IRC 4975(d)(2).

Note: Both this prohibited transaction and the one discussed in 4.72.11.3.6 apply only to fiduciaries. The parallel provisions or ERISA to IRC 4975(c)(1)(E) and (F) are section 406(b)(1) and (3) of Title I of ERISA respectively. (There is no provision in the Code parallel to ERISA 406(b)(2).)

4.72.11.3.5.1 (06-14-2002)
Investments of Plan Assets in Account

(1) A bank or similar financial institution that is supervised by the United States or a State may as the plan fiduciary invest plan assets in its own depository accounts which bear a reasonable rate of interest if the—

a. Plan covers only employees of the financial institution, its affiliates or both, or
b. Investments are expressly allowed by plan provisions or by a fiduciary (other than the financial institution) expressly empowered by the plan to instruct the trustee to make such investments. See IRC 4975(d)(4).

4.72.11.3.5.2 (06-14-2002)
Insurance Purchase From Related Companies

(1) A plan may purchase life or health insurance or annuities from an insurance company, or companies, if each company is the employer maintaining the plan, or wholly owned by the employer or by another disqualified person, but only if:

a. the total consideration received by such wholly-owned insurer from all plans with respect to which it is a disqualified person does not exceed 5% of the total premiums and annuity considerations written by such insurers that year,
b. each insurer is qualified to do business in the state, and
c. the plan pays no more than adequate consideration for the insurance or annuities. See IRC 4975(d)(5).

4.72.11.3.5.3 (06-14-2002)
Examination Steps

(1) Examine the receipts and disbursements journal and related source documents for any transaction involving income or assets which might directly or indirectly benefit a fiduciary who used any of his/her fiduciary authority, control or responsibility to cause the plan to enter into the transaction.

(2) Look for a prohibited transaction whenever an investment manager can generate additional fees on his/her own authority. If an investment management fee structure is based on the management of a certain portion of the plan's assets, and the investment manager can charge additional fees with respect to those same assets for additional services, there may be a prohibited transaction.

- "Sweep fees" are an example of this. An investment manager's fee may be a certain percentage of the value of assets managed. If the investment manager provides a service whereby all uninvested assets as of the close of business are "swept" into an overnight money fund, there may be a prohibited transaction if any additional fee for this service is based on the value of the funds swept into the overnight fund. Such an arrangement, of course, provides an incentive to the investment manager to maximize the funds available for the sweep fee rather than make longer term investments.

(3) Another type of fiduciary self-dealing occurs when the employer has an arrangement with a plan service provider whereby the employer receives certain benefits from the service provider as a result of the business generated by the plan services.

- For example, if the employer, for its business use, receives computer equipment from a financial institution as a result maintaining a minimum balance of plan assets in the institution's money market account, the employer has engaged in a prohibited use of plan assets for his own account.

(4) The Form 5500 asks for information about the plan's payments to service providers, plan administrative expenses, and terminated service providers. If administrative expenses seem unusually high in relation to plan assets, or if it appears that the plan administrator has been dissatisfied with the service provider, further investigation may reveal the problems described above.

(5) Fiduciary self-dealing transactions will not necessarily involve the employer or plan administrator in a prohibited transaction.

- If, for example, an examination of a plan's investment management contract reveals that the investment manager is charging multiple fees, the investment manager may have engaged in a prohibited transaction. Scrutinize the investment manager's charges to determine if the multiple fees are reasonable. If they are unreasonable, examine contracts with other plans in an attempt to discover other prohibited transactions engaged in by the investment manager. To accomplish this, request the service provider's client list. If necessary, issue a subpoena to obtain that list.

4.72.11.3.6 (06-14-2002)
Third Party Dealing by Fiduciary

(1) If a fiduciary receives any consideration for his own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan, it is a prohibited transaction. See IRC 4975(c)(1)(F).

(2) The general area addressed by this prohibited transaction is "kickbacks".

- For example, a fiduciary retaining a person to provide services to a plan or investing plan assets in a specified investment media in return for a sum of money or other consideration paid to the fiduciary.

(3) There are no statutory exemptions for "kickbacks". Very common payments not normally considered a "kickback", such as commissions on the purchase or sale of insurance or securities are also considered prohibited transactions.

Note: However, the Service and DOL have issued administrative class exemptions to cover many common business practices which would otherwise be prohibited transactions subject to excise tax. See Exhibit 4.72.11–1, for a list of class exemptions from the prohibited transaction rules, particularly PTEs 75–1, 77–9, 79–60, and 86–128.

4.72.11.3.6.1 (06-14-2002)
Examination Step

(1) This type of transaction is very difficult to uncover in the course of a routine examination of plan records. Be on the look-out for such a situation, and if discovered, it should be pursued to its end.

4.72.11.3.7 (06-14-2002)
Acquisition of Employer Securities or Employer Real Property

(1) IRC 4975(c)(1)(A) prohibits the direct or indirect sale, exchange or leasing of property between a plan and a disqualified person. Thus, the sale of securities or real property between an employer and a plan or the leasing of property to the employer by the plan is prohibited. See 4.72.11.3.1.

(2) IRC 4975(d)(13) provides a statutory exemption for the acquisition, sale or lease by plans of certain employer securities or real property. See ERISA 408(e).

a. A plan's acquisition or holding of employer securities or employer real property is not a per se prohibited transaction, although IRC 4975 does make the acquisition of such property from, or sale to, a disqualified person a prohibited transaction.
b. However, ERISA 407(a), which is administered by the DOL, generally prohibits the acquisition or holding of employer securities or employer real property (defined in ERISA 407(d)(1) and (2)). That section does permit plans to acquire or hold a total of no more than 10% of its assets in the form of qualifying employer securities or qualifying employer real property (as defined in ERISA 407(d)(4) and (5)) or any combination of these types of property. Generally, an eligible individual account plan is excepted from this limitation. See 4.72.11.3.7.1 and ERISA 407(d).

(3) To meet the requirements of ERISA 408(e), four requirements must be met.

1. Plan must be eligible
2. Securities or real property must be qualifying
3. Acquisition must be for adequate consideration
4. No commission must be charged with respect to the acquisition

4.72.11.3.7.1 (06-14-2002)
Eligible Plans

(1) Defined benefit plans and most money purchase plans may not acquire qualifying employer securities or qualifying employer real property exceeding 10% of that plan's assets. However, money purchase plans that were in existence on 9/2/74, and on that date invested primarily in employer securities, may invest in qualifying employer securities or qualifying employer real property exceeding 10% of their assets.

Example 3: Company A's money purchase plan was established in 1979. It recently acquired qualifying employer securities from the employer which increased its holdings in Company A to well over 25% of the plan's assets. The acquisition is a prohibited transaction because a money purchase plan established after 1974 may not acquire or hold qualifying employer securities exceeding 10% of its assets.

(2) The excise taxes described in IRC 4975 apply only in the instance of a prohibited transaction between a plan and a disqualified person. Because ERISA 406 and ERISA 407 are broader in their application than the Code, there might be a prohibited transaction under Title I for which the IRC 4975 excise tax cannot be imposed.

a. A prohibited transaction under Title I can result from acquisitions from third parties as well as from the holding of securities or real property in excess of the prescribed limits.
b. However, real property acquired through a non-cash contribution by the employer to satisfy a funding obligation is considered a sale or exchange and is a prohibited transaction. See 4.72.11.3.1 for the discussion on the Keystone case. The DOL in Interpretive Bulletin 94–3, 59 F.R. 66735 (12/28/94) applied the holding in the Keystone case to defined contribution plans and welfare plans as well as to defined benefit plans.

(3) Other defined contribution plans, such as profit-sharing or stock bonus plans, are “eligible individual account plans” permitted to acquire qualifying employer securities or qualifying employer real property exceeding 10% of the plan’s assets if the acquisition of these investments is specifically provided for in the plan.

a. However, if the benefits payable under an individual account plan are taken into account in determining the benefits payable to a participant under any defined benefit plan, the plan is not an “eligible individual account plan.”
b. Thus, if a participant’s benefit payable under a defined benefit plan is offset by the participant’s profit-sharing plan account, the profit-sharing plan is not an eligible individual account plan. See ERISA 407(d)(3)(C).

4.72.11.3.7.2 (06-14-2002)

Qualifying Employer Securities and Qualifying Employer Real Property

(1) Generally, a plan may not acquire any employer securities or employer real property that is not “qualifying.”

a. An employer security is a security issued by an employer of employees covered by the plan or an affiliate of such employer. ERISA 407(d)(1). (See ERISA 407(d)(7) for the definition of an affiliate of the employer.)
b. A qualifying employer security is stock, a marketable obligation (such as a bond, debenture, note, or certificate or other evidence of indebtedness), or an interest in a publicly traded partnership. ERISA 407(d)(5).

(2) A marketable obligation is not qualifying unless immediately after the acquisition of the obligation:

a. The plan holds no more than 25% of the aggregate amount of the outstanding debt issue;
b. At least 50% of the aggregate amount of the issue is owned by persons independent of the issuer; and,

c. No more than 25% of the assets of the plan are invested in obligations of the employer or an affiliate of the employer.

Example 4: B Corporation maintains an eligible individual account plan which has invested 70% of its assets in recently issued bonds of the employer. The plan purchased 60% of a recent issue of the employer's marketable obligations. The obligations are not qualifying employer securities because the plan purchased more than 25% of the issue and the plan has more than 25% of its assets invested in obligations of the employer.

(3) A marketable obligation is not qualifying unless purchased—

a. On the market
b. From an underwriter
c. Directly from the issuer at the same price that would be established for a party entirely independent of the issuer. See ERISA 407(e)(1).

(4) Stock or an interest in a publicly traded partnership acquired on or after 12/17/87, by a defined benefit plan or money purchase pension plan, is not qualifying unless immediately following the acquisition of such stock:

a. No more than 25% of the aggregate amount of stock of the same class issued and outstanding at the time of the acquisition is held by the plan; and,
b. At least 50% of the aggregate amount of stock of the same class of stock is held by persons independent of the issuer.

(5) After 1/1/93, for Title I purposes only, the employer securities owned (not merely acquired) by these plans must meet certain requirements. See ERISA 407(d)(5) and 407(e).

4.72.11.3.7.2.1 (06-14-2002)

Qualifying Employer Real Property

(1) Employer real property is defined in ERISA 407(d)(2) as real property (and related personal property) which is owned by a plan and leased to an employer of employees covered by the plan or to an affiliate of such employer.

a. This term is often confused with property that is owned by an employer. Employer owned property leased to the plan is not exempt under ERISA provisions relating to the acquisition and holding of qualifying employer real property.

Example 5: Company C reports on the Form 5500 filed for its defined contribution plan that it owns employer real property or employer securities valued at $200,000. Its statement of assets, however, lists no real estate holdings and corporate debt and lists equity instruments valued at $25,000. This discrepancy may indicate that the filer is confusing employer real propery (i.e., property owned by the plan and leased to the employer) with property owned by the employer and leased to the plan.

(2) Qualifying employer real property is defined in ERISA 407(d)(4) as parcels of employer real property that:

a. are geographically dispersed (Note: there must be more than one property);
b. are suitable (or adaptable without significant cost) for more than one use (even if such property is leased to only one lessee); and,
c. insofar as their acquisition or retention is concerned, comply with the requirements of Part 4 of Subtitle B of Title I of ERISA other than the diversification requirements. (In other words, the investment in employer real property is prudent, in accordance with plan documents, etc., but not necessarily sufficiently diversified so as to minimize the risk of large losses to the plan.)

4.72.11.3.7.2.2 (06-14-2002)
Adequate Consideration

(1) Eligible plans that acquire or hold qualifying employer securities or qualifying employer real property must also assure that the acquisition, sale, or lease is for adequate consideration, i.e., FMV or the price that a third party independent of the issuer would pay for such property.

a. For employer securities (or employer real property) for which there is a generally recognized market, the market will determine the adequacy of consideration.
b. In almost all other instances this requires an appraisal from a party independent of the employer.

Example 6: The defined contribution plan of D Corporation leases several properties it owns at different locations to the employer. D Corporation proposes that the plan purchase a warehouse next to the corporation's present facilities at $100,000 without an appraisal. Without a third party's appraisal of the value of the building, there is likely to be no reliable way to establish that the building was purchased for adequate consideration. Therefore, one or more prohibitied transactions are likely to have occurred.

4.72.11.3.7.2.3 (06-14-2002)
No Commission

(1) No commission may be charged with respect to a transaction involving the acquisition, sale or lease of employer securities or employer real property to or from a disqualified person.

4.72.11.3.7.2.4 (06-14-2002)
Examination Steps

(1) Determine whether the employer property is real property or securities. Compare the amount reported on Form 5500 in response to the employer securities or real property question with the amount listed in the statement of assets and liabilities for corporate debt and equity instruments and/or real estate and mortgages.

(2) Determine the total percentage of the plan's assets invested in employer securities or real property. Compare the amount reported in the prohibited transactions section of the applicable Form 5500 with the amount of total assets listed for the plan.

(3) If the plan is a defined benefit plan, check to see whether the plan had more than 10% of its assets invested in employer securities or real

property immediately after the acquisition, and, if so, whether the DOL has granted an administrative exemption to permit this.

(4) If the plan is a defined contribution plan, determine whether the plan is an “eligible individual account plan.”

a. If the plan is a money purchase pension plan with more than 10% of its assets invested in employer securities or real property, make sure the plan was in existence on 9/2/74, and invested primarily in employer securities on that date.
b. Determine whether the plan specifically provides for the acquisition and holding of qualifying employer securities and qualifying employer real property.
c. Make sure that benefits payable under the individual account plan are not taken into account in determining the benefits payable to any participant under any defined benefit plan of the employer.

(5) If the employer property is securities:

a. Determine that the plan has purchased qualifying employer securities in accordance with the criteria under ERISA 408(e). See 4.72.11.3.7(3).
b. Determine whether the plan has purchased nonpublicly traded securities without an independent appraisal, and whether the stock was purchased from an employer that is a closely-held corporation. In this situation, determine if the acquisition of the securities is for adequate consideration. See 4.72.11.3.7.2.2.

(6) If the employer property is real property:

a. Determine that the plan has purchased qualifying employer real property in accordance with the criteria under ERISA 407(d)(4). See 4.72.11.3.7.2.1.
b. Determine whether there are at least two parcels of employer real property.

Note: In Lambos v. Commissioner, 88 T.C. 1440 (1987), the U.S. Tax Court held that two parcels of land situated in different parts of the same county were not geographically dispersed. The Tax Court stated that an economic condition peculiar to the county would significantly affect the entire plan. By the same reasoning, contiguous (or nearly contiguous) land separated by a state or county line may not be sufficient to establish geographic dispersal.

c. If there was a sale or exchange of employer real property, determine whether there was an independent appraisal of the land before the acquisition. See 4.72.11.3.7.2.2.

4.72.11.3.7.3 (06-14-2002)

Terminated Plans

(1) Terminated plans or plans merged with other plans to form a new plan are of special concern because the disposition of plan assets may not be adequately reported and may be prohibited.

4.72.11.3.7.3.1 (06-14-2002)
Disposition of Qualifying Employer Securities

(1) Plans are permitted to dispose of qualifying employer securities upon termination by offering such property to the employer at FMV. Any transactions with respect to employer securities require the payment of adequate consideration. Therefore, the price at which an employer buys back employer securities from a terminating plan must be based upon FMV.

4.72.11.3.7.4 (06-14-2002)
Disposition of Qualifying Employer Real Property

(1) Upon plan termination qualifying employer real property may be sold to the employer or placed on the market as the plan fiduciaries deem appropriate.

4.72.11.3.7.4.1 (06-14-2002)
Disposition of Employer Real Property or Employer Securities Not Qualifying

(1) Any employer securities or employer real property that are not qualifying to begin with may not be sold to the employer upon termination of the plan. Such a sale is not a correction within the meaning of Reg. 53.4941(e)–1(c), and therefore, would constitute a second prohibited transaction. See Rev. Rul. 81–40, 1981–1 C.B. 508.

4.72.11.3.7.4.2 (06-14-2002)
Disposition of Other Plan Assets

(1) In the case of a plan merger or consolidation, each participant's account balance after the transaction must be equal to or greater than each participant's account balance prior to the transaction. See IRC 414(l).

4.72.11.3.7.5 (06-14-2002)
Wasting Trusts

(1) All plan assets must be distributed as soon as administratively feasible after the amendment terminating the plan was adopted.

(2) Generally, a distribution which is not completed within one year following the date of plan termination specified by the employer will be presumed not to have been made as soon as administratively feasible. See Rev. Rul. 89–87, 1989–2 C.B. 81.

(3) A plan under which all assets are not distributed as soon as administratively feasible is an ongoing plan and must continue to meet the qualification requirements of IRC 401(a) and the Form 5500 reporting requirements.

- The Form 5500 filed for the year in which the plan terminated should accurately report the plan's assets and liabilities before and after termination as well as the benefits distributed to employees and/or the assets transferred to a new plan in the case of mergers.

4.72.11.3.7.6 (06-14-2002)
Examination Steps

(1) From the Form 5500 filed for the current plan year or the two previous plan years, determine whether any assets of the plan were sold to a disqualified person prior the plan's termination.

(2) For employer securities or employer real property reported by the plan, determine:

a. how they were disposed of prior to termination;
b. whether a third party appraisal was obtained in those cases where there was no recognized market for the securities;
c. whether an independent third party appraised the real property; and
d. whether the real property was sold to the employer or an affiliate.

(3) Determine whether—

a. any potentially non-exempt loans were reported on the Form 5500, or
b. an extension was given on any prior loans involving a substantial portion of the plan's assets.

(4) If the plan held mortgages on property bought with participant loans, determine whether the disposition of the mortgage resulted in a taxable distribution to the participant when the plan terminated.

(5) Determine whether there was a net loss to the plan preceding termination. Such a loss may indicate an underlying prohibited transaction involving a sale of assets to a disqualified person for less than FMV or a previous purchase of assets from a disqualified person at an inflated price.

4.72.11.4 (06-14-2002)
Prohibited Transactions Tax

(1) IRC 4975(a) and (b) impose a two level, nondeductible excise tax on each prohibited transaction entered into by a disqualified person (other than a fiduciary acting only as such). Pending issuance of final regulations under IRC 4975, the excise tax on prohibited transactions is calculated in the same manner as the excise tax on self-dealing transactions with respect to private foundations. Because the terms "amount involved" and "correction" have not changed, this is the case even though the first level excise tax rates are now different.

- The validity of Reg. 141.4975–13 was upheld in Rutland v. Commissioner, 89 T.C. 1137 (1987). The Rutland case also reaffirms the holding in Lambos. See 4.72.11.3.7.2.4.

4.72.11.4.1 (06-14-2002)
First Level Tax

(1) An excise tax is imposed on a disqualified person (other than a fiduciary acting only as such) for each prohibited transaction with the plan.

(2) Where a fiduciary participates in a prohibited transaction, in a capacity other than as a fiduciary, he/she is to be treated as a disqualified person subject to tax.

a. The tax imposed on the disqualified person is 10% for prohibited transactions occurring after August 20, 1996, and 15% for prohibited transactions occurring after August 5, 1997 of the “amount involved” in the transaction for each year or partial year of the “amount involved” in the transaction for each year or partial year (of the disqualified person) in the taxable period.
b. See Exhibits 4.72.11-4 and 5 Computation of the “Amount Involved” and Amount of Tax for a Continuous Prohibited Transaction and Computation of “Amount Involved” and Amount of Tax for a Continous Prohibited Transaction with Repayments.

4.72.11.4.1.1 (06-14-2002)

Second Level Tax

(1) If the prohibited transaction is not corrected within the taxable period a tax of 100% of the “amount involved” is imposed on the disqualified person. See Exhibit 4.72.11–6.

(2) Under IRC 4961, the second tier tax can be abated if the prohibited transaction is corrected during the taxable period. See 4.72.11.4.1.3 for the definition of “taxable period”.

4.72.11.4.1.2 (06-14-2002)

Liability

(1) If more than one disqualified person is liable for the first or second level tax, then all such persons are jointly and severally liable to pay the tax.

4.72.11.4.1.3 (06-14-2002)

Taxable Period

(1) The term “taxable period” means the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of the date on which:

a. notice of deficiency is mailed under IRC 6212 with respect to the tax imposed by IRC 4975(a), or
b. the tax imposed by IRC 4975(a) is assessed, or
c. correction of the prohibited transaction is completed.

(2) A prohibited transaction occurs on the date on which the terms and conditions of the transaction and the liabilities of the parties have been fixed. When a notice of deficiency is not mailed because there is a waiver of the restriction on assessment and collection of a deficiency, or because the deficiency is paid, the date of filing of the waiver or the date of payment of the deficiency is treated as the end of the taxable period.

4.72.11.4.2 (06-14-2002)

Amount Involved First Level

(1) The “amount involved” under IRC 4975(f)(4) is the greater of the amount of money and fair market value (FMV) of other property:

a. given, or
b. received.

(2) The FMV for first level excise tax purposes is measured as of the date of the prohibited transaction.

Example 7: A corporation that maintains a plan purchases equipment from the plan for $12,000. The FMV of the equipment is $15,000. The amount involved on the first level tax is $15,000. If the corporation paid $20,000 the amount involved would be $20,000.

(3) The method for determining the amount involved is described in more detail in the following instances—

a. Excess compensation
b. Loan or other use of money or property (a lease)
c. Good faith effort to determine fair market value as described in Reg. 53.4941(e)–1(b)(2)(iii).

4.72.11.4.2.1 (06-14-2002)
Excess Compensation

(1) Generally, services exempted from treatment as a prohibited transaction because they fall within the purview of the statutory exemptions provided by IRC 4975(d)(2) and (10) are not subject to the excise tax unless the compensation is deemed to be excessive. In such a case, the “amount involved” is only the excessive compensation.

Example 8: An investment advisor to a plan is paid $100.00 per day for each day worked. It is determined that only $60.00 per day is reasonable based upon the facts in the case. The amount involved for the violation of IRC 4975(c)(1)(C) in this case would be $40.00 per day.

4.72.11.4.2.2 (06-14-2002)
Use of Money or Property

(1) Where the use of money or other property is involved, the “amount involved” is the greater of the amount paid for such use or the FMV of such use for the period for which the money or other property is used.

- For example, in the case of a lease of a building by a plan to a disqualified person, the “amount involved” is the greater of the amount of rent received by the plan from the disqualified person or the fair rental value of the building for the period such building is used by the disqualified person.

Example 9: If on 1/1/99, the plan borrowed $100,000.00 from the employer, a disqualified person, at 6% interest while the prevailing rate in the financial community for loans of a similar nature at the time of the loan was 10%, the “amount involved” would be $10,000.00 (the $100,000.00 loan x the 10% interest rate). The amount of the first level excise tax for 1999 would be $1,500.00 (15% x $10,000.00).

Example 10: If the plan leased its building to a disqualified person for $10,000.00 a year and the fair rental value was $11,000.00, the “amount involved” for purposes of the IRC 4975(a) tax would be $11,000.00. However, if the fair rental value was $9,000.00 the “amount involved” for purposes of the IRC 4975(a) tax would be $10,000.00.

4.72.11.4.2.3 (06-14-2002)
Less than FMV Received

(1) In the case of a prohibited transaction which would otherwise be protected from the excise tax by virtue of a statutory or administrative exemption or a transitional rule, but failed to meet the conditions of such exemption or transitional rule solely because the plan paid more, or received less, then FMV for the property transferred or a reasonable interest rate in the case of loans, the "amount involved" is the difference between the FMV over the amount the plan paid or received if the parties made a good faith effort to determine FMV.

(2) A good faith effort is ordinarily made when the:

a. person making the valuation is not a disqualified person, is competent to make such valuations and is not in a position to derive an economic benefit from the value utilized, and
b. valuation method is a generally accepted one for valuing comparable property for purposes of arms-length business transactions.

Example 11: Assume in this case a good faith effort was made to determine FMV value. The amount paid in the transaction was $5,000.00 and the FMV was determined to be $5,500.00. The "amount involved" would be $500.00. In a similar case where a good faith effort was not made, the amount involved would be $5,500.00.

4.72.11.4.3 (06-14-2002)
Amount Involved Second Level

(1) For determining the "amount involved" for second level tax purposes, the first level tax guidelines may be used except that the "amount involved" is the highest FMV during the taxable period. This provision is to insure that the person subject to the tax will not postpone correction of the prohibited transaction in order to earn income on such amounts.

(2) The FMV used in determining the "amount involved" for second level tax purposes is not necessarily the same as the FMV used for corrections under 4.72.11.4.3.1.

4.72.11.4.3.1 (06-14-2002)
Correction

(1) Correcting a prohibited transaction means undoing the transaction to the extent possible. The resulting financial position of the plan may be no worse after the correction than if the highest fiduciary standards had been applied. The date of correction may end the taxable period with respect to which the first level tax is imposed if the correction is completed prior to the mailing of the notice of deficiency. However, the main significance of a correction is to avoid the second level 100% excise tax set forth in IRC 4975(b).

Note: The undoing of the prohibited transaction does not constitute another prohibited transaction, and in correcting the prohibited transaction, the higher of the FMV of the property given or received, either at the occurrence of each prohibited transaction or at the time of correction, must be utilized. Also, the FMV for "correction" is not necessarily the same as the FMV for "amount involved." See 4.72.11.4.2.

4.72.11.4.3.1.1 (06-14-2002)
Correction Involving Use of Money or Property

(1) If a disqualified person uses the money or property of a plan, correction includes, but is not limited to, the termination of such use. In addition, the disqualified person must pay to the plan the excess, if any, of the—

a. FMV (greater of the value at the time of the prohibited transaction or at the time of correction) for the use of the money or property over the amount paid for the use until termination, plus
b. Amount that would have been paid by the disqualified person for the period such disqualified person would have used the property if such termination had not occurred, over the FMV (at the time of correction) for the use for such period.

4.72.11.4.3.1.2 (06-14-2002)
Correction Involving Use of Money or Property by a Plan

(1) If a plan uses the property of a disqualified person, correction includes, but is not limited to, termination of such use. In addition, the disqualified person must pay to the plan the excess, if any, of the—

a. amount he/she received from the plan over the FMV (lesser of the value at the time of the prohibited transaction or at the time of correction) for the use of the money or property until the time of termination, plus
b. FMV at time of correction for the use of the money or property (for the period the plan would have used the money or property if termination had not occurred), over the amount that would have been paid by the plan after termination for use in such period.

4.72.11.4.3.1.3 (06-14-2002)
Correction of Sales of Property by a Plan

(1) In the case of a sale of property by a plan to a disqualified person for cash, undoing the transaction includes, but is not limited to, rescinding the sale.

a. The amount returned to the disqualified person must not exceed the lesser of the cash received by the plan or the FMV of the property received by the disqualified person.
b. The FMV to be returned is the lesser of the FMV on the date the prohibited transaction occurred or at the time of rescission of the sale.
c. The disqualified person must also return to the plan any net income derived from the use of the property to the extent that it exceeds any income derived by the plan during the taxable period from its use of the cash received from the original sale, exchange or transfer.

4.72.11.4.3.1.4 (06-14-2002)
Resale Prior to End of Taxable Period

(1) If, prior to the end of the taxable period, the disqualified person resells the property in an arms-length transaction to a bona fide purchaser other than the plan or another disqualified person, rescission of the original sale is not required. See 4.72.11.4.3.1.3

a. The disqualified person must pay to the plan the excess, if any, of the greater of the FMV of the property on the date of correction, (the date on which the money is paid over to the plan) or the amount realized by the disqualified person from the arm's-length sale, over the amount which would have been returned to the disqualified person.

b. In addition, the disqualified person must pay to the plan any net profits realized through the use of the property during the taxable period.

4.72.11.4.3.1.5 (06-14-2002)
Correction of Sale of Property to a Plan

(1) In the case of the sale of property to a plan by a disqualified person for cash, undoing the transaction includes, but is not limited to, rescission of the sale where possible. To avoid placing the plan in position worse than if such rescission were not required, the amount received from the disqualified person pursuant to the rescission is the greatest of—

a. Cash paid to the disqualified person,
b. FMV of the property at the time of the original sale, or
c. FMV of the property at the time of rescission.

(2) In addition to rescission, the disqualified person is required to pay over to the plan any net profits he/she realized after the original sale with respect to the consideration he/she received from the sale to the extent such income during the taxable period exceeds the income derived by the plan during the taxable period from the property which the disqualified person originally transferred to the plan.

4.72.11.4.3.1.6 (06-14-2002)
Resale by Plan

(1) If the plan resells the property before the end of the taxable period in an arms-length transaction to a bona fide purchaser, other than a disqualified person, no rescission is necessary.

a. In such an instance, the disqualified person must pay over to the plan the excess, if any, of the amount which would have been paid to the plan if rescission had been required over the amount which the plan realized on the resale of the property.
b. In addition, the disqualified person is required to pay to the plan any net profits over the plan's income he/she realized.

4.72.11.4.3.1.7 (06-14-2002)
Compensation Paid

(1) If a plan pays compensation to a disqualified person for the performance of personal services that are reasonable and necessary to carry out the provisions of the plan, correction requires paying back to the plan any amount considered excessive. Termination of employment is not required.

4.72.11.4.3.1.8 (06-14-2002)
Less than FMV Received

(1) In the case of a transaction described in 4.72.11.4.2.3, correction will occur if the plan is paid an amount equal to the "amount involved" plus any additional amounts necessary to compensate it for the loss of the use of the money (amount involved) or other property during the period from the date of the prohibited transaction to the date of correction.

4.72.11.5 (06-14-2002)
Transactions Identified on Form 5500

(1) The Form 5500 series return contains several questions designed to determine if the plan has been involved in a prohibited transaction or party-in-interest transaction. (A party-in-interest is a defined term under Title I of ERISA that, in most instances, is parallel to a disqualified person.)

- For example, the Form 5500 series requests “yes” or “no” answers to questions relating to plans investing in employer securities or employer real property, plan loans, sales, exchanges or leases of property, relationships between plan fiduciaries and service providers, and the purchase of non-publicly traded securities without a third party appraisal. The questions on the Form 5500 series returns are designed to identify potential problem areas.

4.72.11.5.1 (06-14-2002)
Examination Steps

(1) If a transaction with a party-in-interest/disqualified person is reported on the Form 5500 series return, investigate to determine if the transaction is a prohibited transaction. For a transaction between the plan and a disqualified person to be a prohibited transaction, it must be one of the transactions described in IRC 4975(c)(1) that is neither statutorily exempt under IRC 4975 nor the subject of an administrative exemption.

(2) Potential prohibited transactions may not be identified on the Form 5500 series return by a direct response to a question. This may occur because of an incorrect interpretation of the definition of party-in-interest/disqualified person, because the plan administrator believes the transaction to be exempt, because the plan administrator does not realize that the transaction is a party-in-interest transaction, or because the plan administrator is not aware of the transaction.

4.72.11.6 (06-14-2002)
Statute of Limitations

(1) The statute of limitations must be protected for purposes of assessing the excise taxes on prohibited transactions. Statutes on prohibited transactions are governed by the year of the plans as indicated on the Form 5500 series return and not the return for the taxable year of the disqualified person. See IRM 25.6, Statute of Limitations for more detail.

Note: The Form 5500 series return is the return for the plan only.

(2) The statutory period is different for a “continuing” transaction, e.g., a loan, versus a “discrete” transaction, e.g., a sale.

a. In a continuing transaction (e.g., a loan or lease), the prohibited transaction is deemed to recur on the first day of each subsequent taxable year of the disqualified person. The filing of the Form 5500 series return starts the statute running only for transactions occurring in the year for which the return is filed; a separate determination as to when the statute expires must be made for each subsequent tax year if the prohibited transaction has not been corrected.

b. In a discrete transaction, a determination as to the running of the statute of limitations need only be made for the tax year in which the transaction occurred. See G.C.M. 38846 as modified by G.C.M. 39066 and by G.C.M. 39475.

(3) If there is inadequate disclosure of a prohibited transaction on the Form 5500 series return, the statute of limitations is generally six years rather than the normal three years. However, to protect the interests of the government, the six-year statute should be protected, to the extent possible, as if it were a three-year statute.

Note: Regardless whether the 3-year or the 6-year statute of limitations applies, the applicable statutes of limitations on the returns of the disqualified persons are for the tax years that correspond to the plan years and are controlled by the Form 5500 series return.

(4) A prohibited transaction of a continuing nature may occur where the plan and the disqualified person are on different tax years. If the transaction is not corrected before the end of the plan year that overlaps the disqualified person's tax year the disqualified person will have engaged in two prohibited transactions within the year and would have to file at least two Form 5330 returns, *Return of Excise Taxes Related to Employee Benefit Plans.*

Example 12: A prohibited transaction of a continuing nature occurs on 7/31/99. The tax year of the plan is 7/1 to 6/30 while the tax year of the disqualified person is a calendar year. The disqualified person must file a Form 5330 for the 1999 calendar year and another Form 5330 for the 2000 calendar year if the transaction is not corrected by 12/31/99. If the transaction is corrected before 6/30/00 but after 12/31/99, there would be one prohibited transaction for the 1999 calendar year and two prohibited transactions for the 2000 calendar year. Because all of the transactions take place during the 2000 plan year, the statute of limitations would be controlled by the Form 5500 filed for the 2000 plan year (in the case of a timely filed return without extensions and assuming a 3-year statute of limitations, it would be 1/31/2004 for both Forms 5330).

(5) Form 5330 must be filed by the employer in the event of a reversion of assets from a plan. Form 5330 in these cases is a monthly return. Each return is filed not later than the last day of the month following the month in which the employer reversion occurs. See IRC 4980(c)(4).

(6) In soliciting consents (Forms 872 and 872–A) to protect the statute, insure the consent is prepared properly, indicate “excise tax”and not “income tax,” and extend the statute for the appropriate length of time. The disqualified person must sign the extension, and if more than one disqualified person is involved in the transaction, a separate extension is secured from each disqualified person because each is considered jointly liable for the excise tax and the correction.

Exhibit 4.72.11-1 (06-14-2002)
List of Granted Class Exemptions

List of Granted Class Exemptions

1.	75–1	10/31/75	40 F.R. 50845	permits certain securities transactions between (1) plans and (2) broker-dealers, reporting dealers and banks (also see, PTE 77–10, PTE 79–1 and PTE 86–128)
2.	76–1	3/26/76	41 F.R. 12740	permits certain transactions between multi-employer plans and parties in interest involving delinquent employer contributions, construction loans, leasing of office space, etc. (Also see, PTE 77–10)
3.	77–3	4/8/77	42 F.R. 18734	purchase and sale of open-ended mutual fund shares by a plan that covers fund's employees, etc.
4.	77–4	4/8/77	42 F.R. 18733	purchase and sale of open-ended mutual fund shares by a plan when a plan fiduciary is also an investment adviser, principal underwriter, etc.
5.	77–7	6/21/77	42 F.R. 31575	permits transfer of life insurance policies to plans by participants or employers (Also see, PTE 92–5)
6.	77–8	6/21/77	42 F.R. 31574	permits transfer of life insurance policies by plans to participants or employers, etc. (Also see, PTE 92–6)
7.	77–9	6/24/77	42 F.R. 32395	permits certain tranactions involving insurance agents and brokers, etc. Amended 1/5/79 and 9/7/79 (Also see, PTE 84–24)
8.	77–10	7/1/77	42 F.R. 33918	multiemployer plans — extension of PTE 76–1 to cover ERISA section 406(b)(2)
9.	78–6	5/30/78	43 F.R. 23024	multiemployer apprenticeship plans – certain sales and leases
10.	79–13	5/1/79	44 F.R. 25533	similar to PTE 77–3 but pertains to in-house closed-end mutual funds

Exhibit 4.72.11-1 (Cont. 1) (06-14-2002)
List of Granted Class Exemptions

List of Granted Class Exemptions

11,	79–15	5/22/79	44 F.R. 29757	judicial orders/not a PT if DOL or IRS is a party to litigation
12.	79–41	9/7/79	44 F.R. 46365	captive insurance — insurers that are substantially affiliated with plan
13.	79–60	10/12/79	44 F.R. 59018	permits sale of insurance to plan by an agent or broker who is a plan sponsor, etc.
14.	80–26	4/29/80	45 F.R. 28545	parties in interest can make interest free loans to a plans for plan operating expenses (Also see, PTE 2000–14)
15.	80–51	7/25/80	45 F.R. 49709	bank collective investment funds may make certain investments without being PTs (Also see, PTE 91–38)
16.	80–83	11/4/80	45 F.R. 73189	permits purchase of securities by plans to reduce indebtedness to parties in interest
17.	81–6	1/23/81	46 F.R. 7527	permits lending of securities by plans to banks and broker-dealers (Amendment 6/19/87, 52 F.R. 18754 which expands list of broker-dealers); also see, PTE 82–63
18.	81–7	1/23/81	46 F.R. 7520	permits certain mortgage pool investments (Also see, PTE 83–1)
19.	81–8	1/23/81	46 F.R. 7511	permits plans to invest in certain short term investment products (Amendment 4/9/85, 50 F.R. 14043)
20.	82–63	1/6/82	47 F.R. 14804	allows compensation to a fiduciary for securities lending to a plan (Also see, PTE 81–6)
21.	82–87	5/18/82	47 F.R. 21331	allows residential mortgage financing by plans (Also see, PTE 88–59
22.	83–1	1/7/83	48 F.R. 895	expands the coverage of mortgage pool investment trusts

Exhibit 4.72.11-1 (Cont. 2) (06-14-2002)
List of Granted Class Exemptions

List of Granted Class Exemptions				
23.	84–14	3/13/84	49 F.R. 9494	permits various transactions if a plan's assets are managed by a qualified professional asset manager
24.	84–24	4/3/84	49 F.R. 13208	permits broader range of transactions for insurance agents — pension consultants (Also see, PTE 77–9)
25.	85–68	4/3/85	50 F.R. 13293	permits plans to purchase and hold certain customer notes that the plan has received
26.	86–128	11/18/86	51 F.R. 41686	permits plan fiduciaries to execute certain securities transactions
27.	88–59	6/30/88	53 F.R. 24811	expands coverage of PTE 82–87 pertaining to residential mortgage financing
28.	T88–1	12/29/88	53 F.R. 52838	class exemption for Federal Employee Retirement System to purchase U.S. debt (amendment 3/11/92, 57 F.R. 8689)
29.	90–1	1/29/90	55 F.R. 2891	amends and supersedes PTE 78–19 regarding insurance company pooled accounts
30.	91–38	7/12/91	56 F.R. 31966	amends and supersedes PTE 80–51 regarding investments by bank collective funds
31.	91–55	9/2791	56 F.R. 49209	permits purchase and sale by IRAs of bullion coins from and to certain broker-dealers (correction 10/8/91, 56 F.R. 50730)
32.	92–5	2/11/92	57 F.R. 5019	amends PTE 77–7 to include transactions between plans and owner-employees
33.	92–6	2/11/92	57 F.R. 5019	amends PTE 77–8 to include transactions between plans and owner-employees (correction 7/7/92, 57 F.R. 29938)
34.	93–1	1/11/93	58 F.R. 3567	permits the receipt of cash and other gifts by beneficiaries of IRAs and HR-10's
35.	93–2	1/11/93	58 F.R. 3561	permits the receipt of services by beneficiaries of IRAs and HR-10's from a bank based on aggregation of accounts (relationship banking)
36.	93–33	5/28/93	58 F.R. 31053	expands PTE 93–2 to include SEPs (amendment 5/2/94, 59 F.R. 22686)

Exhibit 4.72.11-1 (Cont. 3) (06-14-2002)
List of Granted Class Exemptions

List of Granted Class Exemptions				
37.	94–20	2/17/94	59 F.R. 8022	permits certain foreign exchange transactions between banks or broker-dealers and plans
38.	94–71	10/7/94	59 F.R. 51217	permits transactions authorized by settlement agreements
39.	95–60	7/12/95	60 F.R. 39925	permits certain transactions of general accounts of insurance companies
40.	96–23	4/10/96	61 F.R. 15975	permits various asset transactions by in-house managers
41.	96–62	7/31/96	61 F.R. 39988	expedited issuance of certain exemptions if DOL has issued certain similar exemptions
42.	96–63	8/2/96	61 F.R. 40459	pension payback program
43.	97–11	2/7/97	62 F.R. 5855	broker-dealer services HR-10's, IRAs & SIMPLE-IRAs
44.	98–54	11/13/98	63 F.R. 63503	permits certain foreign exchange transactions not allowed in PTE 94–20 (certain transactions between 6/18/91 and 1/12/99 and other transactions after 1/12/99)
45.	2000–14	4/3/2000	65.F.R. 17540	expands exemption described in PTE 80–26 for certain Y2K issues if the transaction occurs between 11/1/99 and 4/3/2000

Exhibit 4.72.11-2 (06-14-2002)
Relationship Between Employer and Disqualified Person

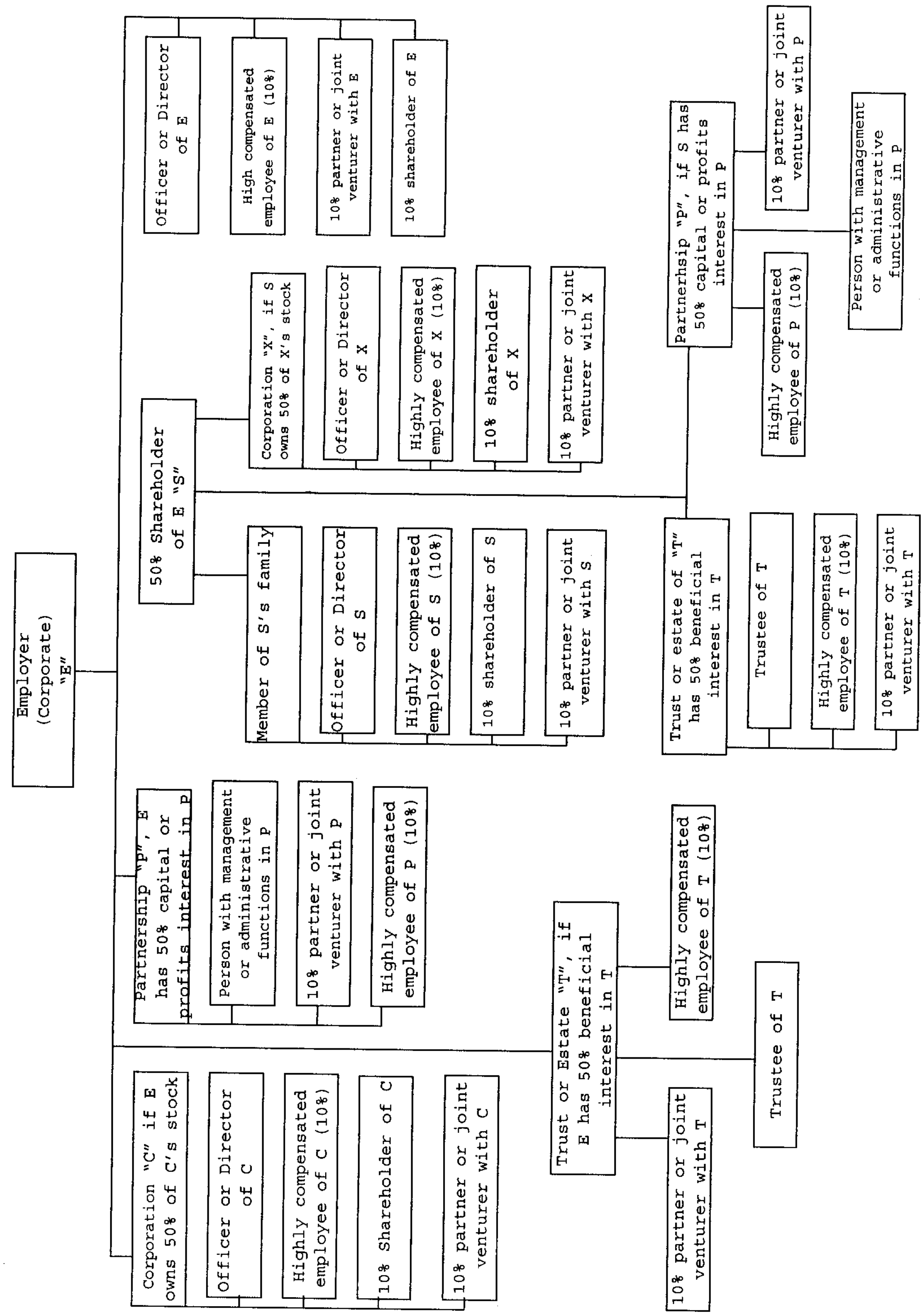

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Exhibit 4.72.11-3 (06-14-2002)
Relationship Between Non-corporate Employer and Disqualified Person

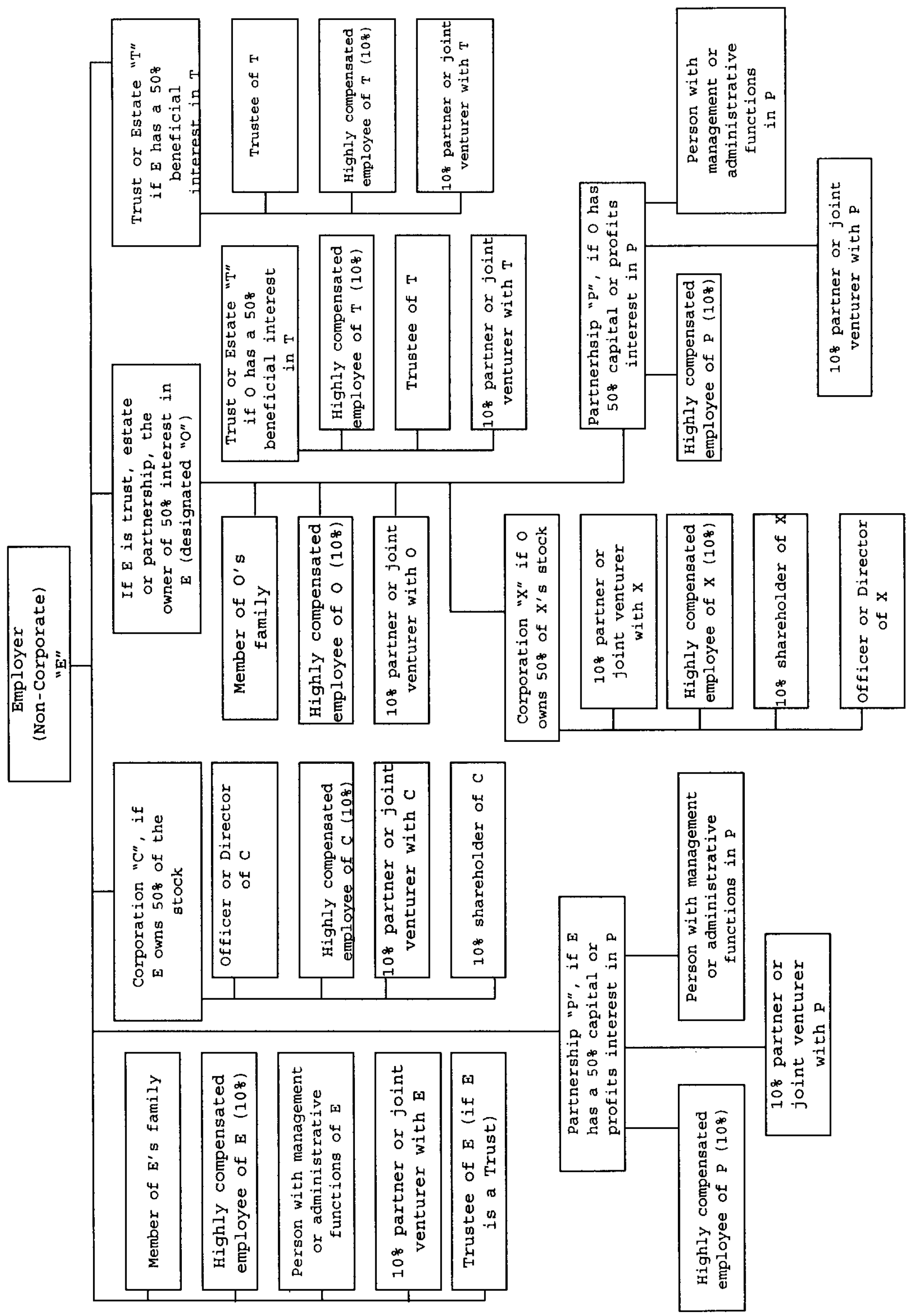

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Exhibit 4.72.11-4 (06-14-2002)
Computation of the Amount Involved and the Amount of Tax for a Continuous Prohibited Transaction (Reserved)

Exhibit 4.72.11-5 (06-14-2002)
Computation of the Amount Involved and the Amount of Tax for a Continuous Prohibited Transaction with Repayments

(1) **Facts**
A disqualified person, a calendar year taxpayer who was not a participant or beneficiary of the plan, borrowed $240,000 from the trust of a profit-sharing plan on April 1, 1997. The interest rate on the loan was at the fair market rate (which was the prime commercial rate + 2%, i.e., on 4/1/97 and on 1/1/98 it was 8.5% + 2% or 10.5% and on 1/1/99 it was 7.75% + 2% or 9.75%). Payment of principal and interest were due on the tenth day of each month (beginning May 10, 1997 with final payment due on March 31, 1999. The amount of each monthly payment applied towards the principal was fixed at $10,000. All payments of principal and interest were timely and as a result the prohibited transaction was corrected on March 31, 1999.

(2) **Computation of the Amount Involved**
Since the prohibited transaction was a loan, an additional prohibited transaction was deemed to occur on the first day of each taxable year in the taxable period after the taxable year in which the loan occurred. Treas. Reg. §53.4941(e)-1(e)(1). In this case there was one actual and two deemed loans. Moreover, the amount involved for any period, varies depending on the taxable period involved, i.e., the interest rate is the same fair market rate for the length of the taxable period and is the interest rate at the time of the prohibited transaction. See, GCM 39424, CC:EE-95–83 (Oct. 23, 1985) and Medina v. Commissioner, 112 T.C. 51 (1999).

(3) **Fair Market Rate**
1. 4/1/97 — 10.5%
2. 1/1/98 — 10.5%
3. 1/1/99 — 9.75%

(4) **Initial Tax**

	Date	Principal	Interest Rate	Time	Amount Involved
1.	4/1/97	$240,000	10.50%	.75	$18,900.00
2.	1/1/98	160,000*	10.50%	1	16,800.00
3.	1/1/99	40,000**	10.50%	.25	1,050.00
4.	1/1/99	40,000**	9.75%	.25	975.00

* $240,000 – $80,000 (8 payments of principal of $10,000 each) = $160,000
** $160,000 – $120,000 (12 payments of principal of $10,000 each) = $40,000

(5) **Computations of Tax**
The rate of tax is 10% of the amount involved for prohibited transactions occurring after August 20, 1996, and 15% of the amount involved for prohibited transactions occurring after August 5, 1997.

Exhibit 4.72.11-5 (Cont. 1) (06-14-2002)
Computation of the Amount Involved and the Amount of Tax for a Continuous Prohibited Transaction with Repayments

Taxable Year	First Taxable Period	Second Taxable Period	Third Taxable Period
1997	$18,900.00	—	—
1998	16,800.00	16,800.00	—
1999	1,050.00	1,050.00	$975.00
Total	$36,750.00	$17,850.00	$975.00
times applicable rate	x .10	x .15	x .15
1st level tax	$3,675.00	$2,677.50	$146.25
Total All Years = $6,498.75			

Exhibit 4.72.11-6 (06-14-2002)
Computation of the Amount Involved – Second Tier Tax – IRC 4975(b) Continuous Prohibited Transaction

(1) **Facts**
The fact are the same as in Exhibit 4 – Computation of Amount Involved and the Amount of Tax for a Continuous Prohibited Transaction except that the loan is not corrected and the most recent year involved is 1999. The highest fair market value of the 1997, 1998 and 1999 loans during the taxable period is 10.5%. The highest fair market value of the 1999 loan during the taxable period is the result of a prime interest rate increase to 8.5% that went into effect on November 17, 1999.

(2) **Computation of the Amount Involved**
Since the prohibited transaction was a loan, an additional prohibited transaction is deemed to occur on the first day of each taxable year in the taxable period after the taxable year in which the loan occurred. Treas. Reg. § 53.4941(e)-1(e)(1). The interest rate is based on the highest fair market value during the taxable period. Treas. Reg. § 53.4941(e)-1(b)(3). Based on the facts, there are three loans (one actual and two deemed) subject to the second tier excise tax. (However, if this had been a discrete prohibited transaction, inasmuch as the prohibited transaction would not be deemed to recur, there would only be one computation of the second tier excise tax.) Pyramiding is not present in determining the amount involved in a second tier excise tax.

(3) **Second Level Tax**

	Date	Principal	Interest Rate	Time	Amount Involved
1.	4/1/97	$40,000	10.5%	.75	$3,150.00
2.	1/1/98	40,000	10.5 %	1	4,200.00
3.	1/1/99	40,000	10.5%	1	4,200.00

(4) **Computation of Tax**
The rate of tax for each year is 100% of the amount involved.

Taxable Year	1997	1998	1999
Amount Involved	$3,150	$4,200	$4,200
times tax rate	x 1.00	x 1.00	x 1.00
2nd level tax	$3,150	$4,200	$4,200
Total All Years = $11,550			