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Section 4975 and PTE 77-9: The Causes of Complexity in the Internal Revenue Code

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INTRODUCTION

Critics often blame the complexity of the Internal Revenue Code on special interests which allegedly attain favorable treatment for themselves by manipulating the federal tax statute.[1] However, I suggest that the complexity of the Code is largely attributable to a subtler force: the tendency of Congress to make the tax law more objective in order to make it more readily enforceable. Section 4975 is a classic manifestation of this tendency.[2]

Section 4975 defines and penalizes "prohibited transactions" involving qualified pension and profit sharing trusts.[3] Congress added section 4975 to the Internal Revenue Code as part of the Employee Retirement Income Security Act of 1974 (ERISA), the most recent and far-reaching of Congress' efforts to regulate pension and profit sharing arrangements.[4] The prohibited transactions rules are designed to prevent the misuse of pension and

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[1] *See* notes 172 and 174 and accompanying text *infra*.

[2] All statutory references, unless otherwise indicated, refer to the Internal Revenue Code of 1954, as amended.

[3] A pension or profit sharing trust is said to be qualified if it is part of a plan which satisfies the requirements of I.R.C. § 401(a). Qualified trusts are exempt from the federal income tax. I.R.C. § 501(a). *See* note 5 *infra*.

[4] Pub. L. No. 93-406, § 2003(a), 88 Stat. 829, 971 (1974).

profit sharing trust assets. Such misuse would frustrate the policy behind these trusts' tax-exempt status: the provision of maximum retirement and deferred compensation benefit for eligible employees.[5]

In 1950, a simple section of the federal tax statute encompassed the original prohibited transactions rules.[6] That section instructed the Internal Revenue Service and the courts to scrutinize individual dealings between tax-exempt entities and certain specified persons. If a particular transaction did not satisfy arm's length standards, it was prohibited and the entity lost its exempt status.

This statutory arrangement proved to be flawed in several respects. Because the class of persons to which the rules applied was extremely limited, the rules could be avoided through the use of controlled and related entities.[7] Moreover, the penalties for violating the rules were so harsh, and had such an unwarranted impact on innocent persons, that the courts and the IRS

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[5] I.R.C. §§ 401(a), 501(a). A pension plan is an arrangement under which an employer provides retirement benefits for its employees. Treas. Reg. § 1.401-1(b)(1)(i). A profit sharing plan is an arrangement through which an employer provides its employees with deferred compensation derived from the employer's profits. *Id.* at § 1.401-1(b)(1)(ii). The assets used to fund pension and profit sharing plans may be held by trusts. If a plan and its trust meet certain requirements of the Internal Revenue Code, the trust will be exempt from the federal income tax. I.R.C. §§ 401-418E. Not all pension and profit sharing plans utilize trusts to retain and invest their assets. Some plans (so-called "insured" plans) deposit their funds with insurers for investment in insurance and annuity contracts issued by the insurers. Other plans (so-called "split-funded" plans) utilize trusts which invest part of their assets in insurance and annuity contracts and part in other investments such as securities and real estate. St. John, *Financing a Pension Plan,* PENSIONS AND PROFIT SHARING 87 (BNA 3d ed. 1964). Whether a plan is trusteed, insured or split-funded, its assets are potential targets for abuse. Pension and profit sharing assets are therefore subject to the prohibited transactions rules regardless of the medium holding those assets. For that reason, in this article, the terms "plan" and "trust" are used interchangeably. In addition, this article uses the term "employee benefit trust" to encompass both pension and profit sharing trusts. For an account of a particularly flagrant abuse of a tax-exempt organization, *see* D. BARTLETT & J. STEELE, EMPIRE, THE LIFE, LEGEND AND MADNESS OF HOWARD HUGHES 198-207, 463-66 (1979)(concerning the Howard Hughes Medical Institute).

[6] Int. Rev. Code of 1939, ch. 38, § 3813, 64 Stat. 957. All references in this article to the Internal Revenue Code of 1939 refer to the 1939 Code as in effect immediately prior to the adoption of the Internal Revenue Code of 1954.

[7] *See* notes 31-32 and accompanying text *infra*.

were reluctant to impose them.[8] These initial prohibited transactions rules proved difficult and time-consuming to enforce since each transaction had to be examined individually to determine if arm's length standards had been violated.[9] The subjectivity inherent in case-by-case determinations led to considerable uncertainty in the law and its enforcement.

Consequently, the prohibited transactions rules were revised and expanded as part of the reforms introduced by ERISA.[10] The coverage of the rules was broadened[11] and the system of sanctions was refined to avoid impact upon innocent parties.[12] In their present form, the prohibited transactions rules no longer regulate specified transactions involving tax-exempt entities to ensure arm's length standards. Rather, such dealings are in large measure proscribed altogether.[13]

While strengthening the prohibited transactions rules has made them more effective and enforceable, it has also made them considerably more complex. The history of the prohibited transactions rules thus reflects an important, but often unrecognized, influence on the development of the Internal Revenue Code: the perceived unenforceability of simple, subjective provisions and the consequent tendency of Congress to adopt more complex, objective legislation. The statutory history of the prohibited transactions rules suggests that much of the Code's complexity stems from the forces of reform[14] and their efforts to make the tax law easier to enforce through detailed objective measures.[15]

The story of the prohibited transactions rules does not end with their statutory revision in 1974. Section 4975 allows the Secretaries of Labor and the Treasury to permit certain otherwise proscribed transactions. One important exemption is Prohibited Transactions Exemption (PTE) 77-9, pertaining, *inter*

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[8] *See* notes 42-44 and accompanying text *infra.*

[9] *See* notes 33-40 and accompanying text *infra.*

[10] I.R.C. § 4975.

[11] *Compare* Int. Rev. Code of 1939, ch. 38, § 3813(b) *with* I.R.C. §§ 4975(e)(2)-(6) inclusive.

[12] I.R.C. §§ 4975(a)(b).

[13] I.R.C. § 4975(c)(1).

[14] The author intends no normative implication in his use of "reform." *See* note 173 and accompanying text *infra.*

[15] *See* notes 175-196 and accompanying text *infra.*

alia, to insurance companies and agents.[16] Without this exemption, the prohibited transactions rules would often prevent agents and insurers from providing traditional services to pension and profit sharing trusts.[17] When it adopted section 4975, Congress declined to exempt the insurance industry from these restrictions.[18]

Nevertheless, the Labor and Treasury Departments have granted a prohibited transactions exemption which accomplishes for insurance companies and their agents what Congress declined to do. The terms and evolution of PTE 77-9 are an integral part of the story of the prohibited transactions rules. PTE 77-9 revives, in the context of insurance transactions, the arm's length standard which Congress had earlier rejected as a proper approach to the problem of prohibited transactions.[19] As a practical matter, arm's length standards established administratively are likely to be as ineffective as arm's length standards mandated legislatively. On a more theoretical level, by reintroducing subjective determinations to a major portion of the law of prohibited transactions, PTE 77-9 reflects administrative resistance to the deeply-rooted and wholly understandable legislative progression toward objective standards in the tax law.

This article undertakes its inquiry in four steps. First, it will trace the statutory history of the prohibited transactions rules from 1950 until the Tax Reform Act of 1969 (TRA). Second, it will examine the TRA and ERISA versions of the prohibited transactions rules, sections 4941 and 4975. Third, it will analyze the history and ultimate form of PTE 77-9. The final section summarizes my conclusions.

Section 4975 and PTE 77-9 may be viewed on several levels: as the practical guidelines for day-to-day transactions involving insurance and pension and profit sharing trusts; as a study in administrative lawmaking by the Treasury and Labor Departments; as an important episode in the extended effort to prevent the misuse of tax-exempt organizations. Most importantly, they may be viewed as manifestations of the forces causing the com-

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[16] 1979-1 C.B. 371, amending and restating 1977-2 C.B. 428. PTE 77-9 also contains certain provisions dealing with the sale of stocks and securities. *See* note 128, *infra.*

[17] *See* notes 116-123 and accompanying text *infra.*

[18] *See* notes 137-139 and accompanying text *infra.*

[19] *See* notes 62-68, 98-102 and accompanying text *infra.*

plexity of the Internal Revenue Code.

I. THE ORIGINS OF THE PROHIBITED TRANSACTIONS RULES: SECTIONS 3813, 503, AND THE KEOGH AMENDMENTS

A. *Section 3813 of the 1939 Code*

Section 3813 of the Internal Revenue Code of 1939 introduced into the federal tax law the concept of a prohibited transaction: a forbidden activity involving a tax-exempt entity and a person in a position to misuse that entity's assets and income. Section 3813 was, in comparison to the legislation it subsequently spawned,[20] a fairly simple measure. It identified the organizations to which it applied, a group of exempt organizations qualifying as private foundations under current law.[21] It also defined a class of persons in positions to abuse these organizations. With respect to any such organization, this class consisted of (1) the person who created such organization, (2) any person who made a "substantial" contribution to the organization, (3) a relative of the organization's creator or of a substantial contributor, and (4) any corporation of which the organization's creator or of which a substantial contributor owned at least fifty percent.[22]

If a transaction occurred between a tax-exempt organization covered by section 3813 and a person belonging to the class of potential abusers, section 3813 required that transaction to meet arm's length standards. If, for example, the transaction involved the sale of securities to an exempt organization, the organization could pay no "more than adequate consideration" if the amount sold was "substantial."[23] If the transaction involved the payment of compensation by an exempt organization, such compensation could not exceed "reasonable" levels.[24] If a tax-exempt entity extended a loan to a person described in section 3813, the entity was to receive "adequate security and a reasonable rate of interest."[25] If a transaction did not meet arm's length standards and

[20] I.R.C. §§ 4941 and 4975.

[21] *Compare* Int. Rev. Code of 1939, ch. 38, § 3813(a), 64 Stat. 957 *with* I.R.C. §§ 170(b)(1)(A) and 509(a).

[22] Int. Rev. Code of 1939, ch. 38, § 3813(b), 64 Stat. 957-58. If the exempt organization was a corporation, rather than a trust, transactions with the corporation's creator were not subject to the prohibited transaction rules. *Id.*

[23] Int. Rev. Code of 1939, ch. 38, § 3813(b)(4), 64 Stat. 957.

[24] Int. Rev. Code of 1939, ch. 38, § 3813(b)(2), 64 Stat. 957.

[25] Int. Rev. Code of 1939, ch. 38, § 3813(b)(1), 64 Stat. 957.

was thus prohibited, the organization lost its tax-exempt status.[26]

B. Section 503 of the 1954 Code

The Internal Revenue Code of 1954 reenacted the provisions of section 3813 as section 503, with one important modification. Section 503 expanded the ambit of the prohibited transactions rules to include qualified pension and profit sharing trusts.[27]

The abuse of funds held by pension and profit sharing trusts may take many forms. Insiders may receive loans from these trusts at low or no interest. Salaries may be paid for services never rendered or worth less than the compensation paid for them. The trusts may purchase assets at inflated prices, providing the seller with a higher price than he could obtain in an arm's length transaction. Pension and profit sharing trusts may sell assets at depressed prices, yielding a windfall to the purchaser. Trustees may accept bribes and kickbacks for making unjustifiable loans and investments.[28]

The diversion of pension and profit sharing trust funds diminishes the assets available for such trusts' exempt purpose, the provision of retirement and deferred compensation benefits. Because these trusts accumulate income free of federal tax liability,[29] they may become sizable in a relatively short time and therefore tempting targets for abuse. The application of the prohibited transaction rules to qualified pension and profit sharing trusts was intended to deter these abuses by imposing arm's length standards upon transactions involving persons identified as potential abusers. Fourteen years after the adoption of section 503, both the Senate Finance Committee and the House Ways and Means Committee declared it ineffective.[30] The com-

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[26] Int. Rev. Code of 1939, ch. 38, § 3813(c), 64 Stat. 958.

[27] I.R.C. § 503(a)(1)(C). Unless otherwise noted, all references in this article to I.R.C. § 503 refer to I.R.C. § 503 as in effect immediately prior to the Tax Reform Act of 1969 (TRA), Pub. L. No. 91-172, 83 Stat. 487.

[28] *See* NEWSWEEK, "The Endless Teamsters Mess" October 13, 1980, at 90; *see also* Knickerbocker, *Prohibited Transactions after Reorganization,* 34 TAX LAW. 147, 150-51 n.20 (1980); *Pension Crackdown: The Labor Department Puts More Heat on Errant Plans,* Wall St. J., September 2, 1980, at 1, col. 2.

[29] I.R.C. § 501(a). Note that these trusts, while exempt from the federal income tax, may be subject to certain penalty taxes. I.R.C. §§ 511-514, 4971-4972.

[30] H.R. REP. No. 413, 91st Cong., 1st Sess. *reprinted in* [1969] U.S. CODE

mittees' conclusions were not surprising in light of section 503's limited coverage, its awkward system of sanctions and the difficulty of enforcing arm's length standards.

C. *The Inadequacies of Section 503*

1. The Limited Coverage of Section 503

Section 503 applied to only a fraction of the persons in positions to misuse the assets of tax-exempt entities. For example, section 503 did not encompass plan fiduciaries. A shareholder owning one hundred percent of an incorporated business could, through his control of the corporation, appoint himself trustee of the firm's pension trust. As such trustee, his actions were not subject to section 503.[31] For example, a low interest loan from the trust to the shareholder/trustee fell outside the coverage of section 503, despite its deleterious impact upon the trust's earnings. Since the corporation, rather than the shareholder/trustee, was the creator of and contributor to the trust, only the corporation and not the shareholder/trustee was subject to section 503. The section did not impute a corportion's status as a potential abuser to any of its shareholders. Thus, the existence of the corporation as a separate legal entity permited controlling shareholders to avoid the restrictions of section 503.

If our hypothetical shareholder owned a second corporation, that corporation also escaped the coverage of section 503 as that section pertained to the pension assets of the first corporation.[32] Section 503 did not encompass brother-sister corporations of firms maintaining pension and profit sharing plans. As trustee for the first corporation, our hypothetical shareholder could engage in questionable transactions with his second corporation without triggering the provisions of section 503. If the first corporation entered into a partnership with its sole shareholder, that partnership was also outside the scope of the prohibited transactions rules. In addition, unincorporated entities such as partnerships, trusts, and estates were not within the coverage of

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CONG. & AD. NEWS 1645, 1664; S. REP. No. 552, 91st Cong., 1st Sess. *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2027, 2055.

[31] *See* Baker National Bank v. Commissioner, 33 T.C.M. 506 (1974), discussed *infra* at text accompanying notes 37-38.

[32] Rev. Rul. 72-532, 1972-2 C.B. 250. *See also*, Rev. Rul. 58-526, 1958-2 C.B. 269.

section 503 even if they were owned or controlled by a corporation which was subject to the statute.

An unscrupulous insurance agent or stockbroker who participated in an improper transaction with an exempt entity also escaped the coverage of section 503 since he was not a creator of or contributor to that entity. For example, if an agent knowingly sold a policy which was disadvantageous for a pension plan and its participants but lucrative for the agent, there was no violation of section 503.

Although section 503 purported to circumscribe the activities of "substantial contributors," it did not define the point at which contributions became "substantial" enough to trigger the statute's application.

2. The Uncertainty of Arm's Length Standards

The imprecise, subjective nature of arm's length standards often made it difficult to ascertain if section 503 had been violated. Whether arm's length standards were satisfied could only be determined by fully evaluating the circumstances of particular transactions.[33] Such case-by-case analysis proved time consuming and frequently involved elusive factual questions such as the price of closely-held stock or the appropriate interest rate for a particular loan.[34] When liability depended upon difficult factual determinations, section 503 encouraged taxpayer resistance and litigation. Since the administration of arm's length standards "required disproportionately great enforcement efforts," section 503 was not an effective deterrent to the abuse of tax-exempt entities.[35]

William Clay, Jr. Foundation v. United States[36] illustrates the difficulty of enforcing section 503. W.J. Clay and his wife had created an exempt charitable foundation in their son's memory. The foundation loaned $10,000 to a corporation owned by Mr. Clay. The mortgage in favor of the foundation, which was to secure the loan, was never executed. Nevertheless, the District Court held that the loan was adequately secured, that it met

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[33] Treas. Reg. § 1.503(b)-1(a). ("Whether a transaction is a prohibited transaction depends on the facts and circumstances of the particular case.")

[34] *See, e.g.,* Treas. Reg. § 1.503(b)-1(c), Example (4) (1976).

[35] H.R. REP. No. 413, 91st Cong., *supra* note 30; S. REP. No. 552, 91st Cong., *supra* note 30.

[36] 233 F. Supp. 628 (1964), 64-2 U.S. Tax Cas. ¶ 9650 (N.D. Tex. 1964).

arm's length standards, and that there was no prohibited transaction.

Similarly, in *Baker National Bank v. Commissioner,*[37] the Tax Court declined to find a violation of section 503. In *Baker,* an individual was controlling shareholder of several banks which established qualified profit sharing trusts and was also trustee of these trusts. The shareholder, in his capacity as trustee, conveyed the trust assets to a business in which the shareholder's family had a ninety-nine percent interest. Even though this sequence of events appears questionable, the Tax Court held that arm's length standards had been met and that, accordingly, there was no prohibited transaction.[38]

In *Donald G. Griswold v. Commissioner,*[39] an exempt charitable foundation made loans to the businessman who created the foundation, to his family, and to his wholly-owned corporations. The Tax Court declined to characterize any of these loans as prohibited transactions even though one loan was in default for two and one-half months. The court specifically noted the difficulty of implementing the arm's length standards of section 503.[40]

3. The Loss of Exempt Status: An Unworkable Penalty

Perhaps the most problematic aspect of section 503 was the sanction it applied to qualified pension and profit sharing trusts participating in prohibited transactions: the loss of tax-exempt status. Revoking a trust's exempt status had a more serious impact on innocent plan participants than it did upon the person whose conduct caused the prohibited transaction. The revocation made trust earnings taxable, thereby leaving less income available to provide benefits.[41] Moreover, participants with vested interests immediately incurred federal income tax liabil-

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[37] 33 T.C.M. 506 (1974).

[38] The Tax Court also noted that the separate identities of the banks, the investment fund, and the family business rendered I.R.C. § 503 inapplicable. Baker National Bank v. Commissioner, 33 T.C.M. 506, 524 (1974).

[39] 39 T.C. 620 (1962), *acq.,* 1965-1 C.B. 4.

[40] Donald G. Griswold v. Commissioner, 39 T.C. 620, 640 (1962). Even now, the IRS is not reconciled to these decisions. *Compare* Rev. Rul. 80-269, 1980-41 I.R.B. 9, *with* William Clay, Jr. Foundation v. United States, 233 F. Supp. 628 (1964), 64-2 U.S. Tax Cas. ¶ 9650 (N.D. Tex. 1964).

[41] I.R.C. § 1(e).

ity on pension and profit sharing payments which they would not receive until retirement.[42]

Section 503 imposed no direct sanction on the person who engaged in a prohibited transaction with a pension or profit sharing trust or who caused a trust to engage in such a transaction.[43] The courts and the IRS were understandably reluctant to revoke tax-exempt status pursuant to section 503 when innocent persons bore the brunt of the punishment.[44]

D. *The Keogh Amendments: The Introduction of Objective Standards Into the Law of Prohibited Transactions*

In 1962, the Internal Revenue Code was amended to facilitate pension and profit sharing arrangements benefiting persons who conduct their businesses in unincorporated forms. These amendments, commonly known as the "Keogh" or "H.R. 10" provisions, permit certain proprietors and partners to participate in qualified pension and profit sharing plans provided that they comply with additional requirements not applicable to corporate plans.[45] For example, unlike corporate plans, Keogh plans must generally appoint institutional rather than individual trustees to manage their assets.[46]

Among the more stringent provisions applied to Keogh plans was section 503(j) which significantly modified the prohibited transactions rules by imposing an outright ban on most transactions between Keogh trusts and persons in positions to abuse them. Section 503(j)(1)(D), for example, prohibited any sales or exchanges of property between a Keogh trust and one of the persons enumerated in section 503. Similarly, section 503(j)(1)(A) proscribed all loans from Keogh trusts to the enumerated persons.

Thus, from 1962 until 1974, when ERISA replaced section 503 with section 4975, there were effectively two sets of prohibited

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[42] I.R.C. §§ 83, 402(b).

[43] If the person who caused the prohibited transaction was also a plan participant, the revocation of tax-exempt status affected him in his latter capacity.

[44] S. Rep. No. 383, 93d Cong., 2d Sess., *reprinted in* [1974] U.S. Code Cong. & Ad. News 4890, 4917, 4978.

[45] *See, e.g.,* I.R.C. §§ 72(m)(5), 401(d). *See also* Kalish & Lewis, *Professional Corporations Revisited,* 28 Tax Law. 471 (1974-75).

[46] I.R.C. § 401(d)(1).

transactions rules embodying two different policies with respect to the abuse of qualified pension and profit sharing trusts. One policy, applicable to corporate plans, required a case-by-case scrutiny to determine if potentially abusive transactions met subjective arm's length standards. Transactions between trusts and insiders were permitted if they satisfied these standards. By contrast, section 503(j) flatly prohibited transactions between Keogh trusts and those persons who might misuse trust assets. Under section 503(j), the attainment of arm's length standards was irrelevant; rather, the enumerated transactions were proscribed per se. The policy of section 503(j), proscribing all sensitive transactions rather than insisting that they meet arm's length standards, ultimately determined the present form of the prohibited transactions rules.[47]

II. The Prohibited Transactions Rules in Their Current Form: Sections 4941 and 4975

A. *The Tax Reform Act of 1969: Section 4941*

Section 503 had been as ineffective with respect to tax-exempt private foundations as it had been with respect to qualified pension and profit sharing trusts.[48] Hence, the Tax Reform Act of 1969 (TRA)[49] removed private foundations from the purview of section 503 and added section 4941 to apply only to such foundations.

Section 4941 made three major changes to the rules which had been embodied in section 503. First, section 4941 covered a wider array of "disqualified persons" than had section 503.[50] Second, section 4941 rejected section 503's arm's length standard in favor of absolute prohibitions on most dealings between disqualified persons and private foundations.[51] Third, section 4941 imposed direct penalties upon the disqualified persons who

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[47] Other amendments were made to I.R.C. § 503 after 1954. *See* I.R.C. §§ 503(h) and 503(i). However, these amendments merely responded to the problems of particular industries and were not significant to the overall development of the prohibited transactions rules.

[48] *See* H.R. Rep. No. 413, 91st Cong., *supra* note 30; S. Rep. No. 552, 91st Cong., *supra* note 30.

[49] Pub. L. No. 91-172, 83 Stat. 487 (1969).

[50] I.R.C. § 4946. The definitions of I.R.C. § 4946 apply to all of the penalty taxes added to the Code by the TRA. *See* I.R.C. §§ 4940-4948, inclusive.

[51] I.R.C. § 4941(d)(1).

violate the statute.[52] Section 4941 represents a distinctly tougher approach to the abuse of tax-exempt organizations than that embodied in section 503. Section 4941 is also a much more complicated statute.

B. *The Terms of Section 4941*

1. The Expanded Coverage of Section 4941

The TRA defined in far more extensive terms than had section 503 those individuals and entities who, with respect to any private foundation, constitute "disqualified persons," that is persons in positions to abuse the foundation's assets and income. Like section 503, the TRA defined the creator of and the substantial contributors to any private foundation as disqualified persons vis-a-vis that foundation.[53] The TRA, however, provided an objective standard for determining when a contributor is "substantial" and therefore is disqualified from dealing with a foundation.[54] For the purposes of section 4941, the TRA also defined the officers, directors, trustees, and responsible employees of any private foundation as disqualified persons with respect to that foundation.[55] This definition cured one of the major flaws of section 503: its failure to include non-contributors who were nevertheless in a position to utilize the institution's funds for their own benefit.[56]

The TRA also defined as a disqualified person any person who owns or benefits from twenty percent or more of a corporation, partnership, trust, or "unincorporated enterprise" which is the creator of or a substantial contributor to a private foundation.[57] If more than thirty-five percent of a corporation, partnership, trust, or estate is owned by or benefits certain persons who are disqualified with respect to a particular private foundation, such corporation, partnership, trust, or estate is itself a disqualified person as regards that foundation.[58] By attributing the disquali-

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[52] I.R.C. §§ 4941(a)-(b).

[53] I.R.C. §§ 4946(a)(1)(A), (a)(2), 507(d)(2). Under the TRA, only creators of exempt trusts, not the founders of corporations, are disqualified persons. I.R.C. § 502(d)(2)(A).

[54] I.R.C. § 507(d)(2).

[55] I.R.C. §§ 4946(a)(1)(B), 4946(b).

[56] *See* notes 31-32 and accompanying text *supra*.

[57] I.R.C. § 4946(a)(1)(C).

[58] I.R.C. § 4946(a)(1)(E), (F), (G).

fied status of juridical entities to their owners and beneficiaries, and vice versa, Congress significantly diminished, and perhaps eliminated, the possibilities for circumventing the prohibited transactions rules by interposing such entities between the real party in interest and the prohibited transaction.[59]

If an individual is a disqualified person with respect to a private foundation under certain of these provisions, so are his spouse, his ancestors, his lineal descendants and the spouses of his lineal descendants.[60] The rules of section 267(c) were also made applicable, with some modification, to the area of private foundations. Those rules attribute, *inter alia,* certain interests in corporations, partnerships, proprietorships, trusts, and estates to the owners and beneficiaries of those interests and to their respective families.[61]

The limited coverage of secton 503 had permitted the use of controlled and unincorporated entities to avoid the prohibited transactions rules. As a matter of policy, the expanded coverage of section 4941 was thus a necessary development. However, that expansion was not without its costs. The coverage provisions of section 503 were easily avoided, but they were short and readily understood. The expanded coverage provisions of section 4941 are tighter, but they are also considerably more complex. Congress, confronted with a choice between comprehensiveness and simplicity, chose the former.

2. The Replacement of Subjective, Arm's Length Standards With Objective, Per Se Proscriptions

The TRA corrected for private foundations a second inadequacy of section 503: its utilization of arm's length standards. Section 4941 prohibits outright most dealings between disqualified persons and the private foundations with respect to which they are disqualified. By banning such transactions per se, the TRA eliminated the need to evaluate each particular transaction and thus eliminated the uncertainty inherent in subjective, case-by-case determinations.

Section 4941(d)(1) prohibits all sales, exchanges, and leases

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[59] *See* notes 31-32 and accompanying text *supra.*

[60] I.R.C. § 4946(a)(1)(D), (d).

[61] I.R.C. § 4946(a)(3), (4). I.R.C. § 4946(a)(1)(I) also subjects certain government officials to the prohibited transactions rules.

between private foundations and their disqualified persons.[62] It also proscribes loans between private foundations and their disqualified persons as well as arrangements pursuant to which goods, services, or facilities are provided by private foundations to their disqualified persons or *vice versa.*[63] Section 4941(d)(1) bans any transaction pursuant to which the income or assets of private foundations are transferred to, used by, or held for the benefit of any of their disqualified persons.[64] Also prohibited are payments by private foundations to their disqualified persons.[65]

Section 4941(d)(1) is more easily enforced than its predecessor, section 503, because section 4941(d)(1) does not require the government to demonstrate that a particular transaction fails to meet arm's length standards: any transaction involving a private foundation and a disqualified person is a per se statutory violation, regardless of the transaction's terms.

The outright prohibition on payments to disqualified persons would, if not modified, prevent foundations from paying their high level employees because such employees are classified as disqualified persons.[66] Similarly, the provisions of section 4941(d)(1)(B) would eliminate harmless arrangements pursuant to which substantial contributors give interest-free loans to private foundations to ameliorate their cash flow problems. To mitigate these and other manifestations of statutory overkill, section 4941(d)(2) outlines seven exceptions which, *inter alia,* allow private foundations to pay their high level employees and to accept interest-free loans in furtherance of their tax-exempt purposes.[67] To prevent these exceptions from eroding the prohibitions of section 4941(d)(1), the exceptions are drafted in a fairly detailed manner.[68] The upshot is a statutory provision, section 4941(d)(2), which makes the Code considerably more complex.

The arm's length tests of section 503 had one great virtue from the perspective of statutory draftsmanship: such tests could be stated succinctly because their detailed development

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[62] I.R.C. § 4941(d)(1)(A). I.R.C. § 4941 technically refers to "acts of self-dealing" rather than "prohibited transactions."

[63] I.R.C. § 4941(d)(1)(B), (C).

[64] I.R.C. § 4941(d)(1)(E).

[65] I.R.C. § 4941(d)(1)(D).

[66] I.R.C. §§ 4941(d)(1)(D), 4946(a)(1)(B), (b).

[67] I.R.C. § 4941(d)(2)(B), (E).

[68] It should be noted that several exceptions in I.R.C. § 4941(d)(2) utilize arm's length standards. *See, e.g.*, I.R.C. § 4941(d)(2)(D).

was left to the rulings of the courts and the Internal Revenue Service. Section 4941 cannot be described as succinct.

3. The Sanctions of Section 4941: Penalty Taxes Replace Loss of Exempt Status.

The TRA completely revised the penalty provisions of section 503. Section 503 provided for only one sanction, loss of tax-exempt status of the entity involved in the prohibited transaction.[69] Section 4941 provides for a system of penalty taxes to be levied upon the disqualified person who engages in a prohibited transaction or who causes the foundation to participate in such a transaction.[70] Under section 503, the foundation would lose its tax-exempt status; under section 4941, the foundation itself is not affected.[71] Section 4941 provides for an initial penalty as a result of the prohibited transaction itself. If the transaction is not remedied within a specified "correction period," an additional, heavier tax is placed upon the culpable disqualified person.[72]

C. The Implications of Section 4941: Expanded Coverage and Congressional Disapproval of Nonabusive Transactions

Adams v. Commissioner[73] illuminated the strengths and weaknesses of section 4941. Paul Adams was the sole shareholder of Automatic Accounting Company (Automatic). He was also an officer and trustee of a private foundation (Stone). Automatic owned real estate adjacent to the Yale campus. The plan giving rise to Mr. Adams' troubles called for Stone to purchase this real estate from Automatic and contribute it to Yale.[74]

Pursuant to this plan, Stone created and funded a subsidiary

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[69] I.R.C. § 503(a)(1).

[70] I.R.C. § 4941(a), (b).

[71] However, the participation of a foundation in a particular transaction may be evidence that the foundation is not operated exclusively for exempt purposes and can, therefore, lead to withdrawal of tax-exempt status under I.R.C. § 501(c)(3).

[72] I.R.C. § 4941(b).

[73] 70 T.C. 373 (1978).

[74] Automatic acquired another parcel for immediate conveyance to York. The Tax Court held, with respect to this parcel, that Automatic was a mere conduit and that no violation of I.R.C. § 4941 occurred. Adams v. Commissioner, 70 T.C. 373, 375-78, 380-82 (1978).

foundation, the York Square Corporation (York).[75] York purchased from Automatic the real estate which Automatic owned near Yale. York was then dissolved and its assets (the newly purchased real estate) were conveyed to its parent, Stone. Stone, in turn, contributed this property to Yale.[76] These transactions began in 1970 and were completed in 1972.

This sequence of events would have been unobjectionable under section 503. The Tax Court in *Adams* found that the price paid to Automatic was reasonable.[77] Under section 503, that finding would have been of controlling significance.[78] Unfortunately for Paul Adams, section 4941 was the applicable Code provision.

Paul Adams was a trustee and officer of Stone and therefore a disqualified person with respect to Stone.[79] Therefore, the TRA also deemed Automatic, as a corporation owned by a disqualified person, to be a disqualified person.[80] Hence, the sale from Automatic to Stone (via York) was a proscribed sale from a disqualified person to a private foundation. It was irrelevant under section 4941 that the sale met arm's length standards.

The per se proscriptions of section 4941, by virtue of their objective, mechanical nature, provide for greater predictability than the subjective, arm's length standards of section 503. Per se proscriptions are readily enforceable since transactions between disqualified persons and private foundations are prohibited regardless of their terms. Once the government proves that there has been a transaction between a disqualified person and a private foundation, the government's case is established conclusively. The identities of the parties to a transaction definitively establish its impropriety; the government need not demonstrate that the transaction was abusive in character.[81]

Adams highlights the nature of Congress' decision to replace the arm's length standards of section 503 with the objective pro-

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[75] Stone found it necessary to create York because of the peculiarities of Stone's corporate character. *Id.* at 375.

[76] While these transactions were occurring, Stone had reconstituted itself from an Ohio corporation to a Connecticut corporation. *Id.* at 378.

[77] *Id.* at 385-387.

[78] I.R.C. § 503(c)(4).

[79] I.R.C. § 4946(a)(1)(B), (b)(1).

[80] I.R.C. § 4946(a)(1)(E).

[81] Unless, of course, the transaction may qualify under one of the limited arm's length exemptions enumerated in I.R.C. § 4941(d)(2).

scriptions of section 4941. The transaction in *Adams* was nonabusive. Stone paid a reasonable price, one which did not constitute a diversion of Stone's assets from its exempt purposes. Nevertheless, this transaction violated section 4941.

Adams also manifests the expanded coverage of secton 4941. Paul Adams was a foundation officer and trustee. His resulting status as a disqualified person was attributed to his wholly-owned corporation. Adams, as a mere foundation officer, would not have been subject to section 503 nor would his personal status vis-a-vis Stone have been imputed to his wholly-owned firm.[82]

Finally, *Adams* highlights an important difference between section 4941, pertaining to private foundations, and section 4975, pertaining to qualified pension and profit sharing trusts. Had the tax-exempt entity in *Adams* been a profit sharing or pension trust, section 4975(c)(2) would have permitted the parties to apply for advance permission to undertake the transaction. By contrast, section 4941 contains no provision for administrative exemptions.[83]

D. ERISA: The Background of Section 4975

By 1974, the law of prohibited transactions had changed considerably from its simple origins in 1950. Congress had removed private foundations from the coverage of section 503 and had recast the prohibited transactions rules in section 4941. Section 503 had also been amended with respect to Keogh plans to proscribe, rather than regulate, potentially abusive transactions.

The Employee Retirement Income Security Act of 1974 (ERISA) enlarged the scope of federal law vis-a-vis the conduct of pension and profit sharing fiduciaries, creating new federal standards to govern their behavior. ERISA section 404(a)(1)(B), for example, requires a pension or profit sharing fiduciary to discharge his responsibilities "with the care, skill, prudence, and diligence" of a "prudent man."[84] ERISA section 404(a)(1)(C) re-

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[82] There is nothing in the Tax Court's opinion to indicate that Adams made any contributions to the foundation or that he was its creator. Hence, I.R.C. § 503 would never have applied to him.

[83] The sequel to the initial *Adams* decision, Adams v. Commissioner, 72 T.C. 81 (1979), revealed certain technical flaws in I.R.C. §§ 4941 and 4975 which Congress corrected in Pub. L. No. 96-596, 94 Stat. 3469 (1980).

[84] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (1974).

quires pension and profit sharing fiduciaries to diversify the assets under their control.[85] As part of this federally-imposed fiduciary law, ERISA further reduced the scope of section 503, creating a separate prohibited transactions provision for qualified pension and profit sharing trusts. Section 4975 was explicitly modeled on section 4941 and thus embodies the same statutory policies.[86]

E. The Terms of Section 4975

1. The Coverage of Section 4975

Section 4975 defines as "disqualified persons" a network of individuals and entities outside the coverage of section 503. Any person who serves as a "fiduciary" of a pension or profit sharing trust is a disqualified person as to that trust.[87] In addition to formally designated trustees, section 4975 defines as fiduciaries investment advisors and all other persons who possess managerial control, authority, or responsibility with respect to trust assets.[88] Thus, under present law, a shareholder who becomes the trustee of his wholly-owned corporation's pension trust is subject to the prohibited transactions rules. A stockbroker or insurance agent who renders investment advice to a trust is also a fiduciary and therefore a disqualified person as to that trust.[89] In addition, an individual or entity providing services to a pension or profit sharing trust is a disqualified person with respect to that trust as is the employer of those employees covered by the plan and any union to which such employees belong.[90]

If a corporation, partnership, unincorporated enterprise, or trust is a disqualified person by virtue of its status as an employer, any person who owns or benefits from half or more of the interest in the corporation, partnership, enterprise, or trust is also a disqualified person.[91] Therefore, the shareholder of a wholly-owned corporation who declines appointment as a fiduciary of his corporation's pension trust is nevertheless a disqualified person as to that trust. If an individual is a disqualified per-

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[85] ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (1974).
[86] S. REP. No. 383, 93d Cong., *supra* note 44.
[87] I.R.C. § 4975(e)(2)(A).
[88] I.R.C. § 4975(e)(3).
[89] *Id.*
[90] I.R.C. § 4975(e)(2)(B), (C), (D).
[91] I.R.C. § 4975(e)(2)(E).

son under any of the foregoing rules, his spouse, his ancestors, his lineal descendants, and the spouses of his lineal descendants are disqualified persons as well.[92] Corporations, partnerships, trusts, and estates of which certain disqualified persons own fifty percent or more are themselves disqualified persons.[93] If certain partnerships, unions, corporations, trusts, unincorporated enterprises, or estates are disqualified persons, any of their officers, directors, substantial owners, or highly compensated employees are disqualified persons as well.[94] Specified partners of disqualified persons are also disqualified.[95] Finally, section 4975 incorporates, with some modifications, the rules of section 267(c) which attribute legal and beneficial interests among family members.[96]

Insofar as the draftsmen of section 4975 sought to eliminate the circumvention of the prohibited transactions rules through the use of related and controlled persons, their efforts largely have succeeded. The coverage of section 4975 is far more comprehensive than the easily circumvented provisions of section 503. However, the resulting statutory provisions[97] add considerably to the Code's complexity.

2. The Objective, Per Se Prohibitions of Section 4975

Section 4975 treats prohibited transactions in the same manner as does section 4941, proscribing them altogether rather than regulating them to meet arm's length standards. Congress thus reaffirmed the policies embodied in the Tax Reform Act of 1969: that arm's length transactions between disqualified persons and tax-exempt entities cannot be policed effectively and are of insufficient value to outweigh the relative ease with which per se proscriptions may be enforced. Section 4975(c)(1)(A) prohibits sales, exchanges, and leases between disqualified persons and the trusts with respect to which they are disqualified. Section 4975(c)(1)(B) proscribes loans and other extensions of credit between pension and profit sharing trusts and their disqualified persons. Section 4975(c)(1)(C) prohibits a disqualified

[92] I.R.C. § 4975(e)(2)(F), and (6).

[93] I.R.C. § 4975(e)(2)(G).

[94] I.R.C. § 4975(e)(2)(H). Note that I.R.C. § 4975(e)(2)(H) contains objective tests for defining highly compensated employees and substantial owners.

[95] I.R.C. § 4975(e)(2)(I).

[96] I.R.C. § 4975(e)(4), (5).

[97] I.R.C. § 4975(e)(2)-(6).

person from furnishing goods, services, or facilities to a pension or profit sharing trust and *vice versa.* Section 4975(c)(1)(D) bans the transfer of any assets or income from a trust to a disqualified person or the use of trust assets or income by or for the benefit of a disqualified person.

Additional statutory restrictions prevent a fiduciary from dealing with trust assets or income "in his own interest or for his own account."[98] Another provision of section 4975, designed to prevent the receipt of bribes and kickbacks, prohibits a fiduciary from receiving compensation from a third party "in connection with a transaction" between the fiduciary's trust and the third party.[99] These additional restrictions reflect an apparent legislative judgment that fiduciaries must be subject to even more stringent standards than those which apply to other disqualified persons. As we shall see, these restrictions have been of particular concern to the insurance industry.

The general proscriptions of section 4975, if not modified, would prevent certain necessary transactions. For example, section 4975(c)(1)(D) prohibits a trust from transferring income or assets to a disqualified person. If a disqualified person is a plan participant entitled to retirement benefits, this prohibition would prevent the trustees from paying to a disqualified person the benefit he has earned under the plan.[100] Section 4975(e)(2)(B) classifies service providers as disqualified persons but section 4975(c)(1)(C) prevents a disqualified person from rendering services to a trust. Even by the standards of the Internal Revenue Code, this could be considered a confusing situation.

To prevent statutory overkill, section 4975(d) delineates thirteen exceptions to section 4975's general prohibitions. For example, section 4975(d)(2) permits a service provider to render services to a trust, thereby clarifying Congress' intent to prevent service providers from engaging in transactions other than the provision of services. Section 4975(d)(9) allows for the payment of a bona fide pension or profit sharing benefit to a participant who is also a disqualified person.

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[98] I.R.C. § 4975(c)(1)(E).

[99] I.R.C. § 4975(c)(1)(F).

[100] This would occur, for example, when a corporate officer is an employee of the corporation, covered by the firm's pension or profit sharing plan. *See* I.R.C. § 4975(e)(2)(H), defining corporate officers as disqualified persons.

As with their private foundation counterparts,[101] the exemptions in section 4975(d) are drawn in a detailed fashion to prevent them from eroding the general proscriptions which they modify. As a result, section 4975(d) adds considerably to the Code's complexity.

Finally, section 4975(c)(2) authorizes a procedure under which the Department of Labor and the Treasury Department may exempt specific transactions or classes of transactions from the prohibited transactions rules.[102]

3. The Penalty Taxes of Section 4975

Section 4975 replicates the two tier tax scheme of section 4941, imposing a first tier tax on the prohibited transaction and a second tier tax if the transaction is not corrected after the exercise of judicial and appellate review.[103]

F. Summary: Section 4975, ERISA, and Prohibited Transactions

In the context of ERISA, the revised prohibited transactions rules constitute the first line of defense against the misuse of pension and profit sharing assets. Section 4975 provides the government with easily enforced, objective standards with which to police disqualified persons. If, however, abuses do not trigger the per se provisions of the prohibited transactions rules, the government may be able to resort to the more problematic, subjective tests of ERISA, such as the prudent man and diversification rules.[104]

The passage of ERISA completed the statutory evolution of the prohibited transactions rules into their present form. Over the course of twenty-four years, section 503 has given way to two more complex progeny, sections 4941 and 4975, which by virtue of their expanded coverage, their substantive emphasis upon objective, per se prohibitions (rather than arm's length standards),

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[101] I.R.C. § 4941(d)(2).

[102] By executive order of the President, most prohibited transactions exemptions are now granted exclusively by the Department of Labor. Exec. Order No. 12,108, 3 C.F.R. 275 (1979), Reorg. Plan No. 4 of 1978, 3 C.F.R. 332 (1979 compilation).

[103] I.R.C. § 4975(a), (b). *See* text accompanying notes 70-72, *supra.*

[104] It should be noted that the fiduciary standards of ERISA do not apply to nonfiduciary disqualified persons.

and their systems of tax sanctions have little resemblance to their forebearer.[105]

III. Insurance and Prohibited Transactions: PTE 77-9

A. The Background of PTE 77-9: Insurers and Agents as Service Providers and Investment Advisors Subject to Section 4975

Prohibited Transactions Exemption (PTE) 77-9 is among the more important class exemptions promulgated pursuant to section 4975(c)(2). PTE 77-9 effectively exempts the insurance industry from the objective per se proscriptions of section 4975, and in their place reinstates subjective, arm's length standards. PTE 77-9 is irreconciliable with the policies and legislative history of ERISA.

Before examining PTE 77-9, it is helpful to review the considerations which impelled the insurance industry to seek this exemption. This review begins with the provisions of section 4975 which encompass insurers and agents previously outside the coverage of section 503.

1. Service Providers as Disqualified Persons

It is quite common for pension and profit sharing trusts to receive services from firms and individuals. Indeed, providing such services has become a major activity of insurers and insurance agents. These services range from simple clerical assistance to actuarial studies and professional investment advice.[106]

A service provider may divert trust assets by taking compensation of greater value than the services performed or by taking compensation for services not performed at all.[107] These possibilities for abuse led Congress to classify as disqualified persons all service providers, including agents and insurers, and

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[105] While I.R.C. §§ 4941 and 4975 have diminished the importance of I.R.C. § 503, § 503 still governs trusts providing supplemental unemployment compensation payments, pension trusts funded only by employee contributions, governmental pension trusts, and certain pension trusts maintained by churches. I.R.C. § 503(a)(1) (current version).

[106] *See* 42 Fed. Reg. 1488, 1526 (1977).

[107] *See* note 28 *supra*. *See also,* Marshall v. Snyder, 572 F.2d 894 (2d Cir. 1978), *aff'g,* 430 F. Supp. 1224 (E.D.N.Y. 1977); *Marshall v. Kelly,* 465 F. Supp. 341 (W.D. Okla. 1978); Priv. Letter Rul. 7951025.

thereby subject such service providers to the prohibited transactions rules.[108]

2. Investment Advisors as Fiduciaries

Under section 4975(e)(3)(B), any person who "renders investment advice for a fee or other compensation" is a fiduciary as to the trust receiving such advice. If, for example, a pension trustee hires a financial counselor, that counselor is treated as a co-fiduciary of the trustee.[109]

Section 4975(e)(3)(B) reflects an apparent legislative determination that advisors may effectively control the investment trust assets because of their real or perceived expertise and the natural deference lay fiduciaries give to that expertise.[110] An investment advisor who exercises de facto control over trust assets can use that control to promote investments which benefits the advisor at the expense of the trust he is advising.[111] Hence the term "fiduciary" is defined broadly to include firms and individuals who control trust assets through their investment advice but who are not trustees under traditional rules of equity.

The term "investment advice" is itself an expansive one which encompasses firms and individuals conventionally viewed as vendors rather than as advisors.[112] Insofar as an insurer, through its employees, makes recommendations with respect to the alternative policies it offers, or with respect to the advantages of its policies as compared to noninsured investments, that insurer may be an investment advisor under section 4975(e)(3)(B).[113]

Similary, an agent selling insurance or annuity policies to an employee benefit trust may be an investment advisor as to that trust.[114] In order to sell his products, an agent will typically make a sales presentation, addressing the advantages of insur-

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[108] I.R.C. § 4975(e)(2)(B). S. REP. No. 127, 93d Cong., 2d Sess. *reprinted in* [1974] U.S. CODE. CONG. & AD. NEWS 4838, 4867.

[109] *See* Treas. Reg. § 54.4975-6(a)(6), Examples 1 and 2.

[110] In Example (2) of Treas. Reg. § 54.4975-6(a)(6), a consultant is held to be a fiduciary because the pension trustee "relies" on the consultant's advice.

[111] *See, e.g.*, Marshall v. Carroll [1980] 289 PENS. REP. (BNA) D-7 (D.C. N. Cal.).

[112] *See* note 159 and accompanying text *infra*.

[113] An insurance company may be a fiduciary by virtue of the activities of its own employees or by virtue of the activities of agents working on its behalf. 42 Fed. Reg. 1488, 1527 (1977).

[114] *Id.* at 1526-28.

ance-funded benefits and the particular attractions of the policies he is promoting. The information presented is aimed at convincing the trustees to make one investment, the agent's policies, rather than others. Since an agent receives a sales commission if his presentation is successful, that presentation may be characterized as investment advice for a fee, making the agent a fiduciary.[115] Alternatively, agents may render explicit investment advice as part of services they furnish to a plan.

B. *Package Arrangements and Agents' Commissions: The Threat of Section 4975 to Existing Practices*

Prior to the adoption of ERISA, no provision of section 503 subjected an insurer or an insurance agent to the prohibited transactions rules.[116] ERISA altered this state of affairs, making section 4975 a source of concern to the insurance industry in two major respects. First, section 4975 may, in certain situations, require insurance companies to abandon package arrangements whereby they simultaneously provide insurance policies and services to pension and profit sharing trusts. Second, section 4975 often prevents insurance agents from receiving sales commissions on policies sold to pension and profit sharing trusts.

A large portion of pension and profit sharing funds are invested in life and annuity policies issued by insurance companies.[117] Policies sold to employee benefit trusts are often part of package arrangements pursuant to which the insurer simultaneously furnishes the plan with service.[118] A trust purchasing a package arrangement usually pays a single combined fee for the policies and services the insurance company provides. Such package arrangements are particularly attractive to smaller plans which lack the resources to provide services for

[115] Note that if an agent who is not a fiduciary provides services, there is no prohibited transaction as long as the services meet statutory arm's length requirements. I.R.C. § 4975(d)(2). However, if an insurer or agent is a fiduciary, the provision of services is a prohibited transaction. 42 Fed. Reg. 1488, 1528 (1977).

[116] Under I.R.C. § 503, an insurer only could be subject to the prohibited transactions rules as the contributor to a pension plan for its employees.

[117] In 1979, almost $139 billion of private pension assets were invested and held by insurance companies. *See Pension Funds' Promise Also Contains Real Peril,* N.Y. Times, Nov. 16, 1980, § 4 at E, col. 6.

[118] 42 Fed. Reg. 1488, 1526 (1977).

themselves.[119]

Under section 4975(e)(2)(B), the service component of a package arrangement makes the insurer a service provider and therefore a disqualified person.[120] The policy component of the package thus constitutes a sale in which the seller is a disqualified person, the insurer/service provider. Section 4975(c)(1)(A) prohibits sales between employee benefit trusts and disqualified persons.

In instances where an insurer is also a fiduciary by virtue of its investment advice, the sale of a policy by an insurer to a trust it advises may additionally violate section 4975(c)(1)(E). That provision prohibits a fiduciary from dealing with trust assets "in his own interest or for his own account."[121]

If an insurance agent is an investment advisor, by virtue of his sales presentation or the services he provides, his fiduciary status triggers the provisions of section 4975(c)(1)(F). That section, designed to prevent bribes and kickbacks, prevents fiduciaries from receiving compensation "from any party dealing with the plan in connection with a transaction involving the income or assets of the plan." The acceptance by an agent/fiduciary of a commission from an insurer could be construed as the receipt of prohibited compensation from a third party dealing with the trust.[122] It may also be a violation of section 4975(c)(1)(E) when the sale of a policy by an agent/fiduciary results in a commission to him.[123]

The insurance industry cannot be expected to accept with equanimity a prohibition on sales commissions.

Congress was not completely unmindful of the insurance industry's concerns. ERISA provided a two and a half year transition period during which certain otherwise proscribed services to pension and profit sharing trusts were permitted.[124] However, Congress refused to give the insurance industry a permanent ex-

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[119] *Id.* at 1527.

[120] I.R.C. § 4975(e)(2)(B).

[121] I.R.C. § 4975(c)(1)(D) might also be violated in such circumstances since the premium paid by the trust to the insurer is income or an asset of the plan. *See* Priv. Letter Rul. 7951025.

[122] Treas. Reg. § 54.4975-6(a)(6), Example (2).

[123] I.R.C. § 4975(c)(1)(D) might also be violated in such circumstances. *See* note 121 *supra*.

[124] ERISA § 2003(c)(2)(D); *see also* ERISA § 414(c)(4), 29 U.S.C. § 1114(c)(4) (1974).

emption from section 4975 since insurance transactions may indeed give rise to unacceptable practices.[125] Having failed to secure a statutory exemption from the prohibited transactions rules, the insurance industry turned next to the administrative procedure of section 4975(c)(2).

C. *PTE 77-9 as Proposed by the Insurance Industry*

On December 22, 1976, the Internal Revenue Service (IRS) and the Department of Labor (DOL) indicated that they had received a proposal for an insurance-related class exemption.[126] Among the groups proposing the exemption were the American Council of Life Insurance, the National Association of Life Underwriters and the Association for Advanced Life Underwriting.[127] These requests led to the promulgation of PTE 77-9.[128]

The arguments advanced to the IRS and DOL presented the position of the insurance industry in a straightforward manner: pension and profit sharing trusts, particularly smaller ones, had traditionally entered into package arrangements. The prohibited transactions rules, if not abrogated administratively, prevent an insurer from selling policies and providing services to the same trust. This "severely disrupt(s) long established business practices and relationships and . . . creates hardship(s) for plans, plan sponsors and plan participants." Similarly, when agents are investment advisors, section 4975 prohibits them from receiving commissions on sales to the trusts they advise.[129]

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[125] An agent acting as an investment advisor or an insurer providing services is indeed in a position to misuse trust assets by charging inflated premiums, by taking excessive commissions, or by selling inappropriate products. *See* note 28, *supra*; *see also* Marshall v. Carroll, [1980] PENS. REP. (BNA) D-7 (D.C. N. Cal.). *See also* N.Y. Daily News, Nov. 5, 1980 at 6; N.Y. Daily News Tonight, Nov. 7, 1980 at 45; N.Y. Post, Dec. 23, 1980 at 43; N.Y. Times. Nov. 11, 1980 at B3; N.Y. Times, Dec. 16, 1980 at B9; N.Y. Times, March 19 1981 at B1.

[126] 42 Fed. Reg. 1488, 1525 (1977).

[127] *Id.*

[128] 1977-2 C.B. 428. PTE 77-9, as proposed and as promulgated, also addresses certain similar concerns of the securities industry. I have not discussed the securities-related aspects of PTE 77-9 since these provisions raise several additional questions not directly related to the Internal Revenue Code, such as whether the protections of the federal securities law, including the Investment Advisors Act of 1940, make the guarantees of I.R.C. § 4975 redundant. I would emphasize, however, that the inadequacies of PTE 77-9, as they relate to insurance, are also of great concern in the securities context.

[129] 42 Fed. Reg. 1488, 1526-27 (1977). Under I.R.C. § 4975, agents and insur-

The exemption proposed by the insurance industry was premised on two basic assumptions: the acceptability of arm's length standards and the efficacy of prior approval by an independent fiduciary. Under the industry proposal, an insurer or agent could have simultaneously sold policies and provided services to the same trust if arm's length standards were satisfied. Under these standards, the consideration paid for policies and services had to be "reasonable"; the terms of such policies and services had to be as favorable to the trust as though the insurer or agent had been "an unrelated party"; and the policies and services had to be provided in the ordinary course of the insurer's or agent's business.[130]

All transactions under the proposed exemption required prior written approval by a fiduciary unrelated to the insurer or agent. Significantly, that fiduciary did not have to be knowledgeable about insurance to give his approval. The fiduciary's approval was to follow disclosure of the amount and terms of any compensation to be paid by the trust and the identity of those receiving such compensation. However, under the proposed exemption, any independent fiduciary could have approved a proposed insurance transaction, whether or not such fiduciary had any familiarity with or expertise in insurance.[131] The insurance industry also requested a statement by the IRS and DOL that "normal sales presentations" by agents do not constitute investment advice, leading to fiduciary status.[132]

D. *PTE 77-9 as Adopted: The Administrative Reinstatement of Arm's Length Standards*

PTE was granted in June 1977 on the basic terms proposed by the insurance industry.[133] Those terms may appear reasonable if

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ers would also be prohibited from providing services to trusts with respect to which they are fiduciaries. 42 Fed. Reg. at 1528-29.

[130] 42 Fed. Reg. 1488, 1529 (1979).

[131] *Id.* at 1529-30. The proposed exemption also mandated certain recordkeeping requiements. *Id.* at 1530.

[132] *Id.* at 1526.

[133] 1977-2 C.B. 428. The industry proposal underwent certain modifications. Master and prototype plans were given special treatment. Technical adjustments were made to ensure that only service providers and investment advisors utilize the exemption. (Thus, for example, an agent who is a trustee cannot sell insurance pursuant to PTE 77-9). Despite these changes, PTE 77-9 is, in essence, the exemption proposed by the insurance industry.

they are examined apart from the prior history of the prohibited transactions rules.

However, the experience accumulated under section 503 indicates that, in practice, arm's length standards are not an effective deterrent to the misuse of pension and profit sharing trust funds. Because they are subjective in nature and therefore uncertain in effect, Congress twice rejected arm's length standards as a means of policing the abuse of tax-exempt institutions: the TRA, as well as ERISA, repudiated the subjective tests of section 503 in favor of objective, per se proscriptions of prohibited practices.[134] Nevertheless, PTE 77-9 reinstates arm's length standards with respect to a major portion of the assets held by pension and profit sharing trusts, their insurance and annuity policies. PTE 77-9 is therefore an administrative reversal of congressional policy.

In promulgating PTE 77-9, DOL and IRS noted that transactions proposed pursuant to PTE 77-9, while exempted from the restrictions of section 4975, may nevertheless be subject to the other fiduciary standards imposed by ERISA.[135] This observation is not reassuring. These subjective statutory standards do not compensate for the loss of the advantages of objective restrictions: certainty, uniformity and ease of enforcement. PTE 77-9 suspends in the insurance context the government's most easily-enforced provisions dealing with pension abuse, the per se proscriptions of section 4975. Additional subjective provisions, supplementing the arm's length tests of PTE 77-9, cannot replace an objective statute.[136]

Significantly, certain of the exemptions established in section 4975(d) utilize arm's length standards. The adoption by Congress of these statutory exemptions strengthens the impression that PTE 77-9 should have eschewed an arm's length approach. Throughout its deliberations on section 4975, Congress understood the impact per se proscriptions would have on the insurance industry.[137] When it created the limited arm's length exceptions of section 4975(d), Congress did not include insurance

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[134] *See* notes 62-68, 98-101 and accompanying text *supra*.

[135] 1977-2 C.B. 428, 432.

[136] Indeed, if the insurer or agent is a disqualified person but not a fiduciary (i.e., a service provider), the fiduciary provisions of ERISA do not apply at all.

[137] S. REP. No. 127, 93d Cong., 2d Sess., *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 4838, 4867-68.

transactions.[138] The administrative promulgation in PTE 77-9 of arm's length standards cannot be reconciled with Congress' failure to create an arm's length exemption for insurance when it adopted section 4975(d).

Section 4975(d)(5)(A) illustrates Congress' intent to limit the use of arm's length standards. That section specifically permits a pension or profit sharing trust to purchase insurance from an insurer on an arm's length basis if the insurer is an employer of participants in the plan. Section 4975(d)(5)(A) thus represents a precise and restricted use of arm's length approach vis-a-vis a specific problem of the insurance industry. Under accepted rules of statutory construction, the use of arm's length standards in a specific insurance context may indicate legislative disapprobation of such standards in the more generalized insurance setting.[139]

E. Review by an Independent Fiduciary: More Form Than Substance

At first glance, the procedural requirements of PTE 77-9 appear to distinguish that exemption from section 503. PTE 77-9 presumes that an informed fiduciary will insist that arm's length standards are met whenever insurers or agents propose insurance transactions. The inadequacies of the arm's length approach will thus be offset by the participation of the independent fiduciary who will ensure that any proposed transaction is indeed nonabusive. However, this arrangement is neither adequate nor consistent with the statute upon which it is allegedly based.

Insurance is a complex and technical subject.[140] Nevertheless,

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[138] *Id.*

[139] It is a traditional rule of statutory construction that *expressio unius est exclusio alterius. See* 73 AM. JUR. 2d, Statutes, §§ 211 and 212. Similar principles have been applied by the courts in the context of exempt entities. *See, e.g.,* HCSC Laundry v. United States, 101 S. Ct. 836 (1981). ("(I)t is a basic principle of statutory construction that a specific statute . . . controls over a general provision. . ."). *Id.* at 838-39. *See also* Hospital Central Services Ass'n v. United States, 623 F.2d 611 (9th Cir. 1980); Clarence La Belle Post No. 217 v. United States, 580 F.2d 270 (8th Cir. 1978).

[140] The complexity of life insurance is apparent from even an introductory textbook on the subject. *See, e.g.,* D. MCGILL, LIFE INSURANCE (rev. ed. 1967). Indeed, insurance experts cannot agree among themselves on a means of comparing the costs of different policies. *See* Quinn, *Sizing Up Life Insurance,*

PTE 77-9 does not require the independent fiduciary to be knowledgeable about insurance before approving a transaction. Hence, there is no reason to believe that this fiduciary will be truly independent from the insurer or agent whose recommendations he is theoretically reviewing.

In subjecting investment advisors to the prohibited transactions rules, section 4975(e)(3)(B) implies that such advisors, by virtue of their real or perceived expertise, exercise decisive influence over trusts' lay fiduciaries and their investment decisions.[141] In contrast, the draftsmen of PTE 77-9 assumed that lay fiduciaries are sufficiently knowledgeable to be immune from the influence of professional investment advisors. PTE 77-9 presumes that an independent fiduciary can evaluate meaningfully the insurance transactions which his investment advisor proposes. It is difficult, if not impossible, to reconcile section 4975(e)(3)(B)'s view as to the impressionability of trust fiduciaries with the critical assumption of PTE 77-9, that nonexpert fiduciaries can make genuinely independent evaluations of recommendations from their investment advisors.

The fact that pension and profit sharing fiduciaries often turn to insurers or agents for investment advice is itself evidence of their dependence and their inability or unwillingness to engage in the review and decision-making contemplated by PTE 77-9. A lay fiduciary seeks the advice of a professional because the professional is alleged to know more. Lay fiduciaries often view agents and insurers acting as investment advisors as experts whose expertise should be given deference. It would not be surprising if nominally independent but unknowledgeable fiduciaries give the approval required under PTE 77-9 on a pro forma basis, relying on the advice of the agents and insurers whose recommendations they are in theory reviewing.

Insurance agents are frequently the prime force behind the establishment of pension and profit sharing plans. When an agent plays a preeminent role in implementing a plan, nonexpert fiduciaries may be even more inclined to defer to his

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NEWSWEEK, Dec. 8, 1980, at 79. *See also,* Note, *Multiple Employer Trusts, Preemption and ERISA: A Case for Federal Regulation and a Proposal for Statutory Reform,* 65 MINN. L. REV. 459, 480-81 (1981).

[141] On the control of trust funds via expertise, *see* H.R. REP. No. 1280, 93d Cong., 2d Sess. 66, *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 5038, 5103.

recommendations.[142]

Ironically, small pension and profit sharing plans, cited as the justification for PTE 77-9, have the fewest possibilities for effective scrutiny under that exemption. Small plans typically are maintained by professional corporations and other closely-held businesses.[143] The world of small corporations is an informal and hectic one, where the distinctions, obligations, and formalities of the law are not always observed with strict care.[144] In many instances the fiduciaries of small plans are simply the firm's shareholders, lacking any particular expertise or sophistication vis-a-vis investments or insurance.[145]

The fiduciaries of small plans may not have the knowledge, time, self-confidence, or inclination to thoroughly review insurance sales proposed to them. A small plan fiduciary may believe that he acts prudently when he defers to the apparent expertise of the agent whose recommendation the fiduciary is theoretically reviewing. The influence of an agent will be particularly great if

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[142] *See* note 144 and accompanying text *infra.*

[143] In order to achieve qualified status under the Internal Revenue Code, pension and profit sharing plans must include most of the nonunionized employees of the employer sponsoring the plan or must include a fair cross-section of such employees. I.R.C. §§ 401(a)(3), and 410(a)(1) and (b). Hence, a qualified plan with few participants will generally be a plan maintained by an employer with few employees.

[144] *See, e.g.,* John P. Scripps Newspapers v. Commissioner, 44 T.C. 453 (1965); Times Publishing Co. v. United States, 63-1 U.S. Tax Cas. ¶ 9325 (W.D. Pa. 1963) ("(S)mall closely held, or family corporations, are not to be held to the strict formalities that are applicable to larger corporations. . . . Such corporations may act informally. . ."). *See also* "Fiduciary Responsibility Requirements: Effect on Professional Corporations," CORP. GUIDE ¶ 17,623, 17,625 (P-H) (hereinafter cited as "Fiduciary Responsibility Requirements"); F. O'NEAL, CLOSE CORPORATIONS at §§ 1.07, 1.12, 8.02 (2d ed. 1971).

[145] Laner & Levin, *The Dilemma of the Small Plan Fiduciary Under ERISA,* 56 CHI-KENT L. REV. 589, 589-91 (1980). Indeed, incorporation is often advocated so that shareholders may become trustees. An individual may serve as trustee of a Keogh trust only in limited circumstances. I.R.C. § 401(d)(1). *See* Kalish & Lewis, *Professional Corporations Revisited,* 28 TAX LAW. 471, 476-77, 496 (1974-75); O'Connor, *Selection of the Form of Business or Professional Organization: A Need for Clairvoyance,* 56 TAXES 880, 895 (1978). For a case in which the shareholder of a closely-held corporation acted as trustee of the firm's pension-trust, *see* Baker Nat'l Bank v. Commissioner, 33 T.C.M. 506 (1974). On the tendency of small plans to utilize their own shareholders as trustees, *see* CAVITCH, TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS § 5.02(5)(a)(ii) (1981). *See also* "Fiduciary Responsibility Requirements," *supra* note 144.

the agent sold the plan to the fiduciary and is therefore his main, if not only, source of information.[146] Having engaged a professional, a small plan fiduciary will often be reluctant to overrule the professional's recommendation.

To summarize, in many cases the procedural guarantees of PTE 77-9 will not be of any practical importance in view of the natural deference a nonexpert gives to the specialist he has hired. Without these guarantees, PTE 77-9 is nothing more than the arm's length approach to prohibited transactions, an approach Congress rejected as inadequate when it passed both ERISA and the TRA.

F. The Legislative History of Section 4975(c)(2)

ERISA's legislative history does indicate congressional acceptance of an insurance exemption if it is "in the interest of participants and beneficiaries of pension plans."[147] However, this history does not countenance an administrative retreat to arm's length standards or otherwise justify the terms of PTE 77-9.

The origins of section 4975(c)(2) can be traced to the version of ERISA passed by the Senate Committee on Labor and Public Welfare. In its report, the committee discussed its proposed procedure for granting exemptions from the prohibited transactions rules. The report specifically rejected as a basis for granting exemptions the arm's length test of "adequate consideration" since, under section 503, "this standard has not, by itself, curbed conflict-of-interest abuse."[148] Arm's length standards are nevertheless the core of PTE 77-9.

Nor does PTE 77-9 satisfy the committee's criteria for granting administrative exemptions. The report cites four factors: (1) the "nature and purpose" of the plan involved; (2) the "indis-

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[146] Notes one insurance expert: "The efforts of sales representatives of insurance companies . . . in popularizing (employee benefit) plans is obvious." Milliman, *Rationale of Employee Benefit Plans,* GROUP INSURANCE HANDBOOK (Eilers & Crowe eds. 1965). D. MCGILL, FULFILLING PENSION EXPECTATIONS 3-9 (1962); Mulock, *The Positive Side of ERISA,* CHARTERED LIFE UNDERWRITERS J. 32 No. 3 at 41; Stoeber, *Qualified Retirement Plans Under ERISA for Small Employers,* 30 CHARTERED LIFE UNDERWRITERS J. No. 4 at 41 ("(T)he life insurance industry and its agents can justifiably take credit for providing the major impetus to smaller employers for adopting qualified plans.).

[147] S. REP. No. 127, 93d Cong., 2d Sess., *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 4838, 4868.

[148] *Id.,* [1974] U.S. CODE CONG. & AD. NEWS at 4868-69.

pensability" of the transaction which would be proscribed but for the requested exemption; (3) the existence of "alternative methods" of managing and investing plan assets if the exemption were not granted; and (4) the existence of "independent safeguards" in the proposed exemption.[149] Viewed against each of these criteria, the impropriety of PTE 77-9 is apparent.

With regard to the first factor, certain plans regulated by ERISA have purposes beyond providing retirement and deferred compensation benefits. These additional purposes may justify transactions which section 4975 would otherwise prohibit. For example, employee stock ownership plans (ESOPs) are intended to promote employee ownership of employer stock and to provide alternative financing for small businesses.[150] Hence, certain practices which are generally not appropriate for pension and profit sharing trusts may be proper for ESOPs, for example, sales of employer stock to the plan. In contrast, the nature and purpose of pension and profit sharing plans cannot justify PTE 77-9 and its departure from the prohibited transactions rules. The raison d'être of PTE 77-9 is to facilitate the purchase of insurance and annuity contracts by pension and profit sharing plans. Under well-established regulations and case law, the purchase of insurance by such plans is necessarily an incidental function, subordinated to the provision of retirement and deferred compensation benefits.[151] While annuity contracts are often a helpful means of funding pension and profit benefits, nothing in the nature of pension or profit sharing plans requires their use or mandates relaxation of the prohibited transactions rules so that they may be purchased.[152]

Even the insurance industry does not characterize PTE 77-9 as "indispensable." The industry's arguments on behalf of PTE 77-9 emphasized the asserted financial savings and convenience which pension and profit sharing plans would achieve by resorting to agents and insurers. The industry never argued that the

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[149] *Id.*

[150] For an introduction to his subject, *see* Kaplan & Cowan, 354 TAX MNGM'T (BNA) *ESOPs and TRASOPs.*

[151] Zelinsky, *Insurance, Pensions and the Internal Revenue Code,* 33 TAX LAW. 427, 427-32 (1980).

[152] Indeed, a majority of pension assets are held as stocks and bonds, indicating that many plans do without annuity and insurance contracts. *See Pension Funds' Promise Also Contains Real Peril, supra* note 117.

PTE 77-9 was indispensable to any plan.[153] Indeed, it could not have advanced such a claim since the services provided by insurers and agents, including investment advice, are available from a variety of other sources.[154]

PTE 77-9 also fails the committee's third criteria in that there are alternative methods of investing plan assets other than that prescribed by the exemption. If plans need the services of agents or insurers, they can contract for such services from agents or insurers other than those engaged to provide policies or from firms and individuals unrelated to the insurance industry.[155]

Only with respect to the fourth criterion, independent safeguards, does PTE 77-9 attempt to satisfy the committee's requirements. However, as I have suggested, the PTE 77-9 safeguards are inadequate, particularly for small plans, since review by the nonexempt independent fiduciary will often be pro forma.[156] Indeed, the report of the ERISA conference committee indicates that, if disqualified persons propose transactions in areas of their expertise, those transactions should be exempted under section 4975(c)(2) only if persons of equal expertise review them.[157] PTE 77-9, which permits review by nominally independent but unknowledgeable lay fiduciaries, is not consistent with this expression of congressional intent.

G. Normal Sales Presentations: A Legitimate Concern of the Insurance Industry

Notwithstanding the impropriety of PTE 77-9, the insurance industry raises a legitimate question as to the status of "normal sales presentations" under ERISA. The industry's apparent concern is that its agents, by virtue of their sales presentations, will inadvertently acquire fiduciary status. The point at which a sales presentation becomes investment advice is far from clear. Insurance agents, unaware that they are fiduciaries, will not comply with the procedural aspects of PTE 77-9. By accepting

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[153] 42 Fed. Reg. 1488, 1526-27 (1977).

[154] Ironically, the announcement that PTE 77-9 was under consideration indicates the great range of service providers other than insurers and agents. 42 Fed. Reg. 1525 *et seq.* (1977).

[155] *Id.*

[156] *See* notes 140-46 and accompanying text *supra*.

[157] H.R. CONF. REP. No. 1280, 93d Cong., 2d Sess., *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 5038, 5090.

their sales commissions, such agents will unknowingly participate in prohibited transactions.[158]

However, the industry's solution to this problem was not a good one. Nothing would have been gained had the IRS and DOL declared that "normal sales presentations" do not constitute "investment advice": case-by-case determinations would still have been required to ascertain whether particular statements constitute "normal sales presentations." The uncertainty inherent in subjective standards would merely have been shifted from one such standard ("investment advice") to another ("normal sales presentation").

The DOL and IRS, properly declining to accept the "normal sales presentation" test, suggested that the regulations under section 4975 elaborate on the term "investment advice" and thereby provide a greater degree of certainty in this area.[159] However, these regulations do not provide much guidance with respect to insurance transactions. Treasury Reg. section 54.4975-9(c) states, in relevant part, that the term "investment advice" means advice furnished "on a regular basis . . . pursuant to a mutual . . . understanding, written or otherwise" that such advice "will serve as a primary basis for investment decisions with respect to plan assets." This regulation does provide a safe harbor to an insurance agent who makes a single, nonrecurring presentation to pension or profit sharing trustees. Beyond this simple case, Reg. section 54.4975-9(c) is of little help in the insurance setting. The regulation would characterize an agent as an investment advisor if his advice is "a primary basis" for the other fiduciaries' investment decisions. It is far from clear what the regulation means by a "primary basis." The phrase adds little, if anything, to the statutory language.

H. The 100 Participant Limit: A Lost Opportunity to Mitigate the Damage

Concurrent with the initial promulgation of PTE 77-9, the IRS and DOL proposed to limit its availability to pension and profit sharing plans with fewer than one hundred active participants.[160] Since PTE 77-9 was largely predicated on the asserted

[158] 42 Fed. Reg. 1488, 1527-28 (1977); 1977-2 C.B. 428, 430-31.
[159] 1977-2 C.B. 428, 431.
[160] 42 Fed. Reg. 32,399-400 (1977).

plight of small plans, the DOL and IRS proposed that the exemption apply only to them. The one hundred participant limit would have mitigated the erosion of section 4975 by reducing the coverage of PTE 77-9.

On April 28, 1978, IRS and DOL withdrew the proposed one hundred participant limit, citing several reasons.[161] Failure to extend the protection of PTE 77-9 to large plans would, they asserted, disrupt existing practices. They also reasoned that large plans can utilize package arrangements in situations which are not abusive. The proposed limit would impose greater costs on large plans since they would be required to purchase services separately from their insurance coverage. Because of routine fluctuations in participation levels, enforcing the one hundred participant limit would be administratively difficult. Hence, the DOL and IRS concluded they should not exclude plans with one hundred or more active participants from the coverage of PTE 77-9.[162] None of these arguments is persuasive.

While the one hundred participant limit would indeed have disrupted the established practices of certain large plans, Congress enacted the prohibited transactions rules knowing, indeed desiring, their disruptive effects.[163] Section 4975 is intended to deter practices which section 503 had failed to prevent. It was not the purpose of ERISA to permit business as usual or to condone established practices.

The solicitude of the DOL and IRS for "nonabusive" insurance transactons cannot be reconciled with ERISA's fundamental policies. Congress understood that section 4975 would terminate nonabusive transactions. Section 4975 was in essence a legislative judgment that the gains from arm's length dealings between tax-exempt institutions and their disqualified persons are of insufficient value to outweigh the advantages of objective prohibitions.[164] The decision to forego the one hundred participant limit reflects a contrary administrative judgment that nonabusive transactions are more beneficial than Congress thought they were. Whatever discretion an administrative agency might appropriately possess, that discretion should not be used to repeal fundamental legislative policies.

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[161] 43 Fed. Reg. 18,359 (1978).

[162] *Id. See also* 1979-1 C.B. 371.

[163] *See* notes 74-83 and accompanying text *supra*.

[164] *Id.*

An equally uncompelling argument is that excluding large plans from PTE 77-9 will increase their costs. The representations made to secure PTE 77-9 emphasized the plight of small plans with their limited resources.[165] Exemption on economic grounds is less compelling for larger plans with greater resources.

In any event, it is not a startling observation that the prohibited transactions rules would, absent administrative exemption, increase costs for large plans utilizing package insurance arrangements. ERISA is an expensive proposition for plans of all sizes. New reporting requirements,[166] minimum funding standards,[167] participation[168] and vesting requirements[169] all add to the costs of qualified pension and profit sharing plans. Congress knowingly decided to impose many costs, including the costs of the prohibited transactions rules, in order to pursue the policies incorporated in ERISA. An administrative decision to repeal congressionally-imposed costs must be predicated on more than the fact that Congress mandated these costs.

The DOL and IRS also rejected the proposed limitation because of its asserted unworkability. Participants enter and leave plans on a continuing basis. Hence, fluctuations in participation levels would cause certain plans at times to exceed a numerical participant limitation. These plans could continually shift between small plan and large plan status.

The number of participants is not the only criterion which may be used to define which plans are "small." For example, the assets of the plan and its total accrued liability could be used as supplementary criteria. A limitation could be designed so that a plan acquiring more than the maximum number of participants could nevertheless retain small plan status and the protection of PTE 77-9 as long as its assets or accrued liabilities did not exceed certain additional standards.

A limitation could also include a grace period. A small plan triggering large plan status would not immediately lose the coverage of PTE 77-9. If during the grace period the plan reverted to small plan status, the coverage of PTE 77-9 would never be

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[165] 42 Fed. Reg. 32,399-400 (1977).
[166] *See* ERISA §§ 101-111, U.S.C. §§ 1021-1031.
[167] I.R.C. § 412.
[168] I.R.C. § 410.
[169] I.R.C. § 411.

lost. If by the end of the grace period the plan had not returned to small plan status, the exemption would then cease to apply to that plan.

Even if a small plan should become a large plan and therefore lose the coverage of PTE 77-9, it would not be necessary to disrupt all of its preexisting insurance and service arrangements. Insurance and annuity policies purchased under PTE 77-9 could remain in effect as long as the terms of such policies were not changed. Similarly, services could be continued as long as the rates for and the nature of such services were not altered. Indeed, had PTE 77-9 been limited in its scope to small plans, large plans would nevertheless have been able to seek individual exemptions for the particular package arrangements they might choose to make with insurers or agents.[170]

On December 29, 1978, more than four years after the passage of ERISA, PTE 77-9 was republished in amended form. While this final version differs from the original exemption in certain respects, the basic approach remains as initially proposed: pre-ERISA arm's length standards applied on a case-by-case basis augmented by the approval of an allegedly independent fiduciary.[171]

IV. Reflections on the Evolution of the Prohibited Transactions Rules

A. *Simplicity and Equity: The Causes of Statutory Complexity*

Many observers of American government have identified the complicated nature of the Internal Revenue Code with the alleged unfairness of the federal tax system.[172] In this view, special interests have inserted self-serving provisions into the federal tax statute and thereby made it more complex. A simpler Code, it is suggested, would be a more equitable Code.

The process by which section 503 gave rise to sections 4941 and 4975 suggests that this perspective, whatever its popular appeal, is incorrect. Sections 4941 and 4975, which admittedly ad-

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[170] I.R.C. § 4975(c)(2).

[171] 1979-1 C.B. 371.

[172] *See, e.g.*, Carter, *A New Beginning*, in 1 The Presidential Campaign 1976 (1978) at 230; P. Stern, The Rape of the Taxpayer (1973); N.Y. Times, Apr. 28, 1981, § A at 28 (letter of Congressman Leon E. Panetta).

ded to the complexity of the tax law, did not open loopholes but closed them. These complicated provisions trace their origins to the forces of reform,[173] anxious to strengthen the IRS against the abuse of exempt entities, rather than to special interests, seeking parochial advantage through arcane amendments to the federal tax statute. The prohibited transactions rules have become more complex because the dictates of public policy required complicated legislation. The ineffectiveness of simple laws required the passage of more complex ones.

This is not to suggest that the Internal Revenue Code is free from the influence of special interests or that the provisions favoring such interests do not often add to the complexity of the federal tax statute. Rather, it is to suggest that the simple identification of complexity with unfairness limits our understanding of the tax law and its evolution. Such analysis may in the end hurt the cause of substantive reform by obscuring the nature of the problem. Complexity is often an unpleasant but necessary side effect of reform.

It is perhaps tempting to dismiss as political rhetoric those arguments which have identified the complicated nature of the Code with the asserted inequity of the federal tax system. However, it would be a mistake to underestimate the potential impact of these arguments. Serious observers, whose comments cannot be dismissed as political rhetoric, have often asserted the connection between complexity and unfairness.[174] Moreover, political rhetoric is not without its effect. It can mold popular attitudes, and popular attitudes often create political imperatives.

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[173] The use of the term "reform" is not meant, in this context, to have normative implications. Interests seeking alterations of the Internal Revenue Code typically argue that the benefits which they derive from such changes are justified because of gains which will accrue to the general public. Hence, investors urge lower capital gains rates because increased investment will create more jobs. For the purposes of this analysis, I would identify as "reformers" those actors who influence tax policy with no direct or apparent financial benefit themselves. This group would include the staff of the Treasury and the congressional tax-writing committees, certain academics, public interest groups, and research institutions. This group has undeniable impact. T. REESE, THE POLITICS OF TAXATION (1980).

[174] Indeed, most of the nation's leading newspapers and magazine dwell at length on the subject every April 15th. *See, e.g.*, N.Y. Times, Apr. 15, 1980, § A at 22. For a more scholarly approach, *see* Turnier, *Evaluating Personal Deductions in an Income Tax—The Ideal*, 66 CORNELL L. REV. 262 (1981).

B. *The Inevitability of Objective Statutory Provisions*

That there is a tendency for the Code to become more complex is something of a commonplace. The history of the prohibited transactions rules suggest a subtler lesson: that the complexity evolves along a certain pattern. Congress tends to make the Code more complicated and more detailed in order to make it more objective and therefore more easily enforced. Congress first recognizes a problem (for example, the abuse of tax-exempt entities). In response, Congress adds to the federal tax statute simple provisions, embodying subjective standards and requiring case-by-case determinations, (for example, section 503). These provisions prove difficult to apply and engender uncertainty in the administration of the tax law. Congress replaces or augments its initial statutes with more detailed objective provisions which add to the complexity of the Code but which are easier to enforce (for example, sections 4941 and 4975).

In enacting sections 4941 and 4975, Congress made a decision similar to one it has made in other areas of the tax law: that certain problems cannot be policed effectively with statutory standards requiring case-by-case examinations, that such problems must be addressed through easily applied mechanical rules, and that objective standards, while proscribing some transactions which otherwise would have been approved, yield compensating benefits, such as certainty, uniformity, and ease of enforcement. Implicit in this decision is an awareness of the limited enforcement capability of the Internal Revenue Service and the resulting need to devise objective and therefore easily enforced revenue laws.

This pattern may also be seen in the evolution of section 269 which disallows any deduction or credit attributable to a corporation acquired for "the principle purpose" of "securing the benefit" of the deduction or credit. Section 269 is a classic example of a subjective tax provision requiring case-by-case analysis of taxpayer motivation. Not surprisingly, section 269 has generated many of the same problems as section 503 and therefore has failed in its intended task, preventing the formulation and acquisition of corporations solely for the use of their tax losses and deductions. The upshot has been the adoption of sections 381, 382, 383, 1561, 1562, and 1563, which prescribe detailed, objective limitations on the use of deductions and credits from acquired corporations.[175]

The protracted effort to curb perceived income tax abuses involving trusts reveals a similar progression. Because the Internal Revenue Code recognizes trusts as separate entities,[176] it is often advantageous for a taxpayer in a high bracket to convey income-producing property to a trust. This allows the income from the transferred property to be taxed to the trust or to the trust's low bracket beneficiaries rather than to the taxpayer/transferor himself.[177]

The IRS historically attacked the validity of a trust for income tax purposes if the taxpayer retained excessive control over it. This litigation policy resulted in government victories in such decisions as *Clifford v. Helvering*.[178] In each of these cases, the court was convinced that the grantor/taxpayer retained excessive control over the trust at issue and that accordingly the trust was not valid for income tax purposes. A case-by-case approach, however, proved to be unsatisfactory. In the absence of reasonably comprehensive and precise standards, taxpayers could draft trusts somewhat different from those addressed judicially and then challenge the IRS to litigate the trusts' validity. Hence, over the course of several years, sections 671 through 678 were added to the Code to provide objective, mechanical tests for the tax-validity of trusts.[179] These provisions are among the more complex of the tax law[180] and deny recognition to a trust failing their standards even if the grantor has a legitimate non-tax reason for the trust's terms.

The tax on personal holding companies[181] constitutes a set of mechanical prohibitions on the use of closely-held corporations to avoid personal income taxes otherwise payable by the corpo-

[175] D. HERWITZ, BUSINESS PLANNING 164-172 (1966); Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733, 754-56 (1978).

[176] I.R.C. § 1(e).

[177] For an introduction to this subject, *see* Calleton, 251-2d TAX MNGM'T (BNA), *Short-term Trusts*.

[178] 309 U.S. 331 (1940). *See also* Commissioner v. Berolzheimer, 116 F.2d 628, 41-1 U.S. Tax Cas. ¶ 9156 (2d Cir. 1941).

[179] Note, *Clifford Trusts: A New View Towards Leaseback Deductions*, 43 ALB. L. REV. 585, 587-88 (1979). *See also* Kahn & Waggoner, FEDERAL TAXATION OF GIFTS, TRUSTS AND ESTATES 532 (1977).

[180] *See* Horne v. Peckman, 97 Cal. App. 3d 404, 158 Cal. Rptr. 714 (3d Dist. 1979).

[181] I.R.C. §§ 541-547.

rations' shareholders.[182] Objective provisions are needed to supplement the tax on accumulated corporate earnings[183] which relies upon subjective determinations of intent and reasonableness.[184] Section 411(a), which prescribes mandatory vesting schedules for qualified pension and profit sharing plans, applies detailed, easily enforced tests to an area previously addressed through case-by-case determinations.[185]

The pattern by which simple, subjective statutory standards give rise to complex, objective progeny suggests that there is an underlying dynamic to the evolution of the tax law and that the increasingly complicated nature of the Internal Revenue Code reflects a process which, if not inexorable, is deeply-embedded. Of course, statutory provisions requiring subjective determinations still govern important areas of the income tax. The reasonableness, and therefore deductibility, of compensation is determined through reference to the facts and circumstances of particular situations.[186] While objective standards regulate certain aspects of the deduction for depreciation, the ultimate test for any such deduction under section 167 is that it constitute "a reasonable allowance."[187]

Nevertheless, in numerous areas of the tax law, statutory standards requiring subjective determinations have proved inadequate and have been replaced by detailed, objective provisions. As one commentator aptly observed, "[p]redictability and a high degree of certainty are essential" to the administration of the federal income tax.[188] The effort to attain predictability and certainty through objective statutory provisions is a major—if not the major—source of complexity in the Internal Revenue Code.

In this context, PTE 77-9 appears as something more than an

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[182] *See* Lubick, *Personal Holding Companies - Yesterday, Today and Tomorrow,* 42 TAXES 855, 857-58 (1964).

[183] I.R.C. §§ 511-537.

[184] *See* I.R.C. §§ 532(a) and 533(a).

[185] Osgood, *Qualified Pension and Profit-Sharing Plan Vesting: Revolution Not Reform,* 59 B.U. L. REV. 452, 458-64 (1979).

[186] I.R.C. § 162(a)(I); Treas. Reg. § 1.162-7 (1981).

[187] I.R.C. § 167(a). But note that the Economic Recovery Tax Act of 1981 (ERTA) has largely supplanted § 167 with a new set of objective tests, the accelerated cost recovery system. *See* I.R.C. § 168 as amended by ERTA § 201.

[188] Letter of Professor Bernard Wolfman, [1980] TAX NOTES (TWR) 106. The progression from subjective to objective may also be seen in the evolution of the Treasury regulations construing the Code. *See, e.g.,* Mylan, *Current Treatment of Education Costs,* 31 U. FLA. L. REV. 387, 395-96 (1980).

industry's effort to exempt itself from unpleasant statutory restrictions. Rather, PTE 77-9 reflects administrative resistance to Congress' tendency to impose objective standards onto the tax law.

It is instructive to compare PTE 77-9 with Rev. Rul. 80-26,[189] describing the IRS' attitude toward section 318. Section 318 includes objective tests for attributing, *inter alia,* the ownership of corporate stock among family members in situations governed by subchapter C of the Code. Section 318 was adopted to provide objective standards in an area of the tax law previously governed by subjective determinations, a development which, I have suggested, reflects a fundamental dynamic of the Internal Revenue Code. In Rev. Rul. 80-26, the IRS argues that the terms of section 318 must be literally observed even in situations where case-by-case determinations would properly lead to contrary results. Rev. Rul. 80-26 expresses a resolve to preserve the integrity of objective statutory provisions and to prevent the erosion of such provisions through the reintroduction of subjective standards. It reflects a fidelity to objective statutory rules which is absent in PTE 77-9.

Similarly, in Rev. Rul. 80-80,[190] the IRS argues that, in other than "exceptional" circumstances, its actuarial tables must be used to value life estates and remainder interests even though an examination of each particular interest will yield a different and more accurate value. The use of its tables, the IRS says, obviates the need for time-consuming "case-by-case analysis." It was precisely this concern which led to the adoption of section 4975 with its objective, per se proscriptions. It is this concern which is absent in PTE 77-9.

C. *The Nature of Objective Tax Statutes: The Connection Between Objectivity and Complexity*

Subjective tax statutes establish general policies in broad terms, and thus require the courts and the IRS to refine those policies as they evaluate particular transactions. In contrast, objective tax statutes establish mechanical rules applied on the basis on easily observable facts and thereby obviate the need for significant administrative or judicial evaluation of individual

[189] 1980-4 I.R.B. 7.
[190] 1980-12 I.R.B. 10.

transactions. Since objective statutes do not contain broad, subjective language which can cover unexpected situations, they must be detailed in order to identify all of the transactions which Congress intends to encompass.[191]

An objective statute minimizes judicial discretion in the interests of certainty and enforceability. Congress mandates that certain easily-observable facts will per se have specified tax consequences. Once these facts are established, the judge applies an automatic rule. He does not delve further into the case or consider any facts other than those enumerated in the statute. He is an enforcer rather than a maker of the law.

On the other hand, when construing a subjective revenue law, the judge acts as a participant in the lawmaking process. Guided only by Congress' general instructions, he assesses the situation at hand and exercises substantial discretion, determining the propriety of imposing a tax in that situation.

The draftsmen of section 4975 could have defined disqualified persons in subjective terms (for instance, "any person in a position to control, directly or indirectly, the assets of an exempt trust").[192] The resulting statute would have been more concise than section 4975(e), but it also would have generated more uncertainty and therefore would have been harder to enforce. It takes time for the IRS and the courts to develop enough rulings to establish the contours of a subjective statute. Some subjective statutes are never construed definitively because their application depends on the facts of each particular case. Since judicial and administrative decisions can be reversed, they can never provide the same degree of certainty as can the statute itself.

Hence, Congress adopted objective definitions for the prohibited transactions rules, specifying individually each of the potential abusers of trust assets. The result, section 4975(e), is a complex statute. It is complex because it must be factually specific in order to be easily applied. Section 4975(e) is also complex because it must be exhaustive, because in the absence of broad, subjective language, those not explicitly identified as disqualified persons are not subject to the prohibited transaction rules.

Drafting subjective statutes is easier than drafting objective ones because subjective statutes state Congress' intent in gen-

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[191] Indeed, if an objective statute is not detailed, it is not likely to be effective.

[192] *See* I.R.C. §§ 269 and 482 for provisions drafted along these lines.

eral, even conclusory, terms.[193] The draftsmen can rely on the courts (and the IRS) to give meaning to these broad phrases through the examination and the evaluation of particular cases.

Objective statutes, designed to eliminate case-by-case evaluations, must establish mechanical rules applicable in every possible situation with a minimum of interpretation or controversy. The draftsmen of an objective statute must anticipate all of the circumstances which the statute should cover and translate those circumstances into easily observable characteristics. An objective law must be complex because its detailed development cannot be relegated to the courts and administrative authorities. The statute itself must provide all necessary details.

It is often difficult for the draftsmen of an objective statute to anticipate all of the situations to be covered by the statute. A case in point is Congress' use of objective tests for determining which employers are related for pension purposes.[194] Abusive situations not encompassed within the letter of the statute have escaped judicial scrutiny because there is no broad, subjective language in the statute for courts to construe as covering these circumstances.[195]

Complete objectivity in the tax law is obviously unattainable. Ultimately, some legal concepts require an evaluation of particular factual settings. We have seen, for example, that despite the efforts of the ERISA draftsmen, the statutory definition of an "investment advisor" is a subjective one and that several of the exceptions embodied in section 4975(d) rely on arm's length standards. Nevertheless, if a perfectly objective tax statute is an unachievable ideal, the impulse to make the tax law more objective, and therefore more readily enforceable, is deeply rooted and explains much of the Code's complexity.[196]

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[193] *Id.*

[194] *See* I.R.C. § 414(b).

[195] *See* Lloyd M. Garland, M.D., F.A.C.S., P.A. v. Commissioner, 73 T.C. 5 (1979); Thomas Kiddie, M.D. Inc. v. Commissioner, 69 T.C. 1055 (1978). Note that the results in *Kiddie* and *Garland* have been reversed by Pub. L. No. 96-605, 94 Stat. 3521 (1980). *See* Lamon & Thompson, *Qualified Retirement Plans for Affiliated Service Corporations: What to Do Under New Legislation,* 59 TAXES 67 (1981).

[196] Thus, it is necessary to qualify the oft-repeated maxim that in tax cases substance should prevail over form. A subjective statute is, indeed, an implicit instruction to the IRS and the courts to examine particular situations and evaluate their substance. However, objective statutes are designed to foreclose

In addition to the complexity they entail, objective tax statutes have a second cost: they sometimes generate unfair results which the courts and the IRS cannot avoid. Because they establish mechanical rules to be applied with a minimum of discretion and interpretation, objective revenue laws may, in some situations, lead to unavoidably harsh outcomes.[197] The enactment of an objective statute is thus a decision that, on balance, the benefits of such a law justify occasional outcomes which are less than fair.

D. *PTE 77-9: How Did It Happen?*

As it reintroduces subjective, pre-ERISA law to approximately one-third of the assets held for qualified pension and profit sharing plans, PTE 77-9 is a significant reversal of congressional policy. Why, then, did it happen?

In part, it happened because no one objected. The opposition expressed to the IRS and DOL never contested the fundamental premise of the exemption, the administrative reinstitution of arm's length standards. Commentators objected to particular details or suggested specific refinements of the exemption which the insurance industry proposed.[198] The exemption itself never was challenged and its inconsistency with the basic policies of section 4975 apparently never was raised.[199]

On a more fundamental level, PTE 77-9 reflects the absence of meaningful statutory restrictions on the process for granting prohibited transactions exemptions. Section 4975(c)(2) authorizes a class or individual exemption if the exemption is "administratively feasible," if it "is in the interests of the plan," the participants, and the beneficiaries affected, and if the exemption protects the "rights" of the participants and beneficiaries. As its expansive terms indicate, section 4975(c)(2) is a "vague

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such evaluations by providing mechanical, formalistic standards. It is inappropriate to search behind form when Congress has deemed form to be controlling.

[197] *See* notes 73-83, and accompanying text *supra*. *See also* Daniel Metzger Trust [1980-81] 76 TAX CT. REP. DEC. (P-H) 21 (regarding § 318) and Miller v. Commissioner, 75 T.C. 182 (1980) (regarding I.R.C. § 267).

[198] *See, e.g.*, 1977-2 C.B. 430-32, 42 Fed. Reg. 32,396-398.

[199] Query: Was there no objection to the promulgation of arm's length standards in PTE 77-9 because, in the post-ERISA period, pension-minded public interest groups had gone on to other areas of interest and therefore did not follow the development of PTE 77-9?

grant . . . of virtually open-ended 'legislative' power"[200] to the DOL and IRS. Nothing in section 4975(c)(2) required the DOL or the IRS to reconcile PTE 77-9 with the policies of ERISA.

E. The Failure of Section 4975(c)(2) to Distinguish Between Class and Individual Exemptions

Section 4975(c)(2) establishes the same vague criteria for both class and individual exemptions. PTE 77-9 illustrates the need for more restrictive requirements for class exemptions.

An individual exemption applies to a specific transaction which is reviewed administratively prior to its execution.[201] The burden in such a situation is on the applicant who must show that the terms of the proposed transaction are appropriate. The administrator reviewing the transaction need not persuade a court or any person other than himself that the transaction should or should not be permitted. If the administrator has any doubts, he may require a change in the terms of the transaction or may withhold the exemption. In such a situation, the ability of the government to insist on arm's length standards is unassailable. Moreover, an improvidently granted individual exemption does relatively little damage since the exemption only applies to that particular transaction. The exemption does not authorize any other transactions. Thus, the unrestricted authority embodied in section 4975(c)(2) may be appropriate for individual exemptions.

By contrast, a class exemption is legislative in nature and supplants the terms of the statute for all persons. A person utilizing a class exemption need not present the terms of the transaction to the government for its prior approval or alter the terms of the transaction to receive an exemption. Rather, the government must audit the transaction and ultimately prove a violation of the class exemption in court. Incorporating arm's length standards into a class exemption creates precisely the same problem that obtained under section 503: such standards are difficult to enforce because of their subjective nature. The taxpayer may in-

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[200] The quoted phrase is Mortimer M. Caplin's, commenting on Congress' proclivity to adopt legislation granting excessive authority to administrators. I.R.C. § 4975(c)(2) appears to be an excellent example of Caplin's thesis. *See* Caplin, *Supreme Court Decisions in Taxation: 1978 Term—Introduction,* 33 TAX LAW. 497, 502 (1980).

[201] For an example of a typical individual exemption, *see* PTE 80-93.

terpret the exemption in his own favor and then challenge the government to litigate.

The propriety of arm's length standards in class exemptions is particularly questionable in view of the availability of individual exemptions. Had PTE 77-9 been more restrictive (or had it not been adopted at all), insurers and trustees could still have applied for advance approval of particular transactions.

Because class exemptions have the potential for reversing fundamental statutory policies, they should be more difficult to promulgate. However, the "vague grant" of authority in section 4975(c)(2) applies to class as well as to individual exemptions. The problems with PTE 77-9 suggest that a different and more restrictive standard should govern class exemptions.

F. Repairing PTE 77-9

It is possible to fashion a class exemption which does not utilize arm's length standards, but which nevertheless permits sales of insurance in the situations regulated by PTE 77-9. One alternative is to promulgate schedules with maximum permissible premiums and commissions. As long as these limitations were not exceeded, pension and profit sharing trusts could purchase policies with services or where an agent or insurer was a fiduciary. If either the commissions or premiums of a policy exceeded the prescribed limits, the trust would have to apply for an individual exemption.

Similarly, there could be specific limits on fees for services. Plans might be permitted certain expenditures for services which presumptively would be acceptable. Expenditures in excess of the de minimis level would require individual exemptions.

If the arm's length standard of PTE 77-9 is retained, the exemption should be restricted to small plans. Administrative exemptions should be constructed narrowly to effect the least possible departure from statutory policies. Hence, the coverage of PTE 77-9 should be as limited as possible.[202] It may also be appropriate to limit the exemption to plans with institutional trustees. Such a restriction, comparable to the Keogh requirement of an institutional trustee, would help insure the in-

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[202] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-14 (1976). *See also* Caplin, note 200 *supra*.

dependent fiduciary's genuine independence from the insurer or agent proposing a transaction.[203] Alternatively, PTE 77-9 could be limited to plans with an independent fiduciary possessing some demonstrated knowledge of the insurance industry and its products.

The insurance industry's concern that normal sales presentations inadvertently will make insurance agents fiduciaries is reasonable, particularly because the regulations provide little guidance in this area.[204] While a mechanical test of fiduciary status is probably not feasible, the regulations could specify factors which militate against or which support a finding that an insurance agent has acted as an investment advisor. If, for example, a pension or profit sharing plan has a paid investment counselor to act on its behalf, it it less appropriate to view an insurance agent or any other salesman as an advisor rather than a vendor. Similarly, if a plan has an institutional trustee with its own research department, an insurance agent's influence is less likely to justify a finding of fiduciary status.

Case law determinations may eventually develop these or other criteria. Rather than relying on the slow process of judicial lawmaking, it would be helpful for the regulations to provide guidance in this area now. Until the regulations or case law furnish such guidance, insurance agents would be well advised to assume that they are fiduciaries and should comply routinely with the procedural requirements of PTE 77-9.

CONCLUSION

Those who drafted the original prohibited transactions provisions in 1950 may have thought that they had solved the problems presented by the abuse of tax-exempt institutions. Even if they understood that their solution was imperfect, it is unlikely that they foresaw the statutory and regulatory evolution which section 3813 began.

We should ourselves be cautious in assuming that sections 4941 and 4975(c)(2) represent the final form of the prohibited transactions rules. I have suggested that PTE 77-9 suffers from the same defects as the statutory arm's length standard of section 503, and that PTE 77-9 could prove to be no more effective

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[203] *See* notes 140-146 and accompanying text *supra.*

[204] *See* notes 158-159, and accompanying text *supra.*

than section 503 in policing the abuse of tax-exempt entities. Certain statutory exemptions embodied in sections 4941 and 4975 also utilize an arm's length test. While narrowly drawn, these exemptions could present the same problems experienced with subjective standards under section 503.

Notwithstanding ERISA and the Tax Reform Act of 1969, tax-exempt institutions will continue to be inviting targets for abuse. As the assets of private foundations and of pension and profit sharing trusts grow, the temptations to utilize those assets in an abusive manner will no doubt keep pace.

Ultimately, the abuses involving tax-exempt entities must be viewed not as a problem to be solved, but as a permanent if unpleasant reality which at best can be minimized and controlled. New techniques of abuse will require the development of new statutory and regulatory responses, making the law more complex, objective, and detailed. The inevitability of that development is the most important lesson to be gained from the history and analysis of the prohibited transactions rules.