DOL's New Rules Restrict Incentive Compensation Involving IRAs

October 06, 2016

McGlinchey Consumer Financial Services Alert

Welcome to a new federal agency that is regulating incentive compensation arrangements, in this case, financial incentives to sell IRAs: the U.S. Department of Labor (DOL). Under the DOL's new fiduciary rule finalized in April 2016 and scheduled to be effective April 10, 2017, individuals who make certain investment recommendations regarding IRAs for a fee or other direct or indirect compensation are deemed to be fiduciaries to the IRAs. The rules also apply to investment advice to qualified retirement plans, which have long been under fiduciary scrutiny, but the extension to IRAs is considered radical and may be catching many financial institutions unaware.

What are the consequences of being classified as a fiduciary under this rule?

Once an individual is classified as a fiduciary to an IRA, the individual's acceptance of the incentive compensation in connection with advice given to the IRA's owner will constitute a prohibited transaction, thereby subjecting the adviser to excise taxes and possible loss of the IRA's tax-deferred status.

Wait, you may say, the new fiduciary rule is promulgated by the DOL under ERISA, and IRAs are not subject to ERISA. However, the prohibited transaction rules that forbid fiduciaries from engaging in self-dealing transactions with plan or IRA assets exist in virtually identical form in both ERISA and the Internal Revenue Code, and the Internal Revenue Code's version of those rules do apply to IRAs. One of the specific acts prohibited by these rules is receipt of any consideration by a fiduciary for his/her own account from any party dealing with the IRA in connection with a transaction involving income or assets of the IRA (Internal Revenue Code section 4975(c)(i)(F)). Thus, once a bank representative is deemed to be a fiduciary to an IRA due to application of the new fiduciary rule, that representative will automatically commit a prohibited transaction once the additional incentive compensation is paid to that individual in connection with his advice given to the IRA owner.

Which investment recommendations constitute advice that will cause a bank representative to become a fiduciary to an IRA?

Advice given to a specific person regarding the advisability of a particular investment decision is enough to convert the giver of that advice into a fiduciary. Advice on which type of property the IRA should hold, such as a certificate of deposit versus a mutual fund, is covered advice. However, the fiduciary rule also deems the simple recommendation that an individual should roll over a retirement plan distribution into a rollover IRA to be fiduciary advice under the new rule. Note that it does not matter that the advice may be given on a one-time basis, that the advice may not be the primary basis for the IRA owner's investment decision, and that the advice may simply constitute a recommendation that no investment change is needed; none of these factors eliminate the advice-giver's fiduciary status under the new rule.

Can the fiduciary bank representative avoid committing a prohibited transaction if the representative accepts incentive compensation for the opening of an IRA at the bank or investing or retaining bank investment products?

The DOL, in its new rule, creates a new prohibited transaction exemption called the Best Interest Contract exemption. If the financial institution enters into a binding contract with the IRA owner that satisfies the DOL's best-interest requirements and files a written notification with the DOL that the financial institution will be relying on the Best Interest Contract exemption, the fiduciary's receipt of reasonable incentive compensation in connection with the IRA transaction will not constitute a prohibited transaction.

A valid Best Interest Contract must:

- Recognize that the bank owes a fiduciary standard of care in its dealings with the IRA;

- Obligate the fiduciary to act in the best interest of the IRA;

- Generally disclose any conflicts of interest that the bank may have in connection with the recommendations made to the IRA owner and the fact that incentive compensation may be paid in connection with the IRA

(and must provide that it will specifically disclose the exact amount and recipients of such compensation upon request); and

- Obligate the bank to implement compliance policies to mitigate any potential conflicts of interest (including an obligation to limit incentive compensation paid to reasonable amounts).

Importantly, the contract may not contain any prohibition on the IRA owners' right to seek or receive compensatory remedies for contractual breaches, including damages, or diminishing the owners' rights to pursue class action relief in court. The contract may, if desired, include mandatory arbitration for individual (not class) actions, and may prohibit receipt of punitive damages.

A transition rule, available from April 10, 2017 through the end of 2017, allows fiduciaries to utilize a simplified Best Interest Contract exemption. The simplified version requires that the adviser give the IRA owner a written statement acknowledging that the adviser is a fiduciary and disclosing any conflicts of interest that may exist and the financial institution must designate a Best Interest Contract exemption officer to monitor compliance with the new fiduciary rule.

The Best Interest Contract exemption also allows simplified compliance for "level fee fiduciaries." A level fee fiduciary is an adviser who receives only an advisory fee, usually a percentage of assets in the account, for advisory services rendered to the IRA. That is, neither the adviser, nor his supervisory entity, which includes their affiliates and related parties, can receive any additional compensation such as revenue sharing or management fees for affiliate products, in connection with the IRA's investments. Because no additional compensation is received due to IRA transactions, no prohibited transactions are occurring.

However, the simple advice to roll over an IRA goes beyond that protected status, as does the act of moving from a commission-based fee arrangement to a fee-based service. Thus, compliance with the simplified level fee fiduciary Best Interest Contract exemption is required. To comply, the adviser must give the client a written acknowledgment of the adviser's fiduciary status. In addition, the adviser must document, in writing, the reason that the recommendation was considered to be in the best interest of the retirement investor, including consideration of the alternatives to a rollover (such as leaving the money with the distributing retirement plan) and the fees and expenses associated with both the Plan and the IRA; whether the employer pays for some or all of the plan's administrative expenses; and the different levels of services and investments available under each option.

So, what is a financial institution to do?

One option is to eliminate all financial incentives related to IRA sales or retention so that, even if a representative renders fiduciary advice to an IRA owner, no prohibited transactions will have occurred in connection with that advice. Another option is to commence use of the Best Interest Contract exemption, which means drafting a compliant agreement and notifying the DOL that this exemption will be relied upon. A third option is to consider whether to switch the relationship with the IRA owner to a level fee fiduciary relationship and rely on the simplified Best Interest Contract exemption available to such advisers.

If none of these options is utilized, the financial institution leaves its representatives at risk of incurring the prohibited transaction excise tax, which is 15% of the amount involved (i.e., the incentive compensation paid to the adviser in connection with the IRA) and, if the prohibited transaction is not corrected (presumably by disgorgement of the pay), a second level tax of 100% of the amount involved is incurred.

Also, if an IRA engages in a prohibited transaction at any time during the year, the account stops being an IRA as of the first day of that year. The effect of this is that all of the IRA's assets are treated for tax purposes as though they were distributed to the IRA owner on the first day of the year. These taxes are imposed by the Internal Revenue Service (IRS), not the DOL. The DOL, in a long-standing arrangement with the IRS, has sole regulatory authority over the definition of fiduciary for these purposes and the creation of prohibited transaction exemptions, but that does not grant the agency enforcement authority over IRAs. Likewise, the new rules do not grant the DOL visitorial rules over banks that are subject to the oversight of the Comptroller of the Currency under the National Bank Act.

Nevertheless, the new DOL rules create potential negative tax effects for IRAs and the bank representatives who provide advice to them, and action should be taken to avoid those negative effects.

Related people

Kathy Conklin