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LEGAL ALERT



Legal Alert: Check Your Individual Retirement Account Agreements

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A recent Department of Labor Advisory Opinion (Ad Op 2009-03A) discussed the effect of certain language that is often found in brokerage agreements that could be used in connection with Individual Retirement Accounts offered by brokerage firms. The Department advised that the language in question would result a series of "prohibited transactions," which would have the effect of invalidating the customer's IRA.

In the case described in the Opinion, a customer had both personal and IRA accounts with the same brokerage firm. In establishing the IRA account, the customer was asked to sign an agreement containing the following paragraphs:

All securities and other property now or hereafter held, carried or maintained by us in our possession or control, for any purpose, in or for the benefit of any of your Accounts, now or hereafter opened, including any Account in which you may have an interest, shall be subject to a continuing first lien and first priority perfected security interest in favor of us for the discharge of all indebtedness and your obligations to us, and are to be held by us as security for the payment of any liability or indebtedness of yours to us in any of your accounts.

You authorize us the right to transfer securities and other property so held by us from or to any other of your Accounts held by us, whenever, in our judgment, we consider such transfer necessary for our protection...

This language had the effect of pledging the customer's personal assets, held in his non-IRA account with the broker, to cover any indebtedness that may be incurred with respect to the IRA account. The Department concluded that this was a prohibited extension of credit between the customer and his IRA, which constitutes a prohibited transaction under Section 4975(c) of the Internal Revenue Code with respect to the IRA.

Although it was not part of the request, the Department also noted in the Opinion that, if the same language were part of the agreements governing the non-IRA account, the customer, by establishing the IRA would be granting to the broker a security interest in the IRA's assets in order to cover any personal indebtedness of the IRA owner. This would constitute a use of the IRA's assets by, and for the personal benefit of, the customer, which also constitutes a prohibited transaction involving the IRA.

Under the Internal Revenue Code, if an individual who maintains an IRA engages in a prohibited transaction with respect to the IRA, the IRA ends, and

is treated as having been distributed to the individual on the first day of that year. This means that (1) the balance of the account is taxable to the individual, and (2) any applicable penalties (e.g., for distributions prior to age 59-1/2) also apply.

Even though the offending language in the brokerage agreement was part of the contract's "boilerplate," and probably was not even intended to apply to accounts that were maintained as IRAs, the result is the same as if the rules were intentionally violated. In addition, the problem is not necessarily limited to brokerage firm IRAs; the same issue could easily arise in the case of bank or insurance company agreements. So it pays to read the agreements that you are asked to sign when opening an account.

If you have any questions regarding this Alert, or concerning prohibited transactions in IRAs or other retirement plans, you can contact the author of this Alert, Jeffrey Ashendorf, 212-453-5926, jashendorf@fordharrison.com, or any member of Ford & Harrison's Employee Benefits practice group.