Buyer Beware!
Self-Directed IRAs and Prohibited Transactions

What the T&E practitioner needs to know

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Natalie B. Choate, Esq.
Nutter McClennen & Fish, LLP
Boston, MA 02210-2604
www.ataxplan.com

Introduction: Self-Directed IRAs

"Self-directed IRA" is the most commonly used term to describe an IRA that the participant (IRA owner) has chosen to invest in nontraditional IRA investments, such as real estate, commodities, private equity, hedge funds, small business, or loans made directly to a real estate owner or business. This is in contrast to the vast majority of IRA investments that are registered securities, federally insured bank deposits, and publically traded mutual funds.

Not your father's self-directed account!

The term "self-directed IRA" is a misnomer. *All* IRAs are actually "self-directed," in that the IRA owner him or herself decides what to invest in. The term "self-directed," as used in general retirement plan parlance simply means an account the investments for which are chosen by the account holder rather than by the plan administrator or trustee (see ERISA § 404(c)). However, the term has come to have the new meaning used in this Outline, namely, an IRA that is invested in nontraditional IRA investments.

Are self-directed IRAs good or bad? The SEC is not a fan; it warns that the self-directed IRA is a convenient vehicle for "fraudulent investment schemes." See http://www.investor.gov/news-alerts/investor-alerts/investor-alert-self-directed-iras-risk-fraud. The IRS is equally unenthusiastic: "IRAs that include, or consist of, non-marketable securities and/or closely held investments, in which the IRA owner effectively controls the underlying assets of such securities or investments, have a greater potential for resulting in a prohibited transaction. Instructions for IRS Form 1099-R (2014), p. 2. So the concept has two strikes against it in the popularity department.

Despite the skepticism of the SEC and IRS, for sophisticated wealthy investors with expert tax and investment advisors on retainer, self-directed IRA investing is no problem. The IRA will invest in the same private equity and hedge fund deals the IRA owner would buy with his outside dollars. At the opposite end of the spectrum, the "little guy" is more vulnerable. Without a private staff of lawyers and accountants to vet deals, he may be suckered in to a fraud masquerading as a self-directed IRA, or may simply fall into one of the many traps surrounding nonvanilla IRA investments, such as improper titling (see ❦8.04), commingling of funds (❦8.01), and prohibited transactions (❦1–❦7).

How about for the middle group—say, the reasonably wealthy careful sophisticated prudent IRA owner who does not fall for any fraud or buy into any "too good to be true" deal—she just wants to invest her IRA in something that happens to be outside the publically-traded securities mainstream. For her, self-directed IRA investing may be a wealth-enhancing opportunity, but it won't be simple. She'll have many added complications and pitfalls if she chooses to invest in the perfectly legal, but ticklishly complex world of alternative IRA investments.

The main complication this Outline is devoted to is prohibited transactions involving IRAs. Because many self-directed IRA investment proposals being floated for our clients' consideration involve transactions with parties who are not "arm's length," estate planners need to have prohibited transactions (PTs) on their radar screens. This Outline helps the planner set up the "radar," by explaining the basic PT rules applicable to IRAs, and catalogues other problems unique to self-directed IRAs.

Unfortunately, some promoters of unconventional IRA investment and tax-saving ideas offer misleading and simplistic advice on this topic. Congress, the IRS, the courts, and the Department of Labor (DOL) have added to the confusion by enacting, promulgating, and issuing unclear laws, regulations, and opinions on the subject of PTs and IRAs. See ❦6.

This Outline explains how the "prohibited transaction" rules apply to individual retirement accounts (IRAs), including both "traditional IRAs" (IRC § 408(a)) and "Roth IRAs" (IRC § 408A). For reasons explained at ❦2.01, additional restrictions may apply to "SEP-IRAs" (IRC § 408(k)); the additional rules applicable to SEP-IRAs are not discussed in this Outline. This Outline also examines some IRA planning ideas in light of the prohibited transaction rules and other restrictions applicable to IRAs.

More extensive rules apply to other types of retirement plans, such as 401(k) plans. For such nonIRA retirement plans, the employer's ERISA counsel or the plan's third-party administrator (TPA) should be dealing with PT issues, using a resource geared to employer plan compliance. This Outline is intended for the estate planner, CPA, or financial planner who may be the individual IRA owner's or beneficiary's only line of defense against involvement in an IRA-disqualifying PT (since IRAs typically do not have ERISA counsel or a TPA).

Abbreviations and Terminology Used in this Outline

❦ Cross-reference to another section of this Outline.
§ Reference to a section of the Code unless otherwise indicated.
¶ Reference to a section of the author's book *Life and Death Planning for Retirement Benefits* (7th ed. 2011, www.ataxplan.com).

Code. The Internal Revenue Code of 1986, as amended through February 2014.
DQP. Disqualified person. See ❦2.02.
ERISA; ERISA '74. See ❦1.01.
ESOP. Employee stock ownership plan. See § 409.
IRA. Individual Retirement Account. See § 408.
IRC. The Code. IRC is specified when there are closely placed references to sections of ERISA.
IRS. The Internal Revenue Service.
Participant. The individual who owns an IRA.
PT. Prohibited transaction. See ❦1.04.
Self-directed IRA. See "Introduction: Self-Directed IRAs," above.
TPA. Third party administrator. Trade jargon for a company that administers retirement plans.
Treas. Reg. Treasury Regulation. Regulations issued by the Department of Labor are cited as "29 CFR...."

1. Meet the Prohibited Transaction Rules

*1.01 **What "ERISA" means and why the term is confusing***

The term "ERISA"generates confusion because it is used to refer to two different things. First it stands for the Employee Retirement Income Security Act of 1974 (P.L. 93-406) ("ERISA '74"), the sweeping legislation signed into law on Labor Day, 1974, that created a national regulation system for employee benefit plans. ERISA '74's provisions were broadly divided into *labor laws* (the duties of employers and plans to the employees and beneficiaries of the plans), found in various places in the U.S. Code; and *tax Code changes* (such as requirements plans must meet to be tax-exempt, new penalty taxes, and the creation of individual retirement accounts).

Second, "ERISA" is used to refer to the labor law (non-tax-code) provisions of ERISA '74. Even though many purely-tax-code provisions were first enacted as part of ERISA '74, the tax provisions are always referenced as sections of the Internal Revenue Code. For example, the section of the law that created individual retirement accounts (IRAs) is always cited as IRC § 408, even though it is also Section 2002 of ERISA '74. The non-tax-code provisions, however, are still usually referred to as sections of "ERISA." The average estate planning lawyer does not have in his office a pension law reporting service that contains ERISA '74, so it is hard for most estate planners to find the sections of ERISA '74 referenced only as such. Accordingly, in this Outline, all references to "ERISA" in this sense will include the applicable U.S. Code citation. It's also easy to find the ERISA sections through the free Department of Labor (DOL) web site; see "Resources" (Appendix A) for how to find the statute, regulations and other source material.

*1.02 **Why estate planners should care about prohibited transactions***

ERISA '74's "prohibited transaction" rules were designed to prevent people involved with a retirement plan from self-dealing with the plan's assets. This Outline will explain (from the perspective of an IRA owner and his advisor) exactly *who* is prohibited from doing exactly *what* transactions with exactly *which* assets.

But first: why do estate planners care about this subject anyway?

Once upon a time, estate planners had little occasion to worry about ERISA '74's prohibited transaction rules. On the rare occasion when a client might be thinking of doing a deal with his own pension plan, the client's retirement plan advisor, rather than the estate planner, would be consulted (if anyone was consulted). The world has changed. Now that IRAs represent an enormous accumulation of wealth, more clients, advisors, and product-sellers are looking at ways to shift value out of overstuffed IRAs—ways other than simply taking a distribution and paying income tax on it. Estate planners are seeing proposals such as the following:

- Client's traditional IRA enters into a partnership with client's Roth IRA, the purpose of which is to shift future growth to the Roth IRA, to reduce income taxes. See ❦9.03.

- Client's IRA enters into a partnership with client, family members and/or one or more trusts, the purpose of which is to allow IRA funds to be used to finance the purchase of life insurance, despite the prohibition of § 408(a)(3). See ❦9.05.

- Client's IRA's only asset is an LLC, the manager of which is the client (IRA owner). The LLC operates a business. The bank custodian of the IRA has no knowledge of what goes on in the business because the client operates the checkbook; the custodian merely passively holds the ownership of the LLC. See ❦9.02.

The various ideas work only if the deal does not involve a prohibited transaction. If the proposal results in a prohibited transaction for the IRA, then the IRA owner becomes taxable on the entire IRA value (see ❦7). It is also important that the proposed transaction not violate the rule that no part of the IRA's funds may be invested in life insurance contracts (§ 408(a)(3)); and that the client be aware of whether the investment will generate "unrelated business taxable income" (UBTI) (see Appendix B). Other possible problems with some planning ideas include the risk of making an excess IRA contribution (triggering an excise tax under § 4973), or making a non-cash IRA contribution in violation of § 408(a)(1).

1.03 ***Where to find the PT rules; why they exist***

The prohibited transaction rules are contained in similar wording in the Internal Revenue Code (IRC § 4975) and the "labor law" part of ERISA '74 (ERISA § 406; 29 U.S.C. Section 1106). The purpose of these rules is to prevent self-dealing with the assets of a retirement plan. Similar rules had been applied to private foundations by the Tax Reform Act of 1969, and had worked so well in cleaning up that area that Congress decided to adapt the rules to retirement plans. See Conf. Committee Joint Explanation for Section 2003 of ERISA '74, "Excise Tax on Prohibited Transactions: In General."

Basically, the rules prohibit any transactions between the plan and related parties (such as the employer, the plan trustee, and the plan's advisors), unless an exemption applies (see ❦4). Indirect self-dealing is prohibited as well as direct transactions.

All such transactions are prohibited, regardless of whether the plan is "hurt." If a "disqualified person" (DQP) wants to engage in a PT with a plan, and the proposed transaction is really a terrific deal for the plan (*e.g.*, the DQP wants to sell the plan an asset for less than its market value), the person still can't do the transaction unless he gets the government to agree, in advance, that it's a great deal (see ❦4.04). On the other hand, if the transaction is a "bad deal" for the plan, then, in addition to being a prohibited transaction merely by virtue of the existence of the transaction, it may also be the separately-prohibited transaction of "use of plan assets for the benefit of a disqualified person." § 4975(c)(1)(D).

The rules were written primarily with "real" retirement plans (i.e. employer-sponsored plans for the benefit of rank and file employees) in mind. Typical abuses that these rules were designed to prevent, in the case of that type of retirement plan, are:

- The employer is in financial trouble, so it borrows money from the retirement plan.

- The plan trustee owns some real estate that he would like to sell. He causes the plan to buy it from him. Or, to avoid a direct transaction with the plan, he causes the plan to buy the real estate next door to his parcel and build a shopping center on it, to increase the value of his adjacent lot.

- The 401(k) plan Investment Committee is responsible for selecting a mutual fund family that employees will be allowed to invest their 401(k) accounts in. They select the Alpo Mutual Fund Family after the president of Alpo Mutual Funds buys each member of the Investment Committee a new car.

As this Outline will show, rules that may work well for "real" retirement plans are an uncomfortable fit for IRAs.

1.04 ***Definition of a prohibited transaction***

Under § 4975(c)(1), "'prohibited transaction' means any direct or indirect—

"(A) sale or exchange, or leasing, of any property between a plan and a disqualified person;

"(B) lending of money or other extension of credit between a plan and a disqualified person;

"(C) furnishing of goods, services, or facilities between a plan and a disqualified person;

"(D) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;

"(E) act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interests or for his own account; or

"(F) receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan."

Note that "fiduciaries" are subject to more prohibitions than other disqualified persons (DQPs); see ❦3.01 for definition of "fiduciary."

Note that some types of PT are "cut and dried." If a DQP sells an asset to the retirement plan, for example, there is a PT—regardless of whether the price was fair. There is a PT even if the retirement plan got a "bargain." It doesn't matter what the price was, § 4975(c)(1)(A) has been violated. All the government has to show is that the transaction occurred. For example, see DOL Advisory Opinion 2011-04A (2/3/11), http://www.dol.gov/ebsa/regs/aos/ao2011-04a.html, in which the DOL opined that an IRA could not purchase, from an unrelated party (a bank), a promissory note on which the IRA owner and his spouse (the IRA beneficiary) were the obligors. A loan exists until it is paid off, said the DOL... [end of sample]