AMERICAN IRA
Self-Directed IRAs and 401Ks

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We know that each of you have different needs. Some of you will prefer to comb through every detail of our white paper including the citations provided, others prefer to keep it on the shelf for reference on an as-needed basis, and still others prefer a short-note version that provides an overview in simple quick terms. With that in mind, we would like to share our newest whitepaper, *Self-Directed IRAs: Rules and Regulations- A Compliance Guide for Individuals and Professionals.*

In this whitepaper, we define Self-Directed IRAs and their benefit in alternative and private investments, as well as share the rules and regulations that allow their tax-free or tax-deferred treatment to continue. It includes details surrounding Prohibited Transactions and ways to avoid the consequences that accompany them. Finally, we have also provided valuable case studies as examples.

It is our goal to arm you with the quality, pertinent information that will enable you to navigate this process successfully whether you are an individual investing on your own or a professional offering guidance to your clients. We have also developed a quarterly newsletter designed specifically for professionals. This newsletter contains information about:

- Legislative and Regulatory Changes
- Recent information on some of the top Self-Directed IRA investment areas
- Timely information on 401(k)s, IRAs, and fiduciary changes
- A calendar of upcoming deadlines, so that you can help your clients plan in advance
- Announcements about upcoming Self-Directed IRA educational events, CE credit classes, and webinars
- Other critical news alerts

Sign up for this newsletter at: www.AmericanIRA.com/self-directed-ira-professionals-newsletter.

To learn more about Self-Directed IRAs or a specific account or investment type, please call us at *866.7500.IRA (472)* or e-mail Info@AmericanIRA.com. You will always receive personalized, one-on-one attention from our Certified IRA Services Professionals.

Sincerely,

Jim Hitt
American IRA
CEO

Self-Directed IRAs: Rules and Regulations

The Short Summary of our Compliance Guide for Professionals

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We have developed this summary as a quick reference for you. For your convenience, we have provided reference boxes throughout this short summary giving you the page and section you can refer to in our full version of the Compliance Guide if you want to learn more.

What is a Self-Directed IRA?

A Self-Directed IRA, is a retirement account that allows your clients to invest in alternative assets in addition to the normal stocks, bonds, and mutual funds that most people typically hold inside their retirement accounts.

Why would my client want to Self-Direct their retirement account?

A Self-Directed IRA offers them more choices for their future.

Self-Directed IRAs allow them to invest in what they know.

These accounts also have the advantage of being eligible for taxdeferred and/or tax-free growth. Depending upon the tax bracket they are in, this could be a savings of up to 39.6% (on federal taxes alone).

Without a Self-Directed IRA, Big Profits Can Equal Big Taxes

Let's analyze this. A property sold with a $100,000 profit purchased outside a Self-Directed IRA can pay up to 39.6% in federal taxes. That's up to $39,600. That leaves your client with $60,400 after taxes. The profits from that same property purchased inside a Self-Directed IRA will be either tax-deferred or tax-free. That means the entire $100,000 profit remains inside their Self-Directed IRA.

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Why American IRA?

Expertise
Gain access to our Certified IRA Services Professionals offering more than 40 years of investment experience.

Value
Receive the benefit of our client-friendly pricing schedule, a flat annual fee. With this your client enjoys unlimited assets, unlimited account values, and no charge on all cash accounts.

Performance
Expect quick and efficient investment processing within 48 hours with completed package. From the first call, you and your client will receive personalized one-on-one attention from our experienced and knowledgeable staff.

Retirement Investment Options

- Raw Land
- Condos
- Townhomes
- Single Family Homes
- Commercial Buildings
- Trust Deeds
- Mortgage Notes
- Unsecured Notes
- Precious Metals
- LLC's
- Tax Liens
- Deeds
- Privately Held Companies

Funding Options

Contribution
Each retirement plan allows your client to contribute personal funds throughout the year. The amount they are permitted to contribute each year varies depending on their age, income and retirement plan type.

Conversion
They can withdraw all or part of the cash and/or assets from a Traditional IRA and reinvest them in a Roth IRA. The assets must be contributed to the Roth IRA within 60 days of the distribution from the Traditional IRA. It is important that they understand the taxable consequences of this conversion before they accept the distribution from their Traditional IRA.

Rollover

A tax-free distribution of cash and/or assets from a retirement account given to your client directly to contribute to another retirement account.

One rollover is permitted per year and there is no taxable consequence as long as the cash and/or assets are rolled into the new retirement accounts within 60 days of the distribution.

Transfer

A direct transfer of cash and/or assets from one IRA retirement account to a like account. Since this is a trustee-to-trustee transfer and your client does not directly take
possession of the cash and/or assets, there is no tax on this transfer and there is no limit to the amount of transfers within a year.

Debt Financing/Non-Recourse Loans

Non-Recourse Loan Defined

A loan in which the lenders only remedy in the event of a default is to repossess the property used as collateral.

Loan Sources:

- Banks
- Individuals
- Businesses

UDFI

Debt financing of an IRA investment can result in unrelated debt-financed income (UDFI), which falls under unrelated business taxable income (UBTI).

UBTI

If an IRA receives income from non-traditional investments such as debt-financed property, certain partnerships, and investments in a business, such income may be considered unrelated business taxable income (UBTI).

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What Types of Retirement Accounts Can be Self-Directed?

- Roth
- Traditional IRA (or Rollover IRA)
- SEP
- SIMPLE
- Coverdell Education
- Health Savings Account
- Inherited IRA
- Solo 401K (No Employees)
- Traditional 401K (With Employees)

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Prohibited Assets (Collectibles)

- Alcohol
- Antiques
- Art
- Other

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Prohibited Transactions

Your client is not permitted to provide services for the assets inside their IRA.

Realtor

That means they may not act as a realtor buying and/selling real estate within their IRA.

Sweat Equity

They may not provide maintenance services and/or sweat equity to assets their IRA owns.

Attorney/CPA/Property Manager

They may not act as an attorney, CPA, and/or property manager for their IRA and/or assets it owns.

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Disqualified People

Your client's IRA is not permitted to do business with a small group of people including:

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- Themselves
- Their Spouse
- Their Children
- Their Children's Spouses
- Their Parents
- Their Grandparents
- Their Grandchildren
- Their Grandchildren's Spouses
- Entities They and Their Lineal Line Owns or Controls

Help Your Clients Diversify Their Portfolios and Watch Your Business Grow!

Self-Directing their IRA Investments gives them...

- More choices
- More diversification
- Potentially higher income/yields
- More control
- Freedom to focus on their areas of expertise

Self-Directing their IRA Investments gives you...

- More options to offer your clients
- A new pool of potential clients you can offer your services to
- The ability to make your clients happier by offering them tax-deferred/tax-free investment options
- A larger referral base as your happy clients start referring other Self-Directed IRA investors to you

You see…there's been this long standing myth that Self-Directed IRA custodians work against professionals. In American IRA's case, it is exactly the opposite. As an IRA administrator, we are not permitted to give advice and/or guidance. This is why we tell 'all' of our clients to 'seek the advice of professionals in every deal they make'. Then we work with their professionals (you) to ensure a smooth closing on whatever asset they have chosen to purchase.

To find out more, or for a detailed consultation, call us today at 1-866-7500-IRA (472).

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Notice: American IRA, LLC is a third-party administrator and does not give legal, accounting, tax, investing or other specific advice. For information and advice specific to your individual situation, you should seek the services of qualified and licensed professionals practicing in your state.

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Self-Directed IRA: Rules and Regulations

A Compliance Guide for Professionals

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Introduction

Individual retirement accounts (IRAs) are retirement savings vehicles that can be established and funded by individuals. In some cases, IRAs, such as simplified employee pension (SEP) and Savings Incentive Match Plan for Employees (SIMPLE) IRAs, can be established by eligible employers for their employees. Generally, the earnings on IRA investments accrue on a tax-deferred basis and are not taxed until withdrawn[1]. For Roth IRAs, distributions are tax-free if qualified[2].

IRAs must be operated in accordance with a strict set of rules in order for this tax-deferred treatment to apply. For investments held in IRAs, one such requirement is that the investments must be done at arm's length to prevent prohibited transactions from occurring. This paper focuses on self-directed IRAs (see ***IRA Investment Options: Including Self-Directed IRAs*** later), and provides some general explanations of the rules that apply.

401(k)s, HSAs , ESAs and Other Tax- Deferred Accounts

While this paper often refers to self-directed IRAs, the option to self-direct investments is available to other tax-deferred accounts, including health savings accounts (HSA)s, Coverdell education savings accounts (ESA), and qualified plans such as 401(k)s, simplified employee pensions (SEP), and savings incentive match plans for employees (SIMPLE).

In some cases, owners of small businesses can roll over amounts from IRAs to 401(k) plans established for their incorporated businesses, and use the amount to fund the start-up cost of a new business by purchasing stocks in the business. The IRS refers to this self-directed investment strategy as *Rollovers as Business Startups (ROBS)*[3]. This is a complex strategy that requires professional guidance.

IRA Investment Options: Including Self-Directed IRAs

The type of investments that can be held in an IRA is often determined by availability at the financial institution (custodian or trustee) with which the IRA is maintained. For example, some mutual fund companies may offer investments only in mutual funds, cash and cash equivalents,

meaning an IRA held with such a company may not be able to invest in real estate or other alternative assets.

In some cases, the custodian or trustee may limit investment options based on the IRA product. For example, a bank may allow only investments of certificate of deposits (CD) for IRA CDs, and a brokerage firm may offer a mutual-fund-only IRA, or a brokerage IRA. The IRA owner would choose the financial institution and IRA product based on their investment needs.

In other cases, IRA owners are given more investment flexibility, allowing them to choose to invest their IRA funds in any publicly-traded asset and even some non-publicly-traded assets such as promissory notes, real estate, tax lien certificates, limited liability companies, and private placements including "investments in" and "financing for" businesses. These are commonly referred to as self-directed IRAs. For this purpose, the term "IRA" includes traditional, SEP, SIMPLE, Roth IRAs, HSAs, ESAs, and traditional 401(k)s.

Debt-Financing/Non-recourse Loans

Summary*: Generally, property that is purchased in an IRA with funds that are not held in the IRA (that is, the acquisition of the property resulted in the IRA incurring a debt), and for which the purpose of the property is to generate income is considered to be debt-financed property[4]. Debt financing can also be used to improve property, and such property would also be considered debt-financed property.*

Generally, IRA owners use the cash in their IRAs to purchase investments within those IRAs. For example, if an IRA owner wants to purchase publicly-traded assets in an IRA, the IRA must have sufficient cash available to purchase those assets within the IRA. However, the rules are more flexible for non-publicly-traded assets and private investments and, in some cases, these rules allow IRA owners to purchase properties with non-recourse loans, and hold those properties in their IRAs. These properties can include certain liens, mortgaged real estate, machinery and equipment, and other tangible properties.

> *A non-recourse loan is defined as a loan for which the lender's only remedy in case of default is to repossess the property being financed or used as collateral. The IRA owner, cannot be pursued for the debt, and neither can the other assets in the IRA.*

Debt financing of an IRA investment can result in unrelated debt-financed income (UDFI), which falls under unrelated business taxable income (UBTI). See *Case Study| Letter Ruling 9703026: Debt Finance Property and Computation of Tax on Unrelated Business Taxable Income* later in this publication. Generally, a portion of the investment earnings may be considered UDFI based on the average acquisition indebtedness, if there is an outstanding debt during the 12-month period preceding the date on which the property is sold or otherwise disposed of. Once the 12-month period has passed after the debt has been paid off, there is no unrelated business income tax[5]. Generally, **the (UDFI) provision does not apply to qualified plans**, such as 401(k) plans[6].

Key Point: Individuals may not personally guarantee debts for their IRAs or their qualified plan (such as 401(k) Plan) accounts.

Private Placements

Generally, when IRA funds are used to purchase stocks and other publicly-traded assets, the result is that the IRA has invested an amount in the company that sells the stock. The same results can be achieved by purchasing securities (as defined under the Securities Act of 1933, 15 U.S.C. § 77b), under a private investment transaction. These are commonly referred to as private placements.

A private placement (the offering, not the securities or the issuer) is generally exempted from Sections 4(a)(2) of the 1933 Act's securities registration requirement and Regulation D, as well as certain State laws.[7]

One key difference with a private placement is that the transaction does not involve a public offering, unlike publicly-traded securities.

Private Lending

Under the private lender option, the IRA acts as a lender to a borrower (including individuals and companies) for investments in assets such as direct mortgages, liens, limited liability companies, private stocks, trust deeds, machinery and equipment, unsecured loans, companies including small businesses and other tangible properties.

Caution: Income and Expenses

It is important to note that all income generated from investment properly held in an IRA must be paid and credited to the IRA. Additionally, expenses for such property must be paid from the IRA. Failure to follow these rules can result in a prohibited transaction.

Prohibited Transaction Risk

IRA owners who engage in private/non-publicly-traded investment transactions with their IRAs should ensure that the investment does not result in a prohibited transaction, as doing so could result in excise tax and disqualification of the IRA.

Prohibited Transaction Defined

A prohibited transaction, as the term suggests, is one that is prohibited under the tax code. If an IRA is involved in a prohibited transaction, involved parties could be subject to an excise tax and the IRA could lose its tax-deferred status. So what is a prohibited transaction? For that answer, we look to the tax code, which defines a “prohibited transaction” as 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[8].

***Note**: For this purpose, the term "plan" refers to employer-sponsored qualified plans but also includes IRAs.*

An example of a prohibited transaction, as defined above, is an IRA owner using his IRA to invest in real estate owned by himself or another disqualified person.

Disqualified Person Defined

Interested parties must be able to identify a "disqualified person" to ensure that such a person does not engage in any activity with the IRA that could result in a prohibited transaction.

For IRA purposes, a “disqualified person” means a person who is any of the following:

- **(A)** a fiduciary (defined below), which includes the IRA owner;
- **(B)** a person providing services to the IRA;
- **(C)** an employer for whom any of their employees are covered by the plan (this usually applies to employer plans, and not IRAs);
- **(D)** an employee organization for whom any of their members are covered by the plan;
- **(E)** an owner, direct or indirect, of 50 percent or more of (C) or (D);
- **(F)** a member of the family of any individual described in subparagraph (A), (B), (C), or (E). Family members includes the IRA owner’s spouse, ancestor, lineal descendant, and any spouse of a lineal descendant;
- **(G)** a corporation, partnership, trust, or estate of which (or in which) 50 percent or more is owned, directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);
- **(H)** an officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10 percent or more shareholder, or a highly compensated employee (earning 10 percent or more of the yearly wages of an employer) of a person described in subparagraph (C), (D), (E), or (G); or
- **(I)** a 10 percent or more (in capital or profits) partner or joint venturer of a person described in subparagraph (C), (D), (E), or (G). [9]

*Note: According to the tax code, the Secretary, after consultation and coordination with the Secretary of Labor or his delegate, may by regulation prescribe a percentage lower than 50 percent for subparagraphs (E) and (G) and lower than 10 percent for subparagraphs (H) and (I). See “*Department of Labor Can Make Exceptions*” later in this publication.*

Investment in Collectibles Treated as Distributions
The acquisition by an individual retirement account or by an individually-directed account under a plan described in section 401(a) of any collectible shall be treated (for purposes of this section and section 402) as a distribution from such account in an amount equal to the cost to such account of such collectible.

For Purposes of This Subsection, the Term "Collectible" Means:

(A) any work of art,

(B) any rug or antique,

(C) any metal or gem,

(D) any stamp or coin,

(E) any alcoholic beverage, or

(F) any other tangible personal property specified by the Secretary for purposes of this subsection.

Exception for Certain Coins and Bullion - For Purposes of This Subsection, the Term "Collectible" Shall Not Include:

(A) any coin which is:

(i) a gold coin described in paragraph (7), (8), (9), or (10) of section 5112 (a) of title 31, United States Code,

(ii) a silver coin described in section 5112 (e) of title 31, United States Code,

(iii) a platinum coin described in section 5112 (k) of title 31, United States Code, or

(iv) a coin issued under the laws of any State, or

(B) any gold, silver, platinum, or palladium bullion of a fineness equal to or exceeding the minimum fineness that a contract market (as described in section 7 of the Commodity Exchange Act, 7 U.S.C. 7) [2] requires for metals which may be delivered in satisfaction of a regulated futures contract, if such bullion is in the physical possession of an approved trustee.

Restrictions for Fiduciaries

Anyone who serves as a fiduciary for an IRA is prohibited from engaging in any transaction with the IRA for his own interest. According to the tax code, this is:

- An 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

- 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.

For IRA purposes, a fiduciary is any person who:

(A) exercises any discretionary authority or discretionary control with respect to management of the IRA;

(B) exercises any authority or control with respect to management or disposition of its assets;

(C) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the IRA, or has any authority or responsibility to do so, or;

(D) has any discretionary authority or discretionary responsibility in the administration of the IRA.

The IRA plan agreement and disclosure statement usually provides a definition of "fiduciary," which can include an investment advisor or managers, discretionary trustees, and any party or entity who is affiliated with either. For self-directed IRAs, where the owner directs the investments, the owner (or beneficiary if applicable) is considered the fiduciary for the IRA.

The Employee Retirement Income Security Act (ERISA) provides an expanded definition of fiduciary, which goes beyond those persons traditionally recognized as plan fiduciaries, such as the trustees of the plan. For this purpose, "fiduciary" generally includes any person who exercises any authority or control regarding management or disposition of plan assets, has or exercises discretionary authority, control or responsibility for plan administration, or renders investment advice to the plan for a fee, or any other direct or indirect compensation.

Department of Labor Can Make Exceptions

The Department of Labor (DOL), has been given authority by the IRS to issue rulings and regulations on prohibited transaction rules, and is also allowed to grant exemptions. These exemptions are referred to as prohibited transaction exemptions or PTEs. The exemption can be a conditional or unconditional exemption of any disqualified person or transaction or class of disqualified persons or transactions, from all or part of the imposed restrictions[10]. The exempted may not be granted, unless it is:

- administratively feasible;

- in the interests of the plan and of its participants and beneficiaries; and
- protective of the rights of participants and beneficiaries of the plan[11].

Before granting an exemption, the DOL must provide adequate notice to interested persons and publish a notice in the Federal Register of the pending exemption, allowing interested persons an opportunity to present views.

***Caution**: Parties who wish to rely on a prohibited transaction exemption have the burden of demonstrating that the conditions of the exemption are satisfied.*

Consequences of a Prohibited Transaction

The consequences of a prohibited transaction depend on the type of account that is involved in the transaction. For IRAs, it also depends on whether the disqualified person is the IRA owner of beneficiary.

Taxes | IRAs and Qualified Plans

Generally, an excise tax of 15 percent of the amount involved in each prohibited transaction for each year is levied. Normally, the tax must be paid by any disqualified person who participates in the prohibited transaction (if the disqualified person is the IRA owner or the IRA beneficiary, see "*Special Rule for IRAs: Loss of Qualified Status and Exemption from Taxes"* below). An exception applies to someone only acting as a fiduciary[12].

If the prohibited transaction is not corrected within the taxable period, an additional tax of 100 percent of the amount involved in the transaction is imposed on any disqualified person who participates in the prohibited transaction. An exception applies to someone only acting as a fiduciary[13].

Joint and several liability: If more than one person is liable for the 15 percent or the 100 percent excise tax, all such persons would be jointly and severally liable with respect to the transaction[14].

For this purpose, the "taxable period" means the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of:

(A) the date of mailing a notice of deficiency with respect to the tax imposed;

(B) the date on which the tax imposed is assessed; or

(C) the date on which correction of the prohibited transaction is completed[15].

Abatement of Tax Where There Is a Correction

If a transaction is not treated as a prohibited transaction because it is corrected in a timely manner, the aforementioned taxes should not be assessed on the transaction. If the tax is assessed, the assessment should be abated, and if collected, the amount should be credited or refunded as an overpayment. *See* ***"Avoiding the Tax and Penalty By Self-Correcting"*** *later in this publication.*

Special Rule for IRAs: Loss of Qualified Status and Exemption from Taxes

A special rule applies to IRAs, which exempts the IRA owner and beneficiaries from the excise tax mentioned above. Under this special rule, an IRA owner or beneficiary is not subject to the excise tax if the IRA ceases to be an IRA (losing tax-deferred status as explained below) as of the first day of the taxable year in which the prohibited transaction occurred, as a result of the prohibited transaction[16].

Caution: *While the tax code provides for an exemption from the excise tax under this special rule, the IRS has taken the position that this exception "does not extend to someone who is a disqualified person for a reason other than acting solely as a fiduciary." According to the IRS, even if the beneficiary of an IRA is not a fiduciary as defined under the tax code, he can otherwise be a disqualified person—such as a family member—and such a person would not be eligible for this exception. An example of when such an exception would apply is if the party effecting the prohibited transaction was merely a beneficiary of the IRA and not a disqualified person[17]. This is based on a private letter ruling (PLR), and a PLR cannot be cited as a legal reference and can be relied on only by the party to whom it is issued.*

Loss of Tax-deferred Status

In any case in which the IRA ceases to be an IRA as of the first day of any taxable year, the IRA is treated as if the entire balance was distributed from the IRA on the first day of the taxable year, and the distributed amount is equal to the fair market value of all assets in the IRA (on such first day)[18],[19]. This means that the amount would be treated as ordinary income, and would be subject to the 10 percent early distribution penalty plus potential underpayment penalties, unless the IRA owner is at least age 59½ or qualifies for an exception to the penalty.

Example:
Sam's IRA balance as of the first day of the year is $500,000.
Sam invested $100,000 of his IRA balance in real estate in September.
Unfortunately, the investment resulted in a prohibited transaction.
The entire $500,000 would be treated as ordinary income for the year, and would be subject to the 10% early distribution penalty if Sam is under age 59½, unless an exception applies.
Because Sam is the owner of the IRA, the 15% and the 100% excise tax would not apply.

Assume the facts are the same, except that a disqualified person, other than Sam or his beneficiary, engaged in a prohibited transaction. That disqualified person would owe the IRS an excise tax of $15,000 (15 percent of $100,000). If the prohibited transaction is not corrected in a timely manner (see ***"Avoiding the Tax and Penalty By Self-Correcting"*** below), that disqualified person will owe the IRS an additional excise tax of $100,000 (100 percent).
The IRA would not be disqualified, since the disqualified person is not Sam or his beneficiary.

Loss of Bankruptcy Protection
Generally, an IRA is exempted from creditors up to $1,000,000, which is subject to increases based on the Consumer Price Index (CPI) every three years. Amounts rolled over from a qualified plan, 403(b), governmental 457(b) plan, and a SEP IRA or SIMPLE IRA assets are not subject to a maximum dollar limit[20]. However, if the IRA is involved in a prohibited transaction, the IRA may not be eligible for this exemption[21].

Avoiding Consequences By Self-Correcting

There are exemptions to the prohibited transaction rule, which allow certain transactions not to be considered prohibited if the transaction is corrected before the end of the correction period[22]. These exemptions are in connection with the acquisition, holding, or disposition of any security or commodity, and apply to the following transactions:

(A) sale, 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[23];

It is important to note that this does not apply to any transaction between a plan and a plan sponsor (or its affiliates) that involves the acquisition or sale of an employer security or the acquisition, sale, or lease of employer real property. Neither does it apply in the case of any disqualified person if, at the time the transaction is entered into, the disqualified person knew (or reasonably should have known) that the transaction would constitute a prohibited transaction.

Correction Period Defined

For this purpose, the term “correction period” means the 14-day period beginning on the date on which the disqualified person discovers, or reasonably should have discovered, that the transaction would constitute a prohibited transaction.

In order for a prohibited transaction to be considered corrected, the transaction must be completely reversed or "undone," and any losses resulting from the transaction must be restored to the IRA, as well as any profits from the transaction.

Not All Tax is Deferred: Unrelated Business Taxable Income

***Summary**: If an IRA receives income from nontraditional investments such as debt-financed property, certain partnerships, and investments in a business, such income may be considered unrelated business taxable income (UBTI). In the UBTI is $1,000 or more, the IRA may need to pay unrelated business income (UBI) tax on the amount for the year in which the UBTI is earned. Unrelated business taxable income (UBIT) is recorded on form 990T.*

Generally, earnings on investments in IRAs, qualified plans such as 401(k)s, ESAs and HSAs are tax-deferred until withdrawn. For Roth IRAs, these amounts are tax-free if the distribution is qualified (Roth account has been established for 5 years and account holder has reached age 59 ½). An exception applies if the earnings are unrelated business taxable income (UBTI). Under this exception, these accounts are subject to tax on unrelated business income[24],[25] . However, the tax applies only if the UBTI is $1,000 or more, including debt-financed income[26].

The tax code defines UBTI as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowed deductions which are directly connected with the carrying on of such trade or business, computed using certain allowed modifications provided under the tax code[27].

If a trade or business regularly carried on by a partnership (or limited liability company (LLC) of which an organization is a member) is an unrelated trade or business with respect to the organization, the organization in computing its unrelated business taxable income must include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income[28]. For IRAs subject to the UBTI rules, "unrelated trade or business" is any trade or business regularly carried on by the IRA or by a partnership of which the IRA is a member.

When computing UBTI for any taxable year, an amount based on the average acquisition indebtedness with respect to each debt-financed property should be included as an item of gross income, an amount based upon the average acquisition indebtedness with respect to the property.[29] The tax code provides that:

- Debt-financed property generally means any property that is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year[30].
- Debt-financed property does not include any property all of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such an organization of its purpose or function constituting the basis for its exemption[31].
- Acquisition indebtedness with respect to debt-financed property means the unpaid amount of indebtedness incurred in acquiring or improving the property, or indebtedness incurred before or after the acquisition of the property that would not have been incurred but for the acquisition or improvement[32].
- Acquisition indebtedness does not include indebtedness inherent in the performance or exercise of the purpose or function constituting the basis of the organization's exemption[33].

Where property is acquired (no matter how it is acquired) subject to a mortgage or other similar lien, the amount of the indebtedness secured by the mortgage or lien is considered an indebtedness of the organization incurred in acquiring the property even though the organization did not assume or agree to pay such indebtedness[34]. See example 4 of section 1.514(c)-1(a) of the Income Tax Regulations.

For information about in unrelated debt-financed income (UDFI), a type of UBTI, see "Debt-Financing/Non-recourse Loans" earlier.

See also *Case Study| Letter Ruling 9703026: Debt Finance Property and Computation of Tax on Unrelated Business Taxable Income.*

General IRA Requirements Must Be Met

The usual procedures for establishing an IRA apply to self-directed IRAs. The following are some general requirements:

- The trustee or custodian must be a bank, a federally insured credit union, a savings and loan association, or an entity approved by the IRS to act as trustee or custodian often referred to as a nonbank trustee. The IRS provides a list of nonbank trustees, which is updated each year[35]. IRA owners and advisors must ensure that the financial institution with which the IRA is established and maintained is one that is approved to hold IRAs.
- The IRA may be established and maintained by an individual, by an employer for the benefit of his employees, or by an employee association for the benefit of its members.
- No part of the IRA can be invested in life insurance contracts.
- The IRA must be nonforfeitable.
- The IRA assets must not be commingled with other property except in a common trust fund or common investment fund; and
- The required minimum distribution (RMD) rules must be satisfied for the IRA owner and beneficiaries.

In addition, certain paperwork must be completed to establish a valid Traditional IRA. The IRA Plan Agreement and disclosure statement must be signed by the IRA custodian or trustee and the IRA owner[36].

Working With A CPA and Tax Professional

For IRA owners who are interested in private investments, care must be taken to ensure that the investments do not violate the provisions of the tax code, as such violations can result in loss of tax deferred status. It is generally a good idea to engage the services of professionals with expertise in the area of self-directed IRAs, to help ensure that the investments do not result in penalties and/or a loss of tax-deferred status.

Case Studies

One of the best ways to determine how the Department of Labor (DOL) would possibly determine if a transaction is in fact prohibited is to review past cases for which they have issued advisory opinions. A review of private letter rulings (PLR) issued by the IRS can also shed some insight. In this section, we review an advisory option issued by the DOL and a PLR issued by the IRS.

Case Study| Letter Ruling 9703026: Debt Finance Property and Computation of Tax on Unrelated Business Taxable Income

***Summary**: If rental income is generated from debt-finance property, such income can be considered unrelated business taxable income (UBTI) and therefore subject to UBI tax.*

The taxpayer submitted a private letter ruling (PLR) request regarding the tax treatment of an investment by his IRA in a limited partnership under the UBTI rules.

Facts of the case:

The IRA purchased a limited partnership interest in Partnership P, a non-publicly traded partnership. Partnership P served independent tire retailers through volume purchases, resale of tires, advertising, and training of employees for sales and marketing. The partnership agreement provides for an allocation of partnership income, gain, and loss at the end of each fiscal quarter in proportion to the partners' capital accounts.

The taxpayer's maximum investment in Partnership P was limited to 3.32 percent of the total partnership capital. As a limited partner, neither the taxpayer nor the IRA custodian participates in the management of Partnership P, and the liability of the IRA is limited to the amount of the investment.

Partnership P also owned and operated a distribution warehouse. Partnership P financed the construction of the warehouse and was leased a portion of its floor space to an unrelated third-party tenant for which it was receiving rental income. Under the lease agreement, Partnership P received a monthly base rent minus expenses attributable to interest, depreciation, and amortization, as well as other amounts for repairs and utilities.

Based on the above facts, the taxpayer requested the following rulings:

1. The business income received by the IRA from the limited partnership interest in Partnership P constitutes unrelated business taxable income.
2. The rental income received by the IRA from Partnership P is generated by debt-financed property and constitutes unrelated business taxable income.
3. The IRA may be required to pay income tax on the unrelated business taxable income to the extent such income exceeds $1,000 per year.

The IRS ruled that:

1. The business income passed through to the IRA as a limited partner constitutes UBTI, because the IRA became a partner in Partnership P, a limited partnership that provides various services to independent tire retailers. The IRA custodian does not participate in the management of Partnership P and the liability of the IRA is limited to the amount of the investment.
2. The income derived from the rental of the warehouse by Partnership P and received by the IRA is generated by debt-financed property and constitutes UBTI. The tax code provides that that acquisition indebtedness with respect to debt-financed property means the unpaid amount of indebtedness incurred in acquiring or improving the property, or indebtedness incurred before or after the acquisition of the property that would not have been incurred but for the acquisition or improvement ,and where property is acquired (no matter how) subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien shall be considered as an indebtedness of the organization incurred in acquiring such property even though the organization did not assume or agree to pay such indebtedness.
3. The IRA may be required to pay income tax on the unrelated business taxable income to the extent such income exceeds $1,000 per year, because the tax code provides that, except for the purposes of computing the net operating loss, a specific deduction of $1,000 should be used in calculating UBTI.

While PLRs cannot be cited as precedence or legal reference, they give a good idea of how the IRS might respond to cases with similar facts.

Case Study | Investment Resulted In Prohibited Transaction: DOL Advisory Opinion 2006-01A

Summary: *If an IRA investment results in a prohibited transaction, the IRA could be disqualified. This advisory opinion focuses on whether certain decisions would result in a party being a fiduciary, and therefore subject to the prohibited transaction rules.*

In this case, a representative from Guidant Legal Group, PLLC requested an advisory opinion from the DOL as to whether the following proposed transaction would be prohibited under section 4975 of the Internal Revenue Code.

Highlights of the request

Salon Services and Supplies, Inc. and "S" Corporation ("S Company") is 68% owned by Miles and Sydney Berry, a marital community (M). The other 32% is owned by a third party, George Learned ("G").

Miles Berry (Berry) proposed to create a limited liability corporation ("LLC") that will purchase land, build a warehouse, and lease the property to S Company. The investors in the LLC would be:

- Berry's individual retirement account ("IRA") (49%);
- Robert Payne's ("R") IRA (31%); and
- G (20%). R is the comptroller of S Company.

R and G would manage the LLC.

The following was represented to the DOL on behalf of the taxpayer:

- S Company is a disqualified person with respect to Berry's IRA under section 4975(e)(2) of the Code.
- R and G are independent of Berry.
- The LLC does not contain plan assets because it is a real estate operating company (REOC) as defined by 29 C.F.R. § 2510.3-101(e).

Generally, the DOL does not challenge representations, but responded under the assumption that they are true.

According to the representative:

- An independent qualified commercial real estate appraiser estimated the rental value of the lease and has found that the terms of the lease are no less favorable to the LLC and its IRA investors than those obtainable in an arm's length transaction between unrelated parties.
- The custodian for Berry's and R's IRAs reviewed the LLC operating agreement and has approved the investment for those two self-directed IRAs.

Based on the representations, the DOL opined that a lease of property between the LLC and S Company would be a prohibited transaction, at least to Berry's IRA. The DOL explained that the lease constitutes a prohibited transaction regardless of whether the LLC qualifies as a REOC under the Department's plan assets regulation (*29 C.F.R. § 2510.3-101).* The DOL also explained that a transaction between a party in interest under ERISA (or a disqualified person under the Code, in this case S Company) and a corporation in which a plan (IRA in this case) has invested (i.e., the LLC) does not generally give rise to a prohibited transaction.

> "For example, where a plan acquires a security of a corporation or a limited partnership interest in a partnership, a subsequent lease or sale of property between such corporation or partnership and a party in interest will not be a prohibited transaction solely by reason of the plan's investment in the corporation or partnership." (See 29 C.F.R. § 2509.75-2(a)).

However, in some cases it can give rise to a prohibited transaction. Regulation section 2509.75-2(c) and Department opinions interpreting it have made clear that a prohibited transaction occurs when a plan invests in a corporation as part of an arrangement or understanding under which it is expected that the corporation will engage in a transaction with a party in interest (or disqualified person).

The DOL explained that according to the representations in the request, it appears that Berry's IRA will invest in the LLC under an arrangement or understanding that anticipates that the LLC will engage in a lease with S Company, a disqualified person. Therefore, the lease would amount to a transaction between Berry's IRA and S Company that is prohibited under Code section 4975(c)(1)(A) and (D). Additionally, the proposed lease, if consummated, may also constitute a violation by Berry, a fiduciary, of Code section 4975(c)(1)(D) and (E).

For more details, please see the Advisory Opinion at http://www.dol.gov/ebsa/regs/aos/ao2006-01a.html.

Case Study | Living Rent-Free in IRA Rental Property is a Prohibited Transaction: CCA 201105035

***Summary**: A violations of the prohibited transaction rule would occur if a transaction is part of an agreement, arrangement or understanding in which the fiduciary caused IRA assets to be used in a manner designed to benefit any person in whom such fiduciary had an interest that would affect the exercise of his or her best judgment as a fiduciary.*

Prohibited Transaction Exemption Provision Under IRC § 4975(d)(20): An IRA may engage in sales of property, loans and transfers or use of IRA assets with a disqualified person who is a disqualified person only because the person provides services (or has certain relationships with a service provider), **as long as the IRA receives no less, nor pays no more, than adequate consideration in connection with the transaction**. However, this exemption does not apply to a fiduciary who has or exercises any discretionary authority or control with respect to the investment of the assets involved in the transaction or provides investment advice with respect to the assets[37].

In Chief Council Advice (CCA) 201105035, the building was an IRA asset, and was used rent-free by an S Corporation that was owned by the IRA owner's husband, a non-fiduciary service provider. *Generally, professional service providers such as attorneys, accountants, consultants and actuaries are considered non-fiduciary service providers; that is, they are not considered fiduciaries simply by performing their normal and ordinary professional services. However, in this case, the non-fiduciary was a disqualified person*. The IRS ruled that the lease-free (rent-free) living on property that was an IRA asset resulted in a prohibited transaction because there was no adequate consideration paid for the use of the property. As such, the transaction did qualify for the exemption under IRC § 4975(d)(20) (explained above). The PLR referred to the analysis in *DOL Advisory Opinion 93-33A* (December 16, 1993) and *Rollins v. Commissioner, T.C. Memo. 2004-260.*

[1] IRC § 408(e)(1)
[2] IRC. § 408A(d)(2)
[3] IRS Memorandum: Guidelines regarding rollovers as business startups
[4] IRC § 514(b)(1)
[5] IRC § 514(b)(1)
[6] IRC § 514(c)(9)
[7] SEC 17 CFR Parts 230, 239 and 242 Release No. 33-9415; No. 34-69959; No. IA-3624; File No. S7-07-12
[8] IRC § 4975(c)(1)(E)
[9] IRC § 4975(e)(2)
[10] Reorganization Plan No. 4, 43 Fed. Reg. 47,713 (Oct. 17, 1978)
[11] IRC § 4975(c)(2) , ERISA § 408(a)
[12] IRC § 4975(a)
[13] IRC § 4975(b)
[14] IRC § 4975(f)(1),
[15] IRC § 4975(f)(2)
[16] IRC § 4975(c)(3)
[17] 200324018
[18] IRC § 4975(c)(3)
[19] IRC § 408 (e)(2)(A), Treas. Reg. § 1.408-4(d)(1)
[20] Section 522(d)(10)(E) of the Bankruptcy Code,
[21] In re Kirchen, 344 B.R. 908 (Bankr. E.D. Wis. 2006)
[22] IRC § 408(b)(20)
[23] IRC § 4975(d)(23)
[24] IRC §§ 512, 513
[25] IRC § 408(e)(1)
[26] IRC §§ 408(e)(1), 511, 512, 513, 514
[27] IRC § 511
[28] IRC § 512(c)(1)
[29] IRC § 514(a)(1)
[30] IRC § 514(b)(1)
[31] IRC § 514(b)(1)(A)(i)
[32] IRC § 514(c)(1)
[33] IRC § 514(c)(4)
[34] IRC § 514(c)(2)(A
[35] Treas. Reg. Section 1.408-2(e)
[36] Treas. Reg 1.408-6(d)(4)

[37] IRC § 4975(d)(20)