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A MUST-HAVE FOR EVERY RETIREMENT INVESTOR'S TOOLKIT

DON'T RISK IT.

A GUIDE FOR SELF-DIRECTED RETIREMENT ACCOUNT INVESTORS ON AVOIDING PROHIBITED TRANSACTIONS PER PUBLICATION 560 AND 590 OF THE IRS TAX CODE

FIRST EDITION

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Introduction

This eBook discusses self-directed retirement accounts and prohibited transactions. The goal of this eBook is to educate you in avoiding prohibited transactions so you don't incur the incredibly severe penalties used by the IRS.

This eBook will discuss the basics of self-directed accounts, define disqualified persons, go into details of the IRS' definition(s) of prohibited transactions, discuss prohibited transaction penalties, provide examples and wraps up with frequently asked questions.

What is a qualified retirement account?

The Employee Retirement Income Security Act of 1974 (ERISA) was enacted to establish standards that apply to retirement accounts. It is the body of laws that regulate employee benefit plans with the Internal Revenue Code (IRC).

A qualified retirement account is either a tax free or tax deferred account. The funds usually cannot be accessed before the retirement age of 59.5 without a penalty.

Retirement accounts were created by the government in order for you to be encouraged to take responsibility for your retirement as compared to relying on the government. These tax free and tax deferred accounts are designed for you to put aside money for retirement the government to help you accumulate wealth for your retirement years.

Types of Retirement Accounts

There are many different types of retirement accounts. As you can imagine the rules and regulations vary depending on the account type. Below are some of the most common types:

TRADITIONAL ACCOUNT	Tax Deferred (pay taxes on earnings and contributions when taken out)
ROTH ACCOUNT	Tax Free (pay taxes on earnings and contributions when taken out)
401k, 403b, TSP	Retirement plan offered through employer. Can be either traditional Roth account.
SEP	Self Employed Pension plan. Higher contribution limit than Traditional or Roth IRA accounts. Tax Deferred.
SIMPLE IRA	Retirement account with mandatory match component from employer. Higher contribution limits that Traditional or Roth IRA. Tax deferred.
SOLO 401k	Plan for 1 or 2 (spouse) person companies. Higher contribution limit than Traditional or Roth IRA. Tax free or tax deferred components.

What type of investments can I buy with a Self-Directed account?

Despite what your financial advisor, the bank or prior plan custodian (the company that controls the IRA money) tells you your IRA is not limited only to stocks, bonds and mutual funds.

When you think about retirement planning companies the majority of the big names in the industry have done a very good job convincing the masses that their retirement dollars have to be invested in the market and in the paper assets listed above. In reality, real estate and other alternative assets can be and were always allowed in retirement accounts; just no one knew about it! Most retirement companies want you to invest in their mutual funds (that is how they make their money!)

As people started to get wise to the fact that they had more investment options than the 12 stocks managed by their retirement company they started to switch to a Self-Directed IRA (SDIRA), which allows the investor to control what investments are bought and sold in the IRA.

Recognizing they were losing clients to self-directed accounts, retirement companies/ custodians started to offer “Self-Directed IRAs” however these IRAs were limited to paper assets. A “true” self-directed account allows you to invest in a wide range of investments depending on the custodian. These include but are not limited to:

- Stocks
- Bonds
- Mutual Funds
- Real Estate
- Private Placements
- Precious Metals
- Futures
- Trust Deeds
- Notes
- Private Lending
- T ax Liens
- Tax Deeds
- Boat slips
- Oil and Gas rights

There are, however, some prohibited investments to what you can buy and sell in a SDIRA. For example, these include:

- Life Insurance
- Alcohol
- Collectibles
- Coins (excluding gold, silver, palladium bullions and U.S. minted coins)
- Works of art
- Rugs or antiques
- Cars or boats

Also, while not illegal for an IRA, it is illegal for an S Corporation to have a stock owner be an IRA.

Disqualified person(s) definition

In addition to the prohibited investment examples, the self- directed IRA has additional restrictions. Only your IRA can benefit from your IRA's transaction. All transactions must only benefit the IRA. To make sure you are not gaining benefit all transactions must be "arm's length" from disqualified persons. According to the Internal Revenue Code section IRC 4975(e)(2) the following people are consider disqualified persons {exact excerpt from code}:

(2) Disqualified person.

For purposes of this section, the term "disqualified person" means a person who is -

(A) A fiduciary
(B) A person providing services to the plan
(C) An employer any of whose employees are covered by the plan
(D) An employee organization any of whose members are covered by the plan
(E) An owner, direct or indirect, of 50 percent or more of-

a. *The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation*

b. *The capital interest or the profits interest of a partnership*

c. *The beneficial interest of a trust or unincorporated enterprise*

Which is an employer or an employee organization described in subparagraph (C) or (D)

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. *(F) A member of the family as defined in paragraph (6) of any individual described in subparagraph (A), (B), (C), or (E)*

. *(G) A corporation, partnership, or trust or estate of which (or in which) 50 percent or more of-*

  a. *The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation*

  b. *The capital interest or profits interest of such partnership or*

  c. *The beneficial interest of such trust or estate*

. *Is owned directly or indirectly or held by persons described in subparagraph (A), (B), (C), (D), or (E)*

. *(H) an officer, director, 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)*

. *(I) A 10 percent or more partner or joint venture of a person described in subparagraph (C), (D), (E), or (G).*

In simple English this means the following people are consider disqualified from benefiting or interacting with your IRA:

- You (covered in section describing fiduciaries)
- Anyone providing services to the plan
- Descendants of IRA owners/Spouse
- Ancestors of IRA owners/Spouse
- Spouse
- Businesses owned by disqualified people (if the business is owned by you, your wife, etc.)

After reviewing this list, there are usually 2 common responses. The first is that the family member list is limited and aunts, uncles, brothers, sisters and other family members are not on the list. While the IRS currently allows transactions with these people that does not mean they always will. Also, keep in mind while these transactions are not prohibited you probably want to avoid them if possible as they could draw unnecessary IRS attention.

The other common line of thought you might have had was a “quid pro quo” arrangement. Example: Kristina and Jim each have an IRA with vacation properties in Tampa Bay, Florida in their IRAs. A quid pro quo arrangement would be that Kristina stays at Jim’s vacation home for free and Jim stays at Kristina’s for free. This is considered illegal because both Jim and Kristina are gaining indirect benefit from the IRA.

Prohibited Transactions

Listed below are prohibited transactions. Here is the direct language from the Internal Revenue Code 4975(c)(1):

For purpose of this section, the term "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 asset 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*

Please note the words "any direct or indirect"; meaning the scope of prohibited transaction is very broad. Additionally, please note items C and D. This is the part of the code which prevents any personal benefit from IRA transactions. You cannot receive any benefit, goods and services from your IRA. But it goes both ways. The IRA can't get any benefit, goods or services from you. This means you can't manage the tenants, vacancies or do repairs on the property

Additional Prohibited Transaction information

The following are additional detailed descriptions of the things you (or other disqualified persons) cannot do with a SDIRA:

- Buy a property in your IRA that you currently own
- Live in a property that your IRA owns
- Use your IRA property as your personal vacation home
- Buy a house in your IRA and lease it to your daughter to use as a college house
- Buy a house in the IRA and personally guarantee the loan
- Do work (such as repairs or property management activities) on a property owned by your IRA.
- Be a customer of the assets owned by your IRA
- You cannot gain any benefit from the IRA or have the IRA gain benefit from you
- IRA owns a rental and the rent check is paid to you
- Disqualified persons cannot spend personal money on an IRA property

The best way to avoid prohibited transactions is to keep everything at arm's length.

However, please be aware of what happens if you don't keep things at an arm's length as described next.

Prohibited Transaction Penalties

As anyone who has filed taxes incorrectly will tell you the IRS can have some pretty hefty penalties. The penalties on IRA's and disqualified persons who engage in prohibited transactions are some of the most severe. Prohibited transactions are something the IRS takes very seriously and so should you.

The IRS has a page that discusses retirement topics, specifically prohibited transactions. Below are the following maximum consequences on an IRA account that engages in a prohibited transaction with a disqualified person:

Generally, if an IRA owner or his or her beneficiaries engage in a prohibited transaction in connection with an IRA account 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 the account is treated as distributing all its assets to the IRA owner at their fair market values on the first day of the year. If the total of those values is more than the basis of the IRA, the IRA owner will have a taxable gain that is includible in his or her income.

Cont.

To avoid having the entire IRA losing its IRA status many individuals set up multiple accounts so that if a prohibited transaction accidently occurs in one IRA the other accounts might not be affected.

Worse, those are just the penalties on the IRA. There are also penalties on the disqualified person. Here are the IRS maximum penalties applied to each disqualified person involved in the prohibited transaction:

> *A disqualified person who takes part in a prohibited transaction must correct the transaction and must pay an excise tax based on the amount involved in the transaction. The initial tax on a prohibited transaction is 15% of the amount involved for each year in the taxable period. If the transaction is not corrected within the taxable period, an additional tax of 100% of the amount involved is imposed. Both taxes are payable by any disqualified person who participated in the transaction (other than a fiduciary acting only as such). If more than one person*
>
> *takes part in the transaction, each person can be jointly and severally liable for the entire tax.*
>
> *The amount involved in a prohibited transaction is the greater of the following amounts:*
>
> - *The money and fair market value of any property given and*
>
> - *The money and fair market value of any property received.*
>
> *If services are performed, the amount involved is any excess compensation given or received. The taxable period starts on the transaction date and ends on the earliest of the following days*
>
> - *The day the IRS mails a notice of deficiency for the tax*
>
> - *The day the IRS assesses the tax*
>
> - *The day the correction of the transaction is completed.*
>
> *As you can see these penalties are very significant. What does that mean in real numbers?*

Hypothetical Examples

Example 1

Wendy has 200k in a self-directed traditional account. She is 42. Her daughter Lisa is going to college and Wendy buys a property on campus. She paid 110k cash for the property and had no financing. Lisa lives in the property but all legal documents have Lisa's friends and roommates on the lease. Wendy refers to the property in her records as school housing. Wendy thinks that since Lisa is not on any of the legal documents she has snuck it by the IRS.

Fast forward 3 years. Wendy's IRA has done very well. The 90k not invested in the campus property is now worth 130k. The campus house has also appreciated and if it were assessed by an appraiser it would get a fair market value of 125k. Therefore the total fair market value of her IRA is $255,000.

Unfortunately, the IRS is auditing Wendy and as they look through the personal return they notice that Wendy lists Lisa as a dependent. They look up Lisa and realize they have sent mail to her at the campus house. The IRS determines Wendy's IRA and Lisa participated in a prohibited transaction. The following penalties would have to be paid:

Wendy:
Since only Wendy's IRA was involved in the transaction and not Wendy; only Wendy's IRA gets penalized.

Wendy's IRA loses its IRA status and the total value of the IRA is treated as a distribution that Wendy owes tax on. For simplicity, we will assume this is 35%.

Also, since Wendy is distributing money before she turned 59.5 she owes a 10% early distribution penalty.

Tax on early distribution	35% X $255,000	=$89,250
Early distribution penalty	10% X $255,000	=$25,500
Total owed		$114,750

In addition, the remaining money in her IRA no longer is tax deferred and is not in an IRA anymore. All gains are now taxed as income.

Lisa was the disqualified person who engaged in the transaction. She also has to pay penalties. Since there is no record of what her portion of rent is the IRS views the entire rent amount ($1,000 a month, $12,000 a year) was the funds involved in the prohibited transaction. The tax Lisa could owe could look something like this:

15% **excise tax on total**	15% X $36,000	=$5,400
100% **of excise tax if not corrected in tax period**	100% X $36,000	=$36,000
		$41,400

The total owed to the IRS between both parties

$156,150

Example 2

Kyle has been doing real estate investing for a long time. He is very successful at it, even though he is only 41. He just learned he can do real estate related transactions with a Self-Directed IRA. He just set up a Roth IRA with 150k in it. Kyle wants his dad Jake to get involved in real estate investing and lends 65k a real estate investing company Jake owns so the company can purchase a property. Since Jake is his dad, Kyle hooked him up with a 0% loan. Repayment plus 10% interest is due within 7 years when Jake sells the property.

4 years later...
IRS did some digging into Kyle's account and learned about the prohibited transaction. Penalties are as follows:

Kyle's account is no longer considered a qualified account and all earnings are no longer tax free. Kyle never paid taxes on 100k of the Roth account as they were earnings (this is the benefit of the Roth account!). He does not owe taxes on the money contributed to the Roth (he paid this when he contributed to the Roth). However, since the earnings has been in his account less than 5 years and he is less than 59.5 he owes taxes on the earnings in the Roth plus the early distribution penalty. His penalties look like this:

All assets owned by the IRA are still owned by Kyle but he owes taxes on any earnings.

Example 2

100k in earnings in Roth that taxes were never paid on at income rate assume 35%	35% X $100,000	=$35,000
10% penalty for early withdraw	10% X $100,000	=$36,000

TOTAL: $45,000

Jake owes the following:

15% excise tax per year on amount borrowed	15% X 4 X $65,000	=$39,000
100% of excise tax if not corrected in tax period	100% X $65,000	=$36,000

Jake owes the IRS: $45,000

The total owed to the IRS between both parties

$146,000

Both of these examples are hypothetical maximum examples. **These examples are intentionally very broad and severe to illustrate the need to keep all transactions arm's length.**

The point of this section was to help make you aware of the maximum of what the IRS could do if you perform a prohibited transaction with a disqualified person. Just understand it is not worth doing.

The next section is a very simplified discussion of an actual court case. The case was recent occurring mid-year 2013.

Peek VS. Commissioner

In the 2013 case Peek vs Commissioner, two unrelated individuals combined their IRAs and contributed them to a newly created business. They were traditional accounts and each bought half of the stock of the new company. However, they used owner financing to purchase the assets and they personally guaranteed the owner financing loan. In 2003 and 2004 their traditional accounts were converted to Roth accounts. Subsequently, the company was sold in 2006 and no taxes were paid due to its Roth status.

The personal guarantees made in 2001 made the IRA(s) lose IRA status. The two businesses were considered owners of the business in 2001 (not the IRA(s)) and therefore owed taxes on the sale of the business in 2006.

FAQs

Can I get a loan on a property in my IRA? This loan would be either for a purchase, refinance or repair.

Yes! You can obtain a loan for any and all of those options. However, you (or any other disqualified person) cannot personally guarantee this loan. The loan must be made exclusively on the asset.

Can I perform work on my IRA properties?

No work cannot be performed by you or any disqualified person. Most CPAs and Custodians will advise you to hire a 3rd party to do repairs and perform property management.

What if I do the work for free?

This is still a prohibited transaction. In fact, it is a huge red flag to the IRS if the IRA records have no accounting or expenses for a property manager or a subcontractor for the repairs of the property.

What is best way I can determine if my actions could be considered a prohibited transaction?

When I get asked this by my clients I normally suggest that they consider the following: Imagine you are an IRS employee incentivized to find errors in people's returns. You need to ask yourself the same questions your potential auditor is asking when reviewing your file.

If I pay fair market price can I perform a prohibited transaction with a disqualified person?

No.

What if I get checkbook control?

It is still in the IRA. Checkbook control only allows you to write the checks for the IRA versus having a custodian to do it. All prohibited regulations apply.

What if it was an honest mistake?

Regardless of intent IRS penalties still apply. In fact, this came up in a court case in 1987 Rutland vs Commissioner.

What if the “disqualified person” in the transaction was my girlfriend and not my wife? Would this be permissible because she is not related to me?

Depending on how you file taxes she may not be a disqualified person. That doesn’t mean you should do it. This would be a great example of you having to place a call to a professional. You should be asking yourself is there any way you could be gaining benefit? If so, you probably don’t want to do it.