

Self Directed IRAs

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What Is a Self Directed IRA (Plan)?

Self directed plan = plan made available by a provider which allows **alternative investments** for retirement savings

i.e., plan through which provider offers ability to hold asset types in which plan owner wants to invest

- For non-self directed plans, investment options typically include **only** stocks, bonds, mutual funds, bank products and cash
- Self directed plans make available a **significantly broader** range of alternative investments

Self Directed Account Types

- Traditional IRA
- Roth IRA
- SEP IRA
- SIMPLE IRA
- Individual 401(k)
- Health Savings Account (HSA)
- Coverdell Education Savings Accounts (Coverdell ESA)

Why Self Direct?

- Control
- Freedom
- Returns / Growth
- Diversification

Self Directed Asset Options

- Private Equity (closely held stock, closely held LLC or closely held partnership interests)
- Real Estate
- Loans
- Precious metals (certain gold, silver, platinum, palladium) (but not all)
- Other (options, brokerage account, timber, growing crops, oil and gas, horses, oil and gas partnerships, intellectual property, etc.)
- Custodians may contractually restrict type of assets

Self Directed – Forbidden Assets

- **Collectibles** NOT allowed (deemed distributed at FMV the moment acquired) §408(m) (e.g., Ted Williams autographed baseball)
- Life insurance §408(a)(3) (e.g., life insurance formerly inside qualified plan)
- Non-qualifying precious metals §408(m)(3) (e.g., gold coin not listed in §408(m)(3)(A)(i))
- Plan custodians may restrict types of assets in addition to Internal Revenue Code (IRC) restrictions

Polling Question 1

1. Collectibles are the best thing going for investments in Self Directed IRAs

A. True

B. False

Self Directed Account Mechanics

- Open account with provider that allows you to choose your own investment
- Contribute funds
- Choose investment
- Direct the provider to acquire investment
- Provider must hold (keep custody of) assets, handle all financial transactions, pay bills, keep records, issue reports to owner, cause tax return (if required) to be filed, file annual Form 5498, etc.

Unrelated Business Income Tax (UBIT)

- Is UBIT illegal? No. A prohibited transaction? No. It's just a tax.
- Being unfamiliar results in fear
- The question: Are you better off (engaging in transaction that results in UBIT) after paying the tax (i.e., have higher IRA net worth) than you would be had you not engaged in the transaction?
- If better off, go for it. So what if you pay some tax? You're better off.

Self Directed Plan May Face UBIT Tax

- UBIT tax may apply if: Plan engages in certain business activities or purchases assets with borrowed funds
- If plan has more value after tax is paid (compared to if the activity producing the tax had not been engaged in), plan is better off
 - Example: IRA buys apartment building w/ 40% down, 60% borrowed. Initially, 60% of net rental income taxed. % taxed drops as debt paid down. Later, sell building at handsome profit. Only part of gain on sale taxed. Look at then existing debt ratio for allocation of amount taxable vs. amount not taxable.

Polling Question 2

2. Paying UBTI inside an IRA is always a horrible thing

A. True

B. False

UBIT Rap Sheet

- Applies to non-profits, IRAs, Roth IRAs, qualified plans, etc.
- What triggers UBIT?
 - Conducting a business inside an IRA
 - IRA owns a partnership which operates a business
 - Debt financed purchases by IRA
 - Sale by IRA of debt financed property
- 401(k) exemption for debt-financed investment

UBTI vs. UBIT vs. QFDI

- UBIT = Unrelated business income tax (tax IRA pays on > \$1,000 of UBTI and/or QDFI)
- UBTI = Unrelated business taxable income (e.g., income from business operated by IRA (or partnership operated by IRA))
- QFDI = Unrelated debt financed income (e.g., rental income from property purchased with debt) (e.g., proceeds of sale of debt leveraged property)

UBTI – 3 (or 2) Key Elements

UBTI = Income from a trade or business, regularly carried on, that is not substantially related to the charitable, educational or other purpose that is the basis of the organization's exemption

Three criteria must be present:

1. A trade or business
2. Regularly carried on
3. Not substantially related (*generally doesn't apply to IRAs or Qualified Plans*)

Self Directed IRA – IRS Reporting

- Form 5498 annual reporting required
 - Annual valuation by category: Form 5498, Boxes 15a & 15b

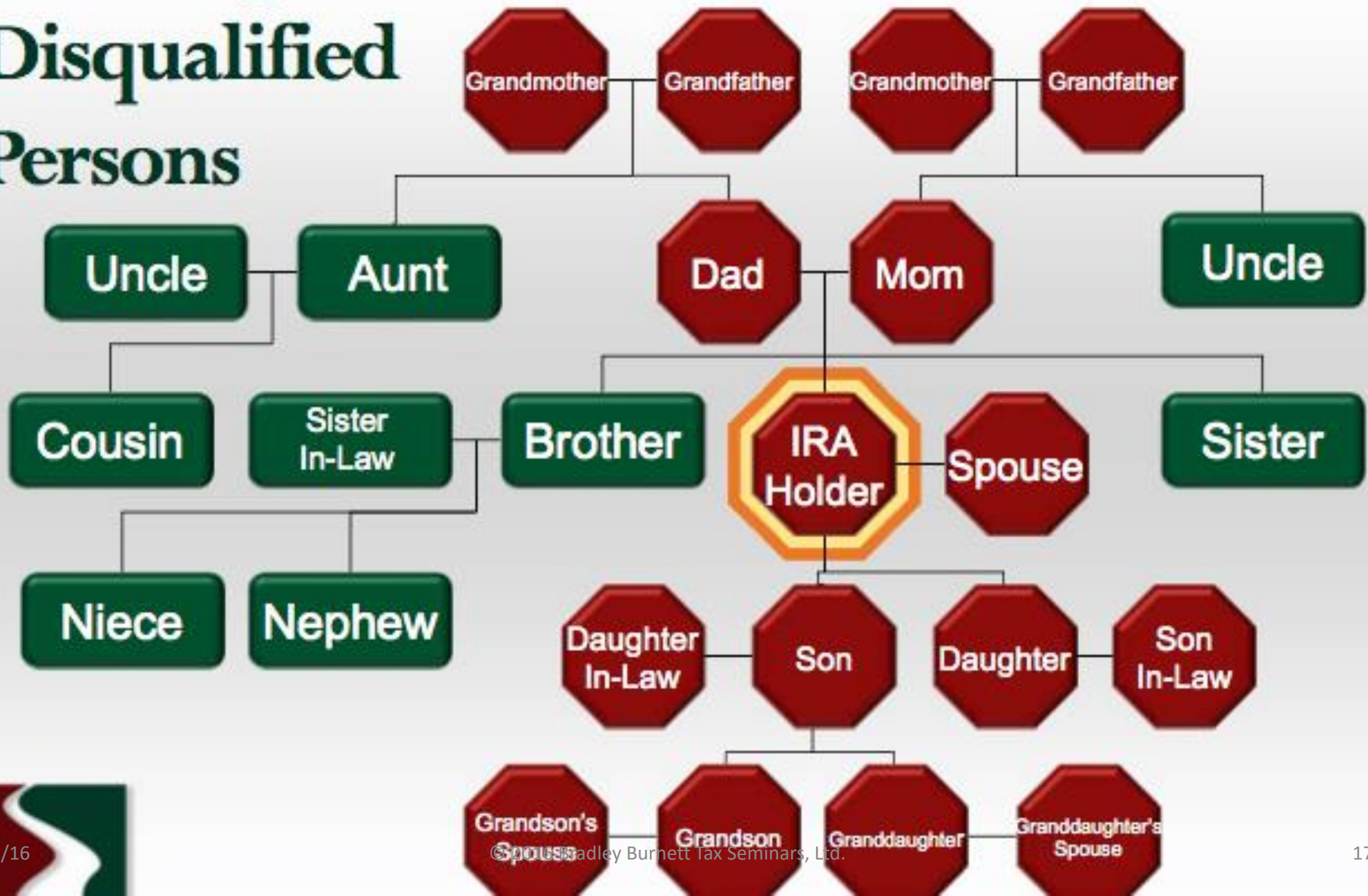
Box 15b codes:

- **A**—Closely held stock
- **B**—Closely held short- or long-term debt
- **C**—Closely held ownership interest in a limited liability company
- **D**—Real estate
- **E**—Closely held ownership interest in a partnership, trust, or similar entity
- **F**—Closely held option contract or similar product
- **G**—Other asset that does not have a readily available FMV
- **H**—More than two types of assets (listed in A through G) are held in this IRA

Prohibited Transactions – IRC §4975

- Disqualified persons **cannot “self deal”** with the plan
- Disqualified person
 - Fiduciary of plan (owner (you) and advisors)
 - Person providing services to the plan
 - Employer of any participant in the plan
 - Employee organization if member covered by plan
- Includes descendants (down-line) and their spouses, ascendants (up-line)
- Includes spouse of owner

Defining Disqualified Persons



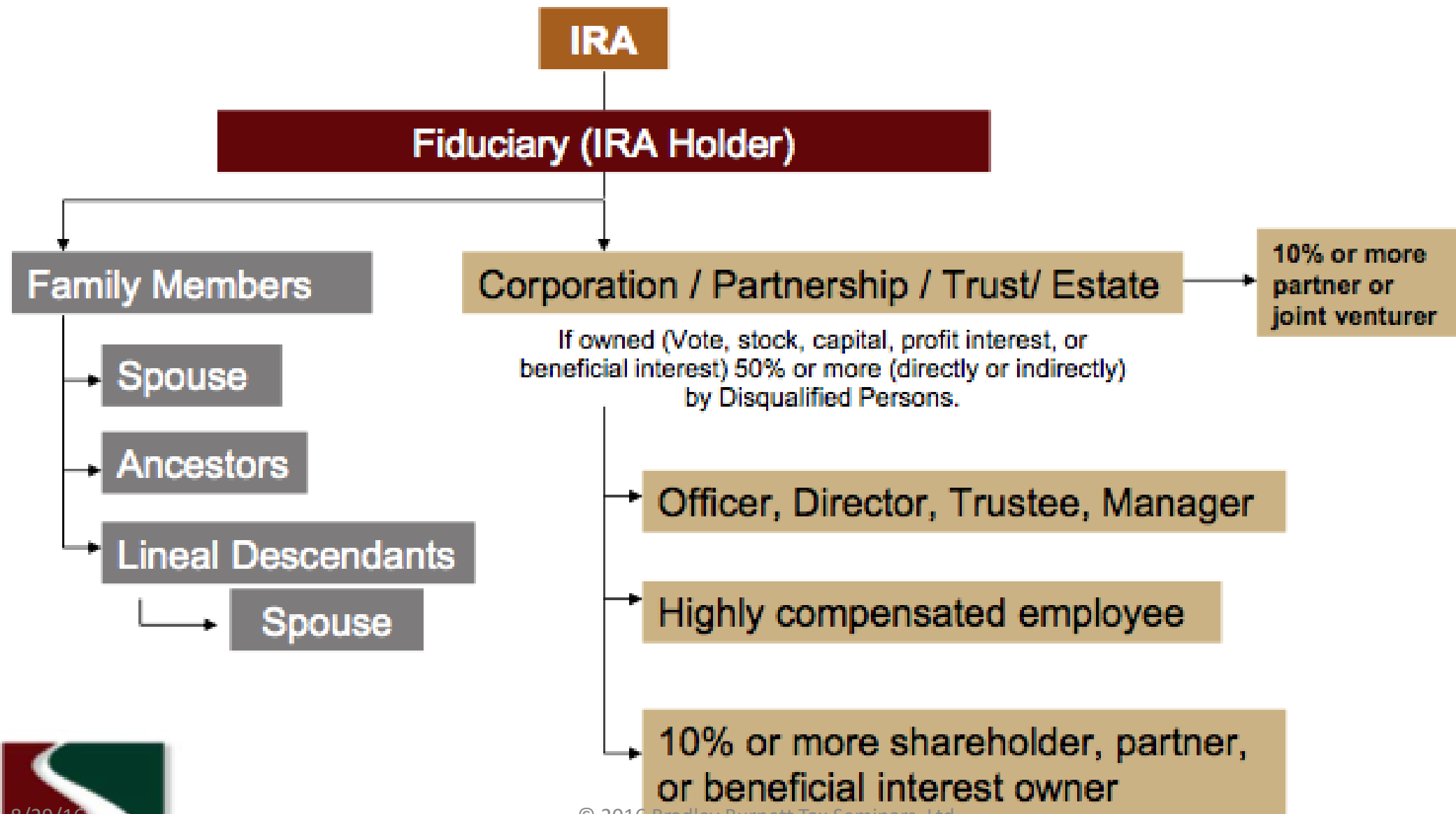
Polling Question 3

3. A sister of an IRA account owner is a disqualified person for prohibited transaction purposes

A. True

B. False

Defining Disqualified Persons



Prohibited Transactions – Disqualified Person

- *Joseph R. Rollins, pro se, v. Comm.*, TCM 2004-260 (11/15/04)
 - Rollins caused 401(k) plan of his 100% owned Corp to lend money to each of 3 companies he owned minority (10% or more) interests in
 - His 100% owned Corp was fiduciary (sole trustee and administrator) of 401(k) plan. He also acted on behalf of borrowers for the loans.
 - Each of loans was “prohibited transaction” §4975(c)(1)(D)
 - Rollins was disqualified person liable for \$208,400 excise tax(es) under §4975(a), (b) and \$11,000 penalty for failure to file Form 5330 excise tax return
 - Plan ceased to be qualified plan (as of January 1 of year of first loan)

Prohibited Transactions – IRC §4975

- Selling something you own to the plan (e.g., sell or supply part to refrigerator)
- Buying from the plan (e.g., purchasing rental property from plan)
- Lending money or extending credit to the plan (*Peek*, 142 TC 216 (05/09/13)) (*Thiessen*, 146 TC 7 (03/29/16))

Prohibited Transactions – IRC §4975

- Providing services to the plan (*Ellis*, TCM 2013-245, affirmed 8th Cir (04/14/15)) (e.g., doing books for IRA or business owned by IRA)
- Getting paid by the plan (*Ellis*, TCM 2013-245, affirmed 8th Cir (04/14/15))
- Personal use of (or benefit from) plan assets (*Kellerman*, DC AR (09/14/15))
- Use of assets by plan fiduciary (e.g., cannot rent building owned by plan)

Prohibited Transactions – Intent of IRC §4975

- Disqualified persons cannot self deal with the plan
- Purpose of §4975 = to prevent taxpayers involved in a plan from using the plan to engage in transactions for their own account that could place plan assets and income at risk of loss before retirement (*Ellis*, TCM 2013-245, affirmed 8th Cir (04/14/15))

Prohibited Transactions – Where the Ruler Hits the Road

- The enumerated transactions set forth in §4975 are meant to exhibit **per se examples** of this kind of self-dealing (*Leib*, 88 TC 1474 (1987))
- Distinction: **What does it say I can't do** vs. **What is it saying (It doesn't say you can)**
 - Many prohibited transaction failures result from “fine line walking”, technical interpretations attempting to slide by §4975
 - The courts don't buy such attempts. Result = lambs led to slaughter
 - **Problem: Each new court case rules on only one issue of many in the case's fact pattern.** Makes things look simpler than they are.

Prohibited Transaction - No Means No

- The fact that a transaction would qualify as a **prudent investment** when judged under the highest fiduciary standards **is of no consequence** (*Ellis*, TCM 2013-245, affirmed 8th Cir (04/14/15))
- It doesn't matter how great the deal is, whether it is at arm's length, etc.
- The fact is **if the action is a prohibited transaction, you can't do it**

What You Can and Cannot Do

- Here is what you can do: Contribute to plan, withdraw from plan, choose what plan invests in
- Here is what you cannot do: Anything else

Consequences of Prohibited Transaction

- IRA **ceases to be IRA** as of first day of taxable year in which prohibited transaction takes place
- All **assets** deemed **distributed** in taxable event as of first day of such taxable year
- Income taxable event results and premature withdrawal penalty may apply
- Gross income from deemed distribution is recognized in amount of **account's value** as of **first day of** such **taxable year**
- IRA is killed deader than a doornail and stays that way

Consequences of Prohibited Transaction

- Plan ceases to be a plan as of 1st day of year in which prohibited transaction takes place
- Excise tax triggered
- Excise tax return (Form 5330) due
- **6 year statute of limitations** (for assessment) for not disclosing prohibited transaction on 1040 (*Thiessen*, 146 TC 7 (03/29/16))

Polling Question 4

4. The consequences of a prohibited transaction are not much more than a mind slap on the wrist

A. True

B. False

ROBS Transactions – Steps to Create

1. Individual creates new corporation (purpose = to sponsor a qualified retirement plan)
2. New corp creates qualified retirement plan (such plan allows participants to invest their whole plan account balance in new corp's stock)
3. Individual becomes employee of new corp, enrolls in plan
4. Individual rolls over (or trustee transfers) funds from his IRA (or previous employer's qualified plan) into new corp's qualified plan
5. Individual directs that his account balance (in qualified plan) purchase stock of new corp
6. Transferred funds (now inside new corp) begin a business enterprise

IRS View of ROBS Transactions

- IRS Memorandum, Guidelines Regarding Rollovers as Business Start-Ups (10/01/08):
 - IRS: ROBS are **questionable, but not necessarily abusive**, mechanisms for individuals to use their **existing retirement accounts as seed money for funding new businesses without first paying taxes** on distributions from those retirement accounts
 - IRS: ROBS may be legitimate tax planning, but IRS recommends assessment on a case-by-case basis through IRS **determination letters**
 - IRS re: IRS exams of ROBS: “Although we do not believe that the form of all of these transactions may be challenged as non-compliant per se, **issues** such as those described within this memorandum should be **developed** on a **case-by-case** basis.”

ROBS Transactions Spell Doom

- ROBS = Rollover Business Startup
- ROBS IRA bad behavior leads to prohibited transaction(s)
- E.g., Can't perform services, get paid (*Terry Ellis*, TCM 2013-245 affirmed 8th Cir (04/14/15))

Variation on ROBS - BORSA

- Variation of ROBS = BORSA, i.e., "Business Owners Retirement Savings Account"
- Mechanics of BORSA: Individual Retirement Account (IRA) withdrawals are nontaxable distributions rolled over into a tax qualified retirement account
- E.g. of a failed BORSA: IRA withdrawals were taxable distributions that were rolled over into another arrangement. Because there was no written plan in existence into which the IRA distributions were reinvested, the new arrangement couldn't be a qualified trust under §401 (*Powell*, US Ct Claims (03/16/16))

IRAs and Asset Protection

- IRAs (combined) \$1,283,025 million (beginning 04/01/16) protected from creditor's reach in Federal Bankruptcy (Fed BR) case (11 USC §522(n))
- Qualified plans unlimited \$ protected in Fed BR (11 USC §522(d)(12))

IRAs and Asset Protection

- Prohibited transaction leads to taxable event, resulting IRS bill and creditors' feast (*Kellerman*, DC AR (09/14/15))
 - IRA bought land
 - Half of such land ended up in LLC owned by IRA owner and his spouse
 - This maneuver was not reported as a distribution
 - IRA owner pretended land operated in partnership w/ LLC and his IRA
 - Result: IRA owner (and spouse) benefited personally. Thus, prohibited transaction.

IRAs and Asset Protection

- Creditors' committees (trustees) (in Fed Bankruptcy cases) getting aggressive to prove prohibited transactions (or other disqualifying events) so creditors can seize plan assets
 - Cross Collateralization Agreement With Merrill Lynch Did Not Automatically Destroy IRA (Trigger a Prohibited Transaction), But It Came Close – Sixth Circuit Reverses Bankruptcy Court and District Court – Predator Was Bankruptcy Trustee (*Daley*, 6th Cir (06/17/13))
 - IRA owner distributed \$267,000 from IRA to purchase single premium annuity. Annuity exempt from creditor's reach in BR (*Running v. Miller*, 8th Circuit, No. 13-3682 (02/13/15))

IRAs and Asset Protection

- Cross Collateralization Agreement With Merrill Lynch Did Not Automatically Destroy IRA (Trigger a Prohibited Transaction), But It Came Close – Sixth Circuit Reverses Bankruptcy Court and District Court – Predator Was Bankruptcy Trustee (*Daley*, (6th Cir) (06/17/13))
 - Tennessean James Daley opened IRA with Merrill Lynch by rolling over \$64,646. Daley signed a Client Relationship Agreement (“cross collateralization” agreement) w/ Merrill Lynch, thus pledging his IRA as security for future debts (if any) to Merrill Lynch. He never borrowed from them.
 - No prohibited transaction

IRAs and Asset Protection

- IRA owner distributed \$267,000 from IRA to purchase single premium annuity product. Annuity exempt from creditor's reach in bankruptcy (*Running v. Miller*, 8th Circuit, No. 13-3682 (02/13/15))
 - Annuity was outside of IRA, but still protected 11 U.S.C. §522(b)(3)(C), 26 U.S.C. §408(b)
 - Part of continuing display of trustees in Bankruptcy's (creditor's committee's) aggressive behavior seeking out prohibited transactions

Creditor Protection for Inherited IRAs

- Inherited IRAs not protected in Federal Bankruptcy case (*Clark*, US S Ct (06/12/14))
- But spouse beneficiary can change name (on account inherited from deceased spouse) to himself or herself and gain protection

Polling Question 5

5. An IRA you inherit from your momma is subject to creditors' reach in a federal bankruptcy case

A. True

B. False

Self Directed IRAs and Distributions

- IRA owner had “claim of right” in payment by SEP IRA, so taxable distribution resulted (*Vandenbosch*, TCM 2016-29 (04/24/16))
 - SEP IRA agreed to lend \$125,000 to a third party
 - \$125,000 drawn from SEP IRA, put in owner’s personal account (without restriction), then transferred to borrower
 - A taxpayer who receives an amount under a claim of right, without restrictions as to its disposition, has received income for tax purposes, even though the taxpayer may still be liable to restore its equivalent (*North American Oil Consolidated* (1932) U.S. Supreme Court)

Self Directed IRAs and Distributions

- IRA owner's direction to IRA custodian to purchase stock did not result in taxable distribution (*McGaugh*, TCM 2016-28 (02/24/16))
 - IRA owner requested Merrill Lynch (ML) to buy FPFC (privately held stock). ML refused.
 - Instead, IRA owner asked ML to wire \$50,000 directly to FPFC. ML did so. ML said FPFC stock certificate not received until > 60 days later.
 - Tax Court: No funds passed through IRA owner's hands (even if stock certificate landed in his hands later)
 - IRA owner was mere conduit with "no claim of right" to distributed funds

IRAs and Contribution Limits

- Annual contribution limit for IRAs = \$5,500 (\$6,500 if age 65)
- Tax Court shoots down attempts to use corps to skirt IRA contribution limits
 - Arrangement between corps to artificially allocate value to Roth IRA (*Polowniak*, TCM 2016-31 (02/25/16))
 - Scheme to overfund Roth IRA via DISC commissions (*Summa Holdings Inc.*, TCM 2015-119 (06/29/15))

IRAs and Contribution Limits

- Tax Court shoots down attempt to use corps to skirt IRA contribution limits (*Polowniak*, TCM 2016-31 (02/25/16))
 - Roth IRA owned 98% of a C Corp (Corp 2)
 - IRA owner performed services for Corp 1 (an S Corp). Corp 1 offered consulting services to outside third parties. Arrangement concocted where 75% of Corp 1's revenue paid by Corp 1 to Corp 2.
 - Tax Court ruled arrangement had no purpose other than to bypass Roth IRA contribution limits
 - Consequences: \$680,000 income to Corp 2 (an S Corp) (and, thus to IRA stockholder via pass-through from S Corp), 6% §4973 excess contribution excise tax, 25% §6651(a)(1) penalty for failure to file Form 5329 with Form 1040 and liable for 30% §6662A penalty for failure to disclose reportable transaction

IRAs and Contribution Limits

- Tax Court rejects scheme to overfund Roth IRA via DISC commissions (*Summa Holdings Inc.*, TCM 2015-119 (06/29/15))
 - Summa was a C Corp owned by James Benenson (James) and Benenson Trust fbo James' 2 sons
 - Sons each set up Roth IRAs, which acquired a DISC
 - Summa paid millions to DISC, which paid millions in dividends to Roth IRAs
 - Court applies “substance over form”, ruling payments by Summa not DISC commissions, but rather dividends to shareholders, followed by excess IRA contributions

IRA Rollover – One Per Taxpayer (Not Per Account) Per Year

- One rollover per taxpayer per year (*Bobrow*, TCM 2014-121)
- IRS Announcement 2014-15: One rollover per year rule starts in 2015
- Trustee transfers have no “one year” limitation

Blown IRA Rollover Relief

- IRS will waive blown rollover if good taxpayer excuse (taxpayer must apply for IRS Private Letter Ruling (PLR) and pay up to \$3,000 user fee)
- If don't go for IRS PLR relief, forget relief in Tax Court (*Thomas Wesley*, TCS 2014-18)

Polling Question 6

- 6. What is the best approach for a blown IRA rollover?
 - A. Find some proverbial sand and hide your head in it
 - B. Go for a ruling, blame someone else and have them pay the user fee

Self Directed Plans

- Pots of Gold at End of Rainbow -OR- Fields of Land Mines?
- Answer: Both!!
- Conduct yourself appropriately for potentially great results

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