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Self-directed IRAs

Opportunities and Pitfalls You Should Know

The Employee Retirement Income and Security Act of 1974 introduced tax-deferred retirement accounts and the workers who have accumulated such accounts are retiring in growing numbers. Many choose to roll over funds from employer-sponsored plan accounts to an IRA—either a trusteed IRA (held by a bank or trust company) or a self-directed IRA, where the IRA owner has primary responsibility for making investment choices.

Not everyone wants to invest in marketable securities, however. So-called "alternative investments" are being sought out by IRA owners out of preferences for other asset classes—such as real estate—or a desire to produce better returns.

Many such investments may be held in IRAs, but some types of investments aren't permissible. And, prohibited transactions must be avoided because they can instantly and irretrievably kill an IRA, causing a deemed distribution resulting in imposition of income taxes on the entire value of the IRA.

Unacceptable Investments

There are only a few restrictions on what an IRA can invest in. No part of an IRA may be invested in any life insurance contract. Also, an investment in certain "collectibles" is treated as an IRA distribution. The amount of the deemed distribution is the IRA's cost of acquiring the collectible.

Prohibited "collectibles" are listed in Internal Revenue Code Sec. 408(m)—which include any work of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage or any other tangible personal property specified by the secretary for purposes of this subsection.

In the case of coins and bullion that may be held by an IRA, those assets must be in the possession of the IRA trustee or custodian to qualify as exceptions to the prohibition on investing in collectibles.

Not everyone wants to invest in marketable securities.

IRC Sec. 408(m)(3) and IRS Publication 590 provide a list of acceptable investments that are not treated as prohibited collectibles. These include certain coins, as well as any gold, silver, platinum or palladium bullion of a fineness equal to, or exceeding the minimum, fineness that a contract market (as described in sec. 7 of the Commodity Exchange Act, 7 U.S.C. 7) requires for metals which may be delivered in satisfaction of a regulated futures contract.

Owning stock in an S corp isn't forbidden, but an IRA is not a permitted shareholder of an S corp, according to Revenue Ruling 92-73, 1992-2 C.B. 224. Nor is a Roth IRA a permitted S corp shareholder [*Taproot Administrative Services, Inc. v. Commissioner*, 9th Cir. (2012), affirming 133 T.C. 202 (2009)].

S corp stock ownership by an IRA or Roth terminates the S election. However, if such a termination occurs, relief may be requested under Sec. 1362(f) and the regulations thereunder. If relief is granted, the S corp is reinstated, provided the defective ownership has been, or will be, cured.

Some IRA investments can result in producing unrelated business taxable income within the IRA, taxable at the highest federal income tax applicable to trusts.

Acceptable Alternative Investments

Among the vast variety of acceptable non-traditional investments, common ones include real estate; debt, such as promissory notes, deeds of trust, mortgages, and tax liens; private placement investments; foreign currency; livestock; oil and gas interests; equipment leasing, and many others.

However, it's important to ascertain that a candidate for IRA ownership is allowable. Review the prospectus before investing. Offering circulars typically alert potential investors regarding unsuitability for an IRA to invest in, and many offerings include a class of investment that is suitable.

Unrelated Business Income Tax

There's an exception to the general rule that IRAs aren't subject to income taxes. IRC Sec. 408(e) imposes on IRAs the Sec. 511 income tax on unrelated business income of charitable and other exempt organizations. For example, investing in a business venture incurs the unrelated business tax rules. For an IRA, the top trust income tax rate applies.

We're aware of an individual who directed his investment adviser to acquire a class of an oil and gas investment that was suitable for his IRA, but the unsuitable kind was acquired instead. The IRA owner was given an offering circular that described a class of oil and gas investment that was IRAappropriate, but his investment representative had instead acquired the wrong type. The error was discovered several years later, during the individual's estate planning process. The IRA owed unrelated business income taxes as a result. The investment was sold and replaced by the correct equity class.

Prohibited Transactions

When an IRA engages in a prohibited transaction, the IRA is treated as having been distributed in full as of the first day of the calendar year when the transaction occurs. Unlike qualified retirement plans, there's no cure for a prohibited transaction.

IRA prohibited transactions consist of two attributes:

- The transaction must be between the IRA and a "disqualified person" under IRC Sec. 4974(e)(2); and
- Must involve a transaction having at least one of the characteristics set forth in IRC Sec. 4975(c)(1).

Disqualified persons include the IRA owner and members of his or her family. A fiduciary with respect to an IRA and a person who provides services to an IRA are also disqualified persons, along with members of such person's family. This is only a partial list.

A member of such a person's family includes his or her spouse, ancestors and lineal descendants, as well as any spouse of a lineal descendant. Thus, for example, nieces and nephews are not disqualified persons, while a son-in-law or daughter-in-law is.

The Sec. 4975(c)(1) list includes any direct or indirect:

- Sale, exchange or leasing of any property between a plan and a disqualified person;
- Lending of money or other extension of credit between a plan and a disqualified person;
- Furnishing of goods, services or facilities between a plan and a disqualified person;
- Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;
- Act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest 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.

No part of an IRA may be invested in any life insurance contract.

When an IRA invests in real estate, the IRA owner should not provide any services to the IRA's real estate. The safest way to approach real estate is to place the IRA funds with a trustee, and have the trustee make the real estate investment for the IRA.

It's easy to make an IRA-killing mistake by entering into a prohibited transaction.

We're aware of a situation where an individual made a loan from her IRA to her daughter-in-law just after her daughter-in-law's marriage to the client's son. The IRA making a loan to the IRA's daughter-in-law was a prohibited transaction as an extension of credit to a family member under IRC Sec. 4975(c)(1)(B).

That meant that the IRA was treated as having terminated on the first day of the tax year when the loan was made, and the entire amount of IRA was treated as having been distributed in a taxable distribution as of first day of the tax year when the loan was made.

Because the prohibited transaction was discovered during 2015, but the loan was made in 2014, it was too late to cure by making a rollover. The IRA's entire value as of Jan. 1, 2014, was the amount treated as distributed as of that date.

In this case, the deemed distribution was fully taxable. Also, income and gains on the IRA's investments beginning Jan. 1, 2015, were includible on the client's personal income tax returns.

Prohibited transactions have been found where an IRA owned a corporation's stock and the IRA owner provided a loan guarantee of the corporation's debt in *Peek v. Commissioner*, 140 T.C. 216 (2013) and, very recently, in *Thiessen et ux. v. Commissioner*; 146 T.C. No. 7; No. 11965-10 (2016). *Thiessen* cited and discussed *Peek*. In both cases, the court found that the loan guarantees were an indirect extension of credit from the IRA owner to the IRA under IRC Sec. 4975(c)(1)(B).

A prohibited transaction was found in *Ellis, et ux v. Commissioner*, T.C. Memo. 2013-245 (2013), where an IRA owned a corporation and the IRA owner received compensation from the IRA-owned corporation.

Kellerman, et ux, Bk Ct., E. AK, (May 26, 2015) presented several prohibited transactions that caused termination and deemed distribution of an IRA. That finding had the effect of defeating bankruptcy protection for the IRA.

Barry Kellerman was found to be fiduciary with respect to his IRA because the IRA was self-directed, and because "fiduciary" includes "any person who exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets," or "any person who has any discretionary authority or discretionary responsibility in the administration of such plan." He also was a disqualified person in his capacity as beneficiary of his own IRA.

Kellerman loaned money to a partnership controlled by himself and his wife, an impermissible extension of credit.

There are just a few prohibited transactions cases, but the lesson is clear: Great caution is required when an IRA makes alternative investments. CPAs can provide a valuable service in helping clients' IRAs stay safe. CPA

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