

IRA & 401(k) Insights

The Leading Industry Newsletter on Self-Directed Retirement Plans and Investments

About: IRA & 401(k) Insights

IRA & 401(k) Insights is a monthly publication for anyone interested in self-directing their retirement funds and investing in nontraditional assets.

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Letter from the Editor

Welcome to the September edition of the IRA Insights Newsletter. Our newsletter is just one of the educational resources available from Entrust to help you control your self-directed retirement investments. Entrust's local offices also provide educational seminars on self-direction to help clients and professionals understand the broad spectrum of investment options and the benefits of self-direction. Explore all of the educational opportunities by visiting our web site www.theentrustgroup.com.

Investing in Tax Deeds with Your Self-Directed IRA

By: Jon Galane, CISP

You don't have to use your imagination to see an economy with land foreclosures hitting all-time highs. There's no government program to help developers and land-owners in tough times. Unemployment is in double-digits for the first time since the Great Depression, with no end in sight. The Gross Domestic Product (GDP) has had three consecutive quarters with a -5% decline.

Government borrowing is at an all time high of more than \$3 trillion a year. This is the largest deficit spending, not only in the history of the United States, but in the history of any other executive and legislative branch of our government combined—from George Washington to George W. Bush. A federal budget of \$3.6 trillion for 2010 easily passed the bi-cameral houses, with total unfunded deficit spending in the United States to reach \$63 trillion over the next ten years, not including any new programs.

Economists like Arthur Laffer and Harry Dent are predicting a collapse of the commodities markets leading to a collapse of the Dow Industrial 30, from its current level of 8500 down to 3800, by the end of 2010. This could also mean that inflation would come roaring back to 1978 levels in the next five years. Secured bondholders at GM and Chrysler saw losses on their investment of greater than 90%, with the swipe of a pen.

This seems like a bleak and pessimistic view of our world and our future, as well as our investment portfolios. There is no more security or ability of the rule of law to dictate the value of paper investments. What does it all mean? How do you find hard assets that will weather the oncoming storm and make sure your retirement funds can weather a hyperinflationary market?

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Many economists believe long-term investments in hard assets are preferential. Those assets have always kept pace or exceeded inflation in any economic storm or governmental intervention in the paper markets. Economists and investors alike, have found that raw land is one such hard asset. It withstands the test of time in creation of wealth and security in inflationary markets. For example, during the late 1970's and early 1980's when inflation was running as high as 20%, a person could find an FDIC-insured CD for 15%. That means the investment was losing 5% in actual cash value every year. The average American family during that same period paid 50% in federal income taxes. That means that their actual return was 7.5%, or an inflationary decay of a stunning -12.5%, on each dollar invested.

Tax deeds give an investor the advantage of the security of land, combined with the purchase of the tax deed for the taxes owed to the governmental authority holding the land, not the value of the land. Normally these tax deeds are sold at auction by the governmental authority such as city, county, or state. They are actually quite simple to buy inside your self-directed IRA account.

First you need to open an account with an Entrust self-directed IRA administrator. Next, you can either go to a tax deed auction or find a company that does all the foot work for you and re-sells tax deed properties. The administrator signs the contracts to purchase the property inside the IRA. The IRA owner fills out the necessary paperwork and reads and approves all documents. The administrator, such as Mountain West Entrust IRA in Idaho, then funds the property from your IRA. After that transaction is completed, the IRA becomes the owner of the property.

If you have a Roth IRA, all gains go back to your retirement account tax-free when the property is sold. It can then be reinvested in another asset. Any gains on the property and any future investments are not taxed, as long as Roth IRA rules are followed. If you have a traditional IRA, all gains from the sale of property are tax deferred until the IRA owner takes distributions after age 59 1/2. All gains can be used for other investments tax free, until distribution. Therefore, gains are truly 100% non-taxable while they stay in the IRA, allowing you to invest 100% of your money for attaining future gain.

For more information about these kinds of investments, you can contact Mountain West Entrust IRA at (866) 377-3311 or marnold@theentrustgroup.com.

Jon Galane, one of the Principals of Mountain West Entrust IRA, has more than 28 years of experience in the investment and retirement planning industry.

Tip of the Month: Four Things to Know About Getting Audited

By : Lisa Moren-Bromma

Do you think as real estate investors, your chances of getting audited by the IRS are greater than most? If so, please take note of these four ways to prepare for an audit, in advance.

1. Delaying a request from the IRS can cost you the right to fight. If you receive correspondence from the IRS, take action within the required time frame, which is usually 30 days. Otherwise, the dispute becomes final and will be moved to the collections department. You have the right to ask for a postponement if you need more time, so make sure you do so within the allotted time.
2. Have a professional on your side. Many investors do their own taxes, but if someone else prepares your taxes, make sure they get involved in any correspondence or audit.
3. Anything you say can be used against you. This one is pretty self-explanatory.
4. The auditor's boss or supervisor may be able to negotiate with you if you are unhappy with the auditor's decision. The number of audits is on the rise. If your income is under \$200,000 there is still about a 1% chance the IRS will audit you. If the worse happens, be prepared.

*Lisa Moren-Bromma has 30 years of investing experience, primarily in real estate and the cash flow industry, and has taught more than 1,000 seminars on the subject. She is the author of *Wise Women Invest in Real Estate and Real Estate Investing For the Utterly Confused*, and is editor of the *Wise Women Investor* blog and newsletter.*

How Using an LLC Can Make Self-Directed Investing Easier

By : Scott Maurer

Many investors like to invest in real estate and other assets by forming a limited liability company, or LLC. LLCs are often recommended by attorneys and other professionals as a way to limit the liability exposure of the LLC owners from particular investment hazards. LLCs can also be used to make the acquisition and management of investment assets easier. It is certainly possible to have a self-directed IRA acquire real estate and other assets by utilizing an LLC. The example below shows how this can be done.

Steve and Linda both have self-directed IRAs with \$75,000 of cash in each that they would like to put to use by investing in foreclosed properties available through public auctions. Often, the purchase of foreclosed properties at courthouse auctions requires the successful bidder to furnish the full purchase price within a 24-hour period, if not immediately (as is true in some cases). Due to these time constraints and because of the amount of purchases they hope to make at each auction, Steve and Linda decide it would be easier to set up an LLC for their IRAs to own.

Investing a self-directed IRA within an LLC offers immediate access to the cash needed to operate the LLC and to make investments. Instead of having to go through a custodian for access to cash, a check is written straight from the bank account established by the appropriate manager of the LLC.

Steve and Linda use a local attorney to establish, form, and register the LLC, which is named Foreclosed Properties, LLC. The individual Entrust IRAs are the members (and owners). Steve and Linda direct Entrust to name a third person, their business acquaintance, Ron (who is not related to Steve or Linda), to serve as manager of the LLC. Ron, the manager of the LLC will have the ability to sign contracts, write checks, and wire funds out of the LLC's bank account, as instructed by the LLC Operating Agreement. Steve and Linda had initially wanted to be managers of this LLC, but on the advice of their attorney they decided to simply use Ron as the only manager of the LLC. For more discussions on an IRA owner acting as manager of an IRA-owned LLC, please also visit The Entrust Group website for other articles that more specifically address the "checkbook control LLC."

Steve and Linda complete the necessary documents with Entrust to invest in the LLC, and had their attorney prepare the Operating Agreement for the LLC. They have instructed Entrust that each IRA will purchase a 50% interest in the LLC, in exchange for a capital contribution of \$75,000 from each IRA. Once Steve and Linda have reviewed and approved the LLC operating agreement, the document is sent to Entrust for signatures of authorized representatives who execute the Operating Agreement on behalf of each IRA account. Ron also signs the operating agreement as the manager of the LLC, and opens a bank account in the name of Foreclosed Properties, LLC. Upon receipt of the approved operating agreement and other documentation, Entrust wires a total of \$150,000 (\$75,000 from each IRA) to the LLC bank account as instructed by the IRA owners, Steve and Linda.

Now that the LLC has been funded, Ron is ready to start bidding on and purchasing properties. At Linda and Steve's direction, Ron bids on 10 properties to be purchased. He is the

successful bidder for four foreclosures for a total of \$120,000. The purchased properties are titled in the name of Foreclosure Properties, LLC and Ron, as manager, signs the necessary documents and wires the funds to the county clerk to complete the purchase of the properties.

Steve and Linda, as owners of the LLC, have decided to maintain and rent the acquired properties for a period of three years before selling them. Once the LLC has purchased the assets, Ron pays any expenses that are due (taxes, insurance, maintenance, etc.) out of the LLC bank account. Any rental incomes for the properties are received into the LLC bank account, as well. As cash builds up within the LLC bank account, the LLC can purchase additional properties and other assets, if desired. Each new asset purchased would be titled in the name of the LLC as well.

Rental income and expenses for all of the properties flow in and out of the LLC account. The net profits are credited to the LLC. During the next three years, each of the 4 properties average a net cash flow of \$500 a month, back into the LLC bank account. The net cash flow also includes all of the expenses for establishing, maintaining, accounting, and any filing fees for running the LLC. This means that almost \$72,000 is returned to the LLC account over the three-year rental period, a 16% growth on the cash flow alone.

After the three-year period, Steve and Linda instruct Ron to sell the properties within the LLC and then close the LLC. Ron sells the four properties for a total of \$200,000, and the sale proceeds are deposited back to the LLC account. Thus, in three years time, the LLC bank account has grown from the \$150,000 initial investment to a total of \$272,000. After selling the properties within the LLC, Ron dissolves the LLC and closes the LLC bank account. Ron then returns \$136,000 to each IRA owned by Steve and Linda's LLC, resulting in a more than 27% annual return to their retirement accounts.

As you can see, investing in real estate through an LLC owned by your Entrust IRA may make the investing process simpler. While this process may seem easy at first glance, it is important that you employ a competent attorney and/or accountant for solid advice on creating and maintaining the LLC. Entrust provides no advice regarding the use of LLCs or other investment methodology, as every Entrust IRA is truly self-directed!

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Self-Directed IRAs: An Estate Planner's Primer on Some of the Rules

By: Daniel P. Marsh

As this little-known technique is growing in popularity, advisors should know the basic rules that must be considered when contemplating alternative assets in an IRA.

Retirement plans are not limited to stocks, bonds and mutual funds, but can also invest in real estate, partnerships or equity in a closely held business by purchasing such assets through a self-directed retirement plan.¹ Individual retirement accounts (IRAs) have long been able to invest outside the stock market when using an IRA as the means to make such investments; the technique is referred to as using a "self-directed IRA."² It was not until recently that there has been significant interest in placing non-traditional, alternative investments into an IRA.³

Self-directed IRAs can be invested in traditional stocks and bonds when the IRA owner believes the skill and experience exist to pick and choose the investments of the account. In addition, these accounts can be invested in alternative types of investments such as limited liability companies, limited partnerships, mortgage receivables, promissory notes or real property.

Increasing Interest in Investments in Alternative Assets

There is growing interest in investments in alternative assets. A poll conducted by Rydex Advisor Benchmarking Inc. concluded that there is a growing trend indicating advisors are increasing their use of alternative investments such as hedge funds, real estate and commodities.⁴

The poll found that:

- 55 percent of advisors expect to increase their alloca-

tions in alternative investments by 25 percent over the next five years, and

- 13 percent plan to increase their use of the investments by more than 75 percent.
- Alternative investments are becoming increasingly important to advisers.⁵

Size of the IRA Market

The Investment Company Institute reports the total U.S. retirement assets were \$14.4 trillion as of June 30, 2009, up 7.4 percent from \$13.4 trillion on March 31, 2009. Retirement savings accounted for 34 percent of all household financial assets in the United States.⁶ IRAs held \$3.7 trillion at the end of the second quarter of 2009, up from \$3.4 trillion at the end of the first quarter.⁷ The Employee Benefit Research Institute (EBRI) reports that within IRAs, a majority of those IRAs are from rollover IRAs.⁸

These reports indicate significant movement of retirement accounts and the assets they are holding for investment. Today's estate planner must have an understanding all of the tax and other ramifications of estate planning for IRAs.

Clients are seeking options to support decisions for taking the best approach in their circumstances concerning their IRA investments. The attorney should have the knowledge and experience as a legal, tax and trust specialist to assist clients and their advisers develop an estate plan strategy for the IRA that suits the client's needs. This article discusses a method to facilitate alternative or non-traditional investments with an IRA and provides a general overview of the rules that must be considered when contemplating this technique.

What is a Self-Directed Individual Retirement Ac-

5. *Id.* Looking ahead, advisers cited various reasons to go into alternative investments: the use of different investment techniques (40%), seeking absolute returns (38%), filling portfolio allocations (29%), addressing portfolio correlation (28%) and seeking unique vehicle structures (25%). Over the next five years, 24% of advisers believe that the alternative investments with the greatest business growth potential are capital protected and structured products, including commodities, while real estate (16%), private equity/venture capital (15%) and hedge funds (13%) ranked as rewarding to businesses.

6. See the key findings in a report from the Investment Company Institute (ICI) entitled *The U.S. Retirement Market, Second Quarter 2009*, available at [http://www.ici.org/portal/site/ICI/October 2009 Vol. 18, No. 5-02](http://www.ici.org/portal/site/ICI/October%202009%20Vol.%2018,%20No.%205-02) (last visited November 9, 2009).

7. *Id.* Forty-five percent of IRA assets, or \$1.7 trillion, was invested in mutual funds. Americans held \$3.6 trillion in all employer-based defined contribution (DC) retirement plans, of which \$2.5 trillion was held in 401(k) plans, on June 30, 2009. Those figures are up from \$3.4 trillion and \$2.3 trillion, respectively, on March 31, 2009. Mutual funds managed \$1.8 trillion, or 48 percent, of assets in 401(k), 403(b), 457, and other DC plans at the end of the second quarter. Assets in lifecycle funds grew 22.0 percent in the second quarter.

8. See Employee Benefit Research Institute (EBRI) report "How Distribution of IRA Assets Has Changed Over Time" September 23, 2009, found at <http://www.ebri.org/pdf/FFFE137.23Sept09.Final.pdf> (last visited November 9, 2009). The Employee Benefit Research Institute (EBRI) reports that among IRA assets in 2007, rollover IRAs (assets accumulated in some other account, such as a pension or a 401(k), then moved to an IRA) accounted for 47.3 percent of the total, regular IRAs accounted for 44.4 percent, and Roth IRAs 8.3 percent. Therefore, rollover IRAs in 2007 accounted for a larger share of assets than regular IRAs, while the two together accounted for more than 90 percent of total IRA assets. The study appears in the August 2009 EBRI Issue Brief. Between 2004 and 2007, rollover IRAs surpassed regular IRAs in holding the largest percentage of total IRA assets. Among IRA assets in 2004, regular IRAs accounted for 46.4 percent of the total, rollover IRAs 46.0 percent, and Roth IRAs 7.6 percent. Total IRA assets were \$4.65 trillion in 2007 and \$3.30 trillion in 2004.

1. Real estate has been permitted to be held inside IRA retirement accounts since 1974, under the Employee Retirement Income Security Act of 1974 (ERISA). ERISA, Pub. L. No. 93-406 § 2002, 88 Stat. 829, 958-66 (1974). That act modified rules to allow investors to diversify their holdings to include non-traditional investments, including real estate.

2. An individual retirement account (IRA) is an investment tool that permits qualified individuals to save and invest for retirement, with certain federal income tax advantages.

3. Self-Directed IRAs have been around since 1974, but many investors are unaware of this option and remains one of the least known and unheralded investment vehicles in the vast financial marketplace.

4. See article in *Investment News*, *RIAs Look to Alternative Investments*, by Aaron Siegel, February 12, 2007, found on web at <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070212/REG/70212027/-1/BreakingNews04> (last visited November 10, 2009). The poll included 333 RIAs in November 2006. At the very least there is an educational opportunity. RIAs need to know how such investing should be done. Also, they will be confronted on whether or not an alternative asset is right for the client, and if so, the RIA is going to have to know how to deal with the administration and have an idea of the prohibited transaction rules and possible UBIT and UDRIA to properly advise or conduct due diligence. The poll further found a majority of advisors, 51%, believe retiree clients are hesitant to invest in alternative investments mostly due to a lack of understanding. Other reasons cited were a lack of liquidity, 27%, and a lack of clarity in how alternative investments work in an overall portfolio strategy, 27%.

count?

A self-directed IRA is an IRA in which the account owner has control and decision-making authority over the IRA investments. "Self-directed IRA" does not imply a different type of IRA, or a separate set of IRS rules. The term "self-directed" does not actually have any legal connotation. Self-directed IRAs are similar to traditional IRAs except that a self-directed IRA is one in which the IRA owner is not limited to the IRA trustee's or custodian's investment options, but instead can choose his or her investment options. The IRA owner can still purchase publicly traded investment options such as stocks, bonds and mutual funds as well as non-publicly traded assets like real estate or private placements (pre-IPO stock, Limited Liability Company membership, Limited Partnerships, etc.) Additional investment options permitted under the regulations include, but are not limited to real estate, stocks, mortgages, franchises, partnerships, private equity and tax liens. Self-directed IRAs, by allowing a wide range of investment choices, improve the account owner's opportunities to diversify their IRA portfolio(s).

The Rules for IRAs

An IRA is a federal income tax construct. It is a type of trust recognized by the IRS to hold funds tax-advantaged for the benefit of an individual or the individual's heirs.⁹ The account is set up as a custodial account where the individual account holder is the depositor and owner of the account and a qualified institution serves as a custodian of the IRA under the Internal Revenue Code. An IRA is defined as "a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries" as long as the trust meets certain criteria.¹⁰ It must be established by a written document and must meet all of the requirements of Internal Revenue Code (IRC) 408(a).¹¹

Although the IRC defines an IRA as a "trust," an IRA may also be set up as a "custodial account" that will be treated as a trust for federal income tax purposes.¹² A

9 IRC 408(a); Treas. Reg. 1.408-2(b). An IRA is a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries, but only comes into existence if the written governing instrument meets the requirements set forth in the Internal Revenue Code.

10 IRC 408(a).

11 IRC 408(a) and Treas. Reg. 1.048-2(b).

12 IRC Section 408(h) provides that:

a custodial account shall be treated as a trust if the assets of such account are held by a bank (as defined in subsection(n)) or another person who demonstrates, to the satisfaction of the Secretary [of the U. S. Treasury], that the manner in which he will administer the account will be consistent with the requirements of this section, and if the custodial account would, except for the fact this it is not a trust, constitute an individual retirement account described in subsection (a). For purposes of this title, in the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof.

custodial account for purposes of an IRA is merely a deposit account of an individual that is maintained and held by a bank, financial institution or other person designated by the Secretary of the U.S. Treasury to act as an IRA custodian.¹³ An IRA trustee or custodian must be a bank or another person (nonbank trustee) who demonstrates that the person can and will administer the trust or account in a manner consistent with the requirements of IRC 408.¹⁴ As mentioned earlier, all such IRAs are to be held by a qualified trustee or custodian and must be approved by the IRS to hold IRA assets.¹⁵ An IRA custodial account will be subject to Michigan banking laws if the IRA is administered by a bank or other financial institution that qualifies as a bank under Michigan banking laws.¹⁶ IRAs cannot be self-trusted by the IRA owner.¹⁷

An IRA Must Be in Writing; Model IRA Agreements

Whether an IRA is set up as a trust or custodial account, there must be a written instrument that establishes and governs the trust or account. There is no requirement that any particular form be used to establish an individual retirement account. It is only required that there be a written agreement between the trustee or custodian and the taxpayer that meets certain requirements. The written governing instrument creating the IRA must contain certain provisions that vary based upon whether the plan is created by contribution or by rollover.



IRC 408(h). See also Treas. Reg. 1.408-2 (a), which provides that an IRA must be a trust or custodial account.

13 The IRC and its corresponding regulations related to IRAs do not define what qualifies as a trust or custodial account, nor do they define the difference between the two.

14 IRC 408(a) (2) and Treas. Reg. 1.408-2(b) (2) and (e).

15 The custodian or trustee of an IRA must either be a bank, credit union, or a corporation, subject to the supervision of state banking laws, or a person who meets the requirements of IRC Reg. 5408-2(e)(1).

16 In the case where the IRA is administered by a financial institution or other person who does not qualify as a bank, then the IRA is subject to general contract law, and the relationship between an IRA account owner and a financial institution or other person will largely be defined by the instrument that creates the IRA.

17 See United States Department of the Treasury, Internal Revenue Service, Publication 590 (2008), Individual Retirement Arrangements, ch. 1, available at <http://www.irs.gov/publications/p590/ch01.html>

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The IRS has issued forms 5305 (model agreement for a trust account)¹⁸ and 5305A (model agreement for a custodial account)¹⁹ as Model IRA Agreements. Form 5305A is clear that the IRA owner may direct investments and such direction by the IRA owner will not cause the assets of the IRA to be treated as owned by the IRA owner. Most IRA agreements offer a choice of some sort of institutionally managed product (bank-managed) or what is referred to as a “self-directed” account.²⁰ In the bank-managed product, the IRA owner is asked to select an investment objective and then allows the institution to make investment decisions and trade on the account based upon the investment objective established by the IRA owner. In contrast, a self-directed account will have all of the investments chosen by the IRA owner.

Prohibited Investments and Prohibited Transaction Rules

Prohibited Investments

There are very few restrictions on what a self-directed IRA may invest in. Almost anything that can be documented, other than specific asset types referenced below, can be purchased in a self-directed IRA.

The Internal Revenue Code states there are only two prohibited investments: life insurance contracts²¹ and collectibles.²² Collectibles include any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverages, or any other tangible personal property specified by the Secretary. There are exceptions to what is a collectible—a plan may invest in gold, silver, platinum or palladium bullion and a plan may invest in any U.S.-minted gold, silver or platinum or palladium bullion.²³ To the extent that an IRA invests in a prohibited collectible, that amount is treated as having been distributed to the IRA owner.²⁴

However, there is one more investment that is prohibited, although this restriction is not contained in the IRA-related law, but in the law defining eligible owners for this asset: stock

¹⁸ See United States Department of the Treasury, Internal Revenue Service, Form 5305, available at <http://www.irs.gov/pub/irs-pdf/f5305.pdf>.

¹⁹ See United States Department of the Treasury, Internal Revenue Service, Form 5305A, available at <http://www.irs.gov/pub/irs-pdf/f5305a.pdf>.

²⁰ IRC, 408(h).

²¹ IRC 408(a)(3)

²² IRC 408(m) (1) & (2)

²³ Sections 408(m)(2)(C) and 408(m)(2)(D) of the Code define collectible, for purposes of section 408(m) of the Code, as including any metal or gem and any stamp or coin, respectively. The only exception to classifying bullion as a collectible, for purposes of section 408(m), relates to any gold, silver, platinum, or palladium bullion of a fineness equal to or exceeding the minimum fineness that a contract market requires for metals which may be delivered in satisfaction of a regulated futures contract, if such bullion is in the physical possession of a trustee. This limited exception applies only if a certain type of bullion is in the physical possession of the IRA trustee.

Section 408(m)(3) of the Code provides that for purposes of section 408(m), 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) requires for metals which may be delivered in satisfaction of a regulated futures contract, if such bullion is in the physical possession of a trustee described in section 408(a).

²⁴ See PLR 200732026 and PLR 200732027 where the IRS did not consider money invested in shares of gold and silver ETFs within an IRA to be a distribution subject to an early withdrawal penalty.

in a subchapter “S” corporation.²⁵ The IRS says the only trusts that can be S-corporation shareholders are grant- or type trusts, qualified subchapter S trusts or Electing Small Business trusts. An IRA is not specifically mentioned in the code or regulations, and so is not a trust eligible to be an S corporation shareholder (except in the case of certain S -orporation banks).²⁶ Thus having an IRA as a shareholder in an S corporation invalidates the subchapter S election.²⁷

The Prohibited Transaction Rules

Prohibited transactions are defined at IRC 4975.²⁸ That code section imposes a penalty tax on “disqualified persons” engaged in specified transactions with qualified plans, individual retirement accounts, and individual retirement annuities.

Although there is no provision in the IRC that defines permissible investments, the IRC does address prohibited transactions. The following are prohibited transactions defined in IRC 4975(c) (1):²⁹

- (A) the sale, exchange, or leasing of any property between an IRA and any disqualified person;
- (B) the lending of money or other extensions of credit between an IRA and any disqualified person;
- (C) the furnishing of goods, services, or facilities between any disqualified person and an IRA;
- (D) the transfer to any disqualified person or use by any disqualified person (or for the disqualified person’s benefit) of the income or assets of an IRA;
- (E) an 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
- (F) the receipt by any disqualified person of any consideration in connection with a transaction involving an IRA.

For IRAs, the following definitions of “disqualified person” include, but are not limited to:

- IRA holder (considered to be a fiduciary in a self-directed IRA) See 4975(e) (2) (A)

²⁵ See Treas. Reg. 1.1361-1(h) (1) (vii), which contains an explicit prohibition of an IRA (Roth or traditional) as an eligible S Corporation shareholder. The regulation is effective Aug. 14, 2008. See also Rev. Rul. 92-73 and innumerable private letter rulings, e.g., PLR 200802008.

²⁶ In the case of banks, there is a narrow exception created in Code Section 1361(c) (2) (A) (vi) for stock in a bank or depository institution holding company that was held by the IRA or Roth IRA as of October 22, 2004.

²⁷ IRC 1361(b) (1) (B), (c) (2), (6). In general, S corporation shareholder eligibility is limited to domestic individuals, estates, certain trusts, and certain exempt organizations.

²⁸ IRC 4975.

²⁹ Exceptions to the prohibited transactions are provided in IRC 4975(c) (2).

- IRA holders spouse See 4975(e) (2) (F)
- IRA holder's ancestors See 4975(e) (2) (F)
- Any spouse of lineal descendants See 4975(e) (2) (F)
- Any spouse of lineal descendants of the IRA holder See 4975(e) (2) (F)
- Investment managers and advisors See 4975(e) (2) (B)
- Anyone providing services to the plan See 4975(e) (2) (B)
- Any corporation, partnership, trust, or estate in which the IRA owner individually has a 50 percent or greater interest. See 4975(e)(2)(C), (D), (E),(I),(G), and (H)³⁰

Three factors must be present for a prohibited transaction to exist. There must be 1) a transaction that takes place between 2) the plan (or IRA) and 3) a disqualified person. Provided that an IRA does not engage in a prohibited transaction, alternative types of investments will not disqualify the account and will allow the IRA owner to achieve tax-deferred growth.³¹

Penalties for Engaging in a Prohibited Transaction

If a transaction within an IRA is deemed prohibited, it can result in the disqualification of the entire account as of the first day of the tax year in which the transaction occurred and all assets of the account are considered distributed.³² In this event, the account loses its exemption from income tax and the fair market value of the entire account, as of the first day of the year, is included in gross income.³³ Also, there is a 10-percent early withdrawal penalty if the account holder is less than 59 ½ years of age.³⁴ The penalties for the account holder are severe, but harsh punishment is also foisted upon the disqualified person involved in the prohibited transaction. For the disqualified person involved in the transaction, there is an imposition of an excise tax of 15 percent on the amount involved.³⁵ The disqualified person additionally must pay a 100-percent penalty if the transaction is not corrected within the taxable period.³⁶

30 A sponsoring employer or employee organization, and persons who own 50% or more of them [4975(e) (2)(C), (D) & (E)] 10% or more business partners or joint ventures with persons who are either an employer or employee organization, an owner of 50% or more of an employer or employee organization, or an entity which is itself a disqualified person as a result of being owned 50% or more by specified disqualified persons [4975(e) (2)(I)]

Any entity in which any combination of specified disqualified person have a 50% or greater interest [4975(e)(2) (G)]

An officer, director, highly compensated employee, or 10% or more shareholder of the sponsoring employer, of an employee organization, the owner of 50% or more of an employer or employee organization, or an entity in which the IRA holder or other specified disqualified persons owns 50% or more of the equity in the entity [4975(e)(2)(H)]

31 IRC 408(e) (2), IRC 408 A (a), IRC 4975 (c) (3). It is clear from Private Letter Rulings, Department of Labor Advisory Opinions, and Tax Court Opinions that simple investment in real estate, closely held business interests or other non-stock market types of investments will not disqualify the account.

32 IRC 408(e) (2) (A) and (B). To the extent the prohibited transaction involves a loan or a lease, such transactions are viewed as continuing prohibited transaction and, therefore, are subject to excise taxes for each additional tax year in which the transaction remains uncorrected. See Rutland v. Comr., 89 T.C. 1137 (1987).

33 IRC 4975(a). For traditional IRAs, see IRC 4975(e)(1)(B); for Roth IRAs, see ERISA Op. Ltr. 98-03A (Mar. 6, 1998), and Treas. Regs. 1.408A-1, Q&A-1(b).

34 Id

35 The excise tax is applicable to a disqualified person other than the IRA owner or beneficiary. See PLR 200324018. Also, the IRA account owner cannot reinstate the qualified status of the IRA by correcting the prohibited transaction.

36 Id

Unrelated Business Income Tax And Unrelated Debt Financed Income

Apart from the prohibited transactions listed above, there are additional pitfalls that involve possible Unrelated Business Income Tax (UBIT).³⁷ Retirement plan income that is generated from a trade or business regularly carried on by such account that is not substantially related to its tax-exempt purpose could be subject to UBIT.³⁸ When a retirement account is subject to the tax on unrelated business income, it is generally taxed under the rules and rates that apply to trusts, which is ordinary income at the trust tax rate.³⁹ The tax is payable by the IRA.

An individual can make only cash contributions to an IRA, except in the case of a rollover contribution.⁴⁰ Real estate cannot be contributed to an IRA. However, an IRA can purchase real estate with IRA funds for investment purposes so long as the purchase is not a prohibited transaction under IRC 408(e)(2)(A).⁴¹ The IRA can loan funds as well as borrow funds for the purchase of real estate.⁴²

The IRA can also borrow funds to purchase investment properties under certain conditions.⁴³ This leveraging of real estate can create Unrelated Debt-Financed Income (UDFI).⁴⁴ There are banks that specialize in making loans to IRAs.⁴⁵ When leverage is used to purchase real property in an IRA, a proportionate part of the income, including

37 IRC 408 (e) (1) provides, in general, that IRAs are exempt from taxation. However, section 408(e)(1) also provides that an IRA is subject to the taxes imposed by 511 on unrelated business income of charitable and other tax-exempt organizations. The IRS does not assess this tax, it is reported by the taxpayer on Form 5329, which is attached to Form 1040.

38 IRC 408(e) (1), IRC 408 A (a) and IRC 511 (a) (2). IRC 512 (a) (1) defines the terms unrelated business income derived by any organization from any unrelated trade or business (defined by IRC 513) regularly carried on by it, less deductions allowed. Section 512(b) (3) provides that rents from rental property are generally excluded. IRC 513 defines unrelated business income to mean, in the case of an IRA subject to section 511, any trade or business regularly carried on by such IRA or by partnership of which it is a member.

39 For 2009, taxable income over \$10,700 is subject to 35% maximum federal income tax rate. The first \$1000.00 of unrelated business income is not subject to tax.

40 IRC 408(a)(1)

41 "If the person for whom a regular individual retirement account is established engages in a 'prohibited transaction' with the account, the account will no longer qualify as an IRA (Code Sec. 408(e) (2) (A))."

42 Because financing is so tough to come by in the commercial real estate world now and probably will be for some time, "alternative" financing will need to be found; Hence private investors vs. commercial/institutional money.

Private money from investors can be taxable funds or retirement funds or high net worth investors/families or accredited investors. But in either case, retirement accounts are available for real estate funding, either as debt or equity. If real estate is purchased with debt in an IRA environment, all the same deductions can be used that normally would be to calculate taxable income for regular tax purposes. So in a debt financed situation, tax benefits are not lost at all by holding something in an IRA. On the other hand, if a real estate investment is held in an IRA without financing, most likely there will be positive taxable income which tax will not be on at all (including UBIT) in an IRA. Thus, tax benefits are not lost if the IRA owned property is financed, and if not, there will not be tax at all on the income if it's taxable.

43 For example, the loan must be a non-recourse loan. IRAs are only able to obtain non-recourse loans as the IRA account owner cannot lend personal credit/assets to the IRA (IRC § 4975(c) (1) (b)). Non-recourse financing is going to be about 150 - 250 basis points higher than a traditional commercial loan where they get certain individuals to personally guarantee the loan. There will be more in the way of up front points as well. Usually 2-4% in points up front. There may be shorter term amortizations now as well, 20 years vs. 30 year terms, but that may not always be the case.

44 This is income generated by an IRA, or other retirement plan, through debt-financing or leverage, technically called "acquisition indebtedness" (IRC § 514(b) (1)). UDFI only applies to the profit realized through debt and is based on the average amount of leverage carried within the past 12 months. Any UDFI accumulated is subject to Unrelated Business Income Tax. A percentage that is determined as an average of the acquisition indebtedness divided by the average adjusted basis of the property during the period it's held by the organization during the taxable year is the applied to the income and deductions to compute the amounts to be reported on the unrelated business tax return. IRC 5121(a).

45 For example, North American Savings Bank, F.S.B. Found on web at: <http://www.iralending.com/>

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rental income and gain when the property is sold, is unrelated business taxable income.⁴⁶ Gains from the sale of real estate are generally not unrelated business income, unless the property is inventory or held for sale to customers for a trade or business, or the gain is debt-financed income.⁴⁷

Michigan Self-Directed IRA Case: Aebig V. Cox

For a discussion on the intersection of prohibited transactions rules, disqualified persons, federal law and state law, see Michigan Court of Appeals case *Aebig v. Cox*.⁴⁸ The case dealt with a self-directed IRA that held real property and leased it to a corporation of which the IRA accountholder’s spouse was the sole shareholder. The IRA accountholder had a money judgment against him. The plaintiff sought satisfaction by executing on the property held in the IRA. The IRA accountholder defended against the execution by trying to establish that since the real property was held in an IRA, it is exempt from executions to collect on a judgment provided under MCL 600.6023(1) (k).⁴⁹ The court disagreed

46 IRC 512(a) A percentage is applied to the income and deductions to compute the amounts to be reported on the unrelated business tax return. IRC 514 (a)(1) provides that in computing unrelated business taxable, income under IRC section 512 shall be included with respect to each debt-financed property as an item of gross income, an amount based upon the average acquisition indebtedness with respect to the property. The percentage is an average of the acquisition indebtedness divided by the average adjusted basis of the property during the period it’s held by the qualified organization during the taxable year.

47 IRC 512 (b)(5)

48 *Aebig v. Cox*, Mich.App. No. 258505, May 18, (2006) (unpublished). The case deals with a self-directed IRA, where the debtor’s IRA leased real property to a corporation of which his wife was the sole shareholder. The court held that the real property was not exempt from collection.

49 MCL 600.6023(1) (k). MCL 600.6023 Property exempt from levy and sale under execution; lien excluded from exemption; homestead exemption; rents and profits.

Sec. 6023.

(1) The following property of the debtor and the debtor’s dependents shall be exempt from levy and sale under any execution:

(k) An individual retirement account or individual retirement annuity as defined in section 408 or 408a of the internal revenue code of 1986 and the payments or distributions from such an account or annuity. This exemption applies to the operation of the federal bankruptcy code as permitted by section 522(b) (2) of title 11 of the United States Code, 11 U.S.C. 522. This exemption does not apply to any amounts contributed to an individual retirement account or individual retirement annuity if the contribution occurs within 120 days before the debtor files for bankruptcy. This exemption does not apply to an individual retirement account or individual retirement annuity to the extent that any of the following occur:

(i) The individual retirement account or individual retirement annuity is subject to an order of a court pursuant to a judgment of divorce or separate maintenance.

(ii) The individual retirement account or individual retirement annuity is subject to an order of a court

when it found that the IRA had entered into a “prohibited transaction” under IRC 4975(c) (1) (A) when the IRA accountholder had improperly leased the property to a subchapter S corporation⁵⁰ solely owned by the accountholder’s spouse. As a result, the IRA ceased to be an IRA under IRC 408(e) (2) (A) of the Internal Revenue Code.

The court discussed what a “disqualified person” is in this case. The court recognized that the IRA accountholder’s spouse personally would be a disqualified person because she is “a member of the family” under IRC 4975(e) (2) (F), the definition of which includes a spouse, citing IRC 4975(e) (6). However, since the transaction was between the IRA and the corporation, most of the list of disqualified persons could not apply because it refers to individuals. The court then looked to IRC 4975(e) (2) (G) to disqualify the corporation as follows:

a corporation, partnership, or trust or estate of which (or in which) 50 percent or more of –

- (i) 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,
- (ii) the capital interest or profits interest of such partnership, or
- (iii) 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).

Since the accountholder’s spouse owned more than 50 percent of all stock in corporation that was leasing the property owned by the IRA, and she is a person listed under IRC 4975(e)(2)(A) through (E), the corporation that she owns is a disqualified person.

The court also analyzed direct or indirect ownership under IRC 4975(e) (2) (G). Under IRC 4975(e) (4), “indirect stockholdings which would be taken into account under [26 IRC 267(c)]” are included for the purposes of IRC 4975(e) (2) (G) (i). Among other provisions, IRC 267(c) (2) states:

“[a]n individual shall be considered as owning the stock owned, directly or indirectly, by or for his family.” By operation concerning child support.

(iii) Contributions to the individual retirement account or premiums on the individual retirement annuity, including the earnings or benefits from those contributions or premiums, exceed, in the tax year made or paid, the deductible amount allowed under section 408 of the internal revenue code of 1986. This limitation on contributions does not apply to a rollover of a pension, profit-sharing, stock bonus plan or other plan that is qualified under section 401 of the internal revenue code of 1986, or an annuity contract under section 403(b) of the internal revenue code of 1986.

50 IRC 1361(a)

tion of 26 USC §§ 267(c) (2), 4975(e) (2) (F), and 4975(e) (4), the Account Holder was considered an indirect owner for the purposes of 26 USC 4975(e) (2) (G). Therefore, if either the Account Holder or his spouse qualify under § 4975(e) (2) (A) through (E), the corporation would be a “disqualified person.”

The court also found the account holder was a “fiduciary.” The IRA was recognized as a self-directed IRA since the Account Holder managed and controlled the IRA. As a result, the account holder was found to be a fiduciary of the IRA as defined by IRC 4975(e) (3), since the account holder is one 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 who “has any discretionary authority or discretionary responsibility in the administration of such plan.” Since a fiduciary is a “disqualified person” by operation of IRC 4975(e)(2)(A), then the account holder’s indirect ownership of the corporation leasing property owned by the IRA, as a person described in subparagraph (A), renders the corporation a “disqualified person” under subparagraph (G).

Conclusion

Self-directed IRAs have been an option for investors

since 1974. The use of the technique is growing. Estate planning attorneys may be asked by their clients whether this legal. The Michigan case Aebig demonstrates the technique is recognized and supported in law. An investment advisor can help the client determine whether the investment is commensurate with the client’s goals and expectations, but it is the attorneys that can help the client understand the rules and potential pitfalls of using an IRA to invest in non-traditional and alternative assets. Even though a self-directed IRA can be used to invest in alternative assets, the question for a particular client may be, “Just because it can be done, should it be done?”

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