

IRA INVESTMENT IN REAL ESTATE, CLOSELY-HELD BUSINESS INTERESTS, AND OTHER NON-TRADITIONAL ASSETS

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A. INTRODUCTION.

1. IRA cannot invest in:

- Life insurance contracts on IRA owner.
- Collectibles (coins, artwork, stamps, classic cars, alcoholic beverages, antiques, etc.).
 - But can invest in gold, silver, or platinum coins issued by U.S. or under state law.
- S corporation stock.
 - S stock is not prohibited under IRA rules, but an IRA is not a permissible S corp stockholder.

2. IRA can invest in:

- Real estate (sole ownership or tenancy in common).
- Privately-held C corporation stock.
- LLC membership interests.
- Limited partnership interests.
- Mortgage notes.
- Alaskan sablefish commercial fishing licenses.

3. Self-directing IRAs in non-traditional assets has been well kept secret due to:

- Lack of promotion by financial advisors.
- Lack of public knowledge.
- Lack of qualified custodians.
- Complicated rules.
- Lack of technical understanding of rules by tax professionals.
- Marketing of aggressive schemes.

4. Now the cat's out of the bag:

- Increased press coverage.

- IRA evangelists.
- IRA custodians specializing in handling alternative assets.

5. There is increasing demand for alternative IRA investments:

- \$4 trillion in IRA assets currently.
- \$8 trillion in employer retirement plans.
- 20,000,000 baby boomers reach age 65 by 2010; 75% will roll over to IRA.
- IRA assets will reach almost \$6 trillion by 2011.
- IRA holdings in alternative assets growing at 35% per year.

6. These types of transactions are not limited to traditional IRAs. Investments in alternative assets can be made by Roth IRAs, SEP IRAs, SIMPLE IRAs, solo 401(k) plans, health savings accounts, and participant-directed pension and profit sharing plans with cooperative trustees.

7. SHOULD an IRA invest in alternative assets?

- Possibly, if one can navigate the minefield of:
 - Prohibited transaction rules
 - Plan asset rules
 - Unrelated business taxable income rules
 - Debt-financed income rules
 - Locating qualified custodian (bank, brokerage firm, non-bank trustee meeting stringent IRS requirements)
- Regardless, this is where the money is, and clients are expecting us to assist them with these transactions!

8. Should an IRA invest in alternative assets directly or indirectly through an entity?

- Investment can be made directly by IRA. Investment is titled “[Name of Custodian], Custodian fbo John Smith IRA Acct. No. 12345”
- Alternatively, IRA can invest in entity that in turn acquires targeted investment.
- Advantages of investing through entity:
 - Speed - IRA funds are held in entity account and can be invested quickly when ready.
 - Convenience - other parties may become hesitant if they know an IRA is investing, or they may not be familiar with the technicalities of a direct IRA investment when they are very familiar with traditional entity investments.
 - Privacy - Using an entity results in a veil of secrecy around the identities of the real parties to the transaction.

- Control - it is easier to control the administration of the investment. IRA owner, as manager, may be able to have “checkbook control” of the entity.
 - Asset protection - other IRA assets are not exposed to claims against entity.
 - Lower fees - the custodian’s fees may be lower since it will not be involved in as many transactions and dealings.
- Cautions when investing through entity:
 - Prohibited transactions - analysis becomes more complicated.
 - Plan asset regulations - assets of entity can be considered assets of IRA and managers can be considered disqualified persons (“DQPs”).
 - Unrelated Business Income Tax - profits may be taxable to IRA.
 - Funding restrictions - subsequent advances by IRA can be problem once entity is DQP.
 - Year-end valuations - IRS custodian must submit year-end valuation information to the IRS on Form 5498.
 - No compensation for DQPs - payment of compensation to DQPs usually is an indirect prohibited transaction.
 - Restrictions in organizational documents - capital call provisions, buy-sell provisions, etc. must be carefully reviewed.
 - No review - third party custodian typically will not undertake to review the organizational documents; an attorney or CPA familiar with self-directed IRA rules must do so.
 - Required minimum distributions - if IRA doesn’t have enough non-entity assets, shares of entity may need to be distributed to satisfy minimum distribution requirements.
 - Errors - it's easy for the manager of the entity to make a fatal error that subjects IRA owner to immediate taxation of IRA.

B. PROHIBITED TRANSACTION RULES

1. Prohibited Transactions:

- Section 4975 of Internal Revenue Code prohibits certain transactions between IRA and “disqualified person” (“DQP”).
- Purpose: To encourage use of IRAs for accumulation of retirement savings and prohibit those in control of IRAs from taking advantage of tax benefits for their current personal benefit.
- If IRA violates prohibited transaction rules, it ceases to be IRA (IRC 408(e)(2))
 - IRA is deemed distributed, resulting in taxable income in year of transaction.
 - 10% penalty if not age 59-1/2.
 - For disqualified person other than IRA owner, he or she is subject to excise tax of 15% of amount involved for each year until transaction is

corrected, together with a 100% excise tax if the transaction is not corrected after notification from DOL.

2. Under IRC 4975, "Disqualified Person" means:

- The account owner - YOU.
- Your spouse.
- Your parents and grandparents.
- Your children and grandchildren.
- Spouses of your children and grandchildren (but not parents-in-law).
- Your IRA trustee or custodian.
- An entity more than 50% owned by any combination of the foregoing.
- A 10% owner, officer, director, or highly compensated employee of such entity.
- A trust if 50% or more of the beneficial interests are owned by DQPs.
- Any person providing services to IRA (i.e., CPA preparing IRA tax return).
- If plan asset rules apply, any other fiduciary of the entity owned by IRA.
- Brothers, sisters, aunts, uncles, and cousins are NOT disqualified persons.

3. Types of Prohibited Transactions under IRC 4975:

There are 3 unofficial categories:

- Direct prohibited transactions
- Self-dealing/personal benefit prohibited transactions
- Conflict of interest prohibited transactions

4. Direct Prohibited Transactions:

- IRC Section 4975 prohibits:
 - Sale, exchange, or leasing of property between IRA and DQP.
 - Lending of money or other extension of credit between IRA and DQP.
 - Furnishing of goods, services, or facilities between IRA and DQP.
 - Transfer to or use by DQP of income or assets of IRA (other than regular taxable distributions).
- Examples of Direct Prohibited Transactions:
 - Sue sells interest in real estate owned by her IRA to son.
 - Steve and/or his spouse personally guarantees loan to IRA by bank.
 - John leases real estate owned by his IRA to LLC owned 25% by John, 24% by his wife, and 51% by his father.
 - Paul causes his IRA to buy beach rental house and uses it personally two weeks a year.
 - Joe's IRA buys large tract of undeveloped woodlands, and Joe is looking forward to hunting on it.

- Bill buys beach rental house in his IRA and leases it at FMV to daughter's family for a week.
 - James causes IRA to buy apartment building and personally fixes it up on the weekends (sweat equity not permitted).
 - Sarah's IRA buys 25% interest in corporation owned 30% by Sarah and 30% by daughter.
 - IRA owns 100% of LLC and sells 10% interest to unrelated manager of LLC.
 - Sam locates apartment building he desires to purchase. He signs contract and makes deposit. His IRA closes the purchase and receives title to the apartment, reimbursing Sam for the deposit.
 - Jill owns a rental house in her IRA. The house goes vacant for two months and, since the IRA doesn't have the cash to pay the expenses, Jill pays the expenses while the house is vacant. She intends to reimburse herself from the IRA once a tenant is located.
 - Robert's IRA forms LLC owned 100% by IRA. LLC buys rental real estate. Property goes vacant for two months, and IRA advances additional funds to LLC to fund cash flow deficit.
- ERISA Opinion Letter 2006-09A. Mr. Appelt's son-in-law owned 87.5% and his daughter owned 7.5% of corporation. He wanted to direct IRA to invest in notes issued by corporation. DOL said transaction would be prohibited as loan between IRA and DQP.
 - Gerald M. Harris, T.C. Memo Decision 1994-22. Tax court found direct prohibited transaction occurred when Harris cause his IRA to purchase a home intended to serve as his personal residence, since this would be use of IRA asset by disqualified person.
 - ERISA Opinion Letter 2006-01A. Miles owned 68% of S corp. Miles proposed to create LLC to buy land, build warehouse, and lease it to S corp at FMV. LLC to be owned 49% by Miles' IRA, 31% by Robert's IRA, and 20% by George. Robert was comptroller of S corp. DOL held that Robert was DQP (since he was tantamount to an officer) and that, since Miles' and Robert's IRAs would own more than 50% of LLC, lease would be direct prohibited transaction, essentially looking through LLC and treating warehouse as asset of IRA. DOL ruled that IRA investment involved "arrangement or understanding" that LLC would engage in a lease with a DQP, and thus was direct prohibited transaction.
 - ERISA Advisory Opinion 90-23A. Two attorneys requested approval of transaction in which they would form entity owned by their self-directed IRAs, be officers of entity, cause entity to buy condo from client, and personally guarantee loan. DOL ruled that guarantee would be direct or indirect lending of money or other extension of credit between IRAs and DQPs, and that this could constitute conflict of interest prohibited transaction as well.

- It is clear that all debt incurred in connection with IRA transactions must be non-recourse to IRA and DQPs.
- ERISA Advisory Opinion 97-23A. Pension plan owned 100% of corporation. Plan requested advisory opinion as to transactions between plan and corporation, both at time of establishment and during operation. DOL reasoned that, because assets of corporation were deemed to be assets of plan under the plan asset rules, transactions between plan and corporation, including initial capitalization and transfer of property or services between plan and corporation after formation, would be considered “intra-plan” transactions rather than prohibited transactions between plan and DQP. Note that the court in *Swanson* (below) stated that transfers after initial capitalization would be prohibited transactions.
- Swanson v. Commissioner, 106 T.C. 76 (1996):
 - Important case allowing IRAs to create and invest in entities.
 - Mr. Swanson caused his IRAs to form and own two corporations. He was director of each but never owned any stock himself.
 - Tax Court held that initial formation of company by IRA is not prohibited transaction - a newly-formed, uncapitalized entity is not a DQP until the equity interests are initially issued. The initial capital contribution was not a prohibited transaction although the IRA ended up with 100% of the company.
 - Court also held that receipt of dividends by IRA from company was not prohibited transaction, since this is a "settlor function".
 - Court also held that Mr. Swanson's performance of management functions, as director of the corporations, was not a prohibited transaction.
 - Court stated that, after creation, entity becomes DQP. Therefore, any subsequent advances by IRA to LLC would be prohibited.
- IRS Field Service Advisory 200128011.
 - Dad owned majority of S corp. His 3 children owned remaining shares.
 - Dad and each child created self-directed IRAs. Each IRA acquired 25% of foreign sales corp (FSC).
 - S corp entered into commission agreement with FSC.
 - IRS advised that, based on *Swanson*, neither issuance of stock in FSC to IRAs nor payment of dividends by FSC to IRAs constituted direct prohibited transaction.
 - IRS warned that, based on facts, transaction could be indirect prohibited transaction benefiting IRA owners (discussed further below).
- Example.
 - John creates new entity initially owned 50% by his IRA, 25% by John, and 25% by John's son.
 - Each capitalizes entity proportionately.

- Creation and capitalization of entity should not be prohibited transaction in light of *Swanson* and FSA 200128011.
- Once entity is capitalized and funded, it becomes a DQP, and subsequent funding by IRA probably constitutes a prohibited transaction.
- Subsequent dealings between them must be closely scrutinized. Potential to cross the line in subsequent transactions is substantial.
- However, mere payment of dividends and participation in management functions should be permissible under *Swanson*.
- *Swanson* dealt with corporations wholly-owned by IRAs, and doesn't expressly approve joint formation of entity by IRA and DQPs. Many advisors are comfortable *Swanson* would extend to this as well.

5. Self-Dealing/Personal Benefit Prohibited Transactions:

- IRC section 4975 also prohibits:
 - Indirect use of IRA income or assets for benefit of DQP.
 - Act by DQP who is a fiduciary whereby he deals with income or assets of IRA in his own interest or for his own account.
 - Receipt of any consideration by DQP who is a fiduciary for his own account from any party dealing with IRA in connection with transaction involving income or assets of IRA.
- Examples:
 - Purchase of LLC interest requires \$100,000 minimum investment. Steve can't afford to invest with non-IRA assets, so invests \$25,000 individually and \$75,000 from IRA.
 - John invests his IRA in a real estate deal and receives a brokerage commission.
 - Jane wants to buy \$150,000 rental house. She needs to invest \$50,000 in rental house to get \$100,000 non-recourse loan. To come up with the money, she invests \$10,000 individually and \$40,000 through her IRA.
 - Sue's IRA invests in a private equity deal promoted by her son-in-law's investment banking firm. Son-in-law receives a bonus based on total placements originated.
 - Ben wants to use his IRA to buy restaurant. IRA creates LLC and capitalizes it with IRA cash. Ben serves as manager of LLC, runs the restaurant, and draws a salary.
 - Ben wants to use his IRA to invest in commercial real estate. IRA creates LLC that buys properties. Ben doesn't draw salary but manages checkbook, makes bank deposits, and pays all LLC expenses ("checkbook control"). This may itself not be a prohibited transaction, but many temptations result from checkbook control and IRS/DOL scrutinize such transactions closely.
- Rollins v. Commissioner, T.C. Memo 2004-60.
 - Rollins owned his own CPA firm. He was sole trustee of its 401(k) plan.

- Rollins caused plan to lend funds to 3 companies in which he was largest (9% to 33%), but not controlling, stockholder.
 - Companies had 28, 70, and 80 other stockholders respectively.
 - Rollins made decision for companies to borrow from 401(k) plan.
 - Loans were demand loans, secured by each company's assets. Interest rate was market or higher. However, the same terms probably would not have been available in an arm's length deal with a bank.
 - Rollins signed loan checks for plan and signed notes for borrowers.
 - All loans repaid in full.
 - Tax court held loans were prohibited transactions, since Rollins couldn't prove loans were not use of plan assets for his own benefit.
- ERISA Opinion Letter 93-33A.
 - Robert wanted to use his IRA to buy land and building of high school founded by his daughter and son-in-law.
 - Presumably, this was non-profit organization, without stockholders.
 - Robert's IRA would buy at FMV and lease back to school at FMV rent or lower rent depending on school's ability to pay.
 - Daughter and son-in-law were sole directors and officers of school.
 - DOL stated that proposed transaction would be use of IRA assets for benefit of daughter and son-in-law (DQPs).
- ERISA Opinion Letter 2000-10A.
 - Leonard and his family owned less than 50% of investment partnership.
 - Leonard wanted to open self-directed IRA and invest \$500,000 of IRA assets in partnership.
 - Unrelated person would manage investments.
 - DOL stated that it was not direct prohibited transaction, but it would not rule on whether IRA investment was part of agreement that caused IRA assets to be used for benefit of Leonard.
- PLR 8717079.
 - Ned was accounting manager and 1 of 7 members on Board of Directors of company. Owned less than 1% of common stock.
 - Ned proposed to cause his IRA to buy 100 shares of company stock.
 - Total investment by Ned and IRA would still be less than 1%.
 - IRS ruled that it was not direct prohibited transaction, but that it might be prohibited transaction "benefiting" Ned based on facts and circumstances at time transaction occurs.
- PLR 8009091.
 - George was director of Corp A but not employed by it.
 - Was also President of Corp B, which owned 35% of Corp A.
 - George proposed to cause his IRA to buy up to 5% of Corp A's stock.
 - IRS ruled that it was not direct prohibited transaction, but that if George were to benefit from transaction (such as insuring his reelection to Board of Corp A

or improving his position as President of Corp B), transaction would be prohibited.

- PLR 9119002.
 - Corp was 100% owned by Tom's wife. Tom was co-trustee of its pension plan.
 - Plan made loan to partnership 39% owned by Tom.
 - IRS ruled it was prohibited transaction since Tom was dealing with plan assets for his own account.
 - See PLR 9208001 for same result in similar situation.

- Greenlee v. Commissioner, T.C. Memo 1996-378.
 - Greenlee was sole participant in pension plan maintained by her 100% owned company. Plan had independent trustee (other than Greenlee).
 - Greenlee requested trustee to make loan from plan to company in which she owned 18% interest. Trustee did so.
 - IRS contended that this was prohibited transaction due to personal benefit to Greenlee. Tax court disagreed and found decision of independent trustee kept this from being prohibited transaction.

- ERISA Advisory Opinion 2006-01A. Miles proposed to cause his IRA to purchase 49% of LLC that would purchase land. IRA would build warehouse and lease it to corporation in which Miles and his wife owned 68% of stock. DOL held that even if plan asset rules (discussed below) did not apply, transaction was prohibited since it was part of an arrangement or understanding in which it was expected that a DQP would benefit.

6. Conflict of Interest Prohibited Transactions:

- IRC 4975(c)(1)(E) and (F) preclude transactions by DQP who is a “fiduciary” under which he deals with IRA assets in his own interest or for his own account, including receipt of consideration in his own account. These are known as the conflict of interest provisions.

- IRS and DOL often take position that any transaction in which fiduciary has conflict of interest is prohibited under these sections.

- It is important to note that transaction does not have to involve DQP to be prohibited as conflict of interest.

- Applies any time fiduciary's interest in other parties to transaction affects his independent judgment. Reg. Section 52.4975-6(a)(5)(i).

- IRS Field Service Advisory 200128011 (discussed above). "If the facts were such that the IRA owners' interests in the transaction because of their ownership of [a corporation doing business with company owned by IRAs] affected their best

judgments as fiduciaries of the IRAs, the transaction would violate section 4975(c)(1)(E)."

- PLR 9119002.
 - Corp A owned by Tom's spouse. Tom was co-trustee of Corp A's pension plan.
 - Plan made loan to partnership in which Tom owned 39% interest.
 - IRS found indirect prohibited transaction occurred, stating that "these prohibitions are imposed upon fiduciaries to deter them from exercising [fiduciary authority] when they have interests which may conflict with the interests of the plan for which they act. "

- ERISA Advisory Opinion 88-18A. Mr. Darragh owned 48% of stock of Darragh Company and was employee and on its Board of Directors. He proposed to lend money from his IRA to Darragh Company. DOL found this was not a direct prohibited transaction, but that Darragh Company was a party in which he had an interest, that this might affect his best judgment as a fiduciary, and therefore loan would be act of self-dealing under 4975(c)(1)(E). See also ERISA Advisory Opinion 89-03A.

C. ENTITY LOOK-THROUGH RULES

1. Sufficient Control Rule.

- According to IRS and DOL, transaction between DQP and entity partly (or wholly) owned by IRA is prohibited if IRA and its DQPs have sufficient voting control to cause entity to effect transaction and transaction otherwise would be prohibited if directly between IRA and DQP. 29 CFR 2509.75-2(c); IRS Notice 2004-8; ERISA Opinion Letter 2006-01A; Interpretive Bulletin 75-2.

2. Plan Asset Regulations; 29 CFR 2510.3-101.

- If 100% of "operating company" is owned by one or more IRAs and DQPs, assets of company are deemed IRA assets (even though IRAs owned by unrelated persons).
- If 25% or more of "investment company" is owned by IRAs and DQPs, assets of company are deemed IRA assets. In determining whether 25% threshold is met, **all** IRAs are considered, even if owned by unrelated individuals.
- "Operating company" is entity engaged in production or sale of product or service other than investment of capital.
 - Includes a "real estate operating company", where at least 50% of assets are invested in real estate which is managed or developed; company has right to substantially participate directly in management or development activities; and company in ordinary course of its business engages directly in such activities.

- Includes “venture capital operating company” investing at least 50% of its assets in venture capital investments or derivative investments and exercising management rights with respect to one or more operating companies in which it invests.
 - Consequence of being under plan asset rules:
 - All assets of entity deemed owned by IRA.
 - Transaction between entity and DQP can be prohibited transaction.
 - Fiduciaries of entity deemed fiduciaries of IRA, which expands the list of potential DQPs one must be concerned about.
 - Examples:
 - Laura's IRA owns 100% of Alpha, LLC. Alpha makes loan to Laura's son. Loan is direct prohibited transaction, since loan is deemed to be made by IRA.
 - Ben's IRA owns 20% of Beta, Inc., an investment partnership. John's IRA owns 10% of Beta, Inc. Ben and John are unrelated. Because IRAs own more than 25% of Beta *in the aggregate*, assets of Beta deemed owned by each IRA. If Beta makes loan to Ben's son, loan is direct prohibited transaction.
 - Ben's IRA owns 30% of Delta, LLC, an investment partnership. Jerry is general manager of Delta. Ben and Jerry are unrelated. Ben's IRA is deemed to own assets of Delta, and Jerry is deemed to be fiduciary of Ben's IRA. Sale of Delta stock by IRA to Jerry, or sale of asset owned by Delta to Jerry, is direct prohibited transaction.
 - ERISA Advisory Opinion 97-23A. Pension plan owned 100% of corporation. Plan requested advisory opinion as to transactions between plan and corporation, both at time of establishment and during operation. DOL reasoned that, because assets of corporation were deemed to be assets of plan under the plan asset rules, transactions between plan and corporation, including initial capitalization and transfer of property or services between plan and corporation after formation, would be considered “intra-plan” transactions rather than transactions between plan and DQP. Note: the court in *Swanson* stated that transfers after initial capitalization would be prohibited transactions.
3. Even without plan asset rules, IRS or DOL might challenge transactions as indirect prohibited transactions benefiting DQP or conflict in interest transactions.

D. WHAT ISN'T A PROHIBITED TRANSACTION?

- Any clean, honest transaction not involving related party that IRA owner or other DQP does not, directly or indirectly, contribute to or benefit from.
- In other words, avoid IRA owner or other DQP wearing two hats.
- Examples:
 - IRA buys rental properties managed by third party management company.

- IRA buys stock in start-up bank or private equity deal in which IRA owner is no more than passive investor.
- IRA buys mortgage notes from unrelated mortgage holders.
- IRA buys one of limited number of commercial fishing licenses thru lottery and "flips" it to unrelated fishery at significant profit.
- Settlor and ministerial functions are not prohibited transactions. *Swanson*; DOL Advisory Opinion 2000-10A.
 - Receipt of profit distributions from entity owned by IRA. *Swanson*.
 - Basic management functions. *Swanson*.
 - Initial decision of IRA owner to invest IRA in entity or real estate.
 - Decision of IRA owner regarding which property manager IRA should hire.
 - Decision of IRA owner to make capital improvements to real estate owned by IRA.
 - Serving as manager of LLC without compensation to handle basic management functions (as opposed to working full-time for free).
- "Incidental" benefits (i.e., public recognition) are not prohibited transactions. ERISA Advisory Opinion 2000-10A.
- Bottom-line:
 - There is no way to guarantee that IRA transaction in which IRA owner or other DQP is involved in some other capacity would not be challenged by IRS or DOL.
 - IRS/DOL have too many tools and application of them is based on facts and circumstances.
 - Either be conservative and avoid temptations or risk adverse tax consequences on audit.

E. ANATOMY OF PROPERLY CONSTRUCTED REAL ESTATE PURCHASE BY IRA

- Ben Smith locates apartment complex to purchase.
- Ben rolls over IRA money to qualified IRA custodian who accepts real estate investments.
 - It's important just to roll over enough to do transaction and keep each transaction in separate IRA. That way, if prohibited transaction occurs in one, it will not taint others.
- Ben negotiates deal but IRA custodian signs purchase contract.
- Ben locates attorney or title company to close transaction, but they are engaged by custodian.

- Custodian sends closing proceeds from IRA to attorney/title company.
- If financing is involved, financing must be non-recourse and mortgage note must be signed by custodian.
- Attorney/title company pays purchase price and closing costs out of escrow.
- Deed issued to IRA Custodian fbo Ben Smith IRA.
- IRA purchases property insurance.
- Ben locates property manager who is engaged by custodian.
- Property manager leases units, collects rents, pays operating expenses, withholds commission, and sends check for net rental proceeds to IRA.
- All future expenses and capital improvements must be paid by IRA.

F. UNRELATED BUSINESS OR DEBT-FINANCED INCOME

In addition to prohibited transactions, there are two other potential minefields to navigate when investing IRAs in alternative investments:

- Unrelated business income tax (UBIT)
- Unrelated debt financed income (UDFI)

1. Unrelated Business Income Tax.

- IRAs and qualified retirement plans (as well as charities and other non-profit entities) are subject to UBIT rules. Rationale is that exempt organizations should not receive tax break for business activities not substantially related to performance of exempt purpose.
- Net business income generated by IRA is generally subject to current taxation under IRC Section 511 at trust income tax rates.
- IRA owner must report on Form 990-T.
- UBIT is taxed twice -- when earned and when distributed (no tax basis for previously taxed UBIT).
- Examples:
 - Net income from operation of restaurant owned by IRA.
 - Net income from sale of products by company owned by IRA.

- Typically, business is operated by LLC or limited partnership owned by IRA.
- Doesn't apply to IRA-owned C corporation, only businesses directly owned by IRA and pass-through entities owned by IRA.
- Depreciation and other deductible expenses taken into account.
- Exceptions to UBIT:
 - First \$1,000 of net income.
 - Dividends and interest.
 - Royalties.
 - Rents (unless based on percentage of tenant's profits).
 - Gains from sale or exchange of property (except inventory)
- See IRS Publication 598 on UBIT.

2. Unrelated Debt Financed Income (UDFI).

- Net income generated from debt financed property is subject to UDFI even if it would not be subject to UBIT.
 - Applies to dividends, interest, royalties, rents.
 - Applies to gain from sale or exchange of property (unless financing is paid off at least 12 months earlier).
 - UDFI is calculated on pro rata basis, in proportion to current balance of acquisition indebtedness incurred to purchase the property:

Net Income from property during tax year (determined using straight-line depreciation)

TIMES

Average acquisition indebtedness during tax year

Average adjusted basis during tax year

- UDFI is calculated at trust tax rates, except for capital gains rates on sale of property.
- Proportionate share of depreciation and other deductible expenses taken into account in calculating net income.
- Qualified plans have exception for mortgages used to finance purchase or improvement of investment real estate. This doesn't apply to IRAs. IRC 514(c)(9)(C).

- Example: IRA buys rental real estate for \$100,000 funded with \$50,000 IRA cash and \$50,000 non-recourse mortgage loan. Current year net income is \$11,000. UDFI determined as follows:

\$11,000	Net income before excluded amount
X	
<u>.50</u>	UDFI factor
\$ 5,500	
(1,000)	Excluded amount
\$4,500	Unrelated business taxable income
X	
<u>.20</u>	UBIT effective tax rate on \$4,500
\$ 900	UBIT
\$10,100	Cash-on-cash return - 20% based on \$50,000 invested

3. Strategies to Avoid or Ameliorate UBIT/UDFI.

- Invest outside of IRA (but IRA is where the money is, and alternative IRA investment might outperform traditional nontaxable IRA investment notwithstanding tax burden).
- Use Roth IRA to avoid potential double tax when IRA is distributed.
- Have IRA invest in C corporation instead. Dividends to IRA are tax-free.
- Structure transaction as convertible debenture, so that equity interest is not obtained until entity has appreciated and it's time to sell.
- Structure transaction as an option.

G. REAL LIFE EXAMPLES.

1. Investment in Website.

- Larry has invested significant time and money developing website and has secured valuable Internet domain name.
- Larry wants to set up LLC to promote the website. Larry (himself) has valued the website/domain name at \$150,000. He wants his IRA to purchase 25% membership interest in LLC for \$50,000. Larry will acquire 75% membership interest in exchange for conveyance of his rights in website/domain name to LLC. Larry is manager of LLC and will serve without salary (he has another full-time job).

- Issues raised:
 - Simultaneous investment by IRA and Larry should be OK under *Swanson*.
 - Valuation by Larry is problematic -- if valued too high, he is getting disproportionate benefit of IRA cash; but if too low, he in effect has made excess contribution to IRA. There clearly is a conflict of interest here.
 - It should be OK for Larry to be manager and have checkbook control, but improper use of LLC could result in indirect prohibited transaction -- the temptation will be great.
 - If Larry quits his job and starts drawing salary from LLC, this will be a prohibited personal benefit.
 - Assets of LLC will be deemed IRA assets under “sufficient control rule” (page 10 above) and under plan asset regulations. Even though this is an operating company, IRA and its DQP own 100%. If Larry lends LLC cash to himself or pays a personal expense, this will be a direct prohibited transaction.
 - All profits of LLC will be UBIT, unless Larry elects to tax LLC as C corporation.

2. Family Farm.

- Ralph owns 32%, brother owns 32%, sister-in-law (widow of his other brother) owns 32%, and cousins own balance of family farm. Ralph has been managing farm operations by working with sharecroppers, paying 50% of costs, and receiving 50% of revenues. Has been receiving \$500 annual management fee. Ralph has been filing annual Form 1065, reporting farm profits as partnership income to family.
- Cousins want to give their interests to Ralph to avoid pesky K-1s each year. Also, sister-in-law wants to sell her 32% interest. Ralph is willing to buy it, but only available funds are in his IRA.
- Ralph rolls over IRA to custodian who accepts real estate investments. At simultaneous closing, (a) Ralph and brother convey their interests in farm to LLC as initial capital contributions, (b) IRA contributes cash to LLC as initial capital contribution, (c) LLC buys sister-in-law’s interest, and (d) cousins deed their interests to LLC.
- Issues raised:
 - \$500 management fee might be prohibited personal benefit. Ralph agrees to give up management functions and management fee. LLC hires outside farm management company.
 - IRA’s share of farm profits may be UBIT to IRA.
 - Valuation of farm interests should be by independent appraisal to avoid issues raised in website example above.
 - Objectives met, and Ralph, brother, and IRA now have limited liability protection.

3. Personal Residence.

- Sam has financial troubles. To increase his cash flow, he wants to use his IRA savings to pay off debt, without distributing IRA and paying taxes.
- Sam's plan is that his son and an unrelated friend will form LLC, owned 49% by son and 51% by friend. IRA will make loan to LLC. LLC will purchase Sam's home and another property carrying high debt. Debt will be paid off, and Sam will lease home back from LLC.
- Issues raised:
 - Sam is clearly receiving a personal benefit from transaction, so IRS/DOL probably would view it as self-dealing.
 - Based on ERISA Opinion Letter 2006-01A (page 5 above), there was "arrangement or understanding" that home would be leased to Sam, so this probably constitutes a direct leasing of property between IRA and DQP.

4. Investment in Business.

- Sally is CEO of LLC and owns 17%. She also is on Board of Directors. LLC is making a new offering, and Sally wants to purchase \$70,000 of the new offering in her IRA. After the offering, the IRA will own 10% and her own ownership percentage will drop to 12%.
- Issues Raised.
 - This is not a direct prohibited transaction since LLC is not a DQP. The plan assets rules do not appear to apply. Therefore, the issue is whether Sally receives an impermissible personal benefit.
 - Because she already serves as CEO and on the Board, IRS would have to stretch to find personal benefit. If IRS can show the IRA investment somehow secures her position as CEO or Board member or affects her compensation, the investment would be prohibited. However, this is likely a safe transaction.
 - The IRA most likely will have UBIT from the LLC interest.

5. Purchase of Business.

- Steve wants to form an entity that will buy a business. He plans on participating in management, as a Board member and possibly in some other role, but not be employed by the business. He will personally invest "about" 50% of funds, and there will be other unrelated investors. He wants to use his IRA to purchase "some" of what he will invest.

- Issues Raised.
 - As long as transaction is simultaneously funded and Steve limits his role to basic management, this should not be direct prohibited transaction under *Swanson*, even if Steve and IRA together own more than 50%.
 - If they do own more than 50%, subsequent transactions between IRA and business are prohibited, since business becomes a DQP.
 - If they do own more than 50%, transactions between business and Steve must be closely scrutinized, since assets of business are deemed owned by IRA under sufficient control rule.
 - It's important to analyze whether IRA investment could be prohibited as result of indirect personal benefit to Steve. For example, if Steve bought 45% and IRA bought 10%, the 10% IRA investment might give Steve voting control, which would increase value of his own 45% interest. The IRA investment would "enable" Steve to do things with and receive value for his 45% interest that he couldn't otherwise.
 - If business is LLC, Steve's IRA likely will have UBIT.

H. DOES IRA INVESTING IN NON-TRADITIONAL ASSETS MAKE SENSE?

- Turns capital gain into ordinary income, but this is true of any other IRA investment. Fact is, tax can be deferred for decades and this makes up for tax rate differential over long term.
- UBIT can be a problem, but typically doesn't apply to most real estate investments by IRAs.
- UDFI is a concern but frequently is manageable.
- Long-term financial comparisons from purchase to sale can show better after-tax results though IRA investing in income-producing property through use of debt financing as opposed to buying it outside of IRA under same terms.
- Very beneficial if real estate bought and sold frequently, since eliminates frequent taxation events and complexities of like-kind exchanges.
- Bottom line is you can't really compare investing inside and outside of IRA, because IRA is where the money is. Must compare to other types of IRA investments.
- Clients will be presented with deal opportunities, and IRA may be only uncommitted cash available for investment.
- It's our job to be open-minded, know the rules, and help clients make informed decisions.

For more information:

- Pensco Trust Company -- www.penscotrust.com
- Entrust Administration -- www.entrustadmin.com