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I. The Do's and Don'ts of self-directed investing with retirement accounts

a. Understanding Prohibited Transactions

It is important that the IRA owners understand the rules surrounding IRAs, and more specifically, self-directed IRAs, before investing. There are certain rules and regulations that must be taken into consideration to avoid having your IRA disqualified under the law. RITA and its membership are committed to informing the public and their customers of these rules and in helping them understand them through their proactive educational and informational efforts. For example, the following discussion will help you understand the general prohibitions when transacting with your IRA.

Before we begin exploring the do's and don'ts of self-directed IRA investing, it is important to understand what a self-directed IRA or pension plan (e.g., Solo 401(k)) is and isn't. The term "self-directed" is not a technical or legal term, but rather a descriptive term relative to how the IRA is managed. "Self-directed" essentially means that the IRA (or plan) owner or someone *the IRA Owner* appoints, makes all the investment choices and decisions for their IRA. One can have a self-directed IRA at a brokerage firm or a specialist self-directed IRA custodian such as the members of the RITA Association. The primary difference between these two types of self-directed custodians is that brokerage firms and traditional banks that offer self-directed IRA

services, generally restrict investments to publicly-traded assets such as stocks and mutual funds; whereas, truly self-directed custodians will consider providing opportunities to invest in all legally acceptable investments.

The second important thing to know about self-directed IRAs is that they may belong only to a single individual person and are unique by taxpayer ID. Except for some IRAs established for employees in an employment context, IRAs are not subject to ERISA, so the restrictions placed on fiduciaries of pension plans that are subject to ERISA (such as prudence and diversification standards and foreign investment restrictions), generally do not apply to IRAs. IRAs are governed by IRC section (408) , whereas pension plans, are governed by IRC sections 401, 403, and 457.

Because IRA investments made at firms like those in RITA are not restricted to traditional assets like stocks and mutual funds, there are innumerable ways to invest through self-directed IRAs and an unlimited array of investment choices. However, there are some investment types and some transactions that are prohibited for all IRAs, including self-directed IRAs, that you must be aware of in order to avoid jeopardizing the status of your IRA, and exposing it and you to taxes and penalties. The following, therefore, we will review the basic tax rules regarding IRA investing, while providing you with a general understanding of the legal framework from which the rules flow.

b) The Basics

First of all, a summarized explanation of the basics of what not to do can be found on the IRS's own web-site (www.irs.gov) in Publication 590. These can generally and easily explained by saying that there are:

1. **three asset types that you can't invest in, and**
2. **that neither you nor any other “disqualified person” may, under the tax laws, engage in self-dealing with your IRA.**

Other than the explanation of the detail behind the last sentence, that's what you need to know in a nutshell. Self-dealing means essentially that neither you or any other “disqualified persons” may use your IRA to obtain a personal benefit other than what you receive as a by-product of your IRA's growth. People either ignorant of the rules or desiring more benefit from transactions than the law allows can jeopardize their retirement savings by exposing their retirement accounts to taxes and penalties as consequences of created a “prohibited transaction”. Again, generally speaking, prohibited transactions involve any attempt to gain a personal benefit as a byproduct of your IRA's or pension plan's transaction(s). This is otherwise known as the “exclusive benefit” rule.

Fundamentally, you should understand that IRAs were created as part of the ERISA Act in 1974 (the primary purpose of which was to bolster and reform the pension laws), to provide individuals an alternative way to save for retirement. Benefits, in the form of increasing contribution limits and more flexibility in transporting retirement funds between the various types of pension plans, have increased over time as the government began recognizing the importance of IRAs as part of an individual's overall retirement plan. It may well be that the increasing awareness, of not only the importance of IRAs to

their owners, but the overall size of the IRA market (\$3.7 trillion in 2010), has stimulated an increased interest on the part of the IRS and the Department of Labor (DOL to protect IRAs from disqualification), the latter of which has jurisdiction over determining prohibited transactions.

c) Who can hold your Self-directed IRA?

The IRS has jurisdiction over IRAs and the Internal Revenue Code that defines and governs IRAs, including determining which institutions are eligible to maintain custody of them. Essentially, any bank, credit union or state chartered financial institution (e.g., trust company) is automatically qualified to have custody of IRAs based on their approval and acceptance by a regulating body such as a state banking commissioner or the FDIC, etc. Any institution that is not in that class, must apply and be approved by the IRS in order to be a custodian of IRAs. There are currently about 270 such institutions, called "non-bank custodians", so approved in the U.S. today (e.g., broker/dealers, mutual funds companies, etc.). **If your company is neither in the "banking" group, nor approved by the IRS, then it may not offer IRA custodial services directly. If you place your IRA with an institution that is not authorized as described above, you face the risk that your IRA will be invalidated and that you will be subject to taxes and penalties.** So, a word to the wise, please be sure to determine that the institution with which you place your IRA is duly chartered in one of the two alternative classes described above. If it won't supply you evidence of its status upon request, keep moving. **It should be noted that all RITA members are regulated and authorized to provide custodial services for IRAs.**

d) What you can't invest in

While it is essential that the institution that holds your IRA is authorized to do so, the likelihood that you find yourself with a firm that is not, is not very high. But, in any event, there are several types of actions that you, as the IRA owner, could inadvertently or deliberately take that are impermissible. The simplest one to describe has to do with the type of investment you make with your IRA. As previously alluded to, there are only three types of investments that your IRA *cannot* make:

- 1) collectibles (e.g., stamps, antique furniture, jewelry, art, rugs, alcoholic beverages, 1957 Corvettes, etc.), or anything the U.S. Treasury deems to be a collectible;**
- 2) life insurance; and**
- 3) stock of a subchapter "S" corporation.**

In terms of collectibles there are many other examples (not specifically defined in the IRS code) of what the IRS and DOL might consider to be a collectible. For example, gold coins (other than U.S. Gold eagles) such as Kruggerands, are not permitted investments. Certain other metals and gold that is at least 94% pure are permitted.

While the tax laws also prohibit IRA investment in life insurance, it is important that we clarify what is meant by that prohibition. Essentially, you cannot as the IRA owner invest in life insurance on your own life or that of a disqualified person. After all that

wouldn't help you in retirement, because you wouldn't cash in until you cashed out.

However, ironically, the former is an option under many pension plans and 401(k) plans.

While it is clear that an IRA owner cannot purchase life insurance on his own life (with the exception of certain pension plans) it is also apparent, but not clear, that you can purchase life insurance with an IRA. However, industry practice over the past 18 years would indicate that you may be permitted to purchase a life insurance policy on someone else's life, provided that that person is not a "disqualified person", a term which will be defined later (below). Suffice it to say, at this point, that a "disqualified person" can be defined as yourself, your spouse, any lineal ascendant or descendant or any spouse of a descendant, and certain companies related to you and certain persons within those companies. So, in effect, it appears that you may purchase a life insurance policy on the life of a sibling or unrelated person under the regulations, however, because of the "exclusive benefit" rule, your IRA can be the only beneficiary of such a policy.

So, we now know that an IRA owner cannot purchase a life insurance policy on his own life, nor anything deemed a collectible:

- Artwork;
- Rugs;
- Antiques;
- Most Metals;
- Gems;
- Stamps;

- Alcoholic Beverages; and certain other tangible property
- Coins: An exception allows your IRA to invest in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins, and one-ounce silver coins minted by the Treasury Department. It can also invest in certain platinum coins and certain gold, silver, palladium, and platinum *bullion (94% in purity)*.

There is another problematic investment or asset type for those who have an IRA, and that is the stock of a sub-chapter "S" corporation. While it is not a prohibited transaction for the IRA to make a purchase of the stock of a sub "S" corporation, **it is prohibited for the "S" corporation.** Simply stated, an "S" corporation is not permitted to have an IRA as a shareholder. In fact, the consequence of an "S" corporation allowing and having an IRA investor is the loss of the status as an "S" corporation. That is, there is a very limited time that an "S" corporation can "undo" such an investment by an IRA before it reverts to be a "C" corporation, substantially changing its tax status. Therefore, RITA members will not knowingly invest IRAs in their custody into "S" corporations*.

So, If you stay away from investing in a life insurance policy on your own life with your IRA, don't invest in anything that is on the defined list as a collectible (or which could be "deemed" to be a collectible), and avoid capital investments in "S" corporations, you have addressed one-half of the concerns related to prohibited transactions!

* If you want to extend a loan to an "S" corporation with your IRA, in most cases, you'll be able to do that.

e) What are "prohibited transactions"?

With the exception of three asset types discussed above, **you can invest in virtually any other asset type with an IRA**, and the fact is, that you have been able to do so since 1974, when IRAs were first created! Real estate and private equity are the most common non-traditional asset classes that self-directed retirement account owners invest in, but the possibilities are quite extensive, as long as you follow the rules.

Most people who first hear about the possibilities, react with surprise. For years, they have heard from traditional IRA providers that such investments with IRAs were illegal, extremely complicated and expensive, very risky, or any combination of the previous answers. Rest assured that there innumerable investments beyond the stock market that are legal and possible investment types for self-directed retirement accounts, provided that the nature of the transaction between their IRA and the investment itself does not violate the prohibited transaction rules that we are now going to explore.

f) Exclusive Benefit Rule

First, we need to highlight the one fundamental rule that applies to all IRA investments. That rule, the exclusive benefit rule, states that only the IRA can benefit from the transaction. That makes sense, when you think about the fundamental purpose of an IRA or Individual Retirement Arrangement (the legal term for an IRA). The government created IRAs at the same time it passed legislation (known as Employee Retirement

Income Security Act or ERISA) to put controls over employer sponsored pension plans to prevent abuses by fiduciaries who were, theretofore, misusing or stealing the pension funds of their employees. To further protect future retirees, the government created IRAs to allow them to save for retirement independently from employer-sponsored plans. Unfortunately, the government had to step in again 30 years later with the Pension Protection Act of 2006, to prevent new abuses such as what happened to wipe out Enron and WorldCom employees' retirement accounts.

But what do we mean by the exclusive benefit rule in the real world?

- Basically, neither the IRA owner nor any other "disqualified person" may receive a personal benefit as a result of a transaction by his or her IRA.

It is almost that simple if not for the plan asset rule, and other elements of IRC 4975, which we will discuss later. So, for example, you cannot extend a loan from your IRA to yourself or any direct relative (remember "disqualified person"), even though (believe it or not), because of a Department of Labor (DOL) Prohibited Transaction Exemption (PTE) called 80-26, that you can actually lend money to your own IRA in limited circumstances! A more basic example of a violation of the exclusive benefit rule, would be purchasing a vacation home that you were using personally. No, you can't vacation in your IRA owned vacation home (even for a weekend). And, furthermore, you can't use the property even if you pay rent, because from the government's perspective you are receiving a personal benefit. You can't even buy raw land and hunt on it with your

friends. In simple terms, the consequence of an IRA owner or beneficiary engaging in a prohibited transaction is severe. Essentially, you lose the tax-exempt status of your IRA from the first day of the year in which the prohibited transaction occurs, resulting in a taxable distribution of your entire IRA balance (unless it is a Roth, in which case only the earnings the IRA earned up to the time of the deemed distribution are taxed), plus a 10% penalty if this occurs before you are age 59 1/2, plus penalties and interest if the taxes weren't paid on time!

g) Disqualified Persons

Above we used the term “disqualified person”. It is essential that you understand the meaning of this term, as that understanding will make it easier for you to avoid creating a prohibited transaction. If your IRA engages in a transaction with a disqualified person, in most cases a prohibited transaction will result.

Disqualified persons include*:

1. Yourself as the IRA owner;
2. Your spouse;
3. Your ascendants;
4. Your descendants;
5. The spouses of your descendants;
6. Certain entities that you and other disqualified persons in relation to your IRA own 50% or more of (this will be elaborated on later in the review).

There are a few other less common parties who are considered disqualified persons including fiduciaries like your custodian. The exact list can be found in IRC 4975 (site).

The rules stipulate that you cannot deal with disqualified persons when transacting with your IRA. The following limited examples may help to clarify what would be considered prohibited under the rules:

1. Lending money to yourself from your IRA;
2. Selling or transferring an asset you own personally to your IRA
(unless it was previously owned by your pension plan);
3. Buying your mother a home with your IRA;
4. Buying a rental condo in the Caribbean with your IRA and
vacationing there while it is owned by your IRA;
5. Purchasing a rental property with your IRA and receiving the rental
income personally.

These are just a few examples of dealing with disqualified persons with your IRA. Simply dealing with unrelated third parties when buying, selling, transferring assets, eliminates 99.9% of potential prohibited transactions.

But if you continue reading, we will continue to review what to avoid so as to protect your retirement savings. Let's begin by using an example of self-dealing. Suppose you agree to have your IRA purchase a rental property from someone you are not directly related to and then you rent it to another unrelated person. Ok, right? There are no disqualified persons and no personal benefit. Your IRA will receive the rent, and you will not. Yes, this is fine. However, suppose this agreement is matched by the person you are renting to, and they agree with you to have their IRA or their personal funds buy

another rental property that they will then rent to you. This type of pre-conceived quid-pro-quo (a pre-conceived reciprocal agreement) is called a "step" or "linked" transaction by the IRS, because it is nothing more than a scheme to avoid an otherwise prohibited transaction, and is, therefore, tantamount to a prohibited transaction and will be treated as such.

h) How to determine if you are creating a prohibited transaction?

How do you know when you might be engaging in a prohibited transaction? One of the first things you can do is to identify all of the players involved in the IRA transaction. First there is your IRA, which will fund the investment, then there is you, the IRA owner, and by definition a disqualified person. Are there any other disqualified persons involved in any way with the outcome of this investment? Are you getting any benefit personally from your IRA's transaction? An example may be helpful to explain how this could occur, even innocently. Suppose you are a real estate broker, many of whom, because of their real estate knowledge and interest, use their IRAs to purchase real estate. You find a seller with a nice property that you'd like to put in your IRA. Of course, as a real estate broker working on the seller's behalf, you are due a commission. Is it going to create a prohibited transaction if you collect a commission on this transaction? What do you think? Yes, you are correct, that taking a commission on a purchase involving your IRA will constitute a prohibited transaction as you are personally receiving a benefit from your IRA's transaction. Suppose you are selling a property that your IRA owns. Can you

then charge your IRA a commission? No, you cannot for the same reasons in the first example. Staying with this basic example, suppose your son was also a broker with your firm, could he sell the property to your IRA and take a commission? No, as he is a disqualified person in relation to you and your IRA as he is your descendant.

Suppose you don't take a commission, but you handle the sale. Is that OK? (Stronger position and not just maybe) Maybe. As long as you are just performing ministerial duties (e.g., basic paperwork) and are not providing the types of professional services that normally would be compensated for, you should be fine. However, it is probably advisable to have some other broker (unrelated to you), handle the sale. That broker can then get a commission. Can you have an understanding with that broker that he will do the same thing with his IRA, allowing you to obtain a commission by selling property to his IRA? You should know the answer to that by now. Yes, you are correct in assuming that doing so would be considered a "step transaction". Any such similar quid pro quo arrangements that are pre-conceived in an attempt to avoid directly running afoul with prohibited transactions will not pass an IRS or DOL examination.

Many people suggest that it should be OK if their IRA deals with a disqualified person as long as there is no advantage gained over what might be obtained by two unrelated parties engaging in the same transaction. That is, the transaction is consummated at true fair market value. They would add that their IRA benefits financially in the deal. This argument may be successful to avoiding a prohibited transaction, but only if you request and obtain a prohibited transaction exemption (PTE) from the Department of Labor

before you engage in the transaction, because asking for an exemption after the fact will not suffice.

One of the reasons and one of the sections of the Internal Revenue Code (IRC) that has a significant impact on the ability to transact freely with your IRA, is IRC section 4975. Spending a little time reviewing this IRC section should help give you perspective on how the IRS or DOL might react to an investment scenario if you were audited .

As previously mentioned, the fact that a transaction between disqualified person (e.g., buying a condo with your IRA for your daughter to use while attending college) was executed at fair market value is insufficient to protect the transaction from being considered prohibited primarily because of the rules within IRC 4975. Therefore, it is essential that we cover the main points of this IRC section. First, generally speaking as previously defined, any transaction between an IRA and a disqualified person (owner, spouse of owner, lineal ascendants and descendants, and spouses of lineal descendants, for the most part), is a prohibited transaction. Siblings, ironically, are not disqualified persons, Specifically, the IRC prohibits any:

- sale or exchange between an IRA and a disqualified person;
- loan or other extension of credit between an IRA and a disqualified person
- furnishing of goods, services, or facilities between an IRA and a disqualified person
- 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.

In layman's terms, and by example, you cannot use your IRA to buy ("sale or exchange") your father's farm when he retires, extend a loan ("extension of credit") to your son for the down-payment on the purchase of his first home, nor park your car on the vacant lot ("facilities") owned by your IRA.

Well, what does this all mean? First, it takes three elements to create a prohibited transaction:

- 1) A plan (pension) or an IRA;
- 2) A "disqualified person"; and
- 3) A transaction between 1 and 2 above.

But, IRC 4975 goes on to say that in addition to the previously defined list of "disqualified persons" in relation to IRAs, the following are also classified as disqualified persons:

- 1.) Any entity that is 50% or more controlled or 50% or more beneficially- owned (including attribution from family members, partners and through other entities) by the IRA's owner;
- 2) Any officer, director, 10% shareholder, partner, or individual earning 10% or more of the annual wages of an entity identified in 1); or
- 3) Any IRA trustee or custodian and/or service provider and individuals and entities related to them.

The IRS is saying that if your interest, including any indirect interest through specified relatives, etc., is equal to 50% or more in an entity, your IRA may not transact with that

entity, because the entity is thereby deemed to be a disqualified person. If you and your wife owned 49% of an entity and the remaining 51% was owned by unrelated partners or entities, then your or your wife's IRA could buy out the other partners to end up owning 100% of the entity if you wanted to. The key, in this example, is that at the time of transaction execution, you can't have a 50% or more interest. This rule must be inviolate: failure to comply results in the creation of a prohibited transaction.

In terms of the second point, if the entity is deemed to be a disqualified person by virtue of satisfying item 1 above, then your IRA cannot transact with these individuals whose circumstance match or exceed those outlined in point 2. Lastly, you cannot deal, nor can the entities listed in point 3 above, with your IRA. For example, you cannot co-invest with the custodian of your IRA. The Pension Protection Act of 2006 enacted a new exemption that allowed certain sales and loans with non-fiduciary service providers if certain conditions are met.

i) Certain Exemptions from Otherwise Prohibited Transactions

There are certain exemptions from otherwise prohibited transactions. One interesting exemption that many are not aware of, is that an individual IRA owner or other disqualified person can extend an interest-free, unsecured loan to an IRA for either a purpose incidental to the ordinary operation of the IRA, or for payment of ordinary operating expenses, including payment of benefits. This exemption can be found in PTE

class Exemption 80-26 (and related 2002-13). So if you held a rental property in your IRA that you had a mortgage on and you lost your tenant, you could lend money to your IRA to pay the mortgage. Ironically, you cannot pay the mortgage personally for your IRA, though. Also, you cannot, under this exemption, lend money to augment or support a new investment not held in your account at the time of the loan. If the loan to the IRA will be outstanding more than sixty days, the IRA owner must provide the IRA custodian with a note, indicating the debt obligation by the IRA to its owner.

A statutory exception under IRC 4975(d)(2) allows for a contract or reasonable arrangement between an IRA and a disqualified person for office space, or legal, accounting or other services necessary for the establishment or operation of the IRA , provided no more than reasonable compensation is paid. However, other rules generally prohibit the disqualified person from receiving compensation for permitted services. On the other hand, “sweat equity” might be viewed as “imputed income”, which can also be a problem. Generally, because of overlapping and contradictory rules, it is not advisable without legal advice to have any transaction with a disqualified person.

j) Co-investment rules

One of the important things to understand is that, in most cases, your IRA may co-invest with disqualified persons including yourself, friends, family, third parties (including entities) and any other IRAs or pension plans you may have. DOL Advisory Opinion 2000-10A outlines the caveats, however, including the fact that you have to be in a

position to prove that you could have accomplished the transaction without the use of your IRA (to avoid a PT for enabling). For example, if you have additional financial resources that could be used (e.g., a home equity loan, another qualified pension plan or IRA, a stock brokerage account, etc.), but you chose your IRA to co-invest with because it was convenient or because it was a good investment for the IRA, you should satisfy the exemption. The advisory also warned that a PT could occur if a conflict between the IRA and IRA owner develops at some point and the IRA owner fails to resolve it. Unfortunately, no examples are provided nor are any acceptable solutions. It is important that co-investment involving disqualified persons is executed simultaneously. For example, it would not be permissible to purchase a home for your son with your IRA one week, and have him compensate you or your IRA the next (either directly, or by investing in the property). But under 2010-10A you may jointly purchase the home, provided there is no debt, and you purchase the property from someone other than a disqualified person.

**k) The Swanson case-the seminal case supporting
complete ownership of businesses by IRAs**

The most important case supporting the ability to form an entity 100 % owned with funds exclusively from IRAs is *James H. Swanson and Josephine A. Swanson, Petitioners V. Commissioner Of Internal Revenue, Respondent*. This case serves as a precedent from the Tax Court supporting the idea that an IRA can fund and own an entire business, and as a result has been the basis of many similar transactions with IRAs and the funding of

many American startup companies. Because of the importance of this case in terms of capital formation in this country, we will be reviewing it here in detail.

In Swanson versus the Commissioner (106 Tax Court 76 (1996), the Tax Court held in favor of a taxpayer (Mr. Swanson) who appealed a case that he lost to the IRS.

Essentially, the IRS claimed he had created a prohibited transaction when his IRA purchased all of the initial stock of a company he incorporated. The Tax court held for the taxpayer (Swanson) and against the IRS and **ruled that the initial and complete capitalization of a corporation by an IRA was not a prohibited transaction.**

Basically, the Tax Court concluded that the corporation (since it had no owners prior to the transaction), was not a disqualified person. Furthermore, the IRS has seemingly accepted the verdict as evidenced by its Field Service Advisory 2001-28011. As a result of Swanson, most professionals feel that any percentage ownership through an initial capitalization by an IRA or the IRA and IRA owner investing simultaneously, under the Swanson logic, is not a prohibited transaction. Consequently, many American startup companies have been capitalized either entirely by an IRA and any combination of disqualified persons and others in the U.S. The ability to do so often creates confusion with IRC 4975, which prohibits an IRA from investing in an entity, owned 50% or more by the IRA owner and related persons. The subtle difference is that at formation, the entity has no (zero) ownership.

Specifically, the taxpayers involved filed a joint return as husband and wife. However, the IRAs involved were owned solely by the husband. At the instigation and direction of

the husband, his IRA initially and fully capitalized a Domestic International Sales Corporation (a DISC), . The company was named Swanson's Worldwide (SW). Another IRA initially and fully capitalized another corporation, which apparently transacted business with the DISC or vice-versa, but that is another story and not relevant to the significance of the findings on the major points of Swanson and their implication to similar investment scenarios.

This Tax Court held, in favor of Mr. Swanson, that the initial and full capitalization by formation of a company by an IRA is not a prohibited transaction, but that thereafter that company would be a disqualified person. The Swanson case decision supports the notion that the mere formation of a business by the IRA alone, or by reasonable extension, between an IRA and unrelated parties (or for that matter, related parties) is not a prohibited transaction. For these and other reasons, the *Court agreed that the IRS was not substantially justified in maintaining that prohibited transactions had occurred*. The IRS had based their determination on 4975(c)(1)(A) and (E) which includes the following prohibitions:

- sale or exchange or leasing of any property between a plan and a disqualified person;
- 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.

The IRS position, as set forth in the opinion, was that Mr. Swanson was a disqualified person as a fiduciary because he had the authority to control the investments of his IRA.

Following the IRS case which found in favor of the IRS, Mr. and Mrs. Swanson (petitioners) filed a motion for partial summary judgment on March 22, 1993. In their motion, petitioners restated their position (as set forth in their petition), that no prohibited transactions had occurred with respect to Mr. Swanson's IRA.

Surprisingly, on July 12, 1993, the IRS filed a notice of no objection to petitioners' motion for partial summary judgment, thereby ending the controversy on the charges of the first case and the loss of tax-exemption for Mr. Swanson's IRA. After the agreed summary judgment, Mr. Swanson then requested an award for litigation costs against the government, on the grounds "that the position of the United States was 'not substantially justified.'" The Court approved his grant request.

In short, the Appeals Court determined that no prohibited transaction occurred in relation to a sale or exchange between the plan (IRA) and a disqualified person (in this case, Mr. Swanson). They also concluded that he did not act in his own interest as a fiduciary in his use of plan assets. The Court opined that the stock acquired in the transaction was newly issued and that prior to that point in time, SW had no shares or shareholders.

The upshot of this case for all IRA owners and entrepreneurs are profound. Essentially, the Swanson case is the legal precedent to the legality of having an IRA purchase and operate an entire business to generate returns to benefit the IRA. Thus, an IRA can own and operate a pizza parlor, a gas station, an Internet web-site, a cattle business, a solar-

energy business, a franchise, etc. It should be noted, when an IRA operates a business, that unless the business involved is a "C" corporation, it will be subject to Unrelated Business Income Tax (UBIT) (because other entity structures such as an LLC are pass-through from a taxation perspective). **Investors in such businesses are therefore strongly advised to consult with their tax advisors before investing in a business with their IRAs or pension plans.** In addition, there are still clearly certain other rules that have to be considered, primarily the fact that the IRA owner cannot receive any personal benefits as a result of his IRA's investment in the business (e.g., be a paid employee or occupying space for personal use in the building housing his IRA's business, or many similar scenarios). You would be well-advised to consult with knowledgeable attorneys who may assist you in the review of a planned IRA investment that involves a startup, to ensure that you are not violating the prohibited transaction rules. Be sure to validate the credentials of any lawyer you select, to be sure he or she is familiar with this area of the law.

It is important to understand, that the mechanics of how an organization that you intend to start up and fund with your IRA are critical to avoiding a prohibited transaction. For example, you cannot initially organize the company with yourself personally as the incorporator in the paperwork filed with your state; that is, your IRA has to be named the incorporator. Also, you have to recognize that your IRA owned company cannot employ you personally, at least in the beginning, until you bring other unrelated investors who have a legitimate reason (e.g., to pick the best man or woman to employ to benefit of their own investment in your firm), to hire you and set your salary. It is also advisable to

put specific language in your operating agreement or by-laws prohibiting self-dealing and prohibited transactions so that the rules aren't unintentionally violated. Again, if this is something you want to pursue, we suggest you obtain the services of a business attorney familiar with the related IRA rules. Of course, if you are going to hire others to perform the work in your IRA owned company (as long as they are not otherwise disqualified persons), you will avoid many potential problems with the rules.

1) DOL Plan Asset Rules

The DOL's Plan Asset rules essentially define when the assets of an entity are considered 'Plan' assets (under the laws, IRAs are frequently viewed as pension plans as in this case). If aggregate plan and IRA ownership of any class of equity interests in an entity is 25% or more the assets of the entity are viewed as assets of the investing IRA or plan for purposes of the prohibited transactions rules, unless an exception applies. Among the exceptions are public investment companies and "operating companies", such as companies that either do real estate development, venture capital or companies making or providing goods and services (e.g., a gas station).

One example can help to explain how the plan asset rules come into play when analyzing the potential for a prohibited transaction between an entity with plan investors and a disqualified person in relation to one or more of those plans. Let's assume you have a General Partner of a hedge fund that also wishes to invest his IRA in the hedge fund he manages. If the percentage of IRA and plan ownership, including what it would be after

the General Partner invests his IRA in the fund, equals or exceeds 25% of any class of equity interests, then the fund's assets are considered "plan asset." That means that a transaction between him, as a disqualified person, and the fund, could be deemed a prohibited transaction because the assets of this entity are viewed as assets of his IRA, and as we know, a disqualified person cannot transact with the assets of his plan or IRA. Because of this, the General Partner, cannot receive benefits from his IRA (a fund investor). Thus the General Partner, would need to exempt his IRA from fees he would otherwise charge, because he would be receiving a personal benefit from his IRA. This prohibition for the General Partner applies even if plan assets are less than 25% of total assets. Also, if a plan (including an IRA) or group of related plans owns 100% of an operating company, the operating company exception discussed above will not apply -- the company's assets will still be treated as plan assets.

There are a couple of interesting quirks to the Plan Asset rules. For example, the Department of Labor (DOL) plan asset rules only talk of related plans, and not parties that are not plans that may also be related to the plans. Second, the DOL has taken the position that, even if the assets of an entity are not plan assets of an IRA, a prohibited transaction could still occur if a disqualified person of that IRA enters into a pre-arranged deal to obtain a personal benefit (e.g., an employment contract) from the company as a result of his IRA's investment in the company (i.e., that was the finding in the Department of Labor's 2006-1A finding that will be discussed later).

m) The Rollins Case

"Rollins v. Commissioner" was a tax court case where the court ruled, based on the facts and circumstances that the taxpayer was engaging in prohibited transactions that were the result of his using plan assets for his personal benefit. Despite the fact that the entities dealing directly with the plan were not disqualified persons, the court ruled that Mr. Rollins directed that plan assets be used in way that provided him a personal benefit. This case thus creates uncertainty as to the outcome of any transaction that in any way involves an IRA that benefits, even indirectly, a disqualified person. A similar Department of Labor (DOL) ruling called 2006-1A also extends the potential for a negative finding on potentially prohibited activity where they determine that the purpose of the transaction is to benefit a disqualified person.

The specifics of "Rollins" case are as follows:

- Mr. Joseph Rollins (Rollins) was the 100% owner of his accounting corporation, Rollins & Associates, P.C. (RA).
- RA sponsored a 401(k) profit sharing plan (Plan).
- Rollins was its sole trustee.
- Rollins was also sole owner of Rollins Financial Counseling (RFC)
- Rollins' professional credentials include: CPA, RIA, CFP, ChFC, and Certified Employee Benefits Specialist.

As described in the court case, Mr. Rollins' advisory firm (RFC) entered into an agreement with his accounting firm (IRA) for financial counseling service. The agreement provided that Rollins (as CEO of RFC) would make all investment decisions on behalf of RA. Mr. Rollins was also sole owner of Rollins Financial Counseling, which made all of the Plan's investment decisions. The Plan lent funds to three businesses in which Rollins was, at the time, the largest (between 8.93% and 33.165%), but never a controlling, shareholder or partner. These three businesses had 28, more than 70, or more than 80 other shareholders or partners. Therefore, the entities that his plan lent to were not disqualified persons under 4975 (that is he did not own 50% or more interest in them), and, in isolation, there was no apparent transaction between a disqualified person and the Plan.

Mr. Rollins made the decisions to lend from his pension plan (for which he served as trustee) to the businesses involved. All the loans were demand loans, secured by all the borrowers' machinery, property, and equipment. Interest rates on the loans were market or better and Mr. Rollins signed the loan checks on behalf of his Company's (RA) Plan and he signed the notes on behalf of the borrowers (the companies in which he was invested).

In addition, Mr. Rollins would have to authorize actions by the Plan to collect on loans should borrowers default on repayment. Ultimately, all loans were paid back in full, although Rollins helped one firm by lending it funds to allow it make its payments.

So how and why did the Court rule against Mr. Rollins? First, Rollins was a disqualified person (ownership of Plan and status as Plan fiduciary). There is no doubt about that. However, he was apparently only directing his plan to make the loans. So where is the prohibited transaction? The IRS contention was that there was a transfer of assets for the benefit of a disqualified person (4975 (d)), because the loans enabled businesses in which Rollins owned interests to operate without having to borrow funds at arm's length from other sources. They also maintained that because Rollins was a fiduciary with conflicting interests and that brought him within the scope of 4975(e), 'disqualified person who is a fiduciary dealing with plan income or assets for own interest or account', and the Tax Court agreed that loans were a prohibited transaction pursuant to 4975(d).

Mr. Rollins' argument was that the loans were good investments for Plan, and that the companies were not disqualified persons and that the loans were at market rates. The court felt otherwise, and interpreted that he would not have been able to obtain the same loans from the private sector.

n) Roth IRA abuses

Because of the fact that Roth IRA distributions are potentially exempt from income tax, the IRS is concerned that taxpayers will self-deal or over-contribute to maximize their gains from the tax-free aspects of Roth IRAs and to avoid the limitations on Roth IRA contributions. To the IRS, this is not clever strategizing by the taxpayer, but tax evasion! A case in point, is IRS Notice 2004-8.

In this scenario, a Roth IRA owner, a business he owned, and a corporation which was substantially owned by his Roth IRA, were involved in a transaction. The Roth-owned company received property from the company owned by the Roth IRA owner. The IRS issued guidance (Notice 2004-8; IRB 2004-4) which is designed to **shut down abuses involving indirect contributions to Roth IRAs**. In short the IRS Notice indicated that such strategies were considered abuses and, therefore, dictated the U.S. Treasury Department list-keeping and registration requirements for tax shelter arrangements that are "listed transactions." The guidance addresses situations in which value is shifted into an individual's Roth IRA through transactions involving entities owned by the individual and certain related persons. For example, a business owned by the individual could sell its receivables for less than fair value to a shell corporation owned by the individual's Roth IRA. This scheme artificially shifts taxable income away from the individual's business into the shelter of the Roth IRA structure. The IRS said, "In effect, this is a disguised contribution to the Roth IRA and the notice makes clear that it will be treated as such." Furthermore, in the scenario discussed in IRS Notice 2004-8, the value shift was at a value below fair market value, which the IRS viewed as a violation of the rules.. The requirement to list any transaction that essentially appears similar to the particulars of Notice 2004-8, should not be taken lightly as the penalty for failure to "list" or report such a transaction to the IRS, even if it is not considered a prohibited transaction, is substantial!

o) Be careful of subtle self-dealing

An estate planning attorney decided to ask the Department of Labor to evaluate a transaction that one of her clients was contemplating, to see if they viewed the transaction as prohibited under IRC 4975. Essentially, two IRA shareholders (Messrs. "B" and "R") are to invest in an LLC (which is considered a real estate operating company (REOC) by virtue of the fact that its purpose is to buy land, build a warehouse and lease the warehouse to an "S" corporation), The LLC's ownership is as follows:

-49% owned by Mr. B's IRA;

-31% owned by Mr. R's IRA , and;

-20% owned by a Mr. "G" (who is also a 32% owner (personally) of the "S" corporation along with 68% ownership by Mr. B and his wife as community property).

According to the plan asset rules discussed earlier, because the LLC is a real estate operating company, its assets are not considered plan assets as a result of Mr. G's (who is not a disqualified person in relation to Mr. B and Mr. R) ownership and that of two unrelated IRAs. Therefore, because the entity's assets are not plan assets of any IRA, and, therefore a transaction between the LLC and a disqualified person (the "S" corporation) should not be a prohibited transaction (plan +disqualified person + transaction =prohibited transaction). To help clarify, the "S" corporation is a disqualified person in relation to Mr. B's IRA because it is 50% owned by him and his wife. For that reason, if the LLC was entirely owned by Mr. B's IRA, there would be a clear violation of IRC 4975.

So what is the problem, because we know that the LLC is not tantamount to Mr. B's IRA because the LLC's assets are not considered plan assets of any IRA? What rule was to be broken from the DOL's view? The DOL's analysis was based on an ERISA anti-abuse regulation (29CFR 2509.75-2(a)). This regulation explains that a transaction between a disqualified person, such as the "S" corporation in this case, of an IRA and an entity that does not have plan assets of that IRAs generally not considered a prohibited transaction. However, the regulation states that when a plan (Mr. B's IRA) invests in an entity for the purpose of having that entity engage in a transaction with a disqualified person (the "S" corporation), on a pre-arranged basis, then that is tantamount to a prohibited transaction. Specifically, due to the leasing of the warehouse, the violation is the use by or for the benefit of a disqualified person of plan assets. The DOL also stated that this may be self-dealing as well by virtue of Mr. B, as a disqualified person as fiduciary of his IRA, engaging in a prohibited self-dealing transaction (using his IRA to purchase property to be leased by a corporation that he holds a 50% interest in).

What is the lesson to be learned from DOL 2006-1A? That the understanding of whether or not a prohibited transaction is being created when your IRA invests can be daunting? Possibly, but let's change this scenario a little to try to simplify things in your mind. Assume the same ownership in the LLC, but now assume that neither Mr. B nor his wife has an interest in the "S" corporation. Do you think that a prohibited transaction would occur if the LLC leased the warehouse to the "S" corporation? Assuming there are no

other facts in the scenario that would give rise to the possibility of a PT, then no, there would probably be no prohibited transaction.

Now suppose Mr. B's wife had a 49% or less interest in the "S" corporation and the LLC's ownership remained as well, this can be a little complex. First, the "S" corporation would not be a disqualified person under 4975, and, therefore, on its own, the transaction with the LLC would not be considered prohibited, unless, the DOL determines that the transaction Mr. B engaged in as the fiduciary of his IRA was intentionally designed to gain a personal benefit through his relationship with his wife a large shareholder of the "S" corporation. Sound familiar? This would be similar to what happened in Mr. Rollin's case, however, Mr. Rollins' scenario included a pattern of multiple similar transactions that aggravated claims against him by the tax court. It is quite possible, that proper legal counsel, could set up a structure and process to establish that self-dealing was not occurring in the last example.

The moral to this story, however, is if, when you look through all the entities that your IRA may investing in, and you see yourself or another disqualified person (such as your daughter) benefiting from your IRA's transaction, it is at least time to consult a knowledgeable attorney before proceeding or to abandon the transaction altogether. Otherwise, at the very least you are playing Russian roulette with the DOL and IRS.

p) Consequences of Creating a Prohibited Transaction

Now that you know what not to do, what happens if you do make a mistake and create a prohibited transactions? First, in most cases you can correct it within 14 days without consequence, particularly if there was an administrative error by your custodian or administrator. Otherwise, the consequence will be that your IRA will be treated as distributed to you at the fair market value retroactively determined on the first day of the year of the occurrence of the prohibited transaction. If you have assets and not cash in your IRA, those assets will be treated as being owned by you personally, and not by your IRA. You will have to pay tax on the value of those assets and/or cash as of the tax year in which the prohibited transaction occurred, plus any taxes, penalties and interest as a consequence of not having paid them at the time.

q) Final Thoughts

There are tremendous opportunities for wealth creation through self-directed IRAs without exposing your retirement plan to risk from attempting to have your "cake and eat it too". If you are knowingly attempting to obtain a personal benefit through your IRA's investment, our advice is to stop right there. There are no legitimate workarounds. Finally, additional and more technical explanations and RITA's policies related to them can be found on our website as well, in the Legal and Regulatory section.

r) Summary of what to do and not to do

The Don'ts:

- 1. Don't** create a prohibited transaction by having your IRA transact with yourself personally, your spouse, descendants, or ascendants (e.g. avoid self-dealing);
- 2. Don't** engage in a transaction with your IRA and a third party's IRA on a "quid pro quo" or reciprocal basis in attempt to circumvent an otherwise prohibited transaction;
- 3. Don't** deal with an entity that you or the some of your related disqualified persons own 50% or more of;
- 4. Don't** personally guarantee a loan that your IRA obtains;
- 5. Don't** make personal (including disqualified persons) use of any asset your IRA owns;
- 6. Don't** provide more than ministerial services (e.g., decision-making) to your IRA or IRA owned entity (e.g., no "sweat equity");
- 7. Don't** take any personal compensation for any services provided to your IRA or as a result of a transaction that your IRA participates in;
- 8. Don't** engage in any transaction that results in any personal gain (e.g., a guarantee of employment) for you or your disqualified persons (other than the benefit that the IRA receives);
- 9. Don't** co-invest personally with your IRA in any asset that you use as a loan collateral;
- 10. Don't** take constructive receipt of any income from assets owned by your IRA and do not pay (personally) the expenses of assets held by your IRA.

The Dos:

- 1. Do** consider including alternative assets in your retirement portfolio for diversification and risk protection;

- 2. Do** consult with a knowledgeable advisor when in doubt.
- 3. Do** educate yourself. Read all the free educational material on our website or on those of our members;
- 4. Do** consider using an IRA when you, a relative or friend starts a new business.
- 5. Do** consider your Roth IRA for those investments with the greatest upside potential;
- 6. Do** consult a tax accountant if you are considering using leverage when investing;
- 7. Do** maximize your contributions to 401(k)s that are matched by your employer and contribute to Roth IRAs each year, if eligible;
- 8. Do,** if you are a professional consider learning more about self-directed IRAs as a means to stay at the forefront of the knowledge curve;
- 9. Do** tell your friends about the possibilities of self-directed IRAs - they'll thank you;
- 10. Do** consider getting your children started on saving for retirement and education while they are young by establishing a Roth IRA or Coverdell Education Savings Account.

