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Self-Directed IRA Myths

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Introduction

A search of the internet quickly reveals that there are hundreds, if not thousands, of websites promoting one of the hottest financial concepts – the so-called "self-directed individual retirement account." These range from sites offering simple "hands off" custody and recordkeeping services, to traditional broker-dealers marketing trading accounts, to promoters of "how to" books, to what amount to little more than modern-day snake-oil sales pitches. Similarly, bookstore shelves are lined with guides to building IRA wealth through non-traditional investments.

Many of these products are quite legitimate, and the sponsors work hard to provide meaningful information to help accountholders distinguish between legally acceptable investment practices and activities that may result in unfavorable tax consequences or, worse, complete loss of the tax-advantaged IRA status. Sometimes it is simply impossible to cover a subject in a comprehensive manner, and the materials warn accountholders to hire knowledgeable counsel. Nonetheless, in the opinion of the author, ***most*** of these materials perpetuate certain myths – even among the lawyers – that range from merely incomplete to outright wrong.

Why? In part, because neither the Internal Revenue Service ("IRS") – which has jurisdiction over IRAs themselves – nor the Department of Labor ("DOL") – which has jurisdiction over prohibited transactions – has in the past devoted significant resources to IRA issues, nor have the two agencies devoted much effort to coordinating their views. Thus, while a great deal of learning has developed under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), in connection with qualified retirement plans, in many cases this information has not carried over to IRAs. Until the last few years, most IRAs were small, and were marketed as "retail" products by different channels (and sometimes different financial institutions entirely) from those that dealt with the "institutional" ERISA market.

What are some of these myths? Mainly, they are concepts that have arisen in connection with the establishment of a limited liability company ("LLC") as a wholly-owned subsidiary of an IRA, for the purpose of making non-traditional investments – what are often called "alternative investments" on the institutional side – *i.e.,* things other than traditional mutual funds, stocks and bonds such as venture capital, real estate, derivatives and the like. These myths include the following, all taken verbatim from various self-directed IRA websites:

- **"There appears to be no question that funding the LLC after the IRA's initial purchase of shares constitutes a prohibited transaction because the LLC becomes a disqualified entity after funding."**

  Comment: As discussed below, we believe this is simply ***wrong***.

- **"Once the LLC is funded, you no longer need the custodian to write the checks. The LLC can write its own checks, and since you're the manager, you have control."**

  Comment: Though this *may* be the right answer, the author has not seen a single IRS ruling that confirms this is correct in the case of an LLC owned 100% by an IRA. (Where the IRA owns less than 100%, the authorities are somewhat clearer.) The Swanson case, discussed below, emphatically *does not* support this conclusion. There are good legal reasons why this may be ***false***.

- **"If you and your brother had a company and you owned 49.5%, then your IRA could buy, sell or loan to it without penalty."**

  Comment: Wrong – this is a highly risky proposition. Ironically, the DOL advisory opinion most frequently cited as *support* for the proposition that this is not prohibited actually says that a prohibited transaction is ***likely*** to result.

- **"Can I make a loan to my brother, aunt, cousin or stepchild so that they can use the money as a down payment on a home? Yes. According to IRC 4975, siblings, aunts, uncles, cousin and "step relations" are not included in the definition of disqualified persons. Thus any dealings between your IRA and these would not be a prohibited transaction."** (A variation on this is that you can hire your brother to manage real estate owned by your IRA, and pay him a salary with IRA assets.)

  Comment: Also wrong. This is related to the prior question about a company owned by the accountholder and his/her brother, and the answer is the same – it very well ***could*** be a prohibited transaction. Getting it wrong means loss of the IRA's tax exempt status.

Each of these myths is discussed in more detail below.

Several of these concepts derive from Swanson v. Commissioner, 106 T.C. 76 (1996), cited by at least one IRA custodian as a "landmark" decision around which "an entire industry has been built" but which, in the opinion of the author, was much ado about nothing. The IRS raised the wrong arguments and failed to raise the right ones, and the tax court appears to have arrived at the "right" answer only by accident, via a nearly incomprehensible analysis. As discussed below, one key "holding" of the court was not a holding at all, and is also inconsistent

with later authorities. Swanson is a weak foundation on which to rest a multi-billion dollar industry.

Myth No. 1: An entity 50% or more owned by an IRA is a disqualified person

The issue here at first blush appears to be rather straightforward. According to the tax court in Swanson (or as best we can understand the court's reasoning):

Step 1. The IRA accountholder in that case was a fiduciary with respect to his own IRA. As a fiduciary, he was a "disqualified person" with respect to the IRA.

Step 2. The accountholder was also a "beneficiary" of the IRA. As such, he was deemed "beneficially" to own the shares of a corporation that was owned 100% by his IRA.

Step 3. Under the attribution rules of Code section 4975, any corporation owned 50% or more by a disqualified person (directly or indirectly) is also a disqualified person.

Consequently, once the IRA acquired 50% or more of the corporation, any subsequent dealings between the IRA and the corporation would be a prohibited transaction.[1]

Straightforward, yes, but erroneous. The court's analysis rests upon the following constructive ownership rule:

> Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries….

Swanson, 106 T.C. at 86, n. 15 (quoting Code section 267(c)(1)). Because the IRA was a trust, this means that the accountholder, as the trust's sole beneficiary, was deemed constructively to own stock of any corporation held by his IRA. So far, so good. However, being a beneficiary alone did not make the accountholder a "disqualified person," and neither would it make the corporation a disqualified person. Rather, the court found the accountholder was a disqualified person because he was a "fiduciary" with respect to his IRA. However – and this is an important

[1] The court's entire discussion of this issue was *dicta*, as it had nothing to do with the question of whether a prohibited transaction had occurred, and only gratuitously addressed whether a prohibited transaction might occur in the future.

but rather subtle point – a fiduciary acting *only as such* is **not** a disqualified person. A fiduciary is only a disqualified person when acting in his own interest, or in the interest of *other* persons, *i.e.*, "outside" the IRA.

This conclusion was spelled out rather plainly by the Department of Labor only one year after Swanson.[2] And it is the DOL, *not the IRS*, that has primary jurisdiction to interpret these rules.[3] Specifically, in 1997 DOL issued an advisory opinion to the Financial Institutions Retirement Fund regarding its holding of the stock of a wholly owned corporation named "Pentegra." DOL Adv. Op. No. 97-23A (Sept. 26, 1997). The plan capitalized Pentegra with $400,000 in exchange for 100% of its stock. The plan's trustees requested an advisory opinion that subsequent transactions between the plan and Pentegra would not be prohibited transactions. The concern was that because the trustees as plan fiduciaries held legal title to the Pentegra stock, 50% or more of Pentegra's stock would be deemed "owned" by the trustees, causing Pentegra to become a party in interest and disqualified person with respect to the plan, under the exact same theory that was applied by the court in Swanson. DOL concluded that such ownership would not make Pentegra a party in interest (under ERISA) or disqualified person (under the Code):

> Although, pursuant to ERISA section 3(14)(G), plan fiduciaries would hold all the value of Pentegra stock, they would hold such shares on behalf of the plan, not on behalf of themselves or a third party. As explained below, it is the opinion of the Department that, under the circumstances described, such transactions would not be prohibited because, under the terms of the "plan assets/plan investments" regulation (29 C.F.R. 2510.3-101), they would be treated as "intra-plan" transactions rather than transactions between a plan and a party in interest.

It is true that the Pentegra advisory opinion only addressed a 100% owned subsidiary (as did the Swanson case). However, nothing in the opinion suggested that it would not *also* apply where a plan owns 50% or more, but less than 100%, of the subsidiary entity (the 1980 DOL advisory opinion addressed a single fiduciary owning 100%, but on behalf of multiple plans). However, any remaining doubt was dispelled in a later opinion issued on behalf of Verizon Investment Management Corp. Adv. Op. No. 2003-15A (Nov. 17, 2003). In that case, Verizon set up an

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[2] In fact, this point was first acknowledged by DOL years in two advisory opinions issued nearly 20 years earlier, in 1979 and 1980 (the latter addressed to our firm). Adv. Op. No. 79-85A (Nov. 28, 1979) and Adv. Op. 80-67A (Nov. 13, 1980).

[3] Reorganization Plan No. 4 of 1978 transferred to DOL primary jurisdiction to interpret the relevant Code sections.

investment vehicle for various Verizon plans as well as plans of unaffiliated companies. The Verizon Master Trust, through its bank trustee (a fiduciary), owned more than 50% (but less than 100%) of the fund. Verizon sought confirmation that this ownership would not cause the fund to become a party in interest or disqualified person with respect to the Verizon plans. In confirming this conclusion, DOL noted that:

> Consistent with section 3(14) of ERISA, a plan's ownership of fifty percent or more of a partnership entity will not cause that partnership to become a party in interest with respect to that investing plan. In our view, the application of section 3(14)(G) should not change that result merely because a plan's interests in a partnership are held by a fiduciary on behalf of the plan. Although [bank fiduciary] would hold more than fifty percent of the value of the [partnership] interests, it would hold such interests on behalf of the Verizon Plans, not on behalf of itself or a third party. As a result, it is the view of the Department that the [partnership] will not be a party in interest with respect to the Verizon Plans. *Therefore, transactions between the Verizon Plans and the [partnership], including initial and subsequent contributions to the [partnership] by the Verizon Plans and distributions from the [partnership] to the Verizon Plans, would not be prohibited under section 406(a) of ERISA.*

[Emphasis added.] Although the DOL cited only the relevant sections of ERISA, they noted in a footnote that this conclusion also extended to the parallel sections of Code section 4975, and thus it is directly applicable to LLCs or other entities owned by IRAs.

Myth No. 2: <u>Putting your IRA assets into an LLC gives you "checkbook control."</u>

Scores of websites tout the "Checkbook IRA LLC" or variations thereon as allowing the accountholder to take control of his or her IRA assets away from the custodian. Under this theory, the IRA accountholder directs the custodian to purchase "shares" (units) of the LLC, opens up a checking account in the name of the LLC, and thereafter simply signs the LLC's checks without any participation of the custodian.

There are valid legal arguments why this *might* work if the IRA owns *less than* 100% of the shares of the LLC (which is a different and more complicated concept), but does it work where the IRA is the sole owner of the LLC? The answer is far from clear.

IRS regulations state that an individual retirement account "must be a trust or custodial account" whose assets are "held by a bank" or by an approved non-bank custodian. Proponents of the LLC structure apparently argue that the "assets" of the IRA in this instance are simply the shares of the LLC (which are held by a bank), and that any checking account set up by the LLC

belongs to the LLC, not the IRA. This is absolutely true under state law (and has important ramifications in terms of limited liability and asset protection.). But it does not follow that the IRS would agree for tax purposes. In fact, there are good reasons why it may not agree.

A similar issue arises under ERISA, and it is helpful to begin there.[4] Under ERISA, assets of a retirement plan also must be held in trust. DOL has adopted "plan assets" regulations that determine under what circumstances you "look through" an entity (such as an LLC) to determine that *its* assets are deemed to be assets of a plan. These rules also apply to IRAs. In this case, the rules indicate that when a plan (including an IRA) owns 100% of the shares of an LLC, the LLC's assets always are deemed to be assets of the plan (they may also *sometimes* be plan assets even if the plan owns less than 100%). Back to the trust rules – *other* ERISA regulations expressly state that in the case of a "plan assets" entity such as an LLC, assets held by the LLC (such as a checking account) are *exempt* from ERISA's trust requirement.

The IRS has **not** adopted a similar exemption from the IRA trust/custody requirements. Nonetheless, most practitioners assume that the IRS *would* apply a similar analysis to IRA investments in plan assets vehicles, and there is certainly evidence that they have not challenged such investments in pooled plan assets funds (hedge funds, for instance).

However, there is a *different* reason to ask if the IRS would allow checkbook control in the case of a 100% owned LLC. The reason is simple – a single-member LLC that does not elect to be taxed as a corporation[5] is a "disregarded entity" for tax purposes. According to the IRS:

> A disregarded entity is [one] that is treated as an entity not separate from its single owner. Its separate existence will be ignored for federal tax purposes unless it elects corporate tax treatment.

In other words, for federal tax purposes – and we see no reason why this does not extend to the IRA custody rules – an IRA-owned LLC *does not exist*. Accordingly, in the eyes of the IRS, assets held in the name of the LLC are no different from any other assets of the IRA, and arguably remain subject to the IRA bank custody requirements.[6]

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[4] At least one web article notes – without citing any authority – that "checkbook control" has long been permitted for self-directed 401(k) plans, so it must also be permitted for IRAs.

[5] Generally, a tax-exempt IRA is not likely to find much advantage to investing through a taxable corporation.

[6] Swanson is often cited as supporting the concept of the 100% IRA-owned LLC. However, the entities in question in Swanson were not LLCs, but corporations subject to potentially different rules. In any event, the IRS never raised the custody issue, so it was not addressed in the case.

What is the risk? In theory, the IRS could argue that "checkbook LLC" assets that are controlled by the IRA accountholder have been constructively distributed and are subject to immediate taxation.

Myth No. 3: So long as you own less than 50% of an LLC, you are not prohibited from transacting business between the LLC and your IRA

In a 1988 advisory opinion, the DOL was asked whether a loan from an IRA to a corporation owned approximately 47% by the IRA accountholder would be a prohibited "lending of money or other extension of credit" under Code section 4975(c)(1)(B). Applying (correctly) the reasoning discussed above under Myth No. 1, the DOL concluded that the IRA accountholder was a "fiduciary" with respect to the IRA, and thus a disqualified person. However, DOL further acknowledged that the corporation was not a disqualified person because the accountholder owned (in his personal, rather than fiduciary, capacity) less than 50% of the corporation's stock. Accordingly, DOL agreed that the loan was not a prohibited transaction under section 4975(c)(1)(B).

Citing this opinion, more than one website suggests that so long as you keep your ownership in an entity below 50%, you are free to transact business between the entity and your IRA.

However, although it is correct that the transaction was not a prohibited loan, it does not follow that it was not *otherwise* a prohibited transaction. To the contrary, the last paragraph of the advisory opinion reaches the ***opposite*** conclusion:

> Accordingly, a prohibited use of plan assets for the benefit of a disqualified person under section 4975(c)(1)(D) or an act of self-dealing under section 4975(c)(1)(E) **is likely to result** if [the accountholder] directs the IRA to loan funds to the Corporation. [Emphasis added]

It is not entirely obvious why DOL was not a bit clearer in pointing out that the applicant did not ask exactly the right question. One possible answer is that while the existence of a prohibited loan essentially is *per se* a prohibited transaction, whether a transaction involves a "use" of plan assets or "self-dealing" involves an element of subjective intent. However, if you caused your IRA to lend money (or buy, sell or lease assets, or pay fees) to a business in which you have *any* substantial interest, it is hard to imagine that it is **not** your intent to derive a personal benefit from the transaction. (Or at least it would be hard to prove.)

In a 2004 decision, the Tax Court concluded that a taxpayer engaged in a prohibited "use" of 401(k) plan assets when he cause the plan to loan money to three entities in which he owned minority interests (roughly 25 to 33%). Rollins v. Commissioner, T.C. Memo 2004-260 (Nov.

15, 2004). In a 1987 decision, the Second Circuit found (among other things) that the investment of a plan's assets in a company in which two plan fiduciaries collectively owned approximately 11% (one was also president of the company) was an act of self-dealing. Lowen v. Tower Asset Management, Inc., 829 F.2d 1209 (2d Cir. 1987).

Can these cases be reconciled with Swanson, where the taxpayer caused a corporation he owned "outside" his IRA to pay commissions to a corporation owned by his IRA? Perhaps - one possible difference is that in Swanson the flow of funds was *from* the taxpayer's personal account *to* his IRA, not the other way around. However, we may never know, as it is not clear that either the IRS or the court examined the underlying commission payments in that case except for unrelated business income tax purposes.[7]

Myth No. 4: You are free to loan your IRA assets (sell or buy assets, etc.) to anyone so long as that person is not a disqualified person

This is a variation on Myth No. 3. The idea seems straightforward enough: if a family member (or corporation, or LLC, etc.) is not a disqualified person, then it is not a prohibited transaction to use your IRA assets to loan money to, or buy property from, or pay a salary to, such person. True, the absence of a disqualified person means that there is no transaction "with" a disqualified person. But, the transaction can also involve "self-dealing," which is a separate prohibited transaction.

How can it be self-dealing if the benefit flows not to me personally, but to my brother? Because the definition of self-dealing is far broader than is commonly understood. Code section 4975(c)(1)(E) provides that self-dealing means any "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*." [Emphasis added.] Regulations adopted pursuant to this rule note that:

> These prohibitions [against self-dealing and kickbacks] are imposed upon fiduciaries [such as self-directed IRA accountholders] to deter them from exercising the authority, control or responsibility which makes such persons fiduciaries when they have interests which may conflict with the interests of the plans for which they act. In such cases, the fiduciaries have

[7] We can imagine a possible prohibited transaction in the Swanson arrangement, for instance, if the services were provided by the IRA for less than their fair market value. But, that is unlikely, as the obvious purpose of the transaction was to transfer personal assets into the IRA for tax deferral purposes. So, in focusing on prohibited transactions, perhaps the IRS overlooked the more obvious question as whether the arrangement was a *disguised contribution* to the IRA. *E.g.*, was the payment commensurate with the value of the services performed? Who performed the services that generated the fee and was there any "sweat equity" involved?

> interests in the transactions which may affect the exercise of their best judgment as fiduciaries. Thus, a person may not use the authority, control or responsibility which makes such person a fiduciary to cause a plan to pay an additional fee to such person (or to a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary) to provide a service.

Treas. Reg. § 54.4975-6(a)(5). This regulation goes on to say that:

> A person in which a fiduciary has an interest which may affect the exercise of such person's best judgment as a fiduciary includes, for example, a person who is a disqualified person by reason of a relationship with such fiduciary described in section 4975(e)(2)(E), (F), (G), (H), or (I). [That is, certain disqualified persons such as family members and certain businesses in which the person is an owner, officer, director, etc.]

However, the mere fact that a family member or business enterprise is *not* a disqualified person does not mean that the accountholder *does not* have an interest in the person that may affect his/her best judgment as a fiduciary. The regulation clearly states that disqualified persons (including certain family members) are **examples** of persons in which you have an interest that may affect your judgment as a fiduciary. It does not follow that you do not have an interest in your brother, aunt, step-child, etc. DOL in one situation suggested that owning as little as 1.8% of a business was at least relevant to the question of whether a fiduciary had an impermissible interest. At best, some practitioners have suggested that the above regulation might shift the burden of proof from you (to prove you have no interest in a person) to the government (to prove that you do) – it is neither a bright line nor a safe harbor.

If I did make a loan to my brother, how could I prove that I did not have an impermissible personal interest in doing so? Perhaps I could demonstrate that that it was in the best interest of my IRA to make the loan, because he was a good credit risk and had other lenders lined up to make the same loan, or because he agreed to pay a higher-than-market rate of interest and provided excellent collateral. But, is it worth the risk, which could entail loss of the IRA's tax exemption?

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