

UNDERSTANDING THE PROHIBITED TRANSACTION RULES FOR SELF DIRECTED IRAS

self-directed IRA summit

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Disclaimer & About Mat

DISCLAIMER

All information and materials are for educational purposes only. All parties are strongly encouraged to consult with their attorneys, accountants, and real estate professionals before entering into any type of investment. This presentation does not constitute an attorney client relationship.

ABOUT MAT

Partner at KKOS Lawyers, assisting clients nationwide from offices in Arizona, California, and Utah. Co-Host of Nationally Syndicated Weekly Radio Show and Top-Ranked Podcast Refresh Your Wealth.

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Host of The Self-Directed IRA Summit. A day-long educational event solely for Self-Directed IRA Investors. Held Saturday, May 7, 2016, Live in Phoenix or Virtually Streaming. Details at www.sdirasummit.com

Restrictions on IRA Investments

Restrictions/Rules for IRA Investments?

Collectibles such as art, stamps, certain coins, alcoholic beverages, or antiques, IRC § 408(m);

Life insurance, IRC § 408(a)(3);

S-corporation stock, IRS Letter Ruling 199929029, April 27, 1999, IRC § 1361 (b)(1)(B); and

Any investment that constitutes a prohibited transaction pursuant to IRC § 4975 (e.g., purchase of any investment from a disqualified person, such as the spouse of the retirement account owner).

Important Tip

WITH

WHOM

NOT

WHAT

IRC § 4975

Prohibited Transactions

- IRAs that include, or consist of, non-marketable securities and/or closely held investments, in which the IRA owner effectively controls the underlying assets of such securities or investments, have a **greater** potential for resulting in a prohibited transaction. Internal Revenue Service, Instructions for Forms 1099-R and 5498 (2013), page 2.

What is a Prohibited Transaction?

KEY POINTS

- The prohibited transaction rules restrict with **WHOM** your SDRP may transact. They do not restrict what investments an SDRP may own.
- An SDRP cannot transact (e.g. buy/sell) with the SDRP owner and certain family members of the SDRP owner.
- There are three types of prohibited transactions: 1) per se prohibited transactions, 2) extension of credit prohibited transactions, and 3) self dealing prohibited transactions.

The Prohibited Transaction Rules

PROHIBITED TRANSACTION RULES

IRC 4975 – Outlines three different categories of prohibited transactions. Restrict not WHAT an IRA may invest in but with WHOM.

1. Per Se Prohibited Transaction. Occurs when an IRA engages in a transaction with a disqualified person.
2. Extension of Credit Prohibited Transaction. Occurs when there is an extension of credit between an IRA and a disqualified person.
3. Self Dealing Prohibited Transaction. Occurs when a disqualified person (e.g., IRA owner) personally benefits from the IRA's investments.

Consequence of a Prohibited Transaction is disqualification of that IRA (IRA owner involved) and distribution of the entire account. Other accounts are not effected.

Per Se Prohibited Transactions

PER SE PROHIBITED TRANSACTIONS

A per se prohibited transaction occurs when an IRA engages in a “transaction” with a “disqualified person”. IRC § 4975 (c)

What is a Transaction? “Transaction” includes a purchase, sale, lease, exchange, loan, extension of credit, services, goods, etc.

Who is a Disqualified Person? “Disqualified Person” includes IRA owner (as fiduciary), spouse, children, and parents (ancestors and lineal descendants and their spouses). Also, partners and companies you or other disqualified persons own 50% or more of. See following list.

Who is a Disqualified Person?

An IRA may NOT engage in a transaction with these persons. IRC § 4975 (e)(2)

- IRA Owner, and IRA Owner's
- Advisor (fiduciary)
- Spouse
- Children
- Spouses of Children
- Grandchildren and their spouses
- Parents and grandparents
- Companies (corps, LLCs, LP, partnerships, trusts) where IRA owner or family above own or control 50% or more
- Certain Officers, Directors, or Highly Compensated Employees of companies where the IRA owner owns or controls 50% or more

Per Se Prohibited Transactions

□ 1. SDRP Owner

SDRP account owner as **Fiduciary**. IRC § 4975 (e)(2)(A). The self directed retirement plan account owner is a disqualified person because he or she is a **fiduciary** to the SDRP and makes the investment decisions for the SDRP. *Harris v. Commissioner*, 76 T.C.M. 748 (U.S. Tax Ct. 1994); DOL Advisory Opinion 93-33A.

Per Se Prohibited Transactions

□ 2. Certain Family Members

- Spouse
- Ancestors, which by definition includes the SDRP owner's parents, grandparents, and great grandparents. It does **not** include the SDRP owner's in-laws or grandparent in-laws. Perhaps the IRS isn't so worried about an SDRP owner getting a "sweet-heart" deal from the in-laws.
- Lineal descendant, which includes child, grandchild, great-grandchild, etc.
- Spouse of lineal descendant, which includes son-in-law, daughter-in-law, etc.

IRC § 4975 (e)(2)(F), IRC § 4975 (e)(6)

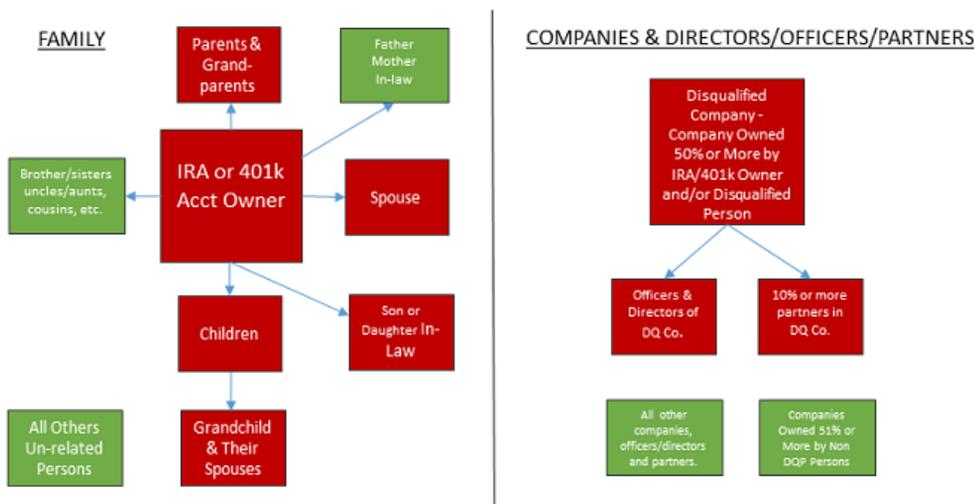
Per Se Prohibited Transactions

- 3. Company Majority Owned
- A corporation, partnership (e.g., LLC), or trust or estate which is owned **50%** or more by disqualified persons (e.g. IRA owner, disqualified family members, disqualified personal business partners).
 - **50%** or more of the voting power of all classes of stock or of the total shares, or
 - **50%** or more of the capital interests or profits of such partnership, or
 - **50%** or more of the beneficial interest of a trust or unincorporated business enterprise. IRC § 4975 (e)(2)(G).

Disqualified Person - Family Chart

SELF DIRECTED IRA & 401K PROHIBITED TRANSACTION DISQUALIFIED PERSON DIAGRAM

A prohibited Transaction occurs when a retirement plan (IRA, 401(k), pension, etc.) transacts with a **disqualified person (red)**. Parties in red are disqualified persons and a plan should not transact with those parties. Parties in **green** and those not listed are not disqualified and a retirement account may transact with those parties. Refer to IRC § 4975 and legal counsel.



IRA Owner – IRC § 4975 (e)(2)(A)

Spouse - IRC § 4975 (e)(2)(F), IRC § 4975 (e)(6)

Parents & Grandparents – As “ancestors” IRC § 4975 (e)(6)

Children- As “lineal descendant”, IRC § 4975 (e)(6)

Son/Daughter In-Law as “spouse of lineal descendant”, IRC § 4975 (e)(6)

Disqualified Company – Owned or controlled 50% or more by disqualified family members. IRC § 4975 (e)(2)(G).

Officer/Director or 10% or More Partner in Disqualified Company - IRC § 4975 (e)(2)(H).

Who is NOT a Disqualified Person?

An IRA may engage in a transaction with these persons.

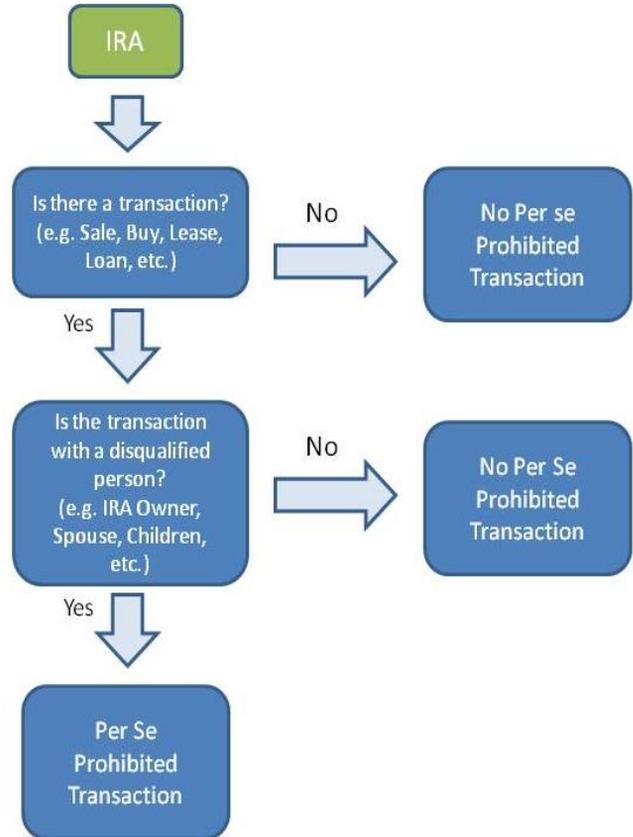
- Non family members or employees of the IRA owner
- Other third party investors
- Step parent (to un-adopted child) or un-adopted step child to IRA owner
- Aunts and Uncles, Nieces and Nephews, and cousins
- In-laws of the IRA owner (not an ancestor)
- Brothers and Sisters
- Companies the IRA owner and other disqualified persons own and control less than 50% (beware of self dealing).
- Everyone else not disqualified in IRC § 4975 (e)(2)

PER SE PROHIBITED TRANSACTION FLOW CHART

IRA + Transaction + Disqualified
Person = Per Se Prohibited Transaction

IRA + Transaction = No Per Se
Prohibited Transaction

IRA + Activity Not a Transaction +
Disqualified Person = No Per Se
Prohibited Transaction



Extension of Credit Prohibited Transaction

EXTENSION OF CREDIT PROHIBITED TRANSACTIONS

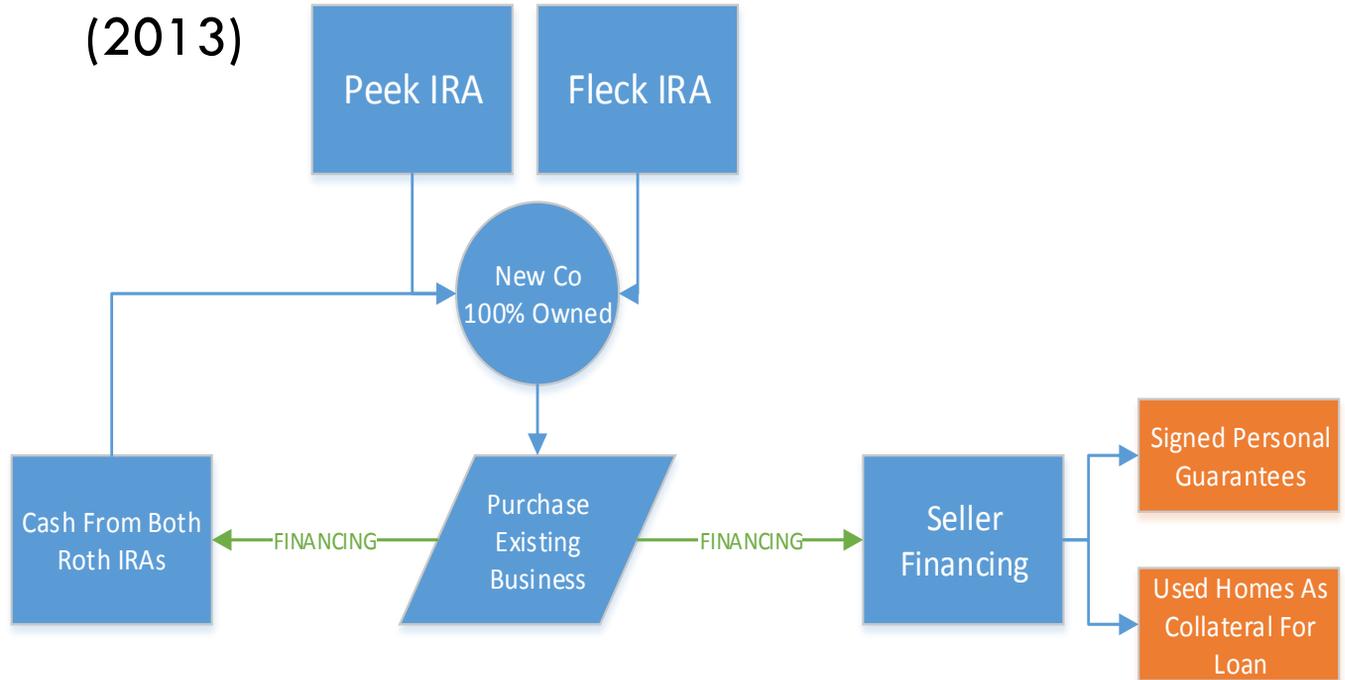
IRC § 4975 (c)(1)(B) specifically states that a prohibited transaction occurs when there is a “lending of money or other extension of credit between a plan [IRA] and a disqualified person.”

RULES FOR OBTAINING A LOAN WITH YOUR IRA

1. If an IRA obtains a loan for its investments the loan must be “non-recourse” to the IRA and the IRA owner (e.g., lender’s only recourse is against asset). The IRA owners cannot personally guarantee the loan. *Peek & Fleck v. Commissioner*.
2. UDFI Tax due on net income from debt. Profits attributable to retirement plan cash or other non-debt investment is not subject to UDFI tax. (more later on this). Applies to IRAs, 401ks other employed based plans are exempt from UDFI tax.

Extension of Credit PT

- *Peek & Fleck v. Commissioner*, 140 T.C. 12 (2013)



Self Dealing Prohibited Transactions

A self dealing prohibited transaction occurs when the IRA owner or other disqualified person benefits from the IRA's investments. IRC § 4975 (c)(1)(D),(E), and (F).

RULE IN PRACTICE

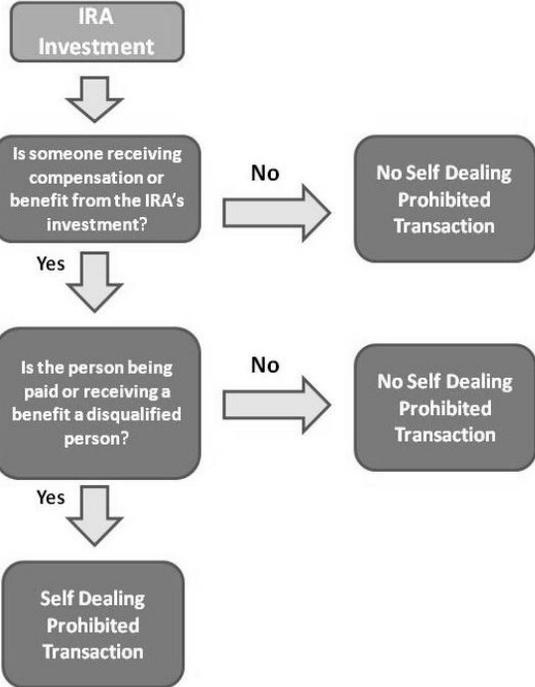
1. No personal compensation or commissions paid to a disqualified person as a result of an IRA's investment. (reasonable compensation unsettled exception, 4975 (d)(2)).
2. You cannot have use of the IRA assets. For example, rental owned by an IRA cannot be personally used by disqualified persons to the IRA (e.g. IRA owner).
3. Bottom line, don't use IRA assets. Use of IRA assets without payment results in a benefit to a disqualified person and is a self dealing prohibited transaction while use and payment by a disqualified person is a transaction with a disqualified person and is a per se prohibited transaction.

Self Dealing Prohibited Transactions

COMMON ISSUES

1. Companies Owned 49% or less by disqualified persons. IRA should tread carefully. *Rollins v. Commissioner*, T.C. Memo 2004-260 case example.
2. Compensation to IRA Owner or Disqualified Person (e.g. avoid commissions, salary, etc.).
3. Avoid Step Transactions. Cannot put in a straw person to get around the rules. Substance over form doctrine.
4. DOL Interpretive Bulletin on Prohibited Transactions. 29 C.F.R. 2509.72-2 . Avoid transactions where IRA requires a company it is an owner of to transact with a disqualified person.

FINDING A SELF DEALING PROHIBITED TRANSACTIONS



PT Consequences: Engaged in by IRA Owner

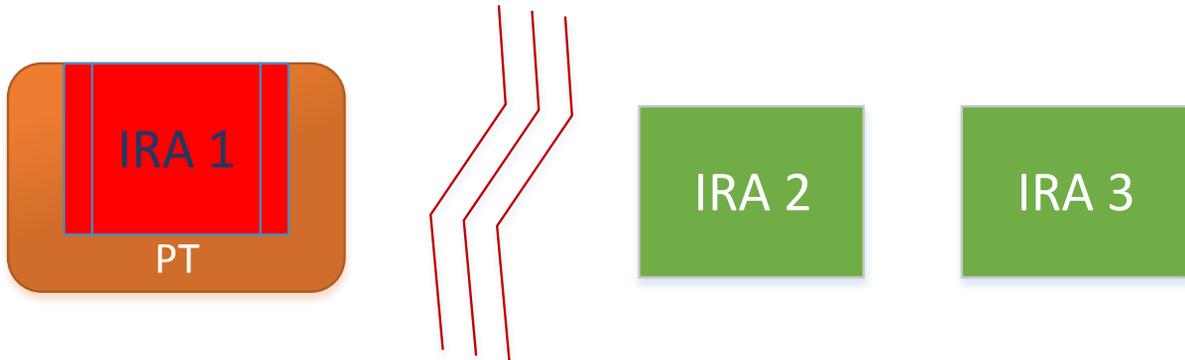
1. Distribution & Taxes. Regardless of the amount involved in the prohibited transaction, *the entire IRA* (including Roth IRAs, SEP or SIMPLE IRAs and HSAs) is deemed distributed and the IRA owner is subject to any applicable taxes from the distribution. The distribution amount is based on the fair market value of the account as of **January 1** of the year in which the prohibited transaction occurred. 10% early withdrawal penalty.

PT Consequences: Engaged in by IRA Owner

2. Revocation of Preferred Tax Treatment. Taxes will be applied to the income and gains from the IRA from the time the IRA engaged in a prohibited transaction. The IRA tax-deferred (Traditional) or tax-free (Roth) benefits are revoked, and any taxes owed on income or gains from the IRA after the prohibited transaction occurred are now due.

PT Consequences: Engaged in by an IRA Owner

Separate IRA or Retirement Accounts



How are PTs Discovered or Alleged?

- 1. Company IRA is invested into is audited (partnership return, corporate return).
- 2. IRA custodian becomes aware and sends and distributes account by filing a 1099-R.
- 3. IRS audits the IRA or 401k (5500 tax return).
- 4. IRA or SD 401k owner enters bankruptcy: claim against IRA or SD 401k.

Statute of Limitations

- 3 Years
- 6 Years
- Unlimited

self-directed IRA summit

- What: Self-Directed IRA Summit, The Most Important Day of Training for SDIRA and SD401k Investors
- When: Saturday, May 7, 2016
- Where: Scottsdale Resort, Scottsdale, AZ or Virtually On-Line.
- Discount Code: Enter “KKOS_Lawyers” at checkout for \$100 off the Virtual Event (\$199 to \$99) and \$150 off the Live Event (\$349 to \$199)

For Details or to Register Visit

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Thanks!

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