



AVOIDING PROHIBITED TRANSACTIONS IN A SELF- DIRECTED IRA



It is critical that owners of a self-directed individual retirement account (an “IRA”) and IRA advisors familiarize themselves with the prohibited transaction rules – particularly when IRA funds can be invested in a variety of assets, including privately offered securities and real estate. This article discusses the IRA prohibited transaction rules and the consequences of an IRA prohibited transaction, as well as some potential investment strategies for IRAs.

BACKGROUND

The Internal Revenue Code of 1986, as amended (the “Code”) prohibits IRAs (including self-directed IRAs) from engaging in certain transactions. Generally, these rules are intended to prevent transactions between an IRA and an interested party to the IRA, known as a “disqualified person.” A “disqualified person” includes the IRA owner, an IRA beneficiary and any fiduciary or service provider to the IRA. A disqualified person also includes a spouse or lineal descendant of a fiduciary, as well as an entity owned or controlled by a fiduciary (including an officer or a director of such an entity).

Types of Prohibited Transactions

The Code provides that the following transactions are “prohibited transactions” with respect to an IRA:

- *Selling, exchanging or leasing property.* Selling or leasing property between an IRA and a disqualified person is a

prohibited transaction. The U.S. Supreme Court has held that transferring property to a qualified plan to satisfy an obligation to contribute to the plan is a prohibited transaction, regardless of whether the property is encumbered.¹

- *Loaning money or otherwise extending credit.* A disqualified person is prohibited from loaning money to, or borrowing money from, an IRA. These transactions are prohibited even if the borrowed amount is included in the recipient’s gross income.
- *Furnishing goods, services or facilities.* A disqualified person is prohibited from providing services to an IRA, such as investment advisory services.
- *Transferring IRA income or assets, or using such income or assets by or for the benefit of a disqualified person.* Using IRA funds or an IRA asset to generate benefits for a disqualified person is a prohibited transaction. For example, an IRA cannot purchase shares of a disqualified person’s

¹ CIR v. Keystone Consol. Indus., Inc., 508 U.S. 152 (1993). This is a controversial case that expands the relevant definition of “sale” under the Code (which only mentions the transfer of encumbered property).

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business. A disqualified person cannot use IRA funds to buy property for such person's personal use. For example, IRA assets cannot be used as collateral for the IRA beneficiary's personal loan.

- *A fiduciary's dealings with an IRA's income or assets in such fiduciary's own interest or for the fiduciary's account.*
- *A fiduciary's receipt of any consideration from any party dealing with the IRA in a transaction involving its income or assets.*

In addition, "step" transactions to avoid these rules are prohibited transactions. For example, a disqualified person cannot engage in a series of transactions in which an IRA sells property to a person who is not a disqualified person, who then sells the property to a disqualified person. These two transactions may be aggregated and treated as if the IRA sold property directly to the disqualified person.

CONSEQUENCES OF A PROHIBITED TRANSACTION

Engaging in a prohibited transaction can often result in grave consequences for an IRA.

- If an IRA owner or his or her beneficiary engages in a prohibited transaction (even if the prohibited transaction involves only a portion of the IRA assets), the IRA is disqualified as of the first day of the taxable year in which such transaction occurs.
- The IRA owner is treated as if he or she received a taxable distribution equal to the fair market value of all IRA assets as of the first day of the tax year. Accordingly, the owner includes the value of such assets (less any basis) in his or her income for that tax year.
- If the IRA owner is under age 59½ on the date that the deemed distribution occurs, an additional 10% early distribution tax will apply to the fair market value of all IRA assets.

If a disqualified person other than the IRA owner (or his or her beneficiary) engages in a prohibited transaction, such prohibited transaction does not disqualify the IRA. Instead, the transaction triggers excise tax(es) under the Code.

- An initial tax equal to 15% of the amount involved is imposed on the disqualified person. If the transaction is not corrected within the relevant taxable

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period, a secondary tax equal to 100% of the amount involved is imposed on the disqualified person. The relevant transaction generally may be “corrected” if the IRA is put in a financial position not worse than that in which it would have been if the disqualified person were acting under the highest fiduciary standard. This correction may involve “undoing” the relevant transaction.

- A fiduciary, who is always a disqualified person, is only subject to such excise taxes if the fiduciary acts in a prohibited transaction in a capacity other than that of a fiduciary. In addition, current DOL regulations (commonly referred to as the “DOL Fiduciary Rule”)² subject an IRA fiduciary to civil liability and remedies under ERISA if such fiduciary knowingly participates in a prohibited transaction.³

number of statutory prohibited transaction exemptions for certain parties to engage in routine IRA transactions, some of which are listed below.

- Purchasing an interest in a common trust fund or pooled investment fund. If the fund is maintained by a disqualified person, the IRA may purchase an interest in such fund if the investment is duly authorized and the disqualified person does not receive more than reasonable compensation. Consider including specific authorizing language in the IRA documents in order to take advantage of this exemption in future transactions.
- Depositing IRA assets with a bank that is an IRA fiduciary. IRA assets may be deposited in a bank that is an IRA fiduciary as long as the interest rate is reasonable and the investment is duly authorized. Consider including specific authorizing language in the IRA document in order to take advantage of this exemption in future transactions.
- Bank fiduciary providing ancillary services to an IRA. A bank that is an IRA fiduciary may provide ancillary services (e.g., certain services involving acts of self-

AVOIDING PROHIBITED TRANSACTIONS

Statutory Exemptions

The prohibited transaction rules for IRAs are so broad as to preclude most routine IRA transactions. However, the Code provides a

² “Reexamining the Impact of the Fiduciary Rule”: https://www.stratatrust.com//content/uploads/2018/04/Whitepaper-DOL_Fiduciary_Rule-1.pdf

³ If the DOL Fiduciary Rule is vacated, however, an IRA fiduciary will not be subject to any penalties under ERISA (because the law will revert to prior law, under which an IRA fiduciary was not subject to ERISA) and will continue to be generally exempt from the excise tax under the Code.

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dealing) to the IRA as long as the bank (1) receives no more than reasonable compensation for such services, (2) utilizes adequate internal safeguards to ensure that its services are consistent with sound banking and financial practice and (3) performs the services subject to specific guidelines issued by the bank (which must state that the bank may not provide the service in a manner that is excessive, unreasonable and/or inconsistent with the best interests of participants and beneficiaries). To use this exemption, the IRA documents should include a limitation on the bank's exercisable discretion in the guidelines relating to the applicable ancillary services and should include a limitation on the discretion exercisable by the bank.

Limited Statutory Exemptions for Transactions Involving IRA “Owner-Employees”

The Code provides that most of the statutory prohibited transaction exemptions referred to above will not apply to transactions involving certain plans or similar arrangements that provide contributions or benefits for employees some or all of whom are “owner-employees” (and persons related to such owner-employees). The Code defines an “owner-employee” broadly to include a

participant in, or beneficiary of, an individual retirement account or arrangement. If this owner-employee rule applies to a self-directed IRA, the statutory prohibited transaction exemptions generally will not apply to any transaction in which a self-directed IRA, directly or indirectly, makes a plan loan, pays any compensation for personal services rendered to the IRA or acquires for the IRA any property from (or sells any IRA property to) an owner-employee and other related persons. Assuming the owner-employee rule applies, the statutory prohibited transaction exemptions generally may only be used for a transaction between the IRA and a disqualified person other than an IRA participant or beneficiary (e.g., an investment advisor or manager).

However, it is unclear whether or not this “owner-employee” rule applies to self-directed IRAs. Other than the statutory language, which includes IRA participants and beneficiaries as “owner-employees,” there is very little guidance from the Internal Revenue Service regarding the application of this rule to a self-directed IRA. Some experts believe that generally including IRA participants and beneficiaries as “owner-employees” may have been a drafting error. Others believe that the “owner-employee” rule was only intended to apply to Section 408(c) IRAs established by an employer, rather than to all IRAs.

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If the “owner-employee” rule applies to a self-directed IRA, only two statutory prohibited transaction exemptions are available to an owner-employee and related persons:

- Receiving certain benefits from the IRA. An owner-employee may receive any benefit to which he or she may be entitled as a participant or beneficiary in the IRA, so long as the benefit is computed and paid on a basis that is consistent with the terms of the IRA as applied to all other participants and beneficiaries.
- Receiving distributions of IRA assets. An owner-employee may receive a distribution of IRA assets.

IRA Investment Strategies

Subject to the prohibited transaction rules described above, there are many different types of investments that are permissible for an IRA. Below is a discussion of a few investments to consider.

- *Investing in private placements.* An IRA may generally invest in a private placement. A private placement is an investment in securities that are registered with the Securities Exchange Commission but that are not traded on the public

markets. However, it is important to ensure that no element of self-dealing is present and that the IRA funds are not invested with a disqualified person (or an entity owned by a disqualified person). If the IRA funds are invested with a disqualified person (e.g., a bank that is a fiduciary of the IRA), ensure that a statutory exemption applies such that the investment is not a prohibited transaction. In addition, certain other non-tax restrictions may apply when investing in a private placement (e.g., holding periods, “accredited investor” rules, etc.). Consider consulting with both a tax attorney to ensure compliance with the prohibited transaction rules and with an attorney that specializes in securities law regarding applicable non-tax restrictions.

- *Investing in leveraged real estate.*⁴ An IRA generally may invest in leveraged real estate. Investing in a leveraged asset can be beneficial because it allows an IRA to diversify its portfolio and benefit from a growing asset for a relatively small upfront investment. However, an IRA that holds leveraged real estate may be subject to the unrelated business income tax (“UBIT”). If an IRA holds leveraged real estate, the portion of any profit realized through the leveraged debt may be

⁴Using an IRA to invest in real estate will be discussed in greater detail in a future article.

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subject to UBTI. A discussion of the UBTI rules is beyond the scope of this article. Consider consulting with a tax attorney before using an IRA to invest in any leveraged real estate.

- *Investing in publicly traded securities.* An IRA generally may invest in any type of publicly traded stock, including stocks, bonds and mutual funds. However, be aware that an IRA cannot engage in certain trading strategies. For example, because an IRA cannot use a margin account (because borrowed money cannot be used for IRA investments), an IRA cannot “short” stock. An IRA also cannot be used for day trading. When an IRA sells stock, a three-day holding period typically applies before the IRA can use the proceeds to purchase other shares. Consider consulting with an accountant or a broker that specializes in IRA stock trading.
- *Investing in stock options.* An IRA generally may trade in “put” or “call” stock options, but only to the extent that the options do not require the use of a margin account. An IRA may use the cash secured put strategy to invest in a put option – in other words, the IRA must set aside sufficient cash to cover the put option if and when it is exercised. Similarly, an IRA may use

the covered call strategy to invest in a call option. The covered call strategy involves setting aside the stock to cover the call option if and when it is exercised. However, an IRA cannot invest in “naked” puts and calls (because a margin account is required for such investments). In addition, before investing in any options, an IRA must request options authorization from the brokerage firm managing the account. Consider consulting with an accountant or a broker that specializes in IRA options trading.

- *Co-investment with a disqualified person.* As explained above, an IRA is generally prohibited from engaging in a transaction with a disqualified person. For example, an IRA generally cannot invest in a disqualified person’s business. However, consider whether co-investing with disqualified person could accomplish a similar investment goal for the IRA. A mere co-investment by an IRA and a disqualified person typically will not cause a prohibited transaction problem (unless there is an element of self-interest).⁵ For example, instead of investing in a disqualified person’s business, the IRA and such business could co-invest in an entity that is not a disqualified person. Note that if a partnership is used to engage in

⁵ See Department of Labor Advisory Opinion 2000-10A (indicating that mere co-investment is permissible).

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the co-investment, the most conservative approach to avoid a prohibited transaction is to ensure that partnership distributions match partnership contributions.

Because there is very little guidance on co-investments between a IRA and a disqualified person, such co-investments are risky and may give rise to an inadvertent violation of the prohibited transaction rules. Consider consulting with a tax attorney before engaging in a co-investment with a disqualified person.

- *Strategy for IRA owner to apply IRA assets to personal use.* As explained throughout this article, IRA assets cannot be used to benefit a disqualified person (e.g., the IRA owner). If an IRA owner engages in a prohibited transaction, the IRA is disqualified as of the first day of the applicable taxable year and, if the owner is under age 59½, an additional 10% early distribution tax will apply to the fair market value of all IRA assets. There may be non-tax circumstances,

however, when an IRA owner prefers to apply IRA assets to a personal use (e.g., financial hardship). Rather than engage in a prohibited transaction with all or a portion of IRA assets, such IRA owner could consider withdrawing the needed IRA funds. In such case, only the withdrawn funds will be treated as a taxable distribution to the owner and the IRA will not be disqualified. The IRA owned would include the withdrawn amount in income in the year of the withdrawal and, if the owner is under age 59½, the 10% early distribution tax would apply to the amount withdrawn. Contrast this situation with the tax consequences if the IRA owner were to instead engage in a prohibited transaction – all IRA assets would be considered distributed in a taxable distribution and the 10% early distribution tax would apply to all IRA assets. Consider consulting with a tax attorney before withdrawing any IRA funds.

This discussion does not purport to address all federal income tax consequences that may arise with respect to transactions involving an individual IRA, IRA owner or IRA beneficiary. This discussion also is in no respect a representation that any of such transactions are appropriate for IRAs generally or any particular IRA.

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Caitlin Sawyer, a Tax Associate at Hunton Andrews Kurth LLP, helps clients navigate complex federal income tax issues. She focuses on corporate mergers, acquisitions and reorganizations, fund formation, and transactions involving partnerships, limited liability companies, and other pass-through entities. Caitlin assists clients with tax issues involved in mergers, acquisitions and other complex transactions. She has significant experience regarding the tax aspects of corporate mergers, acquisitions and reorganizations (including transactions involving banks and S corporations) and drafting tax provisions in partnership and limited liability company (LLC) agreements. She also has extensive experience calculating Section 280G payments and drafting 280G shareholder vote documents in connection mergers and acquisitions. Caitlin also has experience with drafting tax provisions in a variety of disclosure documents, including proxy statements and prospectuses. She regularly advises clients regarding the Foreign Account Tax Compliance Act (FATCA) as well as the Bipartisan Budget Act of 2015 (the New Partnership Audit Rules).

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STRATA Trust Company has quickly catapulted to become a premier national custodian for alternative assets and non-exchange traded investments in self-directed IRAs. Formerly known as Self Directed IRA Services, Inc., STRATA has been helping investors use their retirement account funds to invest since 2008. STRATA currently serves over 33,000 individuals nationwide with over \$1.8 billion in assets under custody.

With offices in Waco and Austin, Texas, our team's vast experience in handling the details and complexities that real estate transactions require is unrivaled. Our seasoned team's experience in the custody of alternative assets spans over 350 years. With a well-established reputation for honesty and integrity, STRATA is committed to delivering responsive, flexible and innovative solutions.

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