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Self-directed IRAs – Top Five Complexities for Estate Planning Attorneys

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Over the past decade, the term "self-directed IRA" has become a more widely used term within the financial world, but its exact meaning is still quite vague. Generally, the term "self-directed IRA" ("SDIRA") is used to describe an IRA that is able to invest in "alternative" or "nontraditional" assets, although even those terms are difficult to define. After all, more and more brokerage firms have increased the ability of their account holders to invest in assets that do not fall into the traditional categories of "stocks, bonds, and mutual funds," though these brokers generally stop short of allowing investments in privately held companies, real estate, and other more obscure (but legally permissible) IRA investments.

After a brief discussion of the three basic types of SDIRAs, this article focuses on five challenges that arise for estate planning attorneys when a client holds a SDIRA which either directly or indirectly (i.e. through an entity) invests in "nontraditional" investments. Many of the complexities discussed in this article are not entirely unique to SDIRAs, but the specific challenges are often magnified because of the illiquidity or uncertain value of the assets in which they invest.

I. The Three Types of SDIRAs

There are three basic types of SDIRAs:

SDIRA #1 (traditional securities investing)

The first type of SDIRA involves traditional securities investing. With this type, the IRA account is held by a large brokerage house which allows IRA owners to "self-direct" (i.e., control) investments, but restricts the available investments to publicly traded assets. For example, an IRA owner might open an IRA account which allows the IRA owner

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to buy and sell stocks without going through a company representative. This type of IRA is definitely "self-directed," but it is likely not the type of IRA your clients are referring to if they mention a "self-directed IRA."

Example Setup/Investment of SDIRA #1. A client believes that he can invest in publicly traded assets more effectively than his current financial advisor. Client executes a trustee-to-trustee transfer from his current IRA at a traditional brokerage firm to a newly-formed IRA at an on-line brokerage firm that allows the client to directly trade assets. Client then selects his own stocks, bonds, mutual funds, etc. going forward, but continues to invest only in these more "traditional" forms of investment.

SDIRA #2 (nontraditional direct investing)

The second type of SDIRA may be generally categorized as "nontradional direct investing." In this category, the IRA is held by a specialized type of trust company or bank ("custodians") that allows "direct" investments into almost any asset imaginable (except for life insurance contracts and "collectibles"). Some of these custodians require (or greatly prefer) the IRA to hold the "nontraditional" asset *directly* (as opposed to through an entity). The reason custodians require or prefer the "direct" investment method is generally twofold. First, an IRA that purchases assets directly often generates larger fees for the IRA custodian, as custodians typically charge fees based on the number of assets held in the IRA (i.e., more assets held directly by the IRA results in more fees to the custodian). Also, more assets held in the IRA generate more "transactional" fees, such as "asset purchase fees" and check writing fees. For example, if an IRA owns five pieces of real estate (as opposed to owning an interest in an entity that owns five pieces of real estate),[1] the holding fees paid to the custodian will be higher. In other words, the IRA custodians are financially motivated to promote the IRA "direct" investment model. The other reason custodians require or prefer the direct investment method is because of the perceived dangers of the IRA-owned LLC method discussed below. Said another way, many custodians are concerned about an IRA owner's ability to follow the legal requirements of an IRA-owned LLC structure.

Example of Setup/Investment for SDIRA #2. A client wants to execute "hard money loans" to local real estate developers. The client forms an IRA at a national trust company and executes a rollover from a 401(k) account sponsored by his former employer. Client then directs the trust company to make a loan directly out of the IRA to the real estate developers in return for a promissory note and deeds of trust against real estate, with the trust company holding the promissory note and deeds of trust on behalf of the IRA. Interest payments are made according to the note and directed to "[Custodian's Name] FBO [Client's Name] IRA." The trust company charges quarterly fees (based on the value of the IRA's assets) and asset holding fees (based on the assets held in the IRA), as well as various other per-transaction charges (e.g., check-writing fee).

SDIRA #3 (nontraditional IRA/LLC investing)

The third type of SDIRA also involves nontraditional investing, except using a slightly different structure. In this category, the IRA is held by the same (or a similar) IRA custodian as described in #2 above. However, rather than directly investing in "nontraditional" assets, the IRA purchases an ownership stake in a newly formed Limited Liability Company ("LLC"), which then executes the particular investments.

Example Setup/Investment of SDIRA #3. Client establishes a new IRA at a trust company and requests a transfer from her current IRA to the new SDIRA. Client then works with her attorney to form a new LLC with the pre-planned intention for the LLC to be solely owned by her IRA. Client then directs the trust company to invest substantially all of her IRA's assets into the new LLC, making the IRA the LLC's sole "member." Client serves as the LLC's "manager" and directs the LLC to invest the LLC assets into a piece of rental real estate. Thereafter, the LLC owns the real property and collects all income and pays all expenses of the real estate investment, without the need for direct interaction with the trust company.

II. Complexities for Attorneys Dealing with SDIRAs Invested in Nontraditional Investments

Complexity #1: More Retirement Dollars / More SDIRAs

The vast amount of money held in retirement accounts means that estate planning attorneys can no longer afford to be ignorant of the laws governing retirement assets generally, and SDIRAs specifically.[2] Most clients' retirement account balances are growing, and even for clients with relatively large estates, the importance of retirement accounts in estate planning continues to increase. Part of this growing importance is based on a shift among employers away from traditional defined benefit pensions and toward defined contribution retirement planning (e.g., Boeing's new contract with the machinists union).[3] As the amount of retirement assets has grown, so has awareness among clients that some types of retirement accounts (e.g., IRAs) are not restricted *only* to marketable securities. This awareness, as well as investor interest in direct investment

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opportunities and many other more "interesting" rationales,[4] has led many clients into the often dangerous world of SDIRAs.

Some sources suggest that the allocation of alternative investments is much lower in retirement accounts than in the broader universe of all individual/retail accounts. Past reports on SDIRA activity suggest the percentage of IRAs that are "self-directed" is below five percent,[5] but the percentage is projected to reach as high as 13 percent by 2015.[6] That could mean $780 billion could be held in alternative assets within SDIRAs by the end of next year.[7] Regardless of the exact figures, overall investment dollars appear to be flowing into alternative investments at a much faster rate than other more traditional asset classes (e.g., mutual funds),[8] and SDIRAs appear to be accounting for a larger share of those investment dollars.

Complexity #2: Prohibited Transactions

During Client's Life. The most important legal and tax principle in SDIRA investing is that "prohibited transactions" must be avoided. A "prohibited transaction," under the Internal Revenue Code of 1986, as amended ("IRC") occurs whenever a SDIRA or SDIRA/LLC and a "disqualified person" engage in any of the following transactions:

1. The sale or exchange, or leasing, of any property between them;
2. The lending of money or other extension of credit between them;
3. The furnishing of goods, services, or facilities between them;
4. A transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a SDIRA or SDIRA/LLC;
5. An act by a disqualified person who is a fiduciary, whereby he deals with the income or assets of a SDIRA or SDIRA/LLC in his own interests or for his own account; or
6. Receipt of any consideration from any party dealing with a SDIRA or SDIRA/LLC, in connection with a transaction involving the income or assets of that plan, for the personal account of any disqualified person who is a fiduciary.[9]

A disqualified person is defined in IRC Section 4975(e)(2). Because the IRA owner exercises discretionary control over a SDIRA, the owner is considered a "fiduciary" (and thus, a disqualified person) with respect to the SDIRA.[10] In addition, attribution rules apply to make certain related persons, including natural persons and entities, disqualified persons with respect to the SDIRA.[11] Specific examples of prohibited transactions include sales of assets from an account holder to the account holder's SDIRA, loans of SDIRA funds to a related person of the account holder, the account holder's use of real property (such as a vacation rental property) owned by the account holder's SDIRA, or the payment of compensation, even if reasonable, from an SDIRA-owned business to a related person of the account holder.[12]

Any prohibited transaction can result in a tax catastrophe. If the SDIRA engages in a prohibited transaction with a disqualified person, it ceases to qualify as a tax-exempt entity as of the first day of the tax year in which the prohibited transaction occurred. For tax purposes, this is treated as a 100 percent lump sum retroactive distribution of the IRA assets to the IRA owner as of the first day of the year *in which the prohibited transaction occurred*. This entire distribution may be taxed as ordinary income, interest may be due because the tax was not paid in the

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year of the deemed distribution, and penalties, including the early withdrawal penalty (if the account holder has not yet reached the age of 59½) and accuracy-related penalties, may also apply.

Many SDIRA account holders take the time to educate themselves on the complexity of the prohibited transaction rules, but many do not. The likelihood of a prohibited transaction increases dramatically if the account holder is unknowledgeable, misinformed (for example, by an IRA custodian or promoter of SDIRAs), or both.

Several recent Tax Court cases provide good examples of the potential disastrous tax consequences that can occur if a client is audited by the IRS for a violation of the prohibited transaction rules. In *Peek v. Commissioner*,[13] two business partners formed SDIRAs and subsequently invested the accounts into a C Corporation. The corporation then purchased a fire safety business. Part of the purchase price was a seller-financing promissory note, which was personally guaranteed by the two SDIRA owners. The business was later sold for a large gain. The Tax Court first ruled that no statute of limitations applied because the prohibited transaction continued to occur during the entire length of the note. The court then determined that a retroactive distribution of the whole of each SDIRA occurred in 2001 (when the promissory note was personally guaranteed). The end result was that each SDIRA owner was found to owe over $225,000 in tax and over $45,000 in penalties.

In *Ellis v. Commissioner*,[14] the SDIRA owner, through his legal counsel, established a SDIRA-owned LLC (as described above). Once purchased by the IRA, the LLC invested into a used car business of which the SDIRA owner was named as the "General Manager." The LLC paid the SDIRA owner compensation of $9,754 in 2005, which constituted a "self-dealing" prohibited transaction. The end result was a constructive IRA withdrawal (retroactive to 2005) of over $320,000, plus a 10 percent early distribution penalty and a 20 percent accuracy related penalty. In addition, because the assets of the IRA (i.e., the LLC and the used car business) became the SDIRA owner's *personal* assets effective as of January 1, 2005, the income of the LLC from 2005 to 2013 was deemed to be includable in the SDIRA owner's personal income.

While it is difficult to quantify the exact financial loss to the SDIRA owner in the *Ellis* case (and the Tax Court elected to not do so in its ruling),[15] it is possible that deemed retroactive IRA distribution resulted in 70 percent of the IRA being due in taxes, penalties, and interest in 2005 alone – not to mention the consequences of incorrect tax filings in years after 2005.[16] Although the facts of the case do not clarify how the SDIRA's investments performed, it is possible that, if the investments lost significant value, the tax consequences of the deemed retroactive distribution may have more than wiped out the total investment!

Prohibited Transactions (continued) – After Client's Death. As mentioned above, many account holders who delve into SDIRA investing take the time to educate themselves on prohibited transaction rules. However, when recordkeeping and decision-making responsibilities pass from the initial account holder (to the SDIRA owner's attorney-in-fact or guardian due to incompetency or to the designated beneficiaries on the SDIRA), those newly responsible individuals often lack the account holder's enthusiasm and capacity for understanding the SDIRA rules and regulations. Because SDIRAs pass according to the account's Beneficiary Designation Form (described more fully below), the death of the account holder will result in his or her beneficiaries (often a surviving spouse, children, or trustees) inheriting the SDIRA and the SDIRA's underlying assets, which may include interests in an LLC. The transfer of assets in and of itself is not a problem, but the transition of responsibility for SDIRA administration to well-meaning but uninformed beneficiaries can easily result in prohibited transactions occurring after the client's death. For example, imagine a situation in which the client owns an SDIRA/LLC. The client is the Manager of the LLC and has signature authority on the LLC's bank account. At the client's death, the client's spouse, who is unaware of the SDIRA/LLC structure, becomes aware of the LLC's bank account and its large balance. Because the LLC's bank does not likely realize the unique nature of the LLC (i.e., the fact that the LLC is owned by an SDIRA), it is unlikely to intervene to stop the spouse from removing funds from the LLC's bank account – especially if the spouse is a co-manager of the LLC and is listed as a "co-signer" on the account.

Even if a surviving spouse is able to successfully navigate the prohibited transaction rules, there is always the potential the IRS could audit him or her at some point in the future and find a prohibited transaction that occurred prior to the client's death. This can result in a retroactive invalidation of the IRA's tax-exempt status, which could be devastating to the financial well-being of the surviving spouse.

Similar issues arise when the SDIRA's beneficiary is a *trust*, as the trustee, whether an individual or a professional trustee, may be uninformed as to the rules and regulations governing the management of SDIRA or SDIRA/LLC assets – again raising the risk of prohibited transactions (not to mention corresponding fiduciary liability problems).

Complexity #3: Required Minimum Distributions (RMD)

During the Account Holder's Life. A peculiar characteristic

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of IRAs is that, until the account holder reaches the age of 59½, he or she cannot access the funds in the IRA without significant penalty, except under narrow circumstances. This built-in inaccessibility of IRA accounts makes them well suited to hold unmarketable, illiquid investments. However, 11 years after the account holder first gains access to the IRA funds without penalty, the liquidity demands on the IRA shift entirely, and the account holder must begin withdrawing funds from the IRA on an annual basis to avoid significant penalty.

These mandatory distributions under IRC Section 401(a)(9), known as "required minimum distributions" or "RMDs," are imposed to limit the duration of the income tax deferral inherent in traditional IRAs.[17] An account owner must begin taking RMDs by April 1 of the year after the year in which he or she reaches age 70½, and must take additional annual RMDs by the end of each subsequent calendar year.[18] Each RMD is determined by multiplying the account balance (revalued annually) by a life expectancy factor based on the account holder's age. Failure to take a RMD can result in a penalty equal to 50 percent of the difference between the RMD for a particular year and the aggregate distributions actually received that year.

For IRAs invested in marketable securities and cash, the only real compliance challenge with RMDs is ensuring that they are planned for and actually occur each year. The determination of the amount is a straightforward calculation based on readily available market quotations. For SDIRAs, however, determining the value of unmarketable, illiquid assets often requires detailed appraisals. If the appraisal undervalues the assets, the IRS may later determine that the distributions for a given year, while correctly calculated based on the appraised value of the assets, did not meet the RMD threshold based on actual asset values. This would result in a 50 percent penalty for the shortfall.

SDIRAs can also raise liquidity issues when the account holders must take RMDs. If the account holder's only IRA is an SDIRA, the account holder may need to generate funds from the SDIRA assets to satisfy RMDs each year, and doing so may strain the underlying SDIRA investment. If the account holder has multiple IRAs, including one or more IRAs invested in marketable securities and/or cash, the RMD may be aggregated across all IRAs and taken from any one of the IRAs.[19] This may allow the account holder to avoid fire sales of illiquid SDIRA assets, but the account holder must still have sufficient liquid investments in his or her other IRAs to fund the RMD attributable to the SDIRA and its assets.

In lieu of cash, the RMDs may be satisfied in-kind, with distributions of interests in the underlying SDIRA assets.[20] Unfortunately, there is no carry-forward available for distributions in excess of a RMD, and the RMDs for multiple years may not be aggregated into a single distribution.[21] Said another way, a large distribution of an illiquid asset that exceeds the value of the required minimum for the year of distribution does not result in a RMD "credit" that may be applied against future years. As an alternative to distributing an entire asset as an in-kind distribution, the account holder might distribute partial interests in the asset (such as fractional interests in real estate or minority LLC interests). However, doing so may directly result in or may increase the likelihood of prohibited transactions.[22] In-kind distributions of partial interests also pose valuation problems, such as whether or not, and how much of, a discount should be applied to the partial interests for lack of control and lack of liquidity.

RMD (continued) – After the Account Holder's Death. Account holders of SDIRA-owned illiquid assets can plan well in advance of reaching age 70½ for the valuation issues and liquidity needs described above. However, the account holder's death fundamentally alters the framework of RMDs, and often accelerates the rate at which SDIRA assets must be distributed. Depending on the account holder's designated beneficiaries of the SDIRA, the RMD may be calculated on the basis of the account holder's actuarial life expectancy at death, the surviving spouse's life expectancy, or the beneficiaries' actuarial life expectancy.

If the account holder designates individuals (other than a surviving spouse) or properly drafted see-through trusts as beneficiaries, RMDs commence in the year following the decedent's death. A younger account holder may be able to plan effectively for an unmarketable SDIRA investment to generate liquidity for RMDs by the time he or she reaches age 70½. However, if that account holder dies unexpectedly, the possibility of near immediate RMD requirements may be incompatible with the deceased account holder's investment arrangements and may result in the forced liquidation of an unmarketable asset at a loss.

If the account holder dies before reaching the age of 70½ and fails to designate individuals or properly drafted see-through trusts as his or her beneficiary(ies), all of the SDIRA assets must be distributed out of the SDIRA to the named or default beneficiary(ies) by the end of the fifth year after the account holder's death.[23] The account holder's untimely death, coupled with his or her failure to properly designate beneficiaries, may erode the anticipated return of unmarketable assets that must be prematurely liquidated or fully distributed within five years of the account holder's death. This problem is exacerbated if the assets within the SDIRA cannot be liquidated due to market conditions, inherent limitations imposed on many privately

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held security interests, or other dynamics that are unique to unmarketable assets. For example, if the SDIRA's investment consists of an interest in a real estate partnership, and the partnership's managers refuse to liquidate the IRA's interest (either because the partnership is financially incapable of doing so, or because the partnership's governing documents failed to properly address liquidation issues), significant RMD problems would likely occur.

Complexity #4: Current IRA Tax Consequences (UBTI/UDFI)

One of the most common misconceptions regarding retirement accounts, including SDIRAs, is that they *never* owe current taxes – i.e., they are always "tax deferred." Unfortunately, that is definitely not the case. Most IRA and SDIRA investments do not trigger *current* tax consequences, not because all income an IRA earns grows tax free, but because the types of income that an IRA typically earns are exempt from unrelated business taxable income ("UBTI").[24] For example, IRAs that are invested in publicly traded securities (e.g., stocks, bonds, mutual funds) do not owe current tax because gains from the sale of C corporation stock, dividends, and interest income are all exempt from UBTI.[25] For this reason, most IRA investors are not even aware that an IRA can be required to file a tax return (Form 990-T)[26] and pay a *current* tax. The two key triggering events for current IRA tax consequences are (1) income from a business that is regularly carried on (whether directly or indirectly through a "flow-through" tax entity), which results in UBTI; and (2) income from debt-financed property (again, either directly or indirectly received), which results in unrelated debt-financed income ("UDFI").[27]

For example, assume an SDIRA (or SDIRA/LLC) purchases membership units (equity) of a real estate partnership structured as an LLC ("Project LLC"). The Project LLC has 20 owners/members, and the SDIRA/LLC owns five percent of the membership units. The Project LLC then purchases 10 acres of vacant land and develops 20 building lots. At the end of each taxable year, the Project LLC would file a partnership tax return (Form 1065) and issue a Schedule K-1 to each of its owners/members (the SDIRA being one).[28] Because the Project LLC's activities will likely be characterized as "ordinary business income" (i.e., not "capital" because the Project LLC is in the ordinary and regular activity of real estate development) on line 1 of the Schedule K-1, the proportionate income "flowing through" to the SDIRA will *not* be exempt from current tax, but instead will be UBTI.

The above example may be slightly altered to demonstrate the concept of UDFI. Assume that instead of conducting real estate development, the Project LLC invests in an apartment building with the goal of accumulating long-term rent and appreciation. The Project LLC again collects equity investments from 20 owners/members, including the SDIRA (or SDIRA/LLC), but also obtains a *bank loan* in order to purchase a larger building than would otherwise be possible with investor funds alone. The Project LLC would still file a Form 1065 and issue a Schedule K-1 to all of its owners/members at the end of each tax year. However, the K-1 would not list "ordinary business income" on line 1, but would instead list "net rental real estate income" on line 2 (i.e., rent from the apartment building's tenants), and potentially "net long-term capital gain" on line 9a (e.g., if the building was sold several years later for a gain). In this case, the SDIRA (or SDIRA/LLC) would not normally owe current tax on the rent or capital gain from the investment. However, because part of the income is generated as the result of *debt-financing* (i.e., UDFI), the income will be *partially taxable* to the SDIRA, and the SDIRA would need to file a Form 990-T.

Although UBTI and UDFI tax consequences might appear to be problems that reside outside of the estate planning attorney's realm, not recognizing potential SDIRA tax consequences can result in negative consequences to the client such as: (1) dramatic reduction in return on investments as a result of tax being imposed on investments that are otherwise expected to be tax-deferred; and (2) penalties and interest resulting from failing to file tax returns and pay the tax owed. Failing to recognize these potential issues during the estate planning process can reflect negatively upon an unknowing advisor.

Complexity #5: Implementation of Beneficiary Designation Forms

Designating beneficiaries of IRAs upon the account holder's death has become a fundamental component of the estate planning exercise. For many clients, the IRA beneficiary designation form disposes of a larger value of the account holder's estate than the clients' wills or revocable trusts. Beneficiary designation planning requires analysis of the estate and income tax consequences, including the RMD rules applicable to various beneficiaries, and consideration of the beneficiaries' ability to manage the assets outright rather than in trust. In practice, beneficiary designation forms may list multiple beneficiaries and/or contingent beneficiaries, some of which may be trusts.

Dividing an IRA of marketable securities in accordance with complex beneficiary designation forms can be a complicated enough task. Dividing a SDIRA with illiquid assets in accordance with complex beneficiary designations can be exponentially more complicated. Even a designation

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that leaves a SDIRA to two surviving children may be very difficult to allocate if, for example, the SDIRA includes real property or investments that include legal restrictions on transfer or practical impediments to liquidation.

In another example, suppose a SDIRA account holder designates a son as a 60 percent beneficiary and a grandson as a 40 percent beneficiary. If the IRA holds 100 shares of a publicly traded company, the shares may be divided 60/40, and the value of the son's inherited IRA will be worth proportionately more than the interest of the grandson's inherited IRA. If, rather than shares of a public company, the SDIRA owns 100 percent of an LLC, a 40 percent interest in the LLC, with a corresponding minority control discount, would be worth less than 40 percent of the net asset value of the SDIRA (and disproportionally less than a 60 percent controlling interest in the LLC). As a result, the grandson may have a valid complaint if he receives an inherited SDIRA with a 40 percent interest in the LLC, while the son's inherited SDIRA received a 60 percent controlling interest.

Even after the distribution is resolved, the competing interests of the son and grandson may raise issues. The son, for example, may want to distribute fully his inherited SDIRA so that he may take outright ownership of his LLC interest and become the compensated manager of the LLC. The grandson, however, might want to preserve his LLC interest in his inherited SDIRA in order to obtain the maximum income tax deferral. On top of it all, it would be a prohibited transaction for the LLC owned in part by the grandson's SDIRA to pay compensation to the grandson's father, and doing so would result in a forced deemed distribution of the grandson's SDIRA interest in the LLC.[29] Needless to say, the shared ownership issues which could arise have the potential to make "ordinary" family LLC planning look simple in comparison.

III. Conclusion

The use of SDIRAs and IRA-owned LLCs to purchase nontraditional assets has increased in recent years and will likely continue to increase as a result of greater public awareness. As account holders age, it will become more important for estate planning attorneys to understand the fundamental legal, tax, and practical complexities that these accounts present for their clients. Specifically, attorneys should recognize the following potential complexities that SDIRAs and SDIRA/LLCs can raise:

Prohibited Transactions

Prohibited transactions can occur at any time and the financial consequences to clients (and/or their beneficiaries) can be catastrophic. Avoiding potential IRS scrutiny with regard to prohibited transactions involves careful record-keeping. Attorneys should be prepared to, at a minimum, ask the SDIRA owner questions that will reveal whether the client is on track with regard to legal and tax compliance.

Asset Management

Attorneys should encourage clients to consider how the SDIRA's or SDIRA/LLC's unique assets will be managed if the client is unable to do so, whether due to incapacity or death.

RMD

RMDs (generally beginning when the IRA owner reaches age 70½) raise unique challenges for clients with nontraditional assets within SDIRA or SDIRA/LLC structures because of the illiquid nature of these assets. Attorneys need to encourage clients to plan for the inevitable day (whether during their life or when the SDIRA is inherited by their beneficiaries) when RMDs will occur.

Current IRA Taxes (UBTI/UDFI)

Attorneys need to recognize that an SDIRA's investments are not always tax-deferred and the SDIRA can potentially be required to file a current tax return and pay a tax as a result of UBTI and UDFI.

Beneficiary Designations

SDIRA assets pass to beneficiaries in the same manner as any other IRA, i.e., according to the account's beneficiary designation form. However, because of the difficulty in legally dividing unmarketable assets, attorneys must consider the practical difficulties that SDIRAs can present when advising clients to fill out beneficiary designation forms in a particular manner.

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1 *See* discussion on SDIRA #3 *infra.*

2 The overall size of the SDIRA marketplace is difficult to gauge – partially due to the fuzzy distinctions among the varieties of SDIRAs. The Investment Company Institute reports that overall IRAs held $6.2 trillion in assets as of September 30, 2013, $2.8 trillion of which were mutual fund holdings. *See Retirement Assets Total $21.9 Trillion in Third Quarter 2013* (January 10, 2014) (ici.org/research/stats/retirement/ret_13_q3).

3 *See* example commentary: Westneat, Danny, *Boeing puts all pensions at risk*, The Seattle Times, (January 7, 2014) (http://seattletimes.com/html/localnews/2022617234_westneat08xml.html).

4 Besides a general awareness that an IRA can invest into assets *outside* of the public securities market, many clients express other reasons for their decision to invest in this manner, including: dissatisfaction with past stock market results; perceived dangers of the current U.S. fiscal situation; personal experience and success within certain asset classes (e.g., real estate, hard-money lending, private equity, etc.); and the desire to hold something "tangible" within the retirement account. The statements in this endnote are based on the author's experience in working with thousands of individual SDIRA investors and observing the rationales expressed by these clients as to why they are choosing to invest in "nontraditional" assets within their retirement accounts.

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5 The Securities and Exchange Commission estimated in 2011 that 2 percent of IRA assets were held in SDIRAs. *See* "*Investor Alert: Self-Directed IRAs and the Risk of Fraud*," Securities and Exchange Commission's (SEC) Office of Investor Education and Advocacy, (September 2011) (sec.gov/investor/alerts/sdira.pdf).

6 McKinsey & Company, *The Mainstreaming of Alternative Investments: Fueling the Next Wave of Growth in Asset Management* (July 2012).

7 *Id.* Assuming total assets within IRAs increase modestly from 2013 to 2015 (e.g., $5.734 trillion in 2013 to $6 trillion in 2015) and alternative assets within SDIRAs increase to 13 percent by the end of 2015, this would result in $780 billion being held within IRAs.

8 McKinsey, *supra* note 6. McKensey's report estimates that the total value of investment dollars in alternative assets grew seven times faster between 2006 and 2011 than other asset class.

9 IRC §4975(c)(1).

10 *See e.g., Ellis v. Commissioner,* T.C. Memo. 2013-245 (October 29, 2013) at page 16: "For the purposes of section 4975, a fiduciary is defined as any person who…exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets. Mr. Ellis…exerted control over his IRA in causing it to engage in the purchase [an entity]. Accordingly, Mr. Ellis was a fiduciary of his IRA within the meaning of section 4975 and consequently a disqualified person with respect to that plan."

11 IRC §4975(e)(2)(E), (F), (G), (H), and (I). For example, if an IRA account holder owns 50 percent or more of a business entity, the entity becomes a disqualified person, and thus, the SDIRA or SDIRA/LLC could not financially interact with the personally owned entity. Further, any other 10 percent or greater owners, officers, directors, or highly compensated employees of the same personally owned business entity would also become disqualified parties. In this way, an IRA account holder can easily get in trouble by having his/her IRA interact with someone who the IRA account holder is currently doing business with, regardless of the fact that the personal business activity is seemingly unrelated to the SDIRA or SDIRA/LLC's investment activity.

12 For a recent example of how the payment of compensation to a disqualified person out of an IRA-owned LLC can result in a prohibited transaction, *see Ellis*, T.C. Memo. 2013-245. Ellis established a self-directed IRA and subsequently invested approximately $320,000 into a newly-formed LLC in exchange for 98 percent of the LLC's membership units. The LLC then operated a used car business and paid less than $10,000 of compensation to Ellis. The Tax Court held that a prohibited transaction occurred in the year in which the compensation was paid, automatically triggering a retroactive deemed IRA distribution of $320,000 – resulting in income tax, a 10 percent premature distribution penalty, and a 20 percent accuracy related penalty. In addition, the assets of the IRA-owned LLC were deemed to be held by Ellis from the time of the prohibited transaction (2005) going forward – likely resulting in additional tax compliance problems for Ellis from 2006 through 2013. For an in-depth look at the *Ellis* case, see my article entitled *Boom! Boom! Boom! IRS Fires Three Shots Across the Bow of Self-Directed IRA Investors*, WSBA Taxation Law newsletter (Winter 2013-2014).

13 140 T.C. No. 9 (May 9, 2013).

14 T.C. Memo. 2013-245 (October 29, 2013).

15 *Id.* In the court's words, the calculation of tax due is purely "computational." In other words, the Tax Court left the calculation of Mr. Ellis's tax bill in 2005 and beyond in the hands of the IRS.

16 For example, if the prohibited transaction in 2005 resulted in Mr. Ellis owing 35 percent tax on the $320,000 deemed IRA distribution, plus 20 percent accuracy penalty, 10 percent early distribution penalty, and interest on the amount due over the prior eight years, the total percentage of the original $320,000 due in taxes could exceed 70 percent.

17 RMDs do not apply the case of *Roth* IRAs, from which distributions are not subject to income tax.

18 Treas. Reg. §1.401(a)(9)-5, A-1.

19 Treas. Reg. §1.408-8, A-9.

20 Treas. Reg. §1.401(a)(9)-5, A-9.

21 Treas. Reg. §1.401(a)(9)-5, A-2.

22 The IRA owner is considered a *fiduciary* to an SDIRA and cannot use the IRA funds to directly *or indirectly* benefit himself. *See* IRC §4975(c)(1)(D) and (E); *see also* Swanson v. Commissioner, 106 T.C. 76, 88 n.13 (1996), *Peek v. Commissioner*, 140 T.C. No. 9 (May 9, 2013), and *Ellis*, T.C. Memo. 2013-245. Co-ownership between an IRA owner (and another disqualified person) and the IRA, whether occurring when the asset is originally purchased or as a result of a partial in-kind distribution, has the potential to result in a prohibited transaction under IRC §4975(c)(1)(D) and (E). Additional examples of investment scenarios that can lead to so-called "fiduciary prohibited transactions" can be found in Department of Labor ("DOL") Op. Ltr. 88-18A, DOL Op. Ltr. 82-08A, and DOL Op. Ltr. 93-33A.

23 Treas. Reg. § 1.401(a)(9)-3.

24 The UBTI provisions are found at IRC §§511-514. Conforming amendments were not made to IRC §§511(a)(2)(A) and 501(a) to include IRAs when the IRS Code provisions were enacted, but IRC §408(e)(1) clearly indicates the UBTI provisions apply to IRAs. Essentially, income that is "unrelated" to a tax-exempt entity's "purpose" is not exempt from current tax. In the case of a charitable organization, this concept is more logical (e.g., an organization with the intended purpose of fighting malaria in Africa cannot operate an ice cream shop in Seattle and have the profits from the ice cream shop be tax-exempt).

25 In general, earnings within an IRA are tax-deferred. See IRC §408(e)(1).

26 Form 990-T information can be found on the IRS website (irs.gov/uac/Form-990-T,-Exempt-Organization-Business-Income-Tax-Return).

27 If the IRA account holder does not realize that the SDIRA's or SDIRA/LLC's investments are resulting in UBTI or UDFI, there will likely be no Form 990-T filed (note: IRA custodians will generally refuse to advise IRA owners on whether a Form 990-T is required and/or file a Form 990-T on the IRA owner's behalf). For a more detailed analysis on the UBTI/UDFI problem, see my article, *Self-directed IRAs: A Tax Compliance Black Hole,* Journal of Accountancy (October 1, 2013), (journalofaccountancy.com/Issues/2013/Oct/20137626.htm).

28 The Schedule K-1 lists various tax items that are "flowing through" to the Project LLC's owners. The owners (including the SDIRA) must then determine their own tax responsibilities based on the items that have been allocated to them. This "flow through" treatment occurs *automatically* and cannot be stopped simply by having the Project LLC retain (i.e., not distribute) its profits.

29 The starting point for determining whether a prohibited transaction has occurred is always to determine whether an individual (or business entity) that is planning to (or already has) financially interacted with the SDIRA or IRA/LLC is considered a "disqualified person" under IRC § 4975(e)(2). Under that section, certain family members of the IRA account holder are considered "automatically" disqualified (e.g., lineal descendants, ascendants, certain business entities owned by disqualified people, etc.). However, as discussed in a prior endnote, even if no disqualified person is involved, a "fiduciary prohibited transaction" can occur in some situations.