PART II

Everything You Need to Know About Individual Retirement Account Prohibited Transaction Rules

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Contrary to some articles promulgated by IRA promoters the IRC prohibits certain transactions between IRAs and "disqualified persons". Rules are essentially same as with qualified plans. IRC § 4975. The IRA owner, his/her beneficiaries, the IRA trustee/custodian, etc. are "disqualified persons". The following are the basic prohibitions:

1. sale or exchange, or leasing, of any property between a plan (IRA) and a disqualified person;
2. lending of money or other extension of credit between a plan (IRA) and a disqualified person;
3. furnishing of goods, service or facilities between a plan (IRA) and a disqualified person;
4. **transfer to, or use by or for the benefit of, a disqualified person, of any assets or income of a plan (IRA);**
5. **an act by a fiduciary whereby the fiduciary deals with the assets or income of a plan (IRA) in the fiduciary's own interest or for the fiduciary's own account (i.e., self-dealing); or**
6. **the receipt of consideration by a fiduciary for the fiduciary's own account from an party dealing with a plan (IRA) in connection with a transaction involving the assets or income of the plan (IRA) (i.e., a kickback).**

An example of a prohibited transaction is the borrowing of money from an IRA by its owner (a rollover of a participant loan from a qualified plan to an IRA also is "borrowing"- see below). Other examples are the sale of property by the IRA owner to the IRA or using the IRA as security for a loan.

See TAM 8849001, ruling that a prohibited transaction takes place when a §401(a) qualified plan participant's personal note to the plan is distributed in kind and then rolled over into an IRA owned by that individual. Following the rollover, the IRA owner would owe the IRA, constituting a prohibited loan between the IRA and a disqualified person, even though the loan was made before the individual established the IRA.

NOTE - The IRS has determined certain "factoring" or other transactions with an IRA were "listed transactions". See Regs 1.6011-4(b)(2), 301-6111-2(b)(2) and 301.6112-1(b)(2).

NOTE 2 - I have been presented with several attempts by potential clients asking me to issue an opinion letter to effect that IRA investment in an LLC that does a "deal" with IRA owner is not a "PT". There is a misconception that use of an LLC obviates PT rules. NOT. A "loan" to an owner - or taking "advantage" of your IRA in an LLC deal (preferred splits) and many proposed co-ownership arrangements still constitutes a PT. There are promoters touting the use of an LLC owned by your IRA (with a cooperating custodian) that allows you, as LLC Manager, to transact business out of view of the custodian. Watch out!

NOTE 3 - There have been rulings or situations where an IRA and the IRA owner can enter into a transaction as "co-owners", with NO advantage to one or the other, and there was no minimum threshold of $ for a deal of that type that the IRA owner could not do individually. CAUTION!

NOTE 4 - An IRA's purchase of leveraged real estate with the IRA owner personally guaranteeing the loan is a PT.

Tax Consequences of PT - If the owner engages in PT with his/her IRA, the entire IRA ceases to qualify as an IRA as of the first day of the taxable year IRC § 408(e)(2). The normal 15% excise tax on PTs does not apply to an IRA unless the person involved in the "PT" is not the IRA's owner or beneficiary. IRC § 4975 (c)(3) - unclear of this as to an Individual Retirement Annuity. Note - the taxation of the entire IRA is a much worse penalty than the excise tax that applies to a qualified plan. Example - $1,000,000 IRA. PT involving $20,000. Entire IRA becomes taxable.

Excise Tax on Entity Manager - A person who causes an IRA to be a party to a "prohibited tax shelter transaction" (IRC § 4965(e)(1)) can be liable for a $20,000 excise tax.

DOL Opinon Letter 89-3A - (Involves purchase of stock by IRAs. Office/Manager (and his Wife) of a Division of "Rock-Tenn Company" asked to DOL if he could purchase Rock-Tenn stock for their IRAs. They owned a small percentage of R-T stock already, but not anywhere near a controlling interest. Facts:

Rock-Tenn total outstanding shares	= 2,500,000
Amount of shares proposed to be purchased by IRAs	= 400
Amounts Manager and family owned already (or would own if options exercised)	= 28,927
Approximate amount of shares owned by Manager/Family	= 1.2%

DOL concluded R-T was not a "disqualified person" under IRC § 4975(c)(i)(A).

But, DOL declined to rule - saying it was a factual determination that IRC § 4975(c)(1)(D) or (E). DOL told the Manager "you may wish to consider whether the purchases of stock involve violations of IRC § 4975(c)(1)(D) or (E)."

Note - Many practitioners less experienced with the workings of 4975 focus on the percentage (%) tests! But they over look the factual tests of IRC § 4975(c)(1)(D) or (E) that have NO minimum percentages! This is not a mechanical "%" test! And as the penalty can be (if the IRA owner is deemed to engage in a PT with his/her own IRA) taxation of the entire IRA - extreme caution is warranted.

NOTE - Promoters of "checkbook IRAs" whereby you cause IRA to set up an LLC under which the IRA owner is the Manager and is operating "fast and loose" on his/her own without IRA custodial supervision are almost certainly violating two principles of IRA rules:

1. That an IRA custodian is necessary - a qualified financial institution - thereby disqualifying the IRA from status as a "qualified IRA".

2. That "PTs" are likely to occur in that scenario - with the IRA account owner acting without proper supervision.

New York Times Article October 20, 2007 - Exotic IRAs: Leaving Stock and Bonds Behind (copy on www.BSLLP.com). This article discussed several concepts:

- Music Teacher from Tucson - IRA owns 25 musical instruments and rents to his students (he has an IRA custodian that apparently allows this).

Comment - Income **is** UBTI. And how these assets are in the possession or control of his IRA custodian is a mystery. And are "musical instruments" "collectibles" (see later tax discussion)?

The article goes on to say ***"In addition, account holders may not personally benefit from their investment in any way other than making legal withdrawals. This means that you may not live in a house you bought with your IRA, or put rental income anywhere but back into the IRA. Finally, any transactions with a lineal family - like children, parents and grandparents - are prohibited. This means a couple cannot invest in a start-up owned by their son.***

When the IRS spots a violation, it shows little mercy, disqualifying the entire IRA, taxing it retroactively and imposing a 10 percent withdrawal penalty on account holders under the age of 59½.

Hugh Bromma, chief executive of Entrust, says one client allowed her daughter to live in a condominium owned through her IRA. The government forced the client to liquidate the entire $750,000 account and charged her over $1 million in taxes and fines."