The Care and Feeding of Self-Directed IRAs

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Presenter's Bio: Warren L. Baker, Esq. is a tax attorney with Fairview Law Group, PS in Seattle, WA. Warren's practice is focused on assisting clients in analyzing, structuring, and negotiating tax-efficient structures for complex investment and business transactions. Warren has been published, featured, and/or quoted in outlets such as *The Wall Street Journal, Forbes, Bloomberg BNA*, *Trusts & Estates*, and *Financial Planning magazine*. His latest publication, entitled "*The Care and Feeding of Large IRAs*" (co-authored with Natalie B. Choate), recently won a Distinguished Author Award ("Thought Leadership" category) by the article's publisher, *Trusts & Estates*.

Objective: The investment of retirement accounts into non-publicly-traded assets (e.g., real estate, private equity, notes, etc.) has increased rapidly over the past 15 years. Regardless of a particular client's investment objectives, it is vital for professional advisors to understand potential legal, tax, and estate planning landmines before they occur. As "self-directed" retirement accounts continue to grow (in both size and importance to many Americans), a professional advisor can distinguish himself or herself from the crowd by understanding the unique issues that these accounts often create.

Attendees can expect to learn about how to identify and plan for the two most significant legal concerns facing self-directed IRAs: prohibited transactions and currently taxable income ("unrelated business taxable income" – UBTI). Attendees will also learn how to manage IRS scrutiny risks, conduct an annual IRA checkup, and plan around unique liquidity and estate planning characteristics of self-directed IRAs holding non-traditional assets.

Supplemental Reading Material: [See hyperlinks on page 23 of materials]

1. ***The Care and Feeding of Large IRAs***, Warren L. Baker and Natalie B. Choate, *Trusts & Estates magazine* (December 1, 2016). [Winner of WealthManagement.com's 2017 Distinguished Author Award in the category of "Thought Leadership"].

2. ***Tax Court Nixes Roth IRA Tax Shelter***, (discussion of Tax Court case: Block Builders LLC v. Commissioner), Ashlea Ebeling, *Forbes* (August 10, 2017). [Warren consulted with and quoted in article].

3. ***Are Taxes Lurking in Your Tax-Free Retirement Account?***, Laura Saunders, *The Wall Street Journal* (March 10, 2017). [Warren consulted with and quoted in article].

4. ***IRAs Gone Wild: How To Invest In Private Equity, Real Estate, Gold***, Ashlea Ebeling, *Forbes* (October 19, 2016). [Warren's practice featured in article].

5. ***Self-directed IRAs – Top Five Complexities for Estate Planning Attorneys,*** Warren L. Baker, *Washington State Bar Association (WSBA) Real Property, Probate & Trust newsletter* (April 2014).

6. ***Boom! Boom! Boom! IRS fires three shots across the bow of self-directed IRA investors****, Warren L. Baker, WSBA Taxation Law newsletter* (March 2014).

7. ***Self-Directed IRAs: A Tax Compliance Black Hole****, Warren L. Baker, Journal of Accountancy* (October 1, 2013).

Table of Contents:

PART 1

INTRODUCTION TO SELF-DIRECTED IRAs ("SDIRA")[1]

1.1. <u>If you learn nothing else…</u> The following five SDIRA issues can cause problems for advisors who work with both IRA owners and/or investment organizers, and regardless of whether the advisor believes his/her scope of service includes retirement plan issues.

(1) A "**prohibited transaction**" will *retroactively* invalidate an IRA (back to the date of the first violation) – often resulting in the loss of 60-70% of the IRA's value after income tax, penalties, and interest are taken into account.

(2) All income earned within IRA *after* a prohibited transaction occurs is **treated as happening in the IRA owner's personal name** (i.e., income and/or any other type of gain/income within IRA after prohibited transaction can result in significant tax problems to IRA owner irrespective of the pain from the retroactive distribution itself).

(3) The **incapacity or death of the IRA owner** can cause additional problems/risks, related to: prohibited transactions, required minimum distributions (RMD), and continuity of asset management. These problems complicate estate planning with regards to SDIRAs, but these issues can be resolved if they are identified and addressed accordingly.

(4) Improperly structured investments can result in **current tax consequences** to the *IRA itself* (i.e., tax free growth is *not* always a given within IRAs). For example, an IRA investment into a real estate development project can result in 35%+ income tax to IRA itself – as a result of "unrelated business taxable income" (**UBTI**). Even if the income to SDIRA (directly or via flow-through business entities) is "passive" (e.g., capital gain, rent from real property), if the income is debt-financed, tax to the IRA can occur because of "unrelated debt-financed income" (**UDFI**). In either case, the IRA must file a standalone tax return (IRS Form 990-T), or face additional penalties and interest.

(5) A "Roll-Over as Business Startup" (**ROBS**) structure, in which a 401(k) is used to purchase substantially all of a newly-forced C-Corporation (which then operates a business and pays the 401(k) owner a salary), operates under very different rules than a SDIRAs or SDIRA-owned LLC. Unfortunately, the marketplace as a whole gets these two structural concepts confused, leading to prohibited transaction problems.

1.2. An Overview of the SDIRA Landscape / Rules.[i]

Although the idea of investing in real estate, promissory notes, non-publicly traded securities, precious metals, limited liability companies (LLCs), and partnerships using a retirement account might still seem obscure (or perhaps impossible) to many people, the practice of using so-called "self-directed IRAs" has become somewhat commonplace in recent years. The rationale for *why* IRA account owners decide to invest some (or all) of their retirement dollars into "alternative" assets varies widely; however, the most common rationales include[ii]: fear based on past stock market crashes; 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/or, the desire to hold something "tangible" within the retirement account. Regardless of the reason, investors with a wide variety of past experiences and net worth are pursuing self-directed IRA investments. For example, a "recovering Wall Street Banker" with a high net worth and a large retirement nest egg might seek an investment in a hedge fund or private equity opportunity; a retired airline pilot with moderate wealth and a smaller retirement account might pursue a single-family home for long-term rental income and appreciation.

As of the end of the first quarter of 2017, the total value of assets within IRAs was over $8.2 trillion.[iii] This compares to $2.6 trillion at the end of 2000.[iv] Another $7.3 trillion currently resides within employer-sponsored defined contribution plans (e.g., 401(k) plans) and $5.5 trillion in government-sponsored plans (e.g., 457 plans).[v] It is likely that the assets within IRAs will continue to increase as baby boomers continue to retire and "rollover" their employer (or government) plans into IRAs, a practice that is generally encouraged by both employers and the financial planning community as a whole.[vi]

The percentage of IRA assets that are currently invested into alternative assets within self-directed IRAs is difficult to measure. In late 2011, the Securities and Exchange Commission estimated that two-percent of IRA assets were held in self-directed IRAs (equal to $94 billion at that time).[vii] However, some sources suggest that the percentage of assets in alternative investments within all individual/retail accounts (both retirement accounts and general brokerage accounts) is much higher, and could be as much as 13 percent.[viii] If this is the case, it would mean that self-directed IRAs are currently holding around $1.066 trillion of alternative assets.[ix] 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).[x]

> **1.3. *Perspective*: A "typical" SDIRA client.** People often ask me, "What does a typical self-directed IRA client look like anyway?" Or, the more cynical person would stay, "This must be just a bunch of people that are nuts about real estate, right?" In the mid-2000s, the typical client was someone who simply felt a grudge toward the stock market and didn't want exposure to an investment world that they viewed as corrupt and akin to gambling. However, today, more and more clients are high net worth individuals who are simply pursuing what they view to be attractive investment opportunity – the type of opportunity that many of these same clients have invested into using personal (non-IRA) money for years, but they now want exposure to these investments within a tax-favorable environment (and/or all of their non-IRA funds recurrently tied up in other illiquid investments).

The legal framework that governs self-directed IRAs is the same as any other IRA,[xi] but the essential element that makes these accounts unique is that they are held by an IRA custodian that allows investments into alternative assets under the direction of the IRA owner. Generally, the most well-known brokerage firms (e.g., Fidelity, Charles Schwab, Vanguard, etc.) will not facilitate an investment from an IRA into alternative investments such as real estate (for example) but that does not mean that this type of investment is not legally permissible. In fact, IRAs are allowed to invest into *any* asset except for life insurance contracts[xii] and "collectibles".[xiii] The companies that hold self-directed IRAs might not be household names, but they are also not as small as many people might think.[xiv] Examples of these alternative IRA custodians include, but are definitely not limited to: PENSCO Trust Company, Millennium Trust Company, IRA Services Trust Company, Provident Trust Group, Kingdom Trust Company, and Trust Company of America. Many small community banks will also hold these types of assets. The precise manner in which these custodians execute transactions and charge fees varies widely, but they all promote themselves as being a good fit for self-directed IRA owners. In reality, they are all purely "passive" (non-fiduciary) custodians, which means that each client is almost entirely on their own with regards to legal and tax compliance.

> **1.4. *Quick Tip*: The IRA custodian tells a lot.** One of the easiest ways to determine whether your client has the type of IRA that *could* raise the problems discussed in these materials is to ask "what company is serving as your IRA custodian?" (note: an Estate Planning Questionnaire, if worded correctly, can also reveal this information). If you haven't heard of the company and/or you conduct a quick Google search and find that the company specializes in "self-directed IRAs", it is safe to bet that nontraditional assets are involved – and, in turn, potential unique legal and tax issues.

TYPES OF SELF-DIRECTED IRAs[xv]

There are three basic types of SDIRAs, but only type #2 and #3 (see 2.2. and 2.3. below) will be addressed in the presentation.

2.1. SDIRA #1 – traditional securities.

The first type of SDIRA involves traditional securities investing (e.g., stocks, bonds, mutual funds, etc.). With this type, the IRA account is held by a large brokerage house (e.g., TDAmeritrade, E*Trade, etc.) which allows IRA owners to "self-direct" 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 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".

2.1.1. Example of Setup/Investment for 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 which 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.

2.2. SDIRA #2 – nontraditional assets / "direct" SDIRA investment.

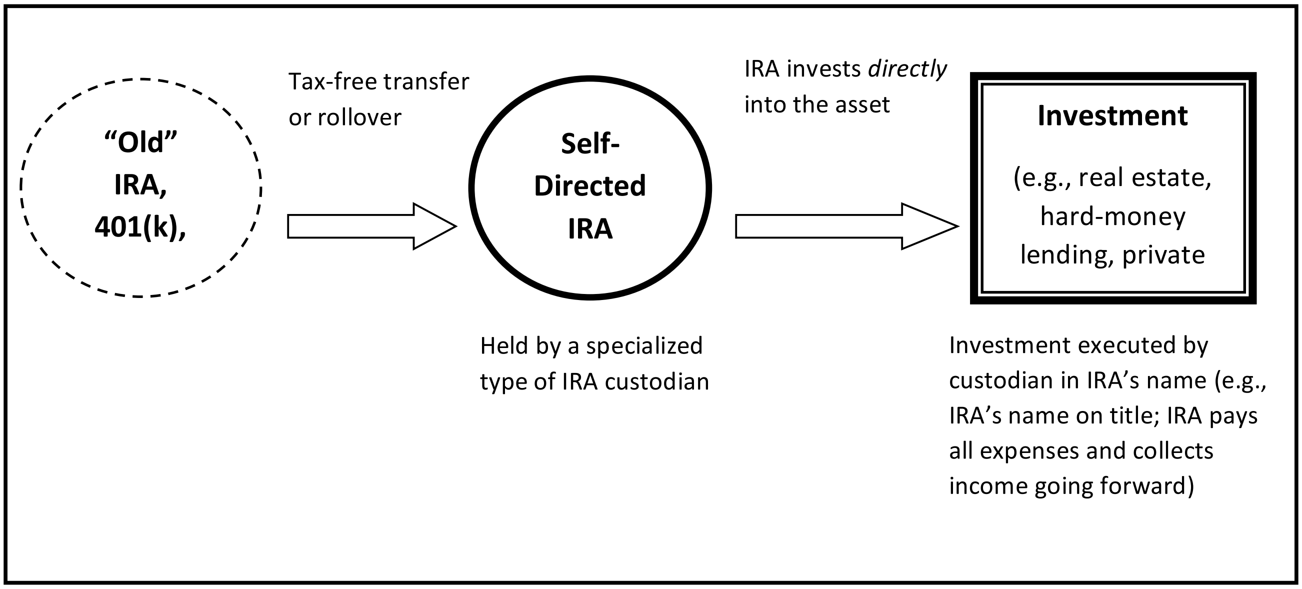
The second type of SDIRA is generally categorized as investments made *directly* out of the IRA into "nontraditional" assets. In this category, the IRA is held by a specialized type of trust company or bank ("custodians") that allows "direct" investments into almost any asset imaginable (except for life insurance contracts and "collectibles") (see example custodians in Part 1.3. above). 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 sometimes generates larger fees for the IRA custodian, as some custodians 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; see "SDIRA#3 below"), the holding fees paid to the custodian will be higher. In other words, some 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.

2.2.1. *Quick Tip*: Beware of pre-arranged plan. A scenario that often occurs is that the IRA owner has moved part of the way down the road on an investment using the IRA owner's *personal name*, but then wants his/her IRA to make the investment. This situation raises major legal concerns (e.g., prohibited transaction) and should be avoided. Thus, the self-directed IRA must generally be established *prior to* investment paperwork being executed.

2.2.2. Example of Setup/Investment for SDIRA #2.

A client wants to execute "hard money loans" to a local real estate developer. The client forms an SDIRA at a trust company (custodian) 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 SDIRA to the real estate developer in return for a promissory note and a deed of trust (aka "mortgage") against real estate, with the trust company holding the promissory note and deed of trust on behalf of the SDIRA. Interest payments are made according to the note and directed to "[Custodian's Name] FBO [Client's Name] IRA[account number]". The trust company charges quarterly fees (based on the value of the IRA's assets), asset holding fees (based on the assets held in the SDIRA), as well as various other per-transaction charges (e.g., check writing fee). After the SDIRA funds have accumulated (or more "old" retirement funds are rolled into the SDIRA), the client can direct the trust company to make another investment on the SDIRA's behalf.

2.2.3. <u>"Direct" SDIRA Investment Diagram</u>.



2.3. <u>SDIRA #3 – nontraditional asses / SDIRA-owned LLC</u>.

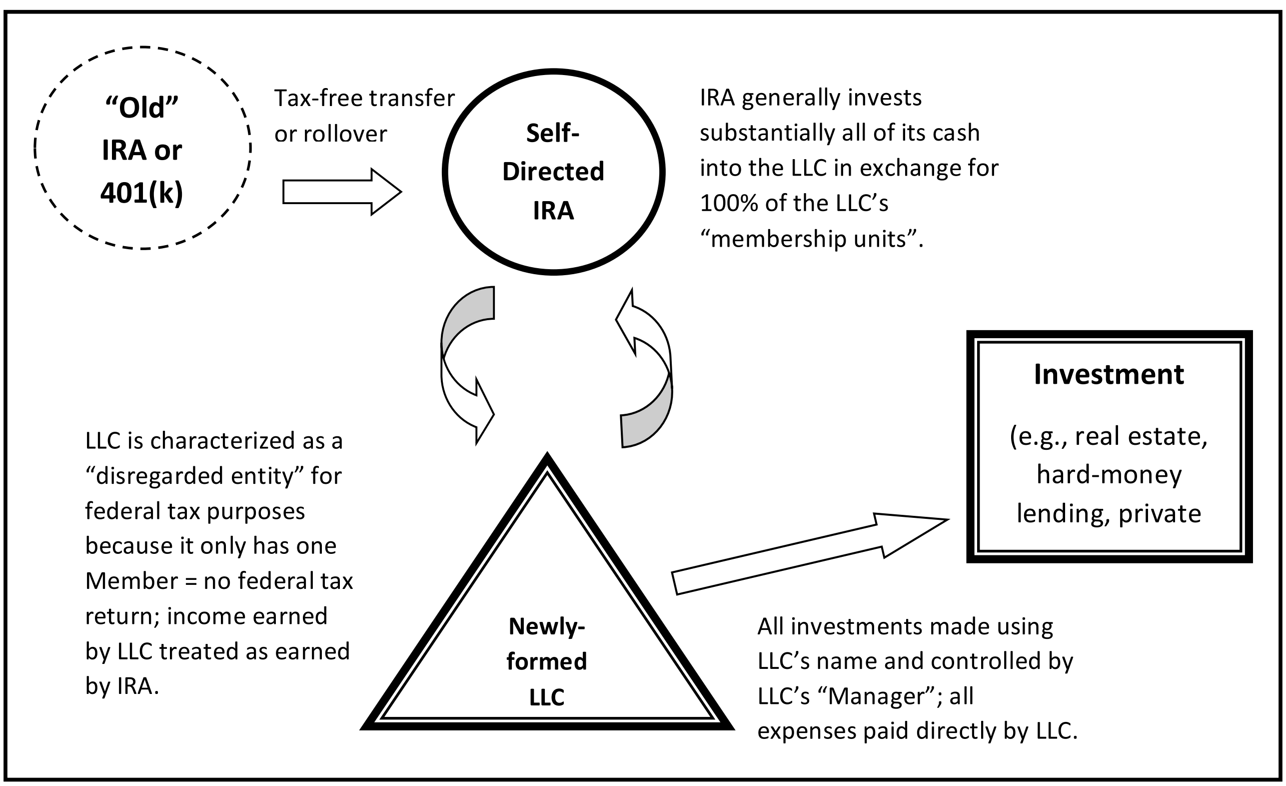
The third type of SDIRA also involves nontraditional investing, except using a slightly different structure. In this category, the IRA is held by the same (or a similar) IRA custodian as described in SDIRA#2 above. However, rather than directly investing in "nontraditional" assets, the SDIRA purchases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

2.3.1. <u>Example of Setup/Investment for SDIRA #3</u>.

Client establishes a new IRA at a trust company (custodian), 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 (i.e., minimal cash left at "IRA level"), making the IRA the LLC's sole "Member." Generally, 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. In addition, the LLC can invest into other assets once funds within the LLC's bank account has accumulated.

2.3.2. *Perspective*: IRA/LLC facilitation companies. An internet search of "self-directed IRA" will reveal many companies that offer to form "checkbook control IRAs" (i.e., IRA-owned LLCs) for around $1000-$1500. These "IRA/LLC facilitation companies" are not law firms or accounting firms (although sometimes they don't make this clear), and thus, do not provide legal or tax advice. These companies are also not IRA custodians themselves, which results in clients getting confused about the difference between these companies and IRA custodians. The fundamental problem with IRA/LLC facilitation companies is that the client often focuses solely on the cost of the IRA/LLC formation (not the legal/tax education), with the result being that the client has a "loaded gun" (in the form of cash in the IRA-owned LLC's bank account), but no idea how to properly use it!

2.3.3. SDIRA/LLC Diagram.



PART 3.

LEGAL RESTRICTIONS

3.1 Prohibited Transactions – in general.

The most important legal and tax principle in SDIRA investing is that "prohibited transactions" must be avoided. A "prohibited transaction," under Internal Revenue Code ("IRC") Section 4975(c)(1), 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;[xvi] 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.[xvii]

A disqualified person is defined in IRC Section 4975(e)(2). Because the IRA owner exercises discretionary control over a self-directed IRA, the owner is considered a "fiduciary" (and thus, a disqualified person) with respect to the self-directed IRA.[xviii] In addition, attribution rules apply to make certain related persons, including natural persons and entities, disqualified persons with respect to the self-directed IRA.[xix] 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.[xx]

Any prohibited transaction can result in a tax catastrophe. If the self-directed IRA 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,[xxi] interest may be due because the tax was not paid in the year of the deemed distribution, and penalties, including the early withdrawal penalty (10 percent of premature withdrawal amount; applies if the account holder has not yet reached the age of 59 ½ at the time the prohibited transaction occurred) and accuracy-related penalties (e.g., 20 percent "gross understatement penalty"), may also apply.

Most SDIRA account holders take the time to educate themselves on the complexity of the prohibited transaction rules (or at least try to), 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 SDIRA/LLCs), or both.

Several 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*,[xxii] 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.[xxiii] 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*,[xxiv] the SDIRA owner, through his legal counsel, established an SDIRA-owned LLC (as section 2.3 of this outline 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; 8 years prior to the court's decision) 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 – resulting in negative tax consequences not only in the year in which the prohibited transaction occurred, but also every year thereafter.

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[xxv]), it is possible that deemed retroactive IRA distribution resulted in seventy percent or more of the IRA being due in taxes, penalties, and interest in 2005 alone[xxvi] – not to mention the consequences of incorrect tax filings in years after 2005. 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!

3.2 **<u>Prohibited Transactions – estate planning concerns</u>**.

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, 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 normally 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 sensitivity of the SDIRA/LLC structure, becomes aware of the LLC's bank account and its large cash 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) and/or is hesitant to give any specific advice, the bank 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. The end result is likely a prohibited transaction when the funds are used for personal use.

3.2.1. *Perspective*: IRA beneficiary designations. When a client forms a self-directed IRA, issues relating to who will *inherit* the IRA and/or who will manage the IRA's investments if the IRA owner is unable to do so, are usually the furthest thing from the IRA owner's mind. There are several typical reasons for this: (1) the IRA owner is focused on an investment opportunity that might disappear soon – therefore, more long term issues like estate planning are ignored; (2) the IRA beneficiary form is "just another form" filled out during the IRA formation process, and therefore, the gravity of the form is often underappreciated; and (3) because an IRA beneficiary form is so easy to fill out, yet the creation of a will or trust seems so complicated (at least from the client's perspective), the IRA owner often assumes that his/her other estate planning documents will ultimately determine the IRA beneficiary at death.

Even if a surviving spouse is able to successfully navigate the prohibited transaction rules, there is always the potential the IRS could audit 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*, and 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).

3.3 Current tax to IRA itself (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. Yes, 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").[xxvii] 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.[xxviii] For this reason, most IRA investors (or their advisors) are not even aware that an IRA can be required to file a tax return (IRS Form 990-T[xxix]) and pay a *current* tax. The two key "trigger 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 (e.g., LLC, partnership)), 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").[xxx]

For example, assume a SDIRA (or SDIRA/LLC) purchases membership units (equity) of a real estate partnership structured as an LLC ("Project LLC"). The Project LLC has twenty owners/members, and the SDIRA/LLC owns five percent of the membership units. The Project LLC then purchases ten acres of vacant land and develops twenty building lots. At the end of each taxable year, the Project LLC would file a partnership tax return (IRS Form 1065) and issue a Schedule K-1 to each of its owners/members (the SDIRA or SDIRA/LLC being one).[xxxi] 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.

> **3.3.1. *Quick Tip*: Basic SDIRA legal analysis.** An advisor looking at a client's previously-executed or proposed SDIRA investment must always consider two basic questions: (1) is there a prohibited transaction concern?; and (2) will the income generated from the investment be exempt from tax at the IRA level? Although there are many intricacies within each of these questions, the vast majority of legal/tax problems fall within one of these two general categories.

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 (perhaps with the plan of selling the building in five years). The Project LLC again collects equity investments from twenty 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 (of course, using leverage is very common in the private equity world, particularly when real estate is involved). The Project LLC would still file an IRS 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). In this case, the SDIRA (or SDIRA/LLC) would normally not owe current tax on the rent or capital gain from the investment, because income of that nature is generally exempt from UBTI. However, because part of the income is generated as the result of *debt-financing*, the income will be *partially taxable* to the SDIRA (i.e., UDFI would be triggered) and the SDIRA would need to file an IRS Form 990-T and potentially pay tax.

> **3.3.2. *Perspective*: IRA tax return sometimes a judgment call.** One of the things that makes the UBTI and UDFI issue so challenging for professional advisors is that an IRA is generally not required to file a federal tax return. Therefore, clients are resistant to suddenly disclose additional information to the IRS regarding their SDIRA's investments – not to mention incurring additional costs associated with preparing a Form 990-T (i.e., accounting costs) and paying tax out of the SDIRA. This challenge is heightened even more when the SDIRA's investments are not clearly triggering UBTI. For example, "flipping" real estate can be viewed as an operating business (thus causing UBTI to occur to an SDIRA that is flipping properties), but not necessarily the *first time* a property is sold. This leads to the difficult analysis of "passive vs. active" real estate investment.

Although UBTI and UDFI tax consequences might appear to be problems that reside outside the realm of some advisors, 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 can reflect negatively upon an unknowing advisor.

3.4 Required Minimum Distributions – during the IRA owner's life.

A peculiar characteristic of IRAs is that, until the account holder reaches the age of 59 1/2, 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, eleven years after the account holder first gains access to the IRA funds without penalty, the liquidity demands on the IRA shifts 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.[xxxii] An account owner must begin taking required minimum distributions by April 1 of the year after the year in which he or she reaches age 70 ½, and must take additional annual RMDs by the end of each subsequent calendar year.[xxxiii] Each required minimum distribution is determined by multiplying the account balance (revalued annually) by a life expectancy factor based on the account holder's age. Failure to take an RMD can result in a penalty equal to 50 percent of the difference between the required minimum distribution for a particular year and the aggregate distributions actually received that year.

For IRAs invested in publicly-traded securities and cash, the only real compliance challenge with RMDs is ensuring that they are planned for and distributions actually occur each year. The determination of the value of the IRA 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 required minimum distribution threshold based on actual asset values. This would result in a 50 percent penalty for the shortfall. [Note, however, that on the opposite side of the spectrum, non-traditional assets within an SDIRA can help minimize RMDs based on appraisal discounts for illiquid assets; this can be extremely valuable, for example, in situations where a Roth IRA is inherited by a young beneficiary and RMDs are being "stretched" over a very long time period].

Most IRA custodians that specialize in holding illiquid assets tend to take a somewhat lackadaisical attitude toward obtaining asset values from the IRA owners [note: even if the SDIRA holds the particular assets "directly" (i.e., not through an SDIRA/LLC, as discussed above), the IRA custodian almost always must rely on statements from the IRA owner and/or other third-parties regarding the asset values]. This results in many SDIRA owners being lulled into believing that the assets values are not important, which is a dangerous long-term mindset, particularly with a pre-tax (non-Roth) SDIRA when the accountholder is older than 70 ½ or if the accountholder passes away and leaves the SDIRA to a beneficiary who subsequently has RMD requirements.

3.4.1. *Perspective*: IRS scrutiny on SDIRA value. The primary way that the IRS keeps track of IRA account balances (and thus the amount of RMD that should be taken each year) is to have IRA custodians file a Form 5498, which lists various information about the particular IRA. In the past, this form had no way of distinguishing between IRA assets that were unmarketable (and therefore difficult to value) and assets that were publicly-traded. However, as of 2015, Form 5498 (via boxes 15a and 15b) now requires new value information regarding "certain specified assets", which includes basically every type of unmarketable asset (i.e., assets typically held within a SDIRA). Although not mandated, it is possible that this change will cause IRA custodians to require more precise IRA asset valuations, particularly in situations where the IRA owner is order than age 70 ½. At a minimum, the IRS will have more information that could potentially be used to challenge the amount of RMD taken in a particular year (e.g., if it appears as though an IRA that holds only real estate is not increasing in value despite a general real estate appreciation trend). More generally, this new Form 5498 information will allow the IRS to target certain types of SDIRAs, if they choose to do so. For example, the IRS could randomly audit any *Roth* SDIRA that holds a privately-held partnership (or LLC) worth more than $1 million.

SDIRAs can also raise liquidity issues when the account holders must take required minimum distributions. If the account holder's only IRA is an SDIRA, the account holder may need to generate funds from the SDIRA assets to satisfy required minimum distributions 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 publicly-traded assets and/or cash, the required minimum distribution may be aggregated across all IRAs and taken from any one of the IRAs.[xxxiv] 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 required minimum distribution attributable to the SDIRA and its assets.

In lieu of cash, the required minimum distributions may be satisfied in-kind, with distributions of interests in the underlying SDIRA assets.[xxxv] Unfortunately, there is no carry-forward available for distributions in excess of a required minimum distribution, and the RMDs for multiple years may not be aggregated into a single distribution.[xxxvi] 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 an 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.[xxxvii] 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 marketability. Being too aggressive with discounts could result in income tax avoidance (via a lower IRA distribution amount) that the IRS could later challenge.

3.5 Required Minimum Distributions – after the IRA owner's death.

Account holders of SDIRA-owned illiquid assets can plan well in advance of reaching age 70 ½ for the valuation issues and liquidity needs described above. However, the account holder's death fundamentally alters the framework of required minimum distributions, and can potentially speed up (or slow down) the rate at which SDIRA assets must be distributed. Depending on the account holder's designated beneficiaries of the SDIRA, the required minimum distribution 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, required minimum distributions 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 required minimum distributions by the time he or she reaches age of 70 ½. However, if that account holder dies unexpectedly, the possibility of nearly 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 (for example, if the SDIRA holds a private equity or hedge fund investment that has no liquidation potential for 5-10 years after being purchased, the premature death of the IRA's account holder could raise major problems).

If the account holder dies before reaching the age of 70 ½ 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.[xxxviii] 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-held security interests, or other dynamics that are unique to nontraditional assets. For example, if the SDIRA's investment consists of an interest in a real estate partnership, and the partnership's managers refuses 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 required minimum distribution problems would likely occur.

PART 4

ROLLOVER AS BUSINESS START-UP ("ROBS")

4.1 Overview of Structure.

What if a retirement owner is interested in SDIRA investing (i.e., nontraditional assets), but wants to purchase an *active/operating business*? One downside of using an SDIRA in this situation is the likely unrelated business taxable income (UBTI) consequences (assuming the business is not structured as a C-Corporation) – because ordinary business income resulting from a "flow through" entity in which an SDIRA owns an equity position is currently taxable to the SDIRA (see Part 3.3 above). Another problem is if the SDIRA owner would like to be an *employee* or *co-owner* in the operating business. This situation can very easily result in a prohibited transaction and completely invalidate the SDIRA. For example, if an SDIRA invests into an entity in which the IRA owner owns more than a 50% interest, the entity itself will be a "disqualified person" and a per se prohibited transaction will occur when the SDIRA purchases an ownership stake. Also, if an SDIRA's investment appears to *personally benefit* the IRA owner (e.g., results in employment; enables the business to get started; etc.), the IRS can argue a prohibited transaction in that situation as well, even if the IRA owner is not a co-owner in the business entity.

However, there is another way to use retirement dollars to fund an operating business in which the retirement account owner is an employee – but it comes with additional compliance issues and potential IRS (and federal Department of Labor) scrutiny. The IRS calls the structure a "Rollover as Business Start-up" (or "ROBS"),[xxxix] and it involves the following steps [Note: it is absolutely critical for a client and his/her advisors to recognize the difference between an SDIRA (or SDIRA-owned LLC) and a ROBS; ignoring these differences can catastrophic; for example, in the *Ellis v. Commissioner* case (discussed in Part 3.1 above), it appears that the client's attorneys *tried* to structure a ROBS, but failed, with the consequence being a prohibited transaction]:

1. The client wants to start a business, but only has available start-up capital in his/her retirement account.

2. The client forms a new C-Corporation (often with the help of a company that specializes in forming these types of structures or his/her attorney).

3. The C-Corporation adopts a prototype 401(k) plan, which permits employees to roll over funds from their current retirement plans (e.g., IRA).

4. The 401(k) authorizes employees to invest their 401(k) assets into Qualified Employer Securities ("QES") – i.e., C-Corporation stock. [side note: this is similar to the much more well-known "Employee Stock Ownership Plan" (ESOP)].

5. The client rolls over his/her current retirement funds into the new 401(k) – thereby funding the new 401(k).

6. The client directs his 401(k) Plan Administrator to invest (normally) all of the 401(k)'s cash into the C-Corporation in exchange for QES – equivalent to 95% (give or take) of the C-Corporation's outstanding stock.

7. The client invests personal cash into the C-Corporation, generally in exchange for around 5% (or more) of the C-Corporation's QES.

8. C-Corporation starts and/or acquires an operating business.

9. The client is paid (as an employee) to operate the business – and ideally he/she begins making regular elective contributions to the 401(k) plan (which would otherwise hold only the QES).

The IRS's general concern regarding the ROBS structure is that it will be used as a roundabout method for removing IRA (or other pre-tax retirement plan funds) to the account owner without incurring the normal corresponding tax consequences. For example, if the client pays himself/herself a large salary immediately after forming the ROBS structure, he/she could potentially withdraw the entire retirement account without incurring early withdrawal penalties (however, note that, because the client is an employee of the C-Corporation, he/she will be taxed on the salary payments – so the IRS's only real concern should be the avoidance of early withdrawal penalties, assuming the client is younger than 59½ years old).

Another complication that the ROBS structure presents is the more complex recordkeeping requirements that are imposed on 401(k) plans (as compared to IRAs). For example, a yearly IRS filing (Form 5500) is normally required. Also, if the C-Corporation has *other employees* (besides the client), those employees must be given proper disclosures and be allowed to participate in the plan (assuming they meet certain eligibility requirements). Unfortunately, many people that form a ROBS think about the 401(k) plan as only a "funding mechanism" to start the business, rather than a living breathing retirement plan going forward.

Personally, my biggest problem with the ROBS structure is the fact that many people do not fully grasp the fundamental investment risks associated with starting a new business – and thus, they can potentially end up with no job (because the C-Corporation fails) and no retirement assets (because the 401(k)'s ownership in the C-Corporation is worthless after the business fails). This extreme situation (i.e., a retirement account going from very valuable to nothing) is more rare in the self-directed IRA world, because investments often involve hard assets (e.g., real estate), which might lose value, but do not become totally worthless.

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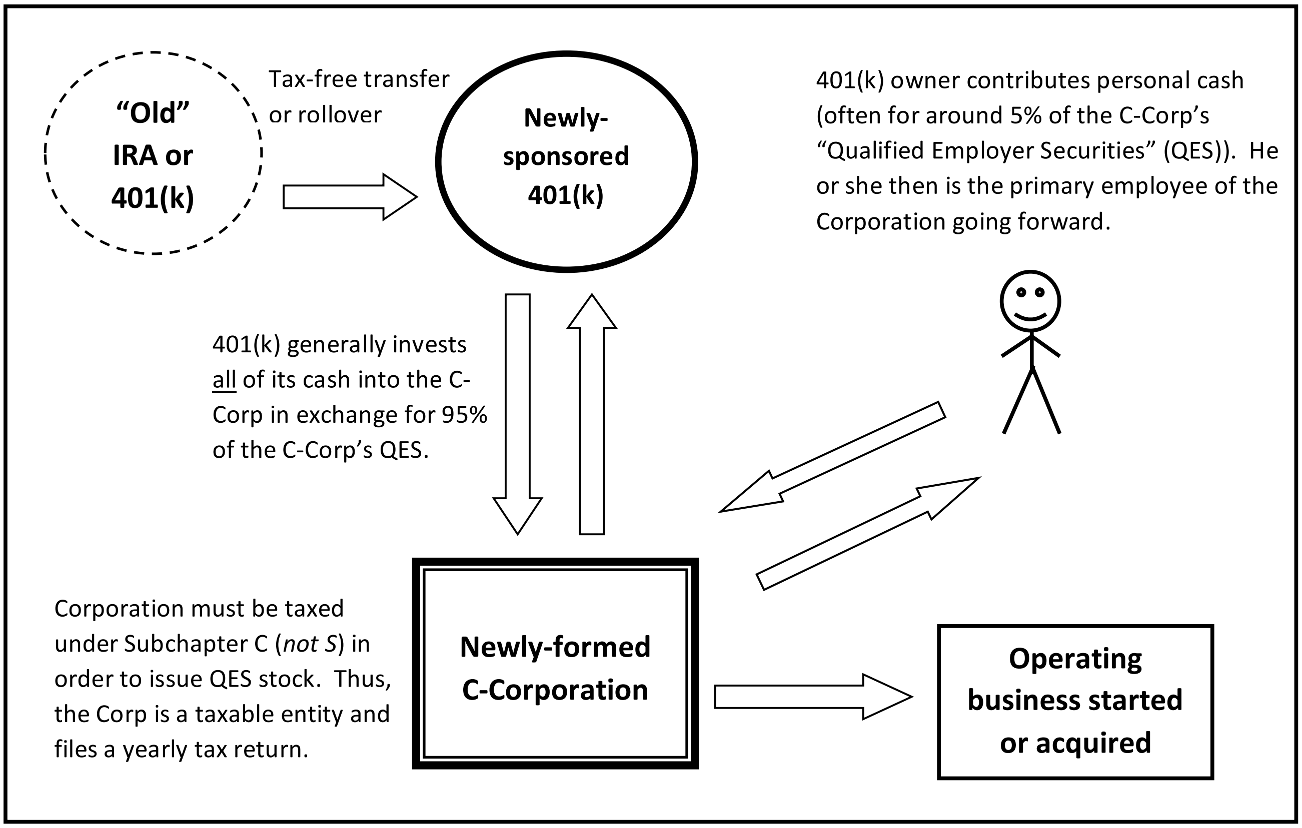
4.2 **ROBS Diagram**.



Links to Supplemental reading material:

The Care and Feeding of Large IRAs, Warren L. Baker and Natalie B. Choate, *Trusts & Estates magazine (December 1, 2016)*.

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Tax Court Nixes Roth IRA Tax Shelter, (discussion of Tax Court case: Block Builders LLC v. Commissioner), *Forbes*, by Ashlea Ebeling (August 10, 2017).

https://www.forbes.com/forbes/welcome/?toURL=https://www.forbes.com/sites/ashleaebeling/2017/08/10/tax-court-nixes-roth-ira-tax-shelter/&refURL=&referrer=#53d072f2fe68

Are Taxes Lurking in Your Tax-Free Retirement Account?, *The Wall Street Journal*, by Laura Saunders (March 10, 2017).

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IRAs Gone Wild: How To Invest In Private Equity, Real Estate, Gold, *Forbes*, by Ashlea Ebeling (October 19, 2016).

https://www.forbes.com/sites/ashleaebeling/2016/10/19/iras-gone-wild-how-to-invest-in-private-equity-real-estate-gold/#18ba9da71eca

Self-directed IRAs – Top Five Complexities for Estate Planning Attorneys*,* Warren L. Baker, *Washington State Bar Association (WSBA) Real Property, Probate & Trust newsletter* (April 2014).

http://fairviewlawgroup.com/wp-content/uploads/2014/10/Self-directed-IRAs-Top-Five-Complexities-for-Estate-Planning-Attorneys-by-Warren-L-Baker-WSBA-RPPT-Sec-April-2014.pdf

Boom! Boom! Boom! IRS fires three shots across the bow of self-directed IRA investors*, WSBA Taxation Law newsletter* (March 2014).

http://fairviewlawgroup.com/wp-content/uploads/2014/10/Boom-Boom-Boom-IRS-fires-three-shots-across-the-bow-of-self-directed-IRA-investors-by-Warren-L-Baker-WSBA-Tax-Sec-Winter-2013-2014.pdf

Self-Directed IRAs: A Tax Compliance Black Hole*, Warren L. Baker, Journal of Accountancy* (October 1, 2013).

https://www.journalofaccountancy.com/issues/2013/oct/20137626.html

ENDNOTES

[i] For more overview information, see my article, *Boom! Boom! Boom! IRS Fires Three Shots Across the Bow of Self-Directed IRA Investors* (WSBA Taxation Law newsletter, Winter 2013-2014).

[ii] These statements are based on the author's experience in providing legal and tax consulting to over 3000 self-directed IRA investors, representing approximately $1 billon of assets. However, the author does not personally believe in many of the rationales for investing in this manner and believes that many self-directed IRA investors should not be involved in this area whatsoever due to the applicable legal and tax complexities.

[iii] Investment Company Institute, *Quarterly Retirement Market Data, 1st Quarter 2017* *https://www.ici.org/research/retirement/retirement/ret_17_q1*. As of March 31, 2017, total IRA market assets estimated to be $8.2 trillion.

[iv] *Id.*

[v] *Id.*

[vi] The investment flexibility within an IRA is generally broader (regardless of whether a self-directed IRA is involved) than within "qualified retirement plans" (e.g., 401(k) accounts). The reason for this is that qualified plan administrators normally limit the investment options in order to streamline administration. Generally, once an employee reaches age 59 ½ or "separates from service" (i.e., is no longer employed by the company that sponsored the qualified plan), the employee is free to "rollover" the qualified plan funds to any IRA custodian that he/she chooses, thereby increasing flexibility going forward. Also, if the individual is nearing age 70 ½ and no longer working for the company that sponsored the plan, rolling the funds into an IRA increases flexibility when dealing with "required minimum distributions". However, there can be some benefits to leaving assets within qualified plans (e.g., increased bankruptcy protection in some case), but those topics are generally beyond the scope of these materials.

[vii] "Investor Alert", Securities and Exchange Commission's (SEC) Office of Investor Education and Advocacy, September 2011 *https://www.sec.gov/investor/alerts/sdira.pdf*.

[viii] McKinsey & Company, *The Mainstreaming of Alternative Investments: Fueling the Next Wave of Growth in Asset Management*, July 2012.

[ix] *Id.* Assuming total assets within IRAs is $8.2 trillion (see footnote above) and alternative assets within self-directed IRAs is currently 13 percent, this would result in $1.066 trillion within self-directed IRAs.

[x] *Id.* McKensey's report estimates that the total value of investment dollars in alternative assets is growing at six times the rate of assets within IRAs in general.

[xi] *See generally* Internal Revenue Code (IRC) Sections 408 and 4975.

[xii] An IRA's governing instrument must prohibit the investment of any part of the account in life insurance contracts. *See* IRC 408(a)(3); Regs. 1.408-2(b)(3).

[xiii] A collectible is any work of art, rug or antique, metal (except as provided below with respect to U.S. coins), gem, stamp, coin, alcoholic beverage (e.g., vintage wines), musical instrument, historical object (such as a document or clothes), or other item of tangible personal property that the IRS determines is a

collectible. *See* IRC 408(m)(2) and Prop. Regs. 1.408-10(b). An IRA that buys a collectible is treated as having distributed the cost of the collectible to the IRA owner. *See* IRC 408(m)(1).

[xiv] For example, PENSCO Trust Company states that it has over $15 billion of assets under custody and 50,000 client accounts (https://www.pensco.com/about-us/why-pensco/history/); Millennium Trust Group has $23.3 billion of assets under custody and $595,000 accounts (*http://www.mtrustcompany.com/about*); IRA Services Trust Company has $10 billion of assets under custody and over 125,000 accounts (*https://www.iraservicestrust.com*). However, just because these custodians have a lot of assets "under custody" (a bit of a loose term in the self-directed IRA marketplace) and/or hold a huge amount of accounts does not necessarily mean that they can be relied upon for specific legal or tax advice. To the contrary, these types of custodians take a very "hands off" (aka "passive") approach and accountholders should be careful to not correlate a custodian "allowing a transaction" with the transaction "being legal".

[xv] This section is an excerpt from my article entitled *Self-directed IRAs – Top Five Complexities for Estate Planning Attorneys* (WSBA Real Property, Probate & Trust newsletter, Winter 2013-2014).

[xvi] This concept can be generally summarized as "self-dealing".

[xvii] Generically, a "kickback".

[xviii] 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."

[xix] IRC Section 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.

[xx] 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 v. Commissioner*, T.C. Memo. 2013-245 (October 29, 2013) (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).

[xxi] Tax consequences will be different if the IRA is a *Roth* IRA (i.e., post-tax retirement funds).

[xxii] 140 T.C. No. 9 (May 9, 2013).

[xxiii] The issue of the statute of limitations is challenging in the self-directed IRA world because the IRA (or IRA-owned LLC) generally does not file a tax return, and thus, at least arguably, the statue never runs.

[xxiv] T.C. Memo. 2013-245 (October 29, 2013).

[xxv] *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.

[xxvi] 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.

[xxvii] The UBTI provisions are found at IRC Sections 511-514. Conforming amendments were not made to 511(a)(2)(A) and 501(a) to include IRAs when the IRS Code provisions were enacted, but § 408(e)(1) clearly indicates the UBTI provisions apply to IRAs. Essentially, income that is "unrelated" to a tax-exempt entities "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).

[xxviii] In general, earnings within an IRA are tax-deferred. See IRC Section 408(e)(1).

[xxix] Form 990-T information can be found on the IRS website (https://www.irs.gov/pub/irs-pdf/f990t.pdf).

[xxx] 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) [See link at end of materials above].

[xxxi] 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 have the Project LLC retain (i.e., not distribute) its profits.

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

[xxxiii] Treasury Regulation Section 1.401(a)(9)-5, A-1.

[xxxiv] Treasury Regulation Section 1.408-8, A-9.

[xxxv] Treasury Regulation Section 1.401(a)(9)-5, A-9.

[xxxvi] Treasury Regulation Section 1.401(a)(9)-5, A-2.

[xxxvii] The IRA owner is considered a *fiduciary* to a self-directed IRA 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*,

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106 T.C. 76, 88 n.13 (1996), *Peek v. Commissioner*, 140 T.C. No. 9 (May 9, 2013), and *Ellis v. Commissioner,* T.C. Memo. 2013-245 (October 29, 2013). 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 Section 4975(c)(1)(D) and (E). Additional examples of investment scenarios that can lead 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.

[xxxviii] Treasury Regulation Section 1.401(a)(9)-3.

[xxxix] On October 1, 2008, the IRS issued a "memorandum" in which it concedes that the ROBS structure works on its face, but that there are potential compliance problems that can occur – for example, improper 401(k) operation and maintenance down the road.