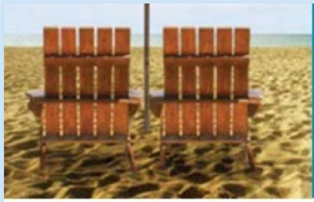
The Care and Feeding of Self-Directed IRAs

FAIRVIEW
LAW GROUP, PS

Warren L. Baker
206-753-0305
warren@fairviewlawgroup.com

Recommended reading…



FEATURE:
RETIREMENT BENEFITS

By **Warren L. Baker** & **Natalie B. Choate**

The Care and Feeding of Large IRAs

Perform annual checkup meetings with your clients

TRUSTS & ESTATES / trustsandestates.com DECEMBER 2016

FAIRVIEW
LAW GROUP, PS

Key takeaways…

1. Eating your dessert is NEVER a bad idea.
2. I will get serious about this presentation at some point, but not yet…

But seriously, please remember these points:

3. Prohibited transactions = bad!
4. UBTI = normally bad, but sometimes good
5. Up-front education + occasional oversight = legally compliant SDIRA

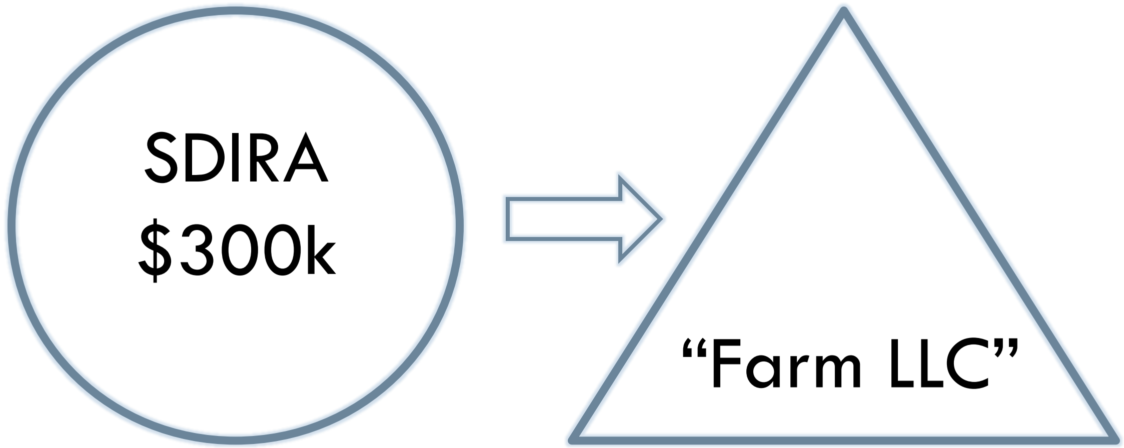
A Self-Directed IRA Story…

Hello, I'm Mark!

[Not actually Warren's client]

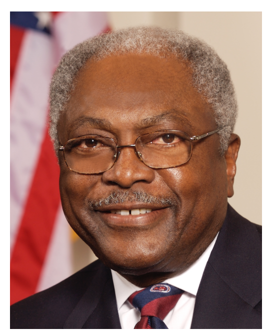
This is my SDIRA

I invested into this



These are my partners

I'm Jim!



Jerry here!

FAIRVIEW
LAW GROUP, PS

A Self-Directed IRA Story…

LLC purchased this

"Farm LLC"

100 acres of land

But it came with this…
a decrepit farmhouse

A Self-Directed IRA Story…

Problem #1:
Insurance Company will not insure a house with broken windows

Problem #2… the squatter

FAIRVIEW
LAW GROUP, PS

A Self-Directed IRA Story…

(the squatter had a bulldozer!)

Long story short…

1. No one got shot.
2. Mark's car was damaged!
3. In Mark's words, "that was terrifying, but it turned out to be the best investment I've ever made!"
4. SDIRAs are not for the faint of heart (literally!), but many people love them, so understanding them is a good idea for advisors.

FAIRVIEW
LAW GROUP, PS

What does "self-directed IRA" even mean?

Let's clear some things up…all IRAs are "self directed". SDIRAs generally come in three forms…

(1) "TV" Brokerage SDIRA

TD Ameritrade

(mostly) publicly-traded assets

SDIRA

IRA owner "self-directs"

FAIRVIEW LAW GROUP, PS

What does “self-directed IRA” even mean?

(2) “Some random trust company” SDIRA

IRA SERVICES TRUST COMPANY

KINGDOM TRUST

PENSCO TRUST COMPANY

MILLENNIUM TRUST COMPANY

BMT BRYN MAWR TRUST

Assets titled in IRA’s name directly

(mostly) “non-traditional” assets

SDIRA

IRA owner “self-directs”

LP/LLC

Privately-held Corp

Lending

FAIRVIEW LAW GROUP, PS

What does "self-directed IRA" even mean?

(3) SDIRA-owned LLC

All income and expenses flow through LLC

SDIRA

Assets titled in LLC's name

(mostly) "non-traditional" assets

$$

LP/LLC

LLC Manager controls

Privately-held Corp

100% IRA-owned LLC

Lending

Size of retirement account marketplace

1. $8.2 trillion in IRAs
   - $2.6 trillion in 2000
2. $7.3 trillion in defined contribution plans (e.g., 401k)
   - $3 trillion in 2000
3. GAO report on "Large Balance IRAs" (GAO-15-16, released Nov. 2014):
   - 9000 IRAs worth more than $5 million
   - 314 IRAs worth more than $25 million
     - Numbers based on 2011 figures by IRS (via Form 5498 in 2011) – too low!

FAIRVIEW
LAW GROUP, PS

Value in SDIRAs is not clear

1. 13% of IRA assets in "alternatives"? = over $1 trillion
2. Values reported by various SDIRA custodians:

MILLENNIUM TRUST COMPANY	$23 billion
PENSCO TRUST COMPANY	$15 billion
IRA SERVICES TRUST COMPANY	$10 billion

A historical perspective on SDIRAs…

- 2005-2007: "I know something you don't know!" / mostly fringe investors / compliance "wild west"

- 2008-2012: "Wall Street hosed me again!" / custodian numbers grow rapidly / compliance improves slightly

- 2013-2017: SDIRAs go (relatively) mainstream / federal oversight increases slightly / compliance still varies widely

FAIRVIEW
LAW GROUP, PS

The “ideal” SDIRA investor

[Disclaimer: I am not a “promotor” of these investments, but people often ask me, “who is a good candidate for doing this?”]

1. Expertise/experience in a particular translateble area (e.g., real estate, private equity, hard money lending)
2. No personal involvement and/or personal benefit from the SDIRA investment
3. Not afraid of additional work/complexity
4. Receptive to up-front education and periodic “monitoring” by professional advisors
5. Organized!

FAIRVIEW
LAW GROUP, PS

SDIRA legal framework

[Online promotor]: “You can invest into <u>ANYTHING</u> with a self-directed IRA!”

[Warren]: “That’s actually true…”

BUT…

SDIRA Legal/Tax Trap #1

Prohibited Transactions

A two-part analysis…

1. **Has an "automatic" PT occurred?**
   - Financial interaction between SDIRA and a "disqualified person" (DP)

FAIRVIEW
LAW GROUP, PS

Disqualified People / Entities

1. IRA's owner (considered "fiduciary" of IRA)
2. Spouse of IRA's owner
3. Family members directly up or down bloodline of IRA's owner
4. Any entity (LLC, Corp, partnership, trust) 50%+ owned by (or for benefit of) people above
5. Other 10%+ owners and some employees of entities above

TRAP ALERT!

FAIRVIEW LAW GROUP, PS

SDIRA Legal/Tax Trap #1

Prohibited Transactions

A two-part analysis…

1. **Has an "automatic" PT occurred?**
   - Financial interaction between SDIRA and a "disqualified person" (DP);
   - Personal guarantee of SDIRA debt by DP; *OR*
   - SDIRA's investment results in personal benefit to DP.

If "**yes**"…big problem!

If "**no**"…

FAIRVIEW
LAW GROUP, PS

SDIRA Legal/Tax Trap #1

Prohibited Transactions

2. **Does a fiduciary conflict of interest exist?**
   - Is IRA owner's loyalty to another person/entity conflicted with loyalty to SDIRA?
   - A disqualified person is <u>not</u> a required element.
     - Example: loan from SDIRA to a brother or sister
     - Do investments appear "commercially reasonable"?

If "**yes**"…potential problem that should be corrected.

If "**no**"…likely no PT concern.

FAIRVIEW LAW GROUP, PS

Consequences of Prohibited Transaction

Retroactive invalidation (to year of PT) of *entire* SDIRA, which results in:

1. Taxable distribution in prior year (39.6%?);
2. "Substantial understatement" penalty (20%);
3. "Failure to pay" penalty (.5% per month) and interest, related to deemed distribution year; *and*
4. Income tax, penalties, and interest related to years *thereafter* (because IRA's assets are now income-generating *personal assets*).

Statute of Limitations (SOL)

How long after prohibited transaction can IRS audit?

- 3-year SOL: normally applies to individual tax return items, but probably not in PT situations, because…
- 6-year (SOL): likely applicable, due to "substantial understatement" from deemed full SDIRA distribution
- Continuous PT (e.g., personal guarantee of debt) = SOL period never ends
- Form 5329: can provide some limited SOL protection
- Consider "silo-ing" the "fun assets" into a separate IRA

FAIRVIEW
LAW GROUP, PS

IRS Form 5329 – should your client file?

- Form 5329 is used to report IRA excise tax
  - 50% excise tax for failure to take Required Minimum Distributions (RMD)
  - 6% levy on excess IRA contributions
- No statute of limitations protection if not filed
- Particularly important if:
  - RMD are applicable (70+ IRA owner, inherited IRA)
  - Protects against IRS's "substance over form" argument
    - See *Block Developers vs. Commissioner (TC Memo 2017-142), July 18, 2017*

FAIRVIEW
LAW GROUP, PS

SDIRA Legal/Tax Trap #2

Unrelated Business Taxable Income (UBTI)

Starting point: **All** income is taxable to the SDIRA

Types of income exempt from UBTI (not taxable):

1. Gains from sale of C-Corporation stock
2. Dividends from C-Corps
3. Interest
4. Rent and gains from sale of real property*
5. Capital gains
6. Royalties

*Assuming not considered "inventory"

FAIRVIEW LAW GROUP, PS

SDIRA Legal/Tax Trap #2

Unrelated Business Taxable Income (UBTI)

WARNING! Potential UBTI exposure:

1. Equity investment into active business (if not C-Corp)
2. Seemingly "passive" investment into multi-owner partnership or LLC
3. Real estate developer or "dealer" status
4. Private equity / hedge funds (even in large broker IRAs!)

- Review of <u>Schedule K-1</u> critical (was one even issued?)
- <u>Don't rely on IRA custodian</u> for review or tax filing

SDIRA Legal/Tax Trap #2

Unrelated Debt-Financed Income (UDFI)

Concerns when debt is involved (directly or indirectly):

1. Initial hurdle: no DP can be liable for debt = limited lender options across country
2. Income otherwise exempt (e.g., rent, capital gain, interest) becomes partially taxable
3. UDFI tax consequences extremely common in real estate partnerships/syndications

FAIRVIEW
LAW GROUP, PS

SDIRA Legal/Tax Trap #2

Unrelated Debt-Financed Income (UDFI)

Concerns when debt is involved (directly or indirectly):

1. Initial hurdle: no DP can be liable for debt = limited lenders across country
   - See *Peek v. Commissioner*, 140 T.C. 216 (May 9, 2013)
2. Income otherwise exempt (e.g., rent, capital gain, interest) becomes partially taxable
3. Tax consequences extremely common in real estate partnerships

FAIRVIEW
LAW GROUP, PS

IRA tax return: Form 990-T

Overview:

- UBTI/UDFI above $1k per year is taxable to IRA
- Taxed at *trust tax rates* (climb quickly to 39.6% above $12.5k of income)

Common 990-T problems:

- Insufficient info from investment provider (e.g., no UBTI schedules on K-1)
- What tax ID#? Who prepares and signs?
- “Black hole” nature of SDIRA-owned LLCs

[Shameless plug: see “*Self-Directed IRAs: A Tax Compliance Black Hole*”, Journal of Accountancy, 9/30/13]

FAIRVIEW
LAW GROUP, PS

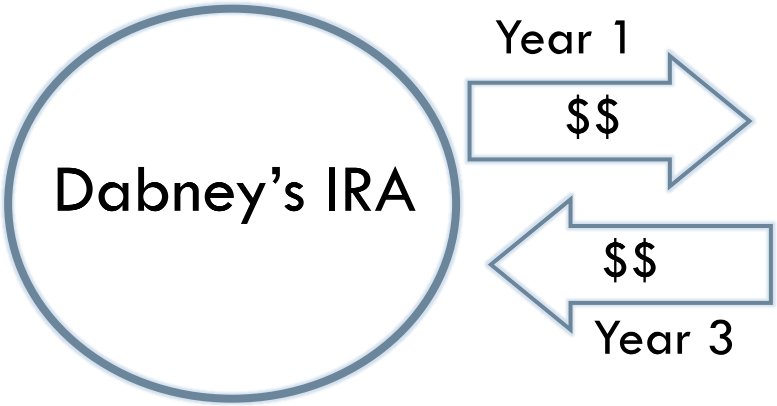
Biggest potential audit triggers

1. SDIRA income reported (e.g., on K-1 or Form 1099) under IRA owner's name/SSN
2. Inconsistency related to "certain specified assets" (new boxes 15a and 15b on Form 5498)
3. UBTI reported (e.g., on K-1), but no Form 990-T filed by IRA
4. Form 1099-R issued (showing distribution from IRA)
   - E.g., custodian resigns due to lack of fees paid or discovery of PT; or this…

FAIRVIEW
LAW GROUP, PS

Form 1099-R problem (*Dabney vs. Commissioner*)

charles SCHWAB



1. Dabney reads online that IRAs can buy real estate
2. Dabney fills out "distribution" form with Schwab
3. Schwab wires funds directly to title company
4. Property later sold and proceeds wired back to IRA
5. Schwab issues Form 1099-R in year of property purchase and IRS audits

FAIRVIEW LAW GROUP, PS

SDIRA Legal/Tax Trap #3

Estate Planning

<u>Required Minimum Distribution</u> problems:

1. Valuation of non-traditional assets
   - Custodian vs. IRS requirements
2. Lack of liquidity to make RMD
   - Maintain several pre-tax IRAs, income producing assets, and/or publicly-traded securities
3. In-kind distributions rarely make sense (but many clients think they do!)
4. RMD concerns for <u>all</u> IRAs post-death of IRA's owner

FAIRVIEW
LAW GROUP, PS

SDIRA Legal/Tax Trap #3

Estate Planning

Management of non-traditional assets upon incapacity or death of IRA's owner:

1. Immediate prohibited transaction risks if IRA's owner cannot oversee "complicated" assets
2. Spouse and children often have very little idea about SDIRA's contents

"I know dad's IRA owned 'Investment Freedom, LLC', but what is in the LLC? The IRA custodian has no clue!"

SDIRA Legal/Tax Trap #3

Estate Planning

Beneficiary Designations:

1. Consider how illiquid assets will be divided (even possible?) between numerous IRA beneficiaries
2. Name a Standalone Retirement Trust as beneficiary of SDIRA? Potential benefis…
   - Long-term management of illiquid assets
   - Maximize future tax-deferred benefits of IRA
   - Organization of unique tax issues (e.g., K-1s, 990-T)

FAIRVIEW LAW GROUP, PS

Rollover as Business Start-Up ("ROBS")

CAUTION! ROBS and SDIRAs are <u>very different animals</u>.

New C-Corp

C-Corp starts or acquires operating business

menchie's frozen yogurt

$$

All 401k cash invested into C-Corp in exchange for "QES" stock (e.g., 95%)

New 401k (Sponsored by new C-Corp)

$$

Existing IRA or 401k

401k's owner, key employee, 5% owner of C-Corp

FAIRVIEW LAW GROUP, PS

Questions?

Thank you

Estate Planning Council of Seattle!

FAIRVIEW
LAW GROUP, PS

Warren L. Baker

206-753-0305
warren@fairviewlawgroup.com