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PPA '06 Makes IRA Rollovers More Attractive: Maybe It's Time to Switch to a Self-Directed IRA? Think Again!

*by Kathryn J. Kennedy**

Summary:

Federal legislation passed in 2006 affords participants and beneficiaries of eligible retirement benefits new distribution options that can result in the reduction or deferral of federal income taxes. These new distribution options may have the domino effect of making rollovers to IRAs a more desirable funding vehicle. If this occurs, the continued interest in self-directed IRAs (i.e., in which the IRA owner is not limited to the IRA trustee's or custodian's investment options, but instead can choose his or her investment options) will become increasingly marketed by custodians. There is particular interest in self-directing in real estate investments. This article first explores the new benefit distribution options and then discusses the practical and legal issues that IRA owners should consider before making self-directed investment decisions, especially with respect to real estate investments.

INTRODUCTION

Due to the enactment of the Pension Protection Act of 2006 (PPA '06),[1] Congress has provided more portable distribution options for qualified plans under §401(a), tax-deferred annuities under §403(b), governmental plans under §457, and individual retirement accounts/individual retirement annuities (IRAs).[2] As a result, leakage of such distributions into current income tax treatment should be curtailed. These new distribution options will present greater opportunities for those participants to consider investment in IRA rollover vehicles, as opposed to other tax-sheltered vehicles. Rollover IRAs (i.e., savings that originated in qualified plans, §403(b) annuities, and §457

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[1] P.L. 109-280 (Aug. 17, 2006).

[2] All section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise indicated.

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governmental plans but were distributed and rolled over into IRAs) continue to dominate the IRA share of the market.[3] As IRA assets presently represent about one-quarter of the total $14.5 trillion in U.S. retirement assets — $3.7 trillion — this demonstrates sustained interest for IRA retirement vehicles now and in the future.[4]

Although rollover IRAs are typically invested in banks and financial institutions, there is a growing interest by IRA owners to self-direct their investments, i.e., the IRA owner decides on his or her own what investments to make and is not limited to the investments offered by the custodian. This is similar to the response employers have experienced in the §401(k) plan arena allowing participants to self-direct their accounts. Contributing factors to self-directed IRAs include the bear market of the early 2000s, corporate scandals and corruption charges, low interest rates, and rising concerns about mutual fund fees. Slowly, but formidably, IRA investors are beginning to look at other more tangible investments, especially real estate.[5] This may change with the news that the real estate market entered a new slump beginning in 2006.[6] However, continued interest in alternative investments may persuade an IRA owner to consider diversification, including the real estate market. Although *self-directed* IRAs have been legal since their inception in 1974, their utilization has been relatively minimal, and thus, recent heightened interest in alternative investments has prompted concerns over the practical and legal problems associated with such IRAs.

This article is divided into two parts — the first highlights the new beneficiary designation options afforded by the PPA '06 and their planning opportunities for IRA owners, and the second explores the various practical and legal issues posed for IRA owners who wish to self-direct their investments. Unfortunately, due to the modest amount of guidance available under PPA '06 and the scant amount of guidance on self-directed IRAs, this article necessarily poses more problems than it does answers. *Responses from practitioners would be greatly appreciated, with the promise of a follow-up article if a sufficient number of questions and answers develop that would be of interest to the benefits community.*

PASSAGE OF PPA '06

Though the Employee Retirement Income Security Act of 1974 (ERISA)[7] has been amended numerous times since its inception in 1974, PPA '06 provided the most sweeping changes for both defined benefit and defined contribution plans that plan sponsors have seen since ERISA's original enactment. With respect to defined contribution plans, Congress continues to make these plans more portable and, therefore, more useful, for participants and beneficiaries. Although retirement plans established by small employers can be designed to provide flexibility with respect to distribution options for participants and beneficiaries, plans established by medium- and large-size employers are not necessarily designed to provide such flexibility. Thus, a participant under such plan has had to roll over distributions into an IRA to accomplish this flexibility. This is especially important if the participant or beneficiary wishes to "stretch out" the distributions from the IRA in order to maximize the duration of the tax shelter.

In the first part of this article, the new distribution options under PPA '06 will be discussed. These include: (1) the use of a *nonspouse* IRA rollover option, (2) a qualified charitable distribution option for IRA owners, and (3) direct rollovers from eligible plans to Roth IRAs. Due to the recent IRS pronouncements, it is extremely important to follow the rules in order to accomplish the desired results.

Nonspouse IRA Rollover Options

Background Information

Prior law extended a great deal of flexibility to the *surviving spouse* entitled to a distribution from an eli-

[3] Federal Reserve Board's Survey of Consumer Finances indicated that close to 50% of all traditional IRA assets in 2004 were held in rollover IRAs. *See* the report from the Investment Company Institute (ICI) entitled "The U.S. Retirement Market, 2005," 15 *ICI Research Fundamentals*, No. 5 (July 2006), available at *http://www.ici.org/stats/mf/fm-v15n5.pdf* (last visited May 5, 2007).

[4] According to the ICI report, retirement assets reached a record high $14.5 trillion in 2005, representing a third of all household financial assets. This figure represents a 40% growth since 2002. *Id.*

[5] The Wall Street Journal reported that, as of the end of March 2000, there were 275 funds — only about 9% of stock funds — that posted triple-digits gains during the prior 12 months. By 2007, Morningstar tracked down this triple-digit club and discovered that 97 of the funds no longer exist, 44 were merged into other funds, 22 were liquidated, and 31 dropped out its database. Of the 179 funds that survived, 37 topped the broader market's modest average return of 1.7% a year in the seven years since March 2000. *See* Tom Lauricella and Joanna L. Ossinger, "An Elite Club's Fall from Grace," *Wall St. J.* (Apr. 3, 2007).

[6] According to the National Association of Realtors, the sales of existing homes fell by 8.4% in March 2007 as compared to February. This was the biggest one-month drop since a 12.6% decline in January 1989, which represented another period of recession in housing. The March 2007 decline reduced optimism among investors that the housing market may have begun a recovery after last year's slump. *See* Martin Crutsinger, *Existing-Home Sales Plunge in March,* AP news source (Apr. 24, 2007), available at *http://money.aol.com/news/articles/_a/existing-home-sales-plunge-in-march/20070424100* (last visited May 5, 2007).

[7] P.L. 93-406.

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gible plan or IRA. The surviving spouse may directly roll such assets into his or her own IRA.[8] As such, the IRA is treated as the IRA of the surviving spouse.[9] In contrast, a nonspouse beneficiary could only *inherit* an *IRA*, but could not roll over distributions from an eligible plan to an inherited IRA.[10] This obviously diminished the flexibility that could be afforded to a nonspouse beneficiary, as the participant would have to roll over a distribution from the eligible plan to an IRA before death and then name the nonspouse as beneficiary under the IRA. The change made by the PPA '06 eliminates this step and allows an eligible plan to roll over the distribution of the nonspouse directly into an IRA. Eligible plans include qualified plans, tax-sheltered annuities (§403(b) annuities), eligible deferred compensation plans of a state or local government employer (a governmental §457 plans), or IRAs.[11] Such IRA is to be treated as an inherited IRA of the nonspouse beneficiary. This provision became effective in 2007.

Inherited IRAs are extremely valuable to the nonspouse beneficiary, as distributions may be extended over his or her life expectancy, as opposed to the options provided under eligible plans.[12] Similar to the rules under prior law for inherited IRAs, the beneficiary cannot make contributions to the inherited IRA, nor roll amounts out of the inherited IRA because the nonspouse beneficiary is not considered the owner of the rolled-over assets.[13] Also, such IRAs cannot be combined with the beneficiary's other IRAs, other than assets from the same decedent. If the beneficiary transfers the IRA to another IRA, this must be accomplished through a trust-to-trust transfer, and the IRA must continue to be held in the name of the deceased IRA owner for the benefit of the beneficiary.[14]

Recent IRS Guidance

The IRS issued guidance regarding this distribution option in Notice 2007-7.[15] However, the IRS's interpretation of the law may diminish the utility of this new option. Senator Gordon Smith (R-Ore.), who was responsible for the nonspouse rollover provision, is working with the IRS to assure that the new legislation assists as many beneficiaries as possible.[16]

Understanding the minimum distribution rules applicable to eligible plan and IRA distribution is essential to interpreting the IRS's recent guidance.[17] Those rules dictate that if the participant dies before the required beginning distribution date (RBD) (i.e., April 1st following the calendar year in which the participant attains age 70½), the distributions to the nonspouse beneficiary are governed under the five-year rule [18] or under the life expectancy rule.[19] Under the five-year rule, there are no minimum required distributions for the first four years following the participant's death; however, all amounts must be received by the end of the fifth year following his or her death. In contrast, the life expectancy rule allows a required minimum distribution for each year following the participant's death determined over the beneficiary's life expectancy. The latter option generally provides the greatest "stretch" in payout if the nonspouse wishes to maximize the use of the tax shelter. However, an eligible plan or IRA is not required to offer the nonspouse the choice in options.[20] Thus, if the plan provides only for a lump-sum distribution option or the five-year rule option, prior law (which did not allow rollovers for such distributions) limited the options for the nonspouse beneficiary.[21] Certainly, if the plan provided for the life expectancy option, the beneficiary did not need the rollover IRA option, as he or she could "stretch" payouts over his or her life expectancy under the plan's payout provisions.

PPA '06 now permits nonspouse beneficiaries to directly roll distributions from qualified plans, §403(b)

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[8] §402(c)(9).

[9] *Id.*

[10] §408(d)(3)(C)(ii).

[11] P.L. 109-280, §829, adding Code §402(c)(11).

[12] Regs. §1.401(a)(9)-5, Q&A-5(c).

[13] *Id.*

[14] *See* PLRs 9737030, 9106045, 9106044, 8716058 (allowing a transfer that involved a transferee IRA opened in the name of the decedent). *See also* Notice 2007-7, 2007-5 I.R.B. 395, Q&A-13 (specifying that the IRA be established and titled in a fashion that identifies the deceased individual and the beneficiary (e.g., "Tom Smith as beneficiary of John Smith")).

[15] 2007-5 I.R.B. 395.

[16] *See* Ashlea Ebeling, "What Is The IRS Thinking?," *Forbes.com* (Feb. 7, 2007), available at *http://www.forbes.com/2007/02/06/beltway-irs-ira-bus-wash-cz_ae_0207beltway_print.html* (last visited May 5, 2007). *See also* "No Transitional Relief for Rollover to Nonspouse, IRS Officials," available at *http://subscript.bna.com/pic2/ppa.nsf/id/BNAP-6Z8HXW?OpenDocument* (last visited May 28, 2007) (stating that Senators Smith and John Kerry (D-Mass.) had asked the IRS to clarify the transitional rule in Notice 2007-7 to permit distributions of nonspouse beneficiaries of participants who died in 2003, 2004 and 2005 to be eligible for rollover relief).

[17] §408(a)(6); *see also* §401(a)(9)(C). For a complete description of the minimum distribution rules, see Kennedy, "Primer on Qualified Plans and IRA Distribution Rules Updated for the 2002 IRS Final Regulations," 30 *Tax Mgmt. Compensation Plan. J.* 307 (11/1/02).

[18] §401(a)(9)(B)(ii).

[19] §401(a)(9)(B)(iii). *See* Notice 2007-7, 2007-5 I.R.B. 395, Q&A-17. *See also* Regs. §1.401(a)(9)-3, Q&A-4, to determine which rule applies to a particular designated beneficiary.

[20] In absence of a specified plan provision, the life expectancy method must be used if the deceased has designated a beneficiary. In the year of the participant's death, there is no required minimum distribution as he or she died before the RBD.

[21] §408(d)(3)(C)(i).

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annuities, and §457 governmental plans into an inherited IRA.[22] Thus, if the plan permits only lump-sum distributions or the five-year payout rule, the nonspouse beneficiary can accomplish a life expectancy payout by rolling the distribution into an inherited IRA. The distribution is not subject to the direct rollover requirements of §401(a)(31), the notice requirements of §402(f) (i.e., the special tax notice) or the mandatory withholding requirements of §3405(c) (i.e., 20% mandatory withholding for any distributions made directly to the recipient).[23] Any amount actually distributed to the nonspouse beneficiary from the plan is not eligible for the rollover.[24]

The Service's initial interpretation of this new rollover option has caused concerns to lawmakers and practitioners. First, the IRS clarified that the nonspouse rollover applies to qualified plans, §403(b) annuities and eligible §457 governmental plans.[25] However, the Notice states that the plan is not required to offer this new rollover option to the nonspouse beneficiary.[26] Such interpretation will clearly undermine the utility of this distribution option. Because this option was previously not permitted under the Code, plans did not permit it. Whether a plan amendment is required to provide such a feature is also a question debated among practitioners.[27] Clearly, if a plan amendment is required, many plan sponsors may be slow in adding this new feature.[28] Terminating defined contribution plans are deemed to offer rollover to nonspouse beneficiaries, regardless of the terms of the plan.[29]

Second, the IRS states the general rule that the same method for determining required minimum distributions under the plan must apply for purposes of the nonspouse's inherited IRA.[30] Hence, if the plan specified the five-year rule to be used for required minimum distribution purposes, then that method would also extend to the inherited IRA. However, Notice 2007-7 provides a special rule that permits the nonspouse beneficiary the opportunity to use the life expectancy method even if the plan requires the five-year method. To take advantage of this special rule, the rollover distribution must be made before the end of the calendar year following the date of the participant's death.[31] Because most plans use the five-year rule as the default, nonspouse beneficiaries must take the first required distribution based on his or her life expectancy by the end of the year following the participant's death. Apparently, the IRS did not want the nonspouse beneficiary to delay the rollover until the fifth year following the participant's death and then rely on the life expectancy rule, thereby stretching payments an additional five years.

Due to the wording in Notice 2007-7, practitioners questioned whether the general rule in Q&A-19 overrode the special rule in Q&A-17. In the February 13, 2007, special edition of the IRS's *Employee Plans News*, the IRS stated that the general rule did not override the special rule.[32]

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[22] P.L. 109-280, §829(a)(1), adding Code §402(c)(11).

[23] Notice 2007-7, Q&A-15.

[24] *Id.*

[25] *Id.* at Q&A-12.

[26] *Id.* at Q&A-14.

[27] Section 401(a)(31) requires that the qualified plan must provide that, if a distributee of an eligible rollover distribution elects to have a direct rollover paid to an eligible retirement plan and specifies such plan, then a direct trustee-to-trustee transfer may be made. This suggests that the plan language must extend the option of a direct rollover to the distributee. However, the language of new §402(c)(11) states that a distribution to an inherited IRA by a nonspouse beneficiary is treated as an "eligible rollover distribution" for purposes of *this subsection* (emphasis added). Thus, it can be argued that because the new rules do not cross reference §401(a)(31), plans do not have to be amended to provide for a direct trustee-to-trustee transfer. However, many trustees may be reluctant to make such a direct transfer without specific plan authorization powers.

[28] *See* Ebeling, above (stating that Vanguard, which services 2,500 plans covering 3 million employees, is designing the nonspouse rollover as the default option as it revises its plans in light of the PPA '06).

[29] Notice 2007-7, Q&A-14. This is consistent with the Department of Labor's guidance regarding abandoned plans. *See* amendments to DOL Regs. §2550.404a-3, 72 Fed. Reg. 7515 (2/15/07), making nonspouse inherited IRA rollovers the default for terminating individual account plans and abandoned account plans.

[30] Notice 2007-7, Q&A-19.

[31] Notice 2007-7, Q&A-17(c)(2). A recent private letter ruling outlined the utility of this new benefit distribution option. *See* PLR 200717023. Under the facts of that ruling, a single taxpayer was a participant of a company-sponsored retirement plan who named someone as sole beneficiary in 2004 of his interest. In 2005, the plan was terminated, and the participant instructed the plan administrator to conduct a direct rollover of his interest from the plan to an IRA, naming the same person as sole beneficiary. The participant died during 2005, prior to his required beginning distribution date. The rollover was not completed, and the named beneficiary was appointed as the sole personal representative of the participant's estate. The IRS was told that the plan will be amended to comply with PPA '06 §829, consistent with the guidance provided by Notice 2007-7, but the transfer to the IRA rollover would occur after the effective date of the plan amendment. Although the participant initiated but did not complete the rollover prior to his death, the IRS permitted a trustee-to-trustee transfer prior to January 1, 2008, as a nonspousal rollover, authorized by PPA '06, §829.

[32] *See* IRS *Employee Plans News*, "Direct Rollovers to Nonspouse Beneficiaries — Clarification of Notice 2007-7," available at *http://www.irs.gov/pub/irs-tege/se_021307.pdf* (last visited May 5, 2007), in which Marty Pippins, Manager of EP Technical Guidance and Quality Assurance, clarified that the special rule in Q&A-17 was an exception to the general rule of Q&A-19. The following example is used to clarify: if a participant dies in a §401(k) plan prior to his RBD and the plan uses the five-year rule

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Remaining Questions

As a result of the IRS's interpretation, the nonspouse rollover option will have very limited retroactive relief for nonspouse beneficiaries before 2006. Certainly, if the participant died in 2006 and a lump-sum distribution was not made, the nonspouse beneficiary could begin distributions under the life expectancy method beginning in 2007. However, if the participant died before 2006 and the plan used the five-year rule, the nonspouse beneficiary presumably would not have taken a distribution until the fifth year following death. According to the IRS's special rule in Notice 2007-7, Q&A-17, the nonspouse beneficiary would be unable to take advantage of the life expectancy rule, as the distribution did not begin within the first year following the participant's death.

Governmental and tax-exempt employers appear to be eager to amend their plans to provide for the nonspouse beneficiary rollover; taxable employers are not as eager to put such a feature in their plans due to operational concerns.[33] When asked whether the beneficiary can ''pay his way back'' into the life expectancy rule by claiming that the prior years' minimum required distributions should have been paid, but were not, and agreeing to pay the applicable excise taxes, a Treasury official stated at an ABA Section of Taxation meeting that Treasury was aware of that technique but decided not to provide ''any comfort'' for such approach in the IRS Notice.[34] Thus, the beneficiary cannot have the plan sponsor force out the minimum distribution payouts for pre-2006 years, pay the applicable excise taxes, and then utilize the life expectancy rule.

In addition, as the IRS's interpretation that the plan's distribution rules are applicable to the inherited IRAs, custodians may be reluctant to assume these inherited IRAs due to the administrative problems of keeping track of different payout periods. To the extent custodians refuse such accounts, the utility of such accounts may be extremely limited.

Qualified Charitable Distribution Options

A New, but Temporary, Option Under the Code

PPA '06 creates a new distribution option, for a very limited time period, solely for IRA owners, age 70½ and older.[35] Such IRA owners may make IRA distributions to eligible charities — referred to as qualified charitable distributions (QCDs) without having to report the distribution as taxable income for federal tax purposes. These distributions may also be counted towards the minimum required distribution rules of the IRA.[36] As taxpayers subject to the minimum distribution rules are required to take distributions into income beginning at age 70½ (unless the taxpayer is a non-5% owner and not yet retired), QCDs permit such taxpayers to donate all or a portion of their minimum distributions and avoid paying federal income tax on such amounts. This option exists only for 2006 and 2007, and the maximum annual exclusion from income is $100,000 ($200,000 for an eligible married couple).[37] Because the amount of the IRA distribution is not taxable as income, taxpayers who itemize deductions are not eligible to claim the contribution to the charity as a deduction.[38]

Because IRA distributions are normally taxable as income and charitable contributions are an offsetting deduction, it would appear that the new law does not provide any new tax relief. However, the existing law characterizes charitable contributions as itemized deductions, and thus, taxpayers who take the standard deduction do not realize any additional tax benefits for such contributions. In addition, for taxpayers who do itemize, the Code limits charitable deductions to 50% of the taxpayer's adjusted gross income; hence, any charitable gift in excess of that threshold provides no tax benefit.[39] This new distribution option – QCD — permits an eligible donor to make a charitable con-

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for determining required minimum distributions, the nonspouse beneficiary is permitted to roll over the participant's entire account in 2007 and take the required minimum distribution under the life expectancy rule. If the account balance is rolled over in 2008, the amount eligible for the rollover must be reduced by the amount of the required minimum distribution for 2008, determined under the life expectancy rule. After 2008, the nonspouse beneficiary could still roll over funds from the §401(k) plan but would have to take required minimum distributions from the IRA under the five-year rule. No amount could be rolled over after 2011.

[33] *See* ''A Costly Glitch for 401(k) Heirs,'' *Business Week* (May 21, 2007) available at *http://businessweek.com/magazine/content/07_21/b4035102.htm* (last visited May 16, 2007), stating that IBM, Eastman Kodak and MetLife have decided to permit their §401(k) plans to offer the IRA nonspousal rollovers, but other companies are not expected to allow IRA nonspousal rollovers due to the cost of plan amendment, increased paperwork and training costs.

[34] W. Thomas Reeder, Acting Benefits Tax Counsel, Office of Benefits Tax Counsel, Department of Treasury.

[35] P.L. 109-280, §1201(a), adding Code §408(d)(8), effective for calendar years 2006 and 2007. Senators Byron Dorgan (D-ND) and Olympia Snowe (R-Me) have introduced S. 810, the Public Good IRA Rollover Act of 2007, to extend the provisions indefinitely, remove the dollar cap on contributions, and expand the eligible group to those age 59½ and older.

[36] *See* Notice 2007-7, Q&A-42.

[37] *Id.*

[38] *Id.* Certainly, a charitable contribution in excess of the $100,000 annual limit would be deductible, subject to the limitations of §170.

[39] §170(b)(1)(A) and (C).

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tribution of up to $100,000, thereby reducing his or her taxable income, regardless of whether the taxpayer itemizes and regardless of the size of his or her adjusted gross income.

Who Should Use QCDs if They Are Otherwise Motivated to Support Charities?

Clearly, taxpayers who take the standard deduction and do not itemize deductions should take advantage of QCDs. One practical problem exists if the taxpayer wishes to make numerous small gifts — $50 to one charity; $100 to another, etc. This can be accomplished through "IRA checkbooks" that brokerage houses are beginning to offer. As nearly 70% of Americans claim the standard deduction,[40] this option offers the best tax savings for the taxpayer who would have made the charitable contribution regardless of the option.

There are also *indirect* tax advantages to making a QCD (as it reduces the taxpayer's taxable income) which will encourage their utilization:

- For taxpayers whose adjusted gross income exceeds $156,400 (for 2007, single, heads of household and joint filers) or $78,200 (for married filing separately), the amount of itemized deductions is increasingly reduced and eventually phased out.[41] Thus, taxpayers with sizable incomes could reduce their income by up to $100,000 with a QCD, thus allowing them to deduct more of their itemized deductions.
- Taxpayers otherwise affected by the phase-out of the $3,400 dependent and personal exemption deduction may avoid the phase-out by keeping income below the thresholds;[42]
- The avoidance or reduction of Social Security benefits that are taxable may be accomplished by keeping the income threshold below the current $32,000 (married-joint) or $25,000 (single or head-of-household) levels;
- Other deductions are subject to income phase-outs (e.g., medical expenses);
- Income in respect of a decedent (IRD) — e.g., income earned by a taxpayer but not realized until after his or her death — is taxable under §691. Thus, retirement distributions are generally subject to income tax when distributed to the beneficiary.[43] This income tax treatment, coupled with the estate taxes, can subject retirement assets to very high combined tax rates. By reducing one's estate through QCDs from IRAs and other qualified plan assets, older taxpayers reduce the proportion of their estates in these types of assets.
- To the extent the state income tax rules mirror the federal income tax rules, there are additional tax savings.[44]

Who May Not Be Interested in QCDs?

Donors who are considering donating appreciated stock, mutual funds or real estate property to a charity may wish to weigh the tax consequences. In the ordinary situation in which a taxpayer holds property outright (e.g., basis of $2,000 and a fair market value of $10,000, eligible for long-term capital gains treatment), the donation of appreciated property worth $10,000 results in no capital gains tax and an itemized deduction of $10,000.[45] Alternatively, if the taxpayer sells the property first and then donates the proceeds, he or she will pay a capital gains tax on the appreciation (e.g., $8,000 at the 15% tax rate) and then receive an itemized deduction for the $10,000 cash contribution. Hence, a gift of appreciated property is more advantageous for the taxpayer. If the appreciated property were held in the IRA, a distribution of $10,000 would result in income taxation on $8,000 ($10,000 less the basis of $2,000). By donating the property directly to the charity through a QCD, the taxpayer avoids income taxation on the $8,000. Therefore, the taxpayer needs to weigh the tax savings of eliminating the capital gains tax of 15% against the taxes

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[40] U.S. Gen Accounting Office, "Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing," GAO-02-509 (Mar. 2002), finding that failure to itemize for payments for mortgage interest and points, state and local income taxes, charitable contributions and real estate and personal property taxes could have resulted in a total overpayment of taxes as high as $945 million. For the calendar year 2006, the standard deduction is $10,300 for married couples filing jointly; $5,150 for single filers; and $7,550 for married couples filing separately or heads of household. See IRS Pub. 554 for greater standard deductions for individuals age 65 or older and/or blind.

[41] §68(a); Rev. Proc. 2006-53, 2006-48 I.R.B. 996, §3.12.

[42] Section 151 reduces the size of the personal and dependent exemption ($3,400) by 2% (for every adjusted gross income increase of $2,500) for adjusted gross income above a given threshold: for 2007, those thresholds are $234,600 for married filing jointly; $195,500 for head of household; $156,400 for single; and $117,300 for married filing separately. Rev. Proc. 2006-53, §3.18

[43] Under §1014(c), an individual who inherits property from an individual who dies before 2010 takes the decedent's income tax basis in that property. Taxpayers about to sell appreciated stocks and bonds, real estate or other assets benefit by giving the property to the charity directly to avoid the 15% federal long-term capital gains tax.

[44] Taxpayers who live in several states — Indiana, Michigan, New Jersey, Ohio, Massachusetts and West Virginia — where charitable donations are not afforded a state income tax deduction, will have no additional incentive to make a QCD. For taxpayers in Illinois, all distributions from retirement plans are exempt from state income tax, and thus, they will not have an additional incentive to making a QCD.

[45] *See* §170(e)(1). The amount of itemized deduction for gifts of property eligible for long-term capital gains treatment is limited to 30% of adjusted gross income. *See* §170(b)(1)(C)(i).

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saved through the QCD. Another issue to consider is that a taxpayer who is age 70½ or older is required to take a minimum distribution and, thus, will otherwise be subject to some income tax on such distribution.

In contrast, taxpayers who have appreciated property within an IRA but are not planning on selling it in the near future will benefit from making QCDs, as the charity will receive a ''step-up'' in basis, normally at the time of death, whereas, IRAs receive no step-up in basis at the taxpayer's death, and thus, distributions to beneficiaries continue to be taxable as ordinary income.

QCD Popularity

How popular were these IRA gifts in the final quarter of 2006 after PPA '06 was passed? The National Committee on Planned Giving (NCPG) has been keeping track of IRA distributions received by charities since the enactment of PPA '06. As of March 5, 2007, the NCPG reports 2,921 individual distributions reported in its survey, with a total value of more than $56 million.[46] The median gift was $5,000 — with 52% of the gifts averaging $5,000 or less and 9% of the gifts at the maximum level of $100,000. Harvard University received 150 of these IRA distributions totaling $2.5 million in 2006, with 11 (7.3%) at the maximum $100,000 level.[47] Hence, eligible charities have an enormous incentive to see this exemption continued or made permanent.

IRS Guidance

In Notice 2007-7,[48] the IRS outlined the following requirements for an IRA distribution to qualify as a qualified charitable distribution (QCD):

- The donor taxpayer must be at least age 70½;
- Only IRAs, not §401(k) plans, profit-sharing plans, pension plans or §403(b) annuities, can take advantage of a QCD. Distributions from ongoing SEP IRA or SIMPLE IRA plans do not qualify. If a taxpayer has a SEP IRA or SIMPLE IRA that received employer contributions during his working career, a QCD may be made if no employer contributions were deposited in the same year as the charitable gift was made.[49] Distributions from Roth IRAs are also eligible for QCDs to the extent the distribution would have been taxable (e.g., made within five years of establishing the Roth IRA).
- Payment may be made directly to the charity, or the IRA owner can deliver a check from the IRA made payable to the charity.[50] The NCPG reported that in 2006, 15% of the IRA gifts were paid directly from IRA donors, whereas 83% were from IRA administrators. The latter caused confusion for the IRA administrators who received requests for a distribution of ''$100 from the IRA of John Smith'' if there were various IRA owners named John Smith.
- The recipient charitable organization must be a public charity, private operating foundation, or a conduit private foundation.[51]
- The exclusion is available only if the charitable contribution deduction for the entire distribution would have otherwise been allowable under current law (without regard to the percentage limitations).[52]
- The QCD is limited to $100,000 per year per individual ($200,000 for a married couple filing a joint federal income tax return). A QCD applies to only the taxable portion of the taxpayer's IRA distribution; thus, if the IRA owner has made nondeductible contributions, charitable distributions will be deemed to come first from the taxable portion, thereby allowing the IRA to keep the maximum amount of tax-free dollars.[53] Thus, if the distribution to the charity also includes tax-free

[46] *See* the results of the NCPG survey at its website at *http://www.ncpg.org/gov_relations/NCPG%20IRA%20survey—general%20results%20(3-05-07).pdf* (last visited May 5, 2007).

[47] *See* Arden Dale, ''Charities Love IRA Rollovers,'' *Wall St. J.* (online, Jan. 27, 2007), available at *http://www.charitynavigator.org/__asset__/_articles_/2007/charities_love_IRA_rollovers%20_WSJ.pdf* (last visited May 5, 2007).

[48] 2007-5 I.R.B. 395.

[49] *See* Notice 2007-7, Q&A-36.

[50] §408(d)(8)(B)(i), Notice 2007-7, Q&A-41.

[51] Section 408(d)(8)(B)(i) requires that the charity fall within the meaning of §170(b)(1)(A), which will include most public charities and certain private operating foundations. There are two important exceptions — donor-advised funds (as defined in §4966(d)(2)) and supporting organizations (as defined in §509(a)(3)) — that do not qualify for the charitable IRA exclusion even if they would otherwise qualify for the public charity tax deductions. Donor-advised funds are philanthropic vehicles generally set up at community foundations or financial institutions. Supporting organizations assist, finance or are somehow closely related to another charity. Also, charitable organizations listed in §170(c) that qualify for charitable income tax deductions (e.g., veteran organizations, fraternal organizations, cemetery companies) are not eligible for the charitable IRA exclusion. In recent years, private foundations, donor-advised funds and supporting organizations have come under attack as regulators and lawmakers become concerned over abusive practices.

[52] Section 408(d)(8)(C) imposes the same limitation that exists on deductions for charitable contributions on a QCD, e.g., if the deductible amount would have been reduced because of a benefit received in exchange (e.g., auction, raffle, fund-raising or other quid-pro-quo transaction) or if the deduction would have been denied because sufficient substantiation was not received, the charitable IRA distribution will not qualify.

[53] §408(d)(8)(B). *See also* Example 2 in the *Technical Expla-*

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amounts from the IRA, that portion will not qualify as a QCD, but the taxpayer can claim a charitable deduction for that part of the payment.

- The IRS also indicates that a QCD to an eligible charity will be treated as an exemption from the prohibited transaction rules.[54] The DOL, which has interpretative jurisdiction under the prohibited transaction rules, concurs, even if the IRA owner already had an outstanding pledge to the receiving charitable organization.[55]

Reporting Problems

Custodians and trustees have been experiencing some confusion as to how to report a QCD on Form 1099-R.[56] Although some have been using Code F (charitable gift annuity distributions) in Box 7 to indicate the charitable status of the IRA distribution, the IRS indicates on its website that Code 7 (for reporting distributions if the recipient is age 70½ or older) in Box 7 is the appropriate response.[57] As a result of the IRS's statement, the IRA owner has the burden of determining whether the charity is an eligible charitable organization for a QCD. For purposes of the taxpayer's income tax return, the instructions to Form 1040 indicate that the IRA owner should report the entire IRA distributions on line 15a, enter the amount less the QCD on line 15b, and enter "QCD" next to line 15b to report a QCD from an IRA.[58]

Direct Rollovers from Eligible Plans to Roth IRAs

Background Information

Before the PPA '06, distributions from qualified plans, §403(b) annuities and eligible §457 governmental plans to Roth IRAs had to be accomplished through a two-step process — rollover to a traditional IRA and then transfer from the traditional IRA to the Roth IRA. Due to the legislative changes of the PPA '06, distributions from qualified plans, §403(b) annuities and eligible §457 governmental plans will be allowed to be *directly* rolled over into a Roth IRA beginning in 2008.[59]

Roth IRAs, which first became available in 1998, provide several tax advantages over traditional IRAs: all earnings/gains can be withdrawn tax-free; distributions do not have to begin at the attainment of the taxpayer's age 70½, as is the case under a traditional IRA;[60] and the IRA owner's beneficiary can enjoy tax-free withdrawals. However, to take advantage of these benefits, there are several restrictions. Roth contributions are not deductible from income tax. High-income taxpayers ($99,000 for individuals in 2007 and $156,000 for joint returns in 2007) are not eligible to contribute. There are also income limits for taxpayers wishing to convert a traditional IRA to a Roth IRA. A rollover from a traditional IRA to a Roth IRA is permitted only if the taxpayer's adjusted gross income does not exceed $100,000.[61] Although the taxpayer incurs an income tax on the conversion of a traditional IRA to a Roth IRA, once the money is rolled over into the Roth IRA, the earnings can be withdrawn tax-free.

Renewed Interest in Roth IRAs

Due to the income restrictions for traditional IRA to Roth IRA conversions, these conversions have limited appeal. As noted above, TIPRA, which was enacted on May 17, 2006, eliminates the adjusted gross income limits beginning in 2010.[62] Hence, high-income taxpayers (whose tax bracket is unlikely to change over time) may decide to convert to a Roth IRA beginning in 2010 in order to shelter future earnings from taxation. Taxpayers can elect to recognize the income as fully taxable in 2010 or can recognize

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nation of H.R. 4, "the Pension Protection Act of 2006," Joint Committee on Taxation, JCX-38-06 (8/3/06), at 268.

[54] *See* Notice 2007-7, Q&A-44 (stating that the QCD will be treated as receipt by a disqualified person of a benefit to which he is entitled to as participant or beneficiary under the plan according to §4975(d)(9)).

[55] *Id.*

[56] This is the form used to report distributions from pensions, annuities, retirement or profit-sharing plans, IRAs, insurance contracts, etc.

[57] *See* Changes to Current Tax Forms, Instructions and Publications: *Caution — Changes to 2006 Instructions for Forms 1099-R and 5498,* available at *http://www.irs.gov/formspubs/article/0,,id=109875,00.html* (last visited on May 5, 2007), in which the IRS states "Qualified charitable distributions. Section 1201 of the Pension Protection Act of 2006 allows certain account holders to direct a tax-free distribution to a qualified charity from a traditional IRA or Roth IRA. However, the trustee is not responsible for knowing if that charity is one described under §408(d)(8) of the Internal Revenue Code. Therefore, follow the general rules for reporting distributions where the recipient is age 70½ or older. Enter Code 7 in Box 7 of Form 1099-R for these distributions. Do not use Code F."

[58] *See* Instructions to Form 1040, *US Individual Income Tax Return,* p. 25, for lines 15a and b on Form 1040, available at *http://www.irs.gov/pub/irs-pdf/i1040gi.pdf* (last visited on May 5, 2007).

[59] P.L. 109-280, §824(a), amending Code §408A(e).

[60] The minimum distribution rules of §401(a)(9) are applicable as to the minimum distributions and commencement dates following the Roth IRA owner's death.

[61] §408A(c)(3)(B), before repeal by the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), P.L. 109-222, §512(a)(1), effective for tax years beginning after 2009.

[62] *See id.*

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the conversion in income ratably in 2011 and 2012.[63] After 2010, taxpayers making rollovers will have to treat the entire rollover as income in the tax year in which the distribution occurs. In addition, the 10% penalty tax for early withdrawals will not apply.[64]

According to IRS rules, a taxpayer must add the balances in *all IRAs,* including IRAs with deductible and nondeductible contributions, as well as SEPs and SIMPLE IRAs, then divide by the nondeductible contributions, in order to determine the percentage of the conversion that is tax-free.[65] Hence, the conversion is not based solely on the IRA that the taxpayer decides to convert. Obviously, the taxpayer should pay the taxes outside the IRA in order to maximize the deferral.

Due to the repeal of the income limitations on conversions effective in 2010, there should be renewed interest in Roth IRAs, as all interest/gains under Roth IRAs will be exempt from tax. To the extent alternative investment options are generating a greater overall return, marketing efforts may divert IRA owners away from traditional IRA custodians and trustees to non-conventional custodians and trustees of Roth IRAs, as the greater return on investments is totally tax-exempt.

SELF-DIRECTED IRAs

This second portion of the article is designed to showcase the various practical and legal pitfalls that should be considered when establishing and maintaining a *self-directed IRA.* Because most such IRAs involve investing in real estate, this portion of the article focuses on self-directed IRAs in real estate investments. Although such IRAs are certainly legal, they may pose legal pitfalls that may result in unintended consequences for the taxpayer — including income tax consequences and excise tax penalties, as well as some state law concerns. Certainly, in the context of a rollover IRA, in which the account balances may be significant, caution is advisable. It may be helpful to carve up the IRA into multiple IRAs, to limit the risk if unintended consequences occur. According to the most recent member's real estate investment report by the Pension Real Estate Association (PREA), pension funds generally invest in a variety of real estate investments.[66] These types are relevant not only for liability purposes, but also for the DOL plan assets regulations (which will be discussed later). For employee benefits practitioners unfamiliar with the various types of real estate investments, they are defined in Appendix A of the article.

Self-directed IRAs have been permitted since ERISA's enactment in 1974, but there has been a heightened interest in such IRAs in recent years due to media attention,[67] poor stock market performance,[68] low interest rates, [69] and concerns over mutual fund fees.[70] Due to the PPA '06 new distribution options, IRA rollovers will be available to a larger group of beneficiaries, especially IRA owners interested in making qualified charitable distributions. Thus, it is expected that IRA rollovers will continue to grow as custodians and trustees aggressively compete for these assets.

Current IRA Market

Presently, who manages IRA assets? Mutual funds manage about 45% of IRA assets.[71] The percentage of IRA assets held by insurance companies and brokerage accounts has grown since 1990, while the dollar amount of bank and thrift deposits held in IRAs has remained stagnant since 1990.[72] As most bank or brokerage firm custodians of IRAs limit an individual's investment choices to the custodian's products, it is not surprising that IRAs are primarily invested in stocks, bonds, mutual funds, money markets and cer-

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[63] §408A(d)(3)(A)(iii), as amended by P.L. 109-222, §512(b)(1).

[64] §408A(d)(3)(A)(ii).

[65] *See generally* IRS Pub. 590.

[66] *See* Jim Clayton, PREA Plan Sponsor Research Report (Feb. 2007), available at *http://www.prea.org/research/plansponsorsurvey_2006.pdf* (last visited May 5, 2007).

[67] *See* Terry Savage, ''Realty Investment Inside an IRA Requires Finesse,'' *Chicago Sun Times* (Mar. 19, 2007).

[68] According to Patrick W. Rice, president of IRA Resource Associates, as the stock market continues to wobble, the ''phenomenal growth'' of self-directed IRAs in real estate is forecast to continue. On Rice's website, he urges IRA owners to ''own a piece of the rock.'' They are asked to note the rate of return realized on their IRAs over the past few years and compare it to the 15% — 20% rate of return for properties in Clark County. See *http://www.iraresource.com/articles/article0595* (last visited May 5, 2007).

[69] *See* the remarks of Governor Mark W. Olson, ''Bank Management Challenges in a Low-interest-rate Environment,'' The Federal Reserve Board (June 26, 2003), available at *http://www.federalreserve.gov/boarddocs/speeches/2003/20030626/default.htm* (last visited May 5, 2007).

[70] *See* U.S. Gen. Accounting Office, ''Private Pensions: Increased Reliance on 401(k) Plans Calls for Better Information on Fees,'' GAO-07-530T, available at *http://www.gao.gov/new.items/d07530t.pdf* (last visited May 5, 2007). The House of Representatives, Committee on Education and Labor, held hearings on the issue of fees assessed under §401(k) plans on March 6, 2007. *See* Full Committee Hearing: *Are Hidden 401(k) Fees Undermining Retirement Security?*, with witness testimonies available at *http://edworkforce.house.gov/hearings/fc030607.shtml* (last visited May 5, 2007).

[71] *See* ICI report cited in note 3, above.

[72] *Id.*

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tificates of deposit (CDs). In fact, it is estimated that only 3% of IRAs are self-directed.[73]

This is beginning to change. Real estate has long been regarded as an inflation hedge due to the potential capital appreciation of the property and the income stream from rentals. Illiquidity is a big disadvantage of real estate investment, which is why there has been a growing trend towards marketable real estate securities (e.g., interest in publicly-traded real estate investment trusts (REITs) or publicly-traded partnerships). Other disadvantages of real estate include the cost and potential uncertainty of valuation of the investment by appraisal.

The Internal Revenue Code does not tell investors what an IRA can invest in, only what it *cannot* invest in, such as collectibles (rare coins, artwork, antiques, rugs, alcoholic beverages, metals, gems or stamps) or life insurance, but there is no restriction against investment in real estate.[74] Thus, through self-directed IRAs, the account owner can invest in single-family homes, multi-family homes, condos, commercial buildings, apartment buildings and land. Until just recently, if an IRA owner wished to invest in a non-traditional investment, such as real estate, he or she would have to go to a traditional trust company, which generally required at least $300,000 of assets.[75] However, over the past decade, there has developed a growing market of IRA custodians that permit the IRA owner to self-direct his or her IRA (regardless of its size) into almost any investment, the most popular being real estate.

Although many financial institutions serve as custodians for IRAs, the two most popular advocates of self-directed IRAs are Pensco (*http://www.pensco.com*) and Entrust (*http://www.entrustadmin.com*).[76] Although they will serve as custodian to handle the account, the IRA owner may need a real estate advisor to help assess the purchase of the real estate, a real estate attorney to accomplish the purchase or sale of the real estate, and an administrator to handle the record-keeping (i.e., collect rent and pay bills and taxes). The IRA owner should also seek the advice of an employee benefits attorney to assure that the IRA does not lose its qualification status and to ascertain whether additional taxes may be owed depending on the type of investment that the IRA owner selects. Because these accounts are new, but growing, there is little formal guidance to rely upon. Hence, IRA investors should proceed cautiously. One Tax Court decision illustrates the problems that may occur if an IRA owner of a self-directed IRA directs the custodian to invest in non-publicly-traded securities but the custodian refuses to comply.[77]

Financial Perspective

Certainly, before deciding on what to invest, an investor should compare the expected rate of return among stocks, bonds, real estate and other forms of investment. Assuming that the gross rate of return on securities/bonds is expected to be lower than the rate for a given real estate investment, the investor must also factor in the *tax* treatment afforded the investment in determining the net expected rate of return. If an IRA owner has $500,000 cash and $500,000 in an IRA rollover, investing in real estate will generally lose its tax advantage if the owner uses the IRA to purchase the real estate, because of (1) the loss of tax deductions generally associated with real estate investment (e.g., depreciation), (2) capital gains treatment for profit,[78] and (3) difficulty in obtaining financing as the IRA owner cannot guarantee the loan of the IRA (otherwise the IRA will be disqualified).

In contrast, the IRA investment results in the following tax treatment: (1) tax deferral[79] (if the investment is made in a traditional IRA or traditional IRA

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[73] *See* Asset Exchange Strategies, "Self Directed IRA FAQ's," available at *http://www.myrealestateira.com/SelfDirectedIRAFAWs.html* (last visited May 5, 2007) (stating that less then 3% of retirement accounts are invested in non-traditional investments and less than 2% are invested in real estate).

[74] §408(a)(3) and (m).

[75] *See* Kristen M. Lynch, "The Truth About Self-Directed IRAs and Real Estate: Inherently Incompatible or Just Misunderstood?," RPPTL Actionline (Spring 2006).

[76] According to Hubert Bromma, CEO of The Entrust Group, Inc., its 25-year data reveals the following: the average account balance in a self-directed IRA is $70,000 (ranging from $500 to $6 million); the average client age is 51 (ranging from 18 to 82); the average number of assets is 3.4 (ranging from one to 60); and the plans with the most activity are those with the highest dollar balances. *See* Bromma, "Self Directed IRA Expands Investment Possibilities and Perils," 76 *Prac. Tax Strategies* 337 (June 2006). A list of providers of comprehensive self-directed plan services include: The Entrust Group (with 30 offices throughout the United States); Equity Trust (with one office in Ohio); Fiserv (with two offices in Colorado); International Bank and Trust (with one office in New Hampshire); Sterling Trust (with one office in Texas); Trustar (with one office in Delaware); and Pensco (with one office in New Hampshire). *See generally* Hubert Bromma, "How to Invest in Real Estate with our IRA & 401(k) & Pay Little or No Taxes" (2006).

[77] *See Ancira v. Comr.*, 119 T.C. 135 (2002). This case involved the owner of a self-directed IRA who directed its custodian to invest $40,000 in a non-publicly-traded company, Smoothie King. When the custodian refused, the owner delivered a check to Smoothie King for the IRA investment. Despite the IRS's position that the $40,000 was a distribution from the IRA, the Tax Court stated that the IRA owner acted as a conduit for the IRA trustee, and thus, the $40,000 was an IRA investment, not a distribution.

[78] An individual taxpayer's net capital gain is subject to four different capital gains rates (5%, 15%, 25% and 28%). *See* §1(h).

[79] Federal income tax applies to distributions from traditional

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rollover), as the distribution will ultimately be taxable as income upon receipt; or (2) tax exclusion if the investment is made in a Roth IRA. A traditional IRA affords the owner a deductible or nondeductible contribution, whereas the Roth IRA does not afford the owner a deductible contribution. A comparison of the tax impact under either approach should be factored into the net expected rate of return to determine which is the more viable option. However, for many investors, the bulk of their estate is in their IRA, not their liquid assets. Thus, the tax advantages afforded to the treatment of buying real estate outright are simply not an option.

Another practical consideration is whether the IRA retains sufficient liquidity to meet ongoing expenses associated with the investment (e.g., taxes, mortgage payments, minimum distribution payouts). Certainly, the prospect of liquidating the investment in order to meet cash-flow expenditures could lead to disastrous investment consequences.

Legal Requirement #1 — Requirements of §408

Explicit Requirements of §408

IRAs are creatures of Code §408. They were originally intended to be tax-deferred retirement vehicles for individuals whose employers did not sponsor a qualified retirement plan.[80] Failure to comply with the requirements of §408 results in the permanent loss of the tax shelter. As the owner of the IRA is the sole participant, the IRA is not an ERISA plan.[81] This is critical, as it means that ERISA's preemption of state law is not applicable.[82] ERISA's fiduciary rules regarding reasonable prudence and diversification are also not applicable.[83] However, Code §408 does require that the IRA be for the exclusive benefit of the owner or his beneficiaries.

Traditional IRAs afford individuals the ability to save on their own through individual retirement accounts (or annuities) without incurring taxes on the original contributions and subsequent interest/gains until the funds are withdrawn. They have limited utility — initially the maximum deductible limit equaled the lesser of $1,500 or 100% of pay — in comparison to the qualified defined contribution plan limits of $25,000 or 25% of pay. Although the annual deductible limits for IRAs have been raised over time (e.g., $4,000 in 2007),[84] they are still considerably less than the qualified defined contribution limits (e.g., $45,000 in 2007).[85]

Roth IRAs were introduced by the Tax Relief Act of 1997,[86] providing a totally different tax approach to individual savings. Although annual contributions to the Roth IRA are not deductible, all earnings accumulate tax-free, and *all* distributions are tax-free upon withdrawal. There are, however, limitations on who can take advantage of a Roth IRA. The annual nondeductible contribution phases out depending on the level of the taxpayer's modified adjusted gross income.

Distributions from an employer's §401(k), §403(b) or other eligible plan can also be rolled over into a traditional IRA or Roth IRA in order to avoid current income tax on the distribution. However, distributions can be rolled over into a Roth IRA only if the taxpayer's modified adjusted gross income is less than $100,000 (this will change in 2010). Similar to withdrawal restrictions that exist under an employer's qualified plan, distributions under IRAs may be limited and, if taken out prematurely, are subject to a tax penalty.[87]

Necessity of a Trustee or Custodian

All IRA assets are required to be held by a trustee, which is normally a bank, or by a custodian, that has been approved by the IRS.[88] Unlike a qualified plan in which the owner-employee can serve as plan trustee, the IRA owner cannot hold title to the IRA's assets.[89] Accordingly, when investing in real estate, the IRA owner should direct the custodian to purchase the real estate and hold the investment in the name of the account (e.g., Name of Custodian, for the benefit of John Smith's IRA).

The IRS has issued Forms 5305 and 5305-A as model IRA agreements, which are used by many trust-

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IRAs under §72 (current income tax rates are 10%, 15%, 25%, 28%, 33% and 35%, depending on the taxpayer's gross income. *See* §1(i)).

[80] *See* Conf. Comm. Joint Explanation to ERISA, P.L. 93-406 (1974) (limiting IRA deduction to any individual who was not an active participant in a qualified or governmental plan or §403(b) contract).

[81] ERISA §3(2)(A) defines a pension plan as one maintained by an employer or by an employee organization, or by both. Generally, employers that simply provide payroll deductions for IRA contributions to a named trustee or custodian are not deemed to be maintaining an ERISA plan. *See* 29 CFR §2510.3-1(j)(3). (Labor Department regulations are hereinafter referred to as "DOL Regs.").

[82] ERISA §514.

[83] ERISA §404(a)(1)(A) – (C).

[84] §219(b)(5)(A).

[85] §415(c)(1)(A), as adjusted.

[86] P.L. 105-34, §302.

[87] §72(t).

[88] §408(a)(2). A non-bank is permitted to act as trustee provided it demonstrates to the IRS that is capable of administering the IRA according to the terms of the Code.

[89] H.R. Rep. No. 807, 93d Cong., 2d Sess. (1974) at 134; Regs. §1.408-2(e). *See also Schoof v. Comr.,* 110 T.C. 1 (1998).

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ees and custodians. Form 5305-A provides that the IRA owner may direct investments and retain most ''traditional'' powers that would otherwise create a passive trust, and that such powers do not cause the IRAs assets to be owned by the IRA owner. Any alterations to the Model IRA agreements must be submitted for IRS approval.

Section 408(h) of the Code expressly holds that IRA custodial accounts are treated as IRA trusts as long as the assets are held by a bank, trust company or other approved entity and that the IRA custodian is treated as the trustee for all Code purposes. As the IRA is not an ERISA plan, state law is not preempted. Thus, applicable state trust/real estate law does not necessarily have to follow the federal income tax interpretation in the context of a self-directed IRA. This may raise state law real estate title issues.

State Law Ramifications

Because ERISA's preemption clause is not applicable to IRAs, IRA owners must be aware of the state law consequences. According to Kristen Lynch, an attorney practicing in Florida, ''[s]everal title companies have taken the position that if the IRA has a custodian as opposed to a trustee, the IRA is no more than a passive trust under the [Florida] Statute of Uses, and therefore title to real property cannot vest in the custodian or the account and would vest in the IRA owner.'' [90] As Ms. Lynch concludes, such result would be disastrous from an income tax viewpoint.[91] One compromise would be to form a limited liability corporation (LLC) which is owned by the IRA. This is also advantageous if the IRA custodian is uncomfortable with holding real estate outright due to the potential for other risks (e.g., tort liability or tax liability) or if the IRA owner does not wish to pay the custodian or a professional management company to handle the record-keeping (e.g., collect rent and pay bills).

To accomplish this, the IRA owner forms an LLC and then transfers the IRA assets to the LLC. The IRA custodian then holds title only to the LLC shares. The IRA owner may serve as the director of the LLC and, as such, may perform all the necessary management functions for the real estate investment. However, now that the IRA owner controls the LLC's checkbook, the chances for error increase. If he or she ever pays the real estate bills out of his or her personal checkbook instead of the LLC checkbook, he or she would risk disqualifying the IRA.

[90] *See* Lynch article cited at n. 75, above.

[91] *See also* Kaler, *Trusts*, The Florida Bar, 2006 Florida Real Property Complex Transactions, available at *http://web2.westlaw.com/result/documenttext.aspx?findjuris=00001&docsample=False&s* (last visited May 5, 2007).

This arrangement also begs the question as to whether such an arrangement runs afoul of the requirement of §408(a)(2) (that the trustee be a bank or other person who demonstrates to the satisfaction of the IRS that the trust will be administered in accordance with the requirements of §408). If the LLC is being operated solely by the IRA owner with no oversight on the part of the custodian, it would appear that §408(a)(2) is being bypassed. Certainly, if IRA-owned LLCs led to a widespread commingling of IRA and personal assets, the IRS and/or Congress would likely react. Thus, one should caution a client considering an IRA-owned LLC to properly monitor the management functions associated with the real estate. Alternatively, a professional real estate management company or the IRA custodian should oversee such functions. That, of course, adds to the administrative costs of the self-directed IRA.

Due to changes made to the federal bankruptcy law, traditional IRAs are exempt up to $1,000,000, and rollover IRAs are fully exempt.[92] However, federal bankruptcy law does not override state law, which may provide little protection for IRAs. For those states that do provide some protection for IRAs, state law does not necessarily adopt the Code's approach that custodian accounts qualify as ''trusts'' for all purposes. Thus, it is important for IRA owners to understand not only the federal tax implications of the IRA arrangement but also its consequences for state law purposes.

Legal Requirement #2 — Prohibited Transaction Requirements of §4975

ERISA's and the Code's Prohibited Transaction Requirements

In reaction to the allegations during the 1960s and 1970s that pension assets were being used by plan trustees for their personal benefit, ERISA set forth prohibited transactions between the plan fiduciary and entities that were presumed to have a conflict of interest under Title I[93] and Title II (for qualified plans).[94] These rules serve as broad, preventative limitations,

[92] §522 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), P.L. 109-8 (2005).

[93] ERISA §406(a) and (b).

[94] §4975(c)(1). ERISA's and the Code's prohibited transaction rules were modeled after the prohibited transaction rules imposed on private foundations by the Tax Reform Act of 1969 (TRA'69) (P.L. 91-172). Prior to 1969, the standard used to determine if a charity's assets were being used for personal noncharitable purposes was a case-by-case arm's-length standard. *See Rollins v. Comr.,* T.C. Memo 2004-260. ''To minimize the need to apply subjective arm's-length standards, to avoid the temptation to misuse private foundations for noncharitable purposes, to provide a

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causing a wise fiduciary to avoid even the appearance of impropriety.[95] This dovetails with trust law that a ''full heart and empty head'' rationale is unacceptable in dictating the actions of a fiduciary. The prohibitions are so broad that they effectively prohibit a wide variety of transactions that the plan would normally engage in, and thus shift the burden to the affected parties to show that the exemptions (statutory or administrative) permit such transactions.[96] Due to the breath of these prohibited transaction rules, a self-directed IRA owner should be made aware of the ramifications of such rules.

Although IRAs are generally not ERISA plans, the DOL has jurisdiction over these plans for purposes of the prohibited transaction rules, including individual requests for exemptions from those rules.[97] There are two different consequences for incurring a prohibited transaction under the Code:

- For the IRA owner, the IRA is deemed immediately disqualified as of January 1 of the year in which the prohibited transaction occurred (an extremely severe tax consequence), resulting in current income tax treatment of a traditional IRA and possible excise tax penalty for a premature withdrawal from an IRA.[98]
- For the disqualified person involved in the transaction, the imposition of an excise tax of 15%.[99] Due to the statutory language, the IRS has ruled that IRA owners and beneficiaries are almost always exempt from such excise tax.[100] Thus, the excise tax is applicable to a disqualified person other than the IRA owner or beneficiary.[101]

ERISA sets forth four different (but all-encompassing) types of transactions, which if they occur between a plan fiduciary and a ''party in interest,'' are automatically prohibited unless statutorily or administratively exempted.[102] The Code lists the same transactions but prohibits them between the plan and a ''disqualified person,'' instead of a ''party in interest.'' [103] The term ''disqualified person'' for Code purposes generally includes the same individuals or entities as the term ''party in interest'' for ERISA purposes;[104] however, the Code includes only employees who are highly compensated (i.e., with annual com-

more rational relationship between sanctions and improperly acts, and to make it more practical to enforce the law, the [Senate Finance] committee has determined to generally prohibit self-dealing transactions and to provide a variety and graduation of sanctions . . .'' ''The committee's decisions . . . are based on the belief that the highest fiduciary standards require that self-dealing not be engaged in, rather than that arm's-length standards be observed.'' S. Rep. 91-552, 1969-3 C.B. 443, as summarized in *Rollins v. Comr.* The self-dealing acts prohibited by TRA '69 are similar to the transactions prohibited by ERISA and the Code.

[95] *See Donovan v. Cunningham*, 716 F.2d 1455, 1464-65 (5th Cir. 1983) (the purpose of ERISA's prohibited transaction rules is to ''make illegal per se the types of transactions that experience had shown to entail a high potential for abuse''). *See also Cutaiar v. Marshall,* 590 F.2d 523, 528 (3d Cir. 1979) (a plan and its fiduciary are prohibited from engaging in a transaction even where there is ''no taint of scandal, no hint of self-dealing, no trace of bad faith'').

[96] For the ERISA exemptions, *see* ERISA §408(a) and (b); for the Code exemptions, see Code §4975(d).

[97] Reorganization Plan No. 4 of 1978, P.L. The IRS retained jurisdiction over determining which IRAs and other plans are subject to the Code's prohibited transaction rules; assessing the excise tax on disqualified persons under §4975; and determining which IRA owners and beneficiaries are exempt from the excise tax of §4975(c)(3). A determination by the DOL that a prohibited transaction has not occurred does not bar §4975 liability. *See O'Malley v. Comr.*, 972 F.2d 150 (7th Cir. 1992), and *Thoburn v. Comr.*, T.C. 132 (1990). The DOL and Treasury are in consultation with each other prior to the issuance of individual exemptions. *See* Ian Lanoff, Patterns in the Denial of Individual Prohibited Transaction Applications, Address (Mar. 20, 1980), in 11 Pens. Rep. (BNA) 42 (Jan. 30, 1984). *See also* Exhibit 1 of the IRS Examination Guidelines on Prohibited Transactions, IRM 4.72.11, for a list of the class exemptions granted by the DOL. Persons seeking individual exemptions from the DOL should follow the procedures contained in DOL Regs. §§2570.30 et seq.

[98] Code §408(e)(2)(A) and (B). The IRA disqualification occurs on the first day of the tax year in which the prohibited transaction occurs, and the amount to be distributed equals the fair market value of the IRA on the first day of the tax year. To the extent the prohibited transaction involves a loan or a lease, such transactions are viewed as continuing prohibited transaction and, therefore, are subject to excise taxes for each additional tax year in which the transaction remains uncorrected. *See Rutland v. Comr.*, 89 T.C. 1137 (1987).

[99] §4975(a). For traditional IRAs, *see* §4975(e)(1)(B); for Roth IRAs, *see* ERISA Op. Ltr. 98-03A (Mar. 6, 1998), and Treas. Regs. §1.408A-1, Q&A-1(b); for individual retirement annuities, *see* §4975(e)(1)(c). The IRS does not assess this tax, it is reported by the taxpayer on Form 5329, which is attached to Form 1040. A second-tier excise tax of 100% is imposed if the transaction is not corrected after notice from the IRS. *See* §4975(b). Correction of the prohibited transaction generally requires reversal of the transaction to the extent possible. The excise taxes are paid by the disqualified person involved in the transaction, not the plan. PPA '06 adds a new paragraph (23) to §4975(d) (providing a 14-day correction period for prohibited transactions involving securities and commodities). *See* §612(b) of P. L. 109-280.

[100] PLR 200324018. Note that the IRA owner cannot reinstate the qualified status of the IRA by correcting the prohibited transaction (but there are exceptions for SEPs and SIMPLE IRAs).

[101] The initial excise tax is 15% of the amount involved in the prohibited transaction, with a second 100% excise tax if the prohibited transaction is not corrected in a timely fashion.

[102] ERISA §406(a) (describing the prohibited transactions).

[103] Code §§4975(c)(1) (describing the prohibited transactions) and 4975(e)(1) (defining ''plan'' to include individual retirement accounts and individual retirement annuities).

[104] Code §4975(e)(2). ERISA §406(a) prohibits these same transactions between the plan and a party in interest (as defined in ERISA §3(14) (where the term ''party in interest'' includes an employee of a service provider, of the employer, of an employee organization whose employees are covered under the plan, of a 50%

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pensation of at least 10% of the employer's total payroll).[105] The prohibited transaction rules do not require that a fiduciary actually benefit from the transaction in order for it to be prohibited.

In the context of IRAs, the four sets of transactions (direct or indirect) that are prohibited include:

- a sale, exchange or leasing of any property between the IRA and a disqualified person;[106]
- lending or money or other extension of credit between the IRA and a disqualified person;[107]
- the furnishing of goods, services or facilities between the IRA and a disqualified person;[108] and
- the transfer to, or use by, or for the benefit of, a disqualified person of the income or assets of the IRA.[109]

The prohibited transactions include *indirect* transactions, such that a plan fiduciary cannot engage in a transaction with someone who is not a disqualified person, who in turn engages in a transaction with a third party that would have been prohibited if done directly by the plan fiduciary and the third party. These transactions are more difficult to identify and often revolve around the role that the "disqualified person" takes in the secondary transaction.

In addition to these prohibited transactions with disqualified persons, the plan fiduciary is prohibited from engaging in the following transactions (referred to as the *fiduciary prohibited transactions*). These transactions (direct or indirect) include:

- acting in a transaction where the fiduciary deals with the income or the assets of the IRA for his own interest or for his own account (i.e., conflict of interest);[110] and
- receiving any consideration for his own personal account in connection with a transaction involving the income or assets of the IRA (i.e., kickbacks).[111]

It is the DOL's position that these fiduciary prohibited transactions are not exempt under the *statutory*

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owner or of a corporation, partnership or trust/estate of which 50% of more is owned by a fiduciary, service provider, employer, employee organization whose employees are covered under the plan, or 50% owner, whereas the Code's "disqualified person" does not; "party in interest" under ERISA also includes officers and directors of service providers, whereas the Code's "disqualified person" does not). According to DOL regulations, an IRA payroll deduction program, administered by an employer, is not an employee benefit plan for purposes of Title I of ERISA, provided: (1) no contributions are made by the employer or employee association other than payroll deductions; (2) participation is completely voluntary for employees or members; (3) the sole involvement of the employer or employee association is to permit the publicization of the program, to collect contributions and to remit them to the sponsor; and (4) the employee or employee organization receives no consideration other than reasonable compensation for the payroll services. DOL Regs. §2510.3-2(d)(1). *See also* DOL Interpretative Bulletin 99-1, 64 Fed. Reg. 33000 (6/18/99).

[105] Code §4975(e)(2)(H).

[106] ERISA §406(a)(1)(A); Code §4975(c)(1)(A). *See* DOL Adv. Op. 2006-09A for an example of an indirect sale or exchange and lending of money or other extension of credit between a plan and a disqualified person. The IRA invested in notes that were offered by STARR Life Sciences Corporation ("STARR"). STARR was owned 87.5% by the IRA owner's son-in-law, who was a disqualified person due to his relationship with the IRA owner. For purposes of the prohibited transaction rules, the majority stockholdings of the son-in-law are indirectly attributable to the IRA owner and thus, there is a prohibited transaction between the IRA owner, (as fiduciary of the IRA) and STARR (a majority ownership indirectly attributed to the IRA owner).

[107] ERISA §406(a)(1)(B); Code §4975(c)(1)(B).

[108] ERISA §406(a)(1)(C); Code §4975(c)(1)(C).

[109] ERISA §406(a)(1)(D) (note that ERISA's prohibited transaction refers to the use of the plan's assets, whereas the Code's prohibited transaction refers to the use of the plan's income or assets, but the legislative history indicates that the labor and tax provisions are to be interpreted in a similar fashion and both are to apply to income and assets; *see* H.R. Conf. Rep. No. 1280, 93d Cong., 2d Sess. (1974); Code §4975(c)(1)(D). *See Rollins v. Comr.*, T.C. Memo 2004-260. In that case, Rollins was the sole trustee of the §401(k) plan for his wholly-owned firm. In his capacity as trustee, he caused the plan to make a series of loans to three businesses, that he and his spouse owned a minority interest. The loans were repaid. The IRS maintained that the plan loans were prohibited transactions under §4975(c)(1)(D) (transfer or use of plan assets for the benefit of a disqualified person) and (E) (dealing with plan assets for the fiduciary's own interest); Rollins stated that the borrowers were not disqualified persons, and therefore, no prohibited transactions occurred. The Tax Court held that the §4975(c)(1)(D) prohibition did not require an actual transfer of money or property between the plan and the disqualified person. The fact that a disqualified person could have benefited as a result of the use of plan assets was sufficient. This is consistent with the approach taken under the self-dealing prohibitions applicable to private foundations. *See* S. Rep. 91-552, 1969-3 C.B. 443, 444.

[110] ERISA §406(b)(1); Code §4975(c)(1)(E). *See Goad v. Rogers*, 57 F.3d 270 (3d Cir. 1995) (withdrawal of plan funds for the fiduciary's personal use and employer's payroll needs violates the prohibited transaction rule whereby fiduciaries may not deal with plan assets in his own interest and for his own account). *But see Brock v. Citizens Bank of Clovis,* 841 F.2d 344 (10th Cir. 1988) (the prohibition of a fiduciary from dealing with plan assets for his own interest requires more than a hypothetical assertion of such self-dealing, but instead, proof of such self-dealing).

[111] ERISA §406(b)(3); Code §4975(c)(1)(F). ERISA, but not the Code, also prohibits a fiduciary from acting in a transaction involving the plan on behalf of a person whose interests are adverse to the interest of the plan or its participants/beneficiaries (i.e., dual loyalty prohibition). See ERISA §406(b)(2). Such prohibition was excluded from the Code's provisions due to the difficulty in ascertaining the excise tax. *See Rollins v. Comr.*, T.C. Memo 2004-260 (referring to ERISA's 1974 conference joint statement of managers, H.R. Conf. Rep. No. 1280, 93d Cong., 2d Sess. (1974).

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exemptions under ERISA §408(b).[112] The IRS concurs with this position.[113] Hence, if an IRA owner engaged in a fiduciary prohibited transaction, he or she would have to rely on an administrative exemption, either a class or individual exemption. A class exemption is very specific to the group of proscribed parties-in-interest or disqualified persons. An individual exemption is granted to a single party-in-interest or disqualified person and must be obtained in advance of initiating the prohibited transaction.[114] There is little DOL guidance as to what fact situations *fail* to qualify as an individual exemption, as the requestor generally withdraws the ruling request when he or she realizes that it will not be granted.

Who Is a Disqualified Person?

The terms "party in interest" and "disqualified person" generally include those persons or entities that have some connection with the plan or its sponsor and, thus, could potentially influence the fiduciary's decision to act on behalf of the plan. For purposes of the Code's rules, a disqualified person includes the following persons or entities:

- a fiduciary to the plan;[115]
- the IRA owner's spouse and his or her ancestors (e.g., parents) and lineal descendants (e.g., children) and spouses of lineal descendants;[116]
- the IRA itself;[117]
- anyone providing services to the IRA, including the IRA custodian and any investment managers or advisors;[118]
- any corporation, partnership, trust or estate in which the IRA owner individually has a 50% or greater interest;[119] and
- a designated representative who the IRA owner directs to take action on his behalf if the IRA owner becomes incapacitated.[120]

Under the definition of a disqualified person, the IRA owner is not specifically listed as a disqualified person. The legislative history suggests that the IRA owner was to be considered a disqualified person as he "created" the account, but the statutory language is ambiguous.[121] In the typical IRA context, it could be argued that the IRA owner is not a *per se* disqualified person because he or she is not a fiduciary. However, in the self-directed real estate IRA context, the IRA owner who is personally managing the plan's investment (or has any discretionary authority or responsibility with respect to the administration) is a fiduciary[122] and, as such, is a disqualified person. In fact, the IRS takes the position that an IRA owner who has the option to self-direct the IRA investments but does not elect to do so is a fiduciary and, therefore, a disqualified person.[123] But, the IRS has gone beyond this position and held in private letter rulings that an IRA owner who is not a fiduciary is nevertheless a disqualified person.[124] The IRS explained its position in the context of a rollover of the taxpayer's promissory note to an IRA (which was not a self-directed IRA):[125]

> The Taxpayer's third argument is that Individual A could not engage in a prohibited

[112] *See* DOL Regs. §2550.408b-2(a).

[113] *See* Treas. Regs. §54.4975-6.

[114] The DOL has an expedited procedure known as "EXPRO" for parties requesting exemptions for factually similar transactions for which the DOL has previously granted exemptions. For a list of exemptions that have been granted through the EXPRO procedure, *see http://www.dol.gov/ebsa/Regs/expro_exemptions.html* (last visited May 5, 2007).

[115] §4975(e)(2)(A).

[116] §4975(e)(2)(F); ERISA Op. Ltr. 93-33A (Dec. 16, 1993); PLR 200324018.

[117] PLR 200324018 (because IRA owner was sole person for whose benefit the IRA was established, the IRA itself was a disqualified person).

[118] §4975(e)(2)(B) (although the trustee is not subject to the Code's monetary penalty under §4975 if it acts solely in its capacity as a fiduciary). *See* §4975(a).

[119] §4975(e)(2)(G). *See* ERISA Op. Ltr. 88-18A (Dec. 23, 1988), in which the DOL ruled that the corporation was not a disqualified person, as the IRA owner owned only 48.14% of the issued and outstanding stock of the corporation. For purposes of determining whether the IRA owner owns 50% or more ownership, the indirect and constructive stock ownership rules of §4975(e)(4) and (6) apply, according to ERISA Op. Ltr. 88-18A (Dec. 23, 1988). *But see Swanson v. Comr.*, 106 T.C. 76 (1996), in which an IRA owner as president and director of a corporation was not a disqualified person in his capacity as president and director until after the corporation's stock was issued to his IRA.

[120] PLR 200324018.

[121] *See* Code §408(e)(2) which describes IRA owners as "creators" of the accounts. The House of Representative's approach during the drafting of ERISA would have applied the Code's prohibited transaction rules of §503 (applicable to "creators" of certain types of entities subject to those prohibited transaction rules). *See* H.R. Conf. Rep. No. 1280, 93d Cong., 2d Sess. 340 (1974). The definitions found in §4975 were adopted instead, but the IRA provisions never were cleaned up before being enacted.

[122] Code §4975(e)(2)(A); ERISA Op. Ltr. 2000-10A (2000); ERISA Op. Ltr. 93-33A (Dec. 16, 1993); ERISA Op. Ltr. 89-12A (Jul. 14, 1989); ERISA Op. Ltr. 89-03A (Mar. 23, 1989); ERISA Op. Ltr. 88-18A (Dec. 23, 1988); ERISA Op. Ltr. 88-09A (Apr. 15, 1988); ERISA Op. Ltr. 82-08A (Feb. 1, 1982); PLR 8009091. *See also Swanson v. Comr.,* 106 T.C. 76 (1996), and *Harris v. Comr.*, 67 T.C.M. 1983 (1994).

[123] PLR 200324018.

[124] TAM 8849001; IRS News Release IR-81-37 (Dec. 18, 1981).

[125] TAM 8849001.

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transaction because Individual A was not a disqualified person with respect to the IRA. Although the individual for whose benefit an IRA is established is not directly defined as a disqualified person under section 4975(e)(2), the legislative history of ERISA supports the view that he or she is a disqualified person.

This legislative intent is clear when one reads sections 408(e) and 4975(c) of the Code together. Section 4975(c) requires that all prohibited transactions have a disqualified person to identify the person with whom the plan must not deal. Section 408(e)(2)(A) provides this identification internally, however, by stating that the IRA owner cannot engage in a prohibited transaction without disqualifying the IRA. Since section 408(e)(2) identifies the individual who cannot engage in a prohibited transaction, one needs to refer to section 4975 only to determine if the transaction that is engaged in is one that is prohibited.

In addition, section 4975(c)(3) of the Code and the flush language at the end of section 4975(d) specify circumstances where certain provisions of section 4975 will be inapplicable to IRA beneficiaries. These limiting provisions would not be necessary if section 4975 did not apply to IRA beneficiaries.

Fiduciary Prohibited Transactions

These types of prohibited transactions appear to be the most common type of prohibited transaction in the self-directed IRA context. Because the IRA owner is a fiduciary in the self-directed IRA context, he or she cannot use the IRA funds to directly *or indirectly* benefit himself or herself.[126] The fiduciary prohibited transaction rules are applicable, regardless of whether there is a disqualified person on the other side of the transaction.[127] For example, the DOL reviewed a sale and leaseback situation in which the IRA owner directed the IRA to purchase and build a high school at fair market value, founded by the IRA owner's brother and sister (who otherwise would not be disqualified persons). The brother and sister were officers and directors of the school. Although the sale and leaseback would not constitute prohibited transactions under the first set of prohibited transactions, a fiduciary prohibited transaction could develop if the transaction benefited the brother and sister of the IRA owner as it affected the IRA owner's exercise of his ''best judgment'' as a fiduciary.[128] In another example, the IRS reviewed the retention of the fiduciary's son to provide administrative services to the plan for a fee.[129] Although the statutory exemption for service providers may permit such an arrangement,[130] the fiduciary prohibited transaction rules do not.

Fiduciary prohibition transaction rules do not permit IRA owners to direct the IRA trustee to enter into any transaction in which the owner has an interest that may affect the ''exercise of his judgment as a fiduciary'' (the typical conflict of interest situation).[131] Also exempt under this second set of prohibited transactions is a situation in which the disqualified person who is also a fiduciary receives consideration for his or her own personal account (e.g., kickbacks) in connection with a transaction involving the income or assets of the plan. The IRS and DOL are consistent in their approach that a disqualified person does not have to be on the other side of the transaction in order to find fiduciary prohibited transactions.[132]

Possible Prohibited Transactions Involving Self-Directed IRAs

The following is a list of various types of prohibited transactions that may occur in the self-directed IRA context:

- *IRA's purchase of a house/apartment:* Investing an IRA in a house that is used by the IRA owner

[126] §4975(c)(1)(D) and (E).

[127] ERISA Op. Ltr. 88-18A (Dec. 23, 1988) (in the case where the IRA owner of a self-directed IRA made a loan to a corporation in which the owner and related parties owned a 48.14% interest, the corporation was not a disqualified person, but the IRA owner had an interest in the corporation that could affect his best judgment as fiduciary. Hence, a prohibited transaction involving self-dealing under §4975(c)(1)(D) and (E) ''is likely to result'' if the loan is made to the corporation). *See also* ERISA Op. Ltr. 82-08A (Feb. 1, 1982) (a loan to a corporation in which the IRA owner and his family had a substantial interest might affect the best judgment of the fiduciary and constitute a prohibited transaction under §4975(c)(1)(D) and (E) even though the corporation was not a disqualified person); and ERISA Op. Ltr. 93-33A (Dec. 16, 1993) (involving a sale and leaseback of property that indirectly benefited the daughter and son-in-law of the IRA owner, where the DOL held that even if there were no ''family members,'' the sale and leaseback benefited the IRA owner's relatives and, therefore, was prohibited).

[128] *See* ERISA Op. Ltr. 93-33A (Dec. 16, 1993). Since the sale and leaseback indirectly benefited the IRA owner's relative, he engaged in a prohibited transaction. *See also* Regs. §54.4975-6(a)(5)(i) (conflicting interest could impact the fiduciary's best judgment).

[129] *See* IRS Employee Plans Technical Guidance, Prohibited Transactions, IRM 4.72.11.3.5 (6-14-2002).

[130] §4975(d)(2) (provided no more than reasonable compensation is paid to the service provider).

[131] *See* Regs. §54.4975-6(a)(5)(i) (stating that plan fiduciaries are not authorized to engage in any transaction ''which may affect the exercise of their best judgment as fiduciaries'').

[132] *See* fn. 127, above, and IRS Employee Plans Technical Guidance, Prohibited Transactions, IRM 4.72.11.3.6 (6-14-2002) (stating that ''if a fiduciary receives any consideration for his own personal account from *any party* dealing with the plan in connection with a transaction involving the income or assets of the plan, it is a prohibited transaction'') (emphasis added).

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(or other disqualified person) for personal use is prohibited.[133] Although the DOL has given numerous individual exemptions for transactions involving the sale of real estate between a plan and a party in interest, these typically require an independent fiduciary to approve of the transaction.[134] It is not clear that the IRA can pay compensation to the IRA owner for managing the IRA's investment, even if it is found to be reasonable.[135]

Transfers of encumbered property by a disqualified person to the plan is also considered a sale/exchange for purposes of the prohibited transaction rules.[136] Hence, sale of property that is subject to a mortgage or similar lien which the plan assumes is prohibited. Similarly, transfer of property to the plan by a disqualified person as repayment of an outstanding loan owed by the disqualified person to the plan is a prohibited sale or exchange.[137]

- *Loans between the IRA and a disqualified person:* The IRA owner cannot borrow from the IRA.[138] The IRA owner may lend IRA assets to a corporation or person who is not a disqualified person *or* a corporation or person that the IRA owner does not have an interest in, provided such investment does not affect the exercise of owner's "best judgment." Thus, for self-directed IRAs investing in real estate, the IRA owner should be aware that the sale of seller-financed real estate to or by the IRA by or to a disqualified person is prohibited; the origination or purchase to or by the IRA of a mortgage by or to a disqualified person is prohibited; and any loan agreement under which the IRA lends money to a disqualified person to purchase real estate is prohibited. Although the DOL has the authority to grant exemptions from loans and other extensions of credit, an IRA owner cannot borrow money from his or her own IRA.[139] Regarding individual exemptions permitting the leasing of property between a plan and a party in interest, the DOL has required the transaction to be on terms at least as favorable to the plan as it could obtain from an unrelated party, as determined by an independent third party.[140] However, a fiduciary could not permit a lease of property from a party in interest under this exception if the transaction was made to bail out a failing business at the expense of the plan.[141]
- *Use of a house/apartment that is owned by the IRA:* The use by an IRA owner (or other disqualified person, such as a child) of real estate that is a plan asset is prohibited, as it is a "use of a plan asset." [142]
- *Owner's pledge or assignment of the IRA:* An IRA may not be assigned by its owner.[143] However, such assignment or pledge does not disqualify the IRA; it is simply treated as a distribution with respect to the portion assigned or pledged.[144]
- *IRA's purchase of life insurance:* An IRA may not be invested in life insurance.[145] Thus, a life insurance contract distribution from a qualified plan may not be rolled over into an IRA.[146] In IRS's private letter rulings, the IRS has prohibited the trustee of an IRA from using its corporate funds

[133] *See Harris v. Comr.,* 67 T.C.M. 1983 (1984). *See* Appendix B of this article for the process that an IRA owner would follow to purchase real estate from a self-directed IRA.

[134] PTE 82-83, 47 Fed. Reg. 21341 (1982); PTE 84-142, 49 Fed. Reg. 38381 (1984); PTE 89-13, 54 Fed. Reg. 10748 (1989).

[135] Although §4975(c) prohibits self dealing, §4975(d)(2) permits the payment of reasonable compensation by a plan to a disqualified person for services rendered to the plan. However, the DOL's position is that the statutory exemptions to the prohibited transaction rules do not apply to the self-dealing prohibitions. However, some courts have held to the contrary. *See Harley v. Minnesota Mining & Mfg. Co.,* 284 F.3d 901 (8th Cir. 2002), and *Lowen v. Tower Asset Mgmt., Inc.*, 829 F.2d 1209, 1216 (2d Cir. 1987).

[136] §4975(f)(3).

[137] *See Morrissey v. Comr.*, T.C. Memo 1998-443, and PLR 9145006.

[138] §§408(e)(2) and 4975(c)(1)(B); H.R. Rep. No. 1280, 93d Cong., 2d Sess. 339 (1974). *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.

[139] Rev. Proc. 75-26; 1975-1 C.B. 722; ERISA Procedure 75-1, 40 Fed. Reg. 18471 (4/28/75). For DOL's jurisdiction in the area of prohibited transaction exemptions, see Reorganization Plan No. 4 of 1978, 1979-1 C.B. 480, and Ann. 79-6, 1979-4 I.R.B. 43. In its regulations, the DOL takes the position that the statutory exemptions contained in ERISA §408(b) do not apply to the fiduciary prohibition transactions. *See* DOL Regs. §2550.408b-2(a), (e).

[140] PTE 83-60, 48 Fed. Reg. 18946 (1983); PTE 84-162, 49 Fed. Reg. 43123 (1984); PTE 84-175, 49 Fed. Reg. 48832 (1984); PTE 93-69, 58 Fed. Reg. 51105 (1993).

[141] *PBGC v. Greene*, 570 F. Supp. 1483 (W.D. Pa. 1983), *aff'd without op.*, 727 F.2d 1100 (3d Cir. 1984), *cert. denied*, 469 U.S. 820 (1984).

[142] §4975(c)(1)(D). *See also* H.R. Conf. Rep. No. 1280, 93d Cong., 2d Sess. 308 (1974) (prohibiting the furnishing of living quarters by the plan to a disqualified person).

[143] Regs. §1.408-4(a)(2).

[144] §408(e)(4), Regs. §§1.408-1(c)(4) and 1.408-4(a)(2).

[145] §408(a)(3).

[146] Rev. Rul. 81-275, 1981-2 C.B. 92.

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to purchase life insurance on behalf of taxpayers who have established an IRA with that trustee.[147]

- *IRA's investment in a corporation/partnership in which the IRA owner has some affiliation (e.g., either as a current owner, co-investor, employee, creditor, director or officer):* Prohibited transaction issues may arise immediately when the IRA investment is initially made or later. An IRA investment in an enterprise in which the IRA owner and other disqualified person already own 50% or more is, on its face, a prohibited transaction.[148] Hence, the IRA and the IRA owner cannot invest 50% equally in a joint venture without triggering a prohibited transaction. In addition, the IRA's investment cannot be made to facilitate or protect the IRA owner's investment in the enterprise. However, the DOL has ruled that the IRA and the IRA owner may form a partnership in which the IRA owner and his or her family owned *less than* 50% of the partnership, provided the IRA owner derived no benefits (other than incidental benefits) from the IRA investment.[149]

Although there is nothing *per se* wrong with the IRA owner and the IRA from investing in the same investment, two DOL Advisory Opinion letters illustrate that not all investments may be proper. Under the facts of a 2000 advisory letter,[150] Mr. Alder (Alder) and his family members were partners in a general partnership (an investment club) managed by Bernard L. Madoff Investment Securities (Madoff), independent of Alder. Madoff required entities under his management to maintain minimum capital accounts. To accomplish this, Alder opened a self-directed IRA with $500,000, which became a limited partner (39.38%) in another partnership (P). The assets of P also included assets from the prior partnership. Alder (6.52% ownership interest) and his family members also invested in P, and Alder was also a general partner of P. As a result, there would be sufficient assets to be managed by Madoff. Alder did not receive any compensation as a result of his IRA's ownership in P. P was a family limited partnership, which is a popular estate planning and creditor protection tool.[151]

The DOL ruled that Alder was a fiduciary (and therefore a disqualified person) due to his investment discretion under the IRA. Alder's son and daughter, who invested in P, were also disqualified persons. P was not a disqualified person, as Alder owned only 6.5% (less than the required 50% majority share). As to the IRA's purchase of an interest in P, the DOL ruled that the investment of the IRA assets in P did not constitute a prohibited transaction for purposes of Code §4975(c)(1)(A) (i.e., sale or exchange of property). As to whether the IRA's purchase violated Code §§4975(c)(1)(D) and (E) (i.e., fiduciary prohibited transactions), the DOL would not issue an opinion, as that would involve questions of a factual nature. However, the DOL did provide examples in which certain actions could trigger such a prohibited transaction:

— A prohibited transaction would occur if the transaction was part of an agreement, arrangement or understanding in which the fiduciary caused the IRA assets to be "used in a manner designed to benefit" the fiduciary (or any person in which the fiduciary had an interest). This would then affect his ability to exercise his best judgment as the IRA's fiduciary. An article critiquing this DOL advisory opinion suggests that one interpretation of this statement might include an arrangement in which the fiduciary was using the IRA's assets to gain a controlling interest in the partnership.[152] Alternatively, if the fiduciary was using the IRA assets to benefit another family member or his business, such use would affect the fiduciary's best judgment.

— If Alder, as fiduciary for the IRA, caused the IRA to engage in a transaction that by its term or nature created a conflict of interest between Alder and his IRA, such transaction would violate Code §4975(c)(1)(D) and (E). As the DOL remarked that the fiduciary was not receiving any compensation from the partnership in his individual capacity, the authors of the previously mentioned ar-

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[147] PLRs 8327075 and 8245075.

[148] §4975(e)(2)(E).

[149] DOL Adv. Op. 2000-10A. *See also* DOL Adv. Op. 89-03A, in which the IRA owner directed the IRA to purchase company stock (of which the IRA owned slightly more than 1%). Due to the degree of ownership, the DOL did not find self-dealing by the IRA owner. *See also* Prop. DOL Individual Prohibited Transaction Exemption d-4950, 52 Fed. Reg. 30977 (Aug. 18, 1987), approved as IPTA 88-93, 53 Fed. Reg. 3880 (a shared investment by the plan and the plan fiduciary is permissible if the fiduciary does not rely on, nor is dependent upon, the plan's investment). The fact that the fiduciary derived an incidental benefit was acceptable.

[150] DOL Adv. Op. 2000-10A.

[151] Family limited partnerships (FLPs) are effective estate planning tools as they permit the taxpayer to make a gift without giving up control over the gifted assets. *See* Willms, "Discounting Transfer Taxes with LLCs and Family Limited Partnerships," 13 *J. Tax'n Investments* 210 (Spring 1996). Such partnerships are also used to protect gifts from the creditors of the donees or former spouse in the context of a divorce.

[152] *See* Wagner and Sheaks, "Your IRA Investments May Not Be As Individual As You Think," 8 *J. Pension Benefits* 73 (Spring 2001).

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ticle suggest that employment of the fiduciary by the partnership, payment of unreasonably large compensation, or compensation based on the IRA's return on investment could trigger a prohibited transaction.[153]

— The fiduciary cannot rely nor be dependent on the participation of his or her IRA in order to undertake or continue to participate in the partnership.

Even if at the beginning of the transaction there was no prohibited transaction, if a divergence of interest develops between the IRA and Alder (or person in which Alder has an interest), then Alder would have to take steps to eliminate the conflict of interest in order to avoid prohibited transaction. According to the DOL, that fact that a fiduciary derives some *incidental* benefit from a transaction involving IRA assets did not constitute a prohibited transaction.[154]

Under the facts of a second DOL advisory letter,[155] a corporation (known as S) was owned 68% by Miles and Syndey Berry (Berry) and 32% by a third party, George Learned (G). Berry formed a LLC with the intent to purchase land, build a warehouse and lease the property to S. All of the investors of the LLC were to be minority interests — Berry's IRA (49% owner), Robert Payne's (R) IRA (31%), and G (20%). R was the comptroller of S; R and G were to manage the LLC. R and G were independent of Berry. The custodians for Berry's and R's self-directed IRAs reviewed the LLC operating agreement and approved the investment. Berry requested an advisory opinion as to whether there were any prohibited transactions.

According to the DOL, Berry was a fiduciary, as he exercised authority or control over his IRA and, thus, was a disqualified person. S was a disqualified person, as Berry (who was a disqualified person) owned a majority interest in S. R, as officer of S, was also a disqualified person with respect to Berry's IRA. The LLC was not a disqualified person, as Berry's IRA was a minority interest. However, because there was an understanding or expectation that the LLC would engage in a transaction (i.e., the lease) with a disqualified person (i.e., S), the DOL concluded that a prohibited transaction would result between the LLC and Berry's IRA.[156] In addition, if the lease had been consummated, it may have triggered a fiduciary prohibited transaction issue for Berry, who was a fiduciary.[157]

The prohibited transaction rules are extremely broad, especially the fiduciary prohibited transactions. Thus, the IRA owner self-directing his or her investments must be especially cautious in engaging in transactions that could compromise the owner's best judgment or result in indirect benefits to the owner.

The Custodian's Role

The fiduciary prohibited transaction rules impose an excise tax penalty on a disqualified person who is a fiduciary, holding such individual jointly and severally liable for applicable taxes.[158] The role of the custodian in a self-directed IRA is critical is determining its liability for any potential prohibited transactions. Normally, a custodian of a self-directed IRA would assert that it is not a fiduciary, as it has no discretionary authority or control over the IRA.[159] However, IRS regulations deem the IRA custodian or trustee as

[153] *Id.*

[154] Although the DOL did not define "incidental benefit" for purposes of this last example, the Supreme Court addressed the issue in the context of an ERISA §406(a)(1)(D) (i.e., plan assets transferred to or used by or for the benefit of a party in interest) prohibited transaction. *See Lockheed Corp. v. Spink*, 517 U.S. 882 (1996). That case involved an employer's conditioning the payment of increased pension benefits on the retirees' release of any employment-related claims against the employer. According to Spink, the employer's early retirement program constituted a prohibited transaction because it created a "significant benefit" for the employer (i.e., gaining a release against potential employment-related claims). The Supreme Court disagreed. The fact that the employer enjoyed legitimate benefits from receiving the waivers, just as it does for operating a plan (e.g., attracting and retaining employees, paying deferred compensation, settling or avoiding strikes, providing increased compensation without increasing salaries, and reducing the likelihood of lawsuits for departing employees) does not make it invalid for purposes of the prohibited transaction rules. However, the Court was addressing one of the first four prohibited transaction provisions, and not the fiduciary prohibited transaction provisions. Whether the Court's interpretation of "incidental" would be different for the fiduciary prohibited transaction provisions was not discussed.

[155] DOL. Adv. Op. 2006-01A.

[156] *See also* DOL Regs. §2509.75-2(c); Op. No. 75-103 (Oct. 22, 1975); 1978 WL 170764 (June 13, 1978).

[157] DOL Adv. Op. 2006-01A.

[158] §4975(f)(1), with a resulting excise tax of 15% of the amount involved in the prohibited transaction for each taxable period.

[159] §4975(e)(3) (a plan fiduciary is defined as any person who: (1) exercises discretionary authority or discretionary control with respect to the management of a plan, (2) exercises any authority or control with respect to the management or disposition of plan assets, (3) exercises discretionary authority or has discretionary authority or discretionary responsibility in the administration of the plan, or (4) provides investment advice for a direct or indirect fee with respect to the assets or property of the plan). ERISA has a similar definition of a fiduciary in ERISA §3(21). DOL regulations provide a safe harbor whereby a broker/dealer may effect a securities transaction at the direction of a fiduciary without becoming a fiduciary itself. *See* DOL Regs. §2510.3-21(d). According to the custodian document used by Entrust Chicago, LLC,

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a trustee for §408 purposes;[160] thus, it is not clear whether that interpretation controls for purposes of the prohibited transaction rules. If the custodian were held to be a fiduciary, this would increase the administrative costs on the part of the custodian. In a private letter ruling, the IRS ruled that an IRA trustee/custodian would not be liable for excise taxes and penalties if it unknowingly participates in a prohibited transaction at the direction of the IRA owner.[161]

If the IRA owner and the custodian are both fiduciaries for purposes of a self-directed IRA, the conflict of interest prohibited transaction rules will often prohibit conduct that is generally acceptable in the real estate industry. For example, an investment manager often uses an affiliate to provide certain services (e.g., valuation, leasing or other management services). If the investment manager is a fiduciary, using an affiliate would result in a prohibited conflict of interest transaction. For this reason, real estate held under an IRA is often structured by having it managed through a commingled investment vehicle such as a limited partnership or limited liability company.

If the IRA custodian is successful in its assertion that it is not a fiduciary under the self-directed IRA, case law has held that an action for restitution may be maintained under ERISA against a nonfiduciary party in interest to disgorge ill-gotten gains realized through a prohibited transaction.[162]

Legal Requirement #3: Plan Asset Rules

DOL Plan Asset Regulations

When an IRA invests in an equity entity, such investment becomes a plan asset, but the underlying assets of the invested entity do not, solely by virtue of the investment, become the assets of the IRA. However, the DOL's plan asset regulations take a counterintuitive approach and provide a ''look-through'' rule for certain investments that are held by ERISA plans and *other plans* (including IRAs).[163] The operation of the plan asset rules may trigger unintended prohibited transactions, thereby disqualifying the IRA. There are exceptions for equity interests in a publicly offered or registered investment entity; for ''operating companies;'' and for certain minority investments.

As a result of the DOL's plan asset rules, it is important to know how IRA assets are invested in order to ascertain whether transactions are related or unrelated to the IRA, whether they are prohibited as respecting the IRA assets, and whether they involve plan fiduciaries and disqualified persons. Personnel marketing these self-directed IRAs to the public rarely mention the *potential for problems in this area.*

Under the DOL's rules, the first issue is whether the IRA is investing in ''equity'' of an entity; otherwise, the plan asset rules do not apply.[164] An interest is regarded as equity unless it is treated as debt according to local law and has no substantial equity features. The DOL regulations provide the following examples of equity interests: a partnership profits interest; an undivided ownership interest in real estate; or a beneficiary interest in a trust.[165] If the IRA's investment is in equity, then the DOL rules deem that the plan assets will include the ownership interest and the underlying assets of the entity, unless an exception applies.[166] Due to ERISA's requirements, such assets of the entity must be held in trust.[167] DOL rules also treat the owners of the entity as fiduciaries of the ERISA plan with respect to the assets held by the entity.[168] If the plan assets are ERISA or other covered plans, the prohibited transaction rules will limit the manner in which the entity invests its assets.

For example, the IRA owner forms a LLC to conduct a bed and breakfast business. The LLC is owned 100% by the IRA assets. Hence, for plan asset purposes, the IRA owns the bed and breakfast business. Does this permit the IRA owner to receive compensation for running the bed and breakfast? No — that would be a prohibited transaction.[169] The IRA can certainly earn an income on the business and when it is sold, the IRA may record the profit.

For state law purposes, some states require that ''controlling interest'' shareholders (i.e., those that own 50% or more) be involved in the management

''[c]ustodian, [a]dministrator and their respective agents or assigns have no responsibility or fiduciary role whatever related to or in connection with the account in taking any action related to any purchase, sale or exchanged instructed by the undersigned or the undersigned's agents, including but not limited to suitability, compliance with any state or federal law or regulation, income or expense, or preservation of capital or income.''

[160] *See* Treas. Regs. §1.408-2(b)(2)(i).

[161] PLR 8137061. In addition, the disqualification of the self-directed IRA by virtue of the prohibited transaction will not taint the other IRAs maintained by the same trustee/custodian. *Id.*

[162] *Cosgrove v. Circle K Corp.*, 915 F. Supp. 1050 (D. Ariz. 1995), *aff'd,* 1997 U.S. App. LEXIS 3853 (9th Cir. 1997).

[163] DOL Regs. §2510.3-101.

[164] DOL Regs. §2510.3-101(a)(2).

[165] DOL Regs. §2510.3-101(b)(1).

[166] DOL Regs. §2510.3-101(a)(2).

[167] ERISA §403(a) (however, ERISA §403(b)(3)(B) exempts IRAs from this requirement).

[168] DOL Regs. §2510.3-101(a)(2).

[169] §4975(c)(1)(C) and (F).

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decisions for the LLC/LLP.[170] Hence, an IRA that owned 50% or more of an LLC/LLP would be required to participate in its management decisions. This certainly would increase the cost of administration of the self-directed IRA.

Exceptions to the DOL Plan Asset Regulations

The look-through rules do not apply if the entity is an operating company or the partnership interests or membership interests are publicly offered or registered under the Investment Company Act of 1940 (e.g., REITs).[171] They do not apply if the entity is an ''operating company,'' which refers to a partnership or LLC that is primarily engaged in the production or sale of a product or service *other than* the investment of capital, including venture capital operation companies and REOCs.[172] The 2006 DOL advisory opinion discussed earlier in the article illustrates that plan asset look-through rules are not applied in a vacuum. In that advisory opinion, the LLC was formed as a REOC in hopes that its investment (49% in IRA assets in the LLC) would not be ''looked through'' for purposes of the plan asset rules. The DOL ruled that the lease between the LLC and the disqualified person was prohibited, regardless of whether the LLC qualified as an REOC, due to the LLC's intent to engage in a subsequent lease with a disqualified person.[173]

PPA '06 Changes

The look-through rules do not apply to minority investors (i.e., if the ''benefit plan investors'' hold less than 25% of each class of equity interest in the partnership or LLC).[174] Before the passage of PPA '06, the term ''benefit plan investors'' included foreign and domestic employee benefit plans, IRAs, Keogh plans and any other entity that holds ERISA plan assets. PPA '06 changed the definition of ''benefit plan investors'' for purposes of the plan asset rules to *exclude* employee benefit plans subject to ERISA, any plan subject to the Code's prohibited transaction rules, and any entity whose underlying assets include plan assets by reason of a plan's investment in the entity.[175] Thus, any partnership or LLC interests held by the IRA are no longer taken into account for purposes of the 25% ownership rule.[176]

Legal Requirement #4: UBTI and UDFI Issues

Federal Tax on Unrelated Business Taxable Income

The tax advantage of an IRA is that income is tax-free until distributed. However, to prevent tax-exempt entities from competing unfairly with taxable entities, tax-exempt entities are subject to unrelated business taxable income (UBTI) when their income is derived from any trade or business that is unrelated to its tax-exempt status.[177] For an IRA, any *business* regularly carried on or by a partnership or corporation of which it is a member is an unrelated business.[178] Although there is little formal guidance on UBTI implications for self-directed real estate IRAs, there is a great deal of guidance on UBTI implications for real estate transactions by tax-exempt entities.[179] Such guidance should be illustrative of how the IRS would view real estate transactions by self-directed IRAs. The fact that an UBTI occurs should not necessarily negate the use of real estate within the IRA — it should simply factor into the IRA owner's costs in deciding upon such an investment. Such income is taxable as ordinary income at the trust tax rate, payable by the IRA.[180] From a practical standpoint, the IRA would need its own checking account to pay for such taxes.

UBTI is defined as ''gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it'' reduced by deductions directly connected with the business.[181] An exempt organization that is a limited partner, member of a LLC,

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[170] *See* Ohio Rev. Code Ann. §§1705.01 et seq., and Mont. Code Ann. §§35-8-101 et seq.

[171] DOL Regs. §2510.3-101(c) (operating company defined as an entity engaged in an act of business other than the business of providing investment management services; a traditional operating company; a venture capital operation company; or a real estate operating company (REOC)).

[172] *Id.* Many large private equity investment funds, including real estate funds, are structured as venture capital operation companies (VCOCs) or REOCs. A VCOC is an investment fund or entity which invests at least half of its assets in ''venture capital investments'' over which it retains and exercises management rights. A REOC is an investment fund which invests at least half of its assets in real estate that it manages or develops or has the right to participate in the management or development.

[173] *See* DOL Adv. Op. 2006-01A. This has been the DOL's long-standing position. *See* DOL Interpretive Bulletin 75-2, I.R. 75-2.

[174] DOL Regs. §2510.3-101(a)(2)(ii), (f)(1).

[175] P.L. 109-280, §611(f), adding ERISA §3(42), effective for transactions occurring after Aug. 17, 2006.

[176] *See* DOL Regs. §2510.3-101(f)(2)(ii) (referring to any plan described in Code §4975(e)(1)); *see also* ERISA §3(42).

[177] The UBTI provisions are found in §§511-514. The language of §§511(a)(2)(A) and 501(a) was not conformed to include IRAs when the IRA provisions were enacted, but §408(e)(1) clearly indicates that the UBTI provisions apply to IRAs.

[178] §513(a) and (b).

[179] *See* 591 T.M., *Real Estate Transactions by Tax-Exempt Entities*.

[180] Treas. Regs. §1.501(c)(2)-1(a); §511(a). (The marginal tax rate for nonexempt trusts for income over $7,500 is 39.6%. *See* §1(e)).

[181] §512(a)(1). UBTI must be reported on the Forms 5500 and 990-T filed by the trust.

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or member of another non-corporate entity will have attributed to it the UBTI of the enterprise as if it were the direct recipient of its share of the entity's income which would be UBTI had it carried on the business of the entity.[182] UBTI also applies to unrelated debt-financed income (UDFI).[183] ''Debt-financed property'' refers to borrowing money to purchase the real estate (i.e., a leveraged asset that is held to produce income). In such cases, only the income attributable to the financed portion of the property is taxed; gain on the profit from the sale of the leveraged assets is also UDFI (unless the debt is paid off more than 12 months before the property is sold).[184]

Exceptions to the Federal Tax on UBTI

There are some important *exceptions* from UBTI: those exclusions relate to the central importance of investment in real estate – dividends, interest, annuities, royalties, most rentals from real restate, and gains/losses from the sale of real estate. However, rental income generated from real estate that is ''debt financed'' loses the exclusion, and that portion of the income becomes subject to UBTI.[185] Thus, if the IRA borrows money to finance the purchase of real estate, the portion of the rental income attributable to that debt will be taxable as UBTI. For example, if the IRA purchases real estate for $100,000 with a $50,000 mortgage, then 50% of the rental income is subject to UBTI. The UBTI must be paid by the IRA, not the IRA owner,[186] and therefore, there must be sufficient cash flow within the IRA. An IRA with $1,000 or more of gross UBTI must file a Form 990-T.[187] An IRA owner must aggregate all of his or her individual accounts to determine if the $1,000 threshold is met.[188] The IRA owner cannot avoid the UBTI by purchasing property that is already subject to an existing debt and assuming that debt. Such taxes obviously must be considered in deciding whether the overall expected rate of return of the investment warrants the investment.

Rental Exclusions

One critical question arises whether the transaction involves rent – available for the exclusion — or whether it has a different character (e.g., lease, loan, partnership). According to IRS regulations, this is a question of facts and circumstances.[189] A transaction may state that payments are rental payments when, in fact, they represent a share of the profits derived by the person operating the property. The IRS has been successful in recharactizing loan arrangements between a joint venture and a purported ''lender'' and the taxpayer, to a real estate venture arrangement between the exempt organization and the builder for rental income.[190] IRS regulations state that rents attributable to personal property leased with real property should not exceed 10% of the total rents from all property subject to the lease.[191] Thus, mortgage loans with ''equity kicker'' features (i.e., the borrower agrees to pay contingent interest based on a share of the potential appreciation in, or cash flow from, the real estate secured by the mortgage) are subject to the IRS's challenge that the debtor-creditor relationship between the lender and the borrower should be treated as a disguised joint venture.

Type of Mortgage

Normally, when an individual purchases real estate with a mortgage, the traditional loan provides for recourse against the borrower (i.e., personal liability for the mortgage). However, if the IRA purchases real estate and secures a mortgage for the purchase, the loan must be nonrecoursive; otherwise there will be a prohibited transaction.[192] Most institutional lenders do not permit nonrecourse loans because there is no secondary market for such loans. Community bankers, private lenders or third parties may provide such loans but generally require a certain loan-to-value ratio. Normally, banks prefer an 80% loan-to-value ratio (mortgage for no more than 80% of the appraised value) for mortgages on single-family dwellings. The lower the loan-to-value ratio, the more likely an IRA owner is able to secure the requested mortgage.

Nonrecourse mortgages to IRAs have higher appraisal fees than commercial mortgages, as determining the appraised value of the real estate is of critical importance. Such mortgages also tend to have a short repayment schedule — 20 to 25 years — and there must be sufficient assets in the IRA to make the necessary loan repayments, as well as the taxes, insurance and property management costs. Rents from personal property do not qualify for the UBTI exclusion

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[182] *See* §§761(a) and (b), 7701(a)(2); Rev. Rul. 79-222, 1970-2 C.B. 236; *Service Nut & Bolt Co. Profit Sharing Trust v. Comr.,* 724 F.2d 519 (6th Cir. 1983).

[183] §514(a).

[184] §514(b).

[185] §512(b)(3) (there is a $1,000 exemption for leveraged rent income).

[186] §511.

[187] *See* 2006 Instructions for Form 990-T, Exempt Organization Business Income Tax Return, available at *http://www.irs.gov/pub/irs-pdf/i990t.pdf* (last visited May 5, 2007).

[188] *Id.*

[189] Treas. Regs. §1.512(b)-1.

[190] *See* the discussion in II, E, 5, in 591 T.M., *Real Estate Transactions by Tax-Exempt Entities.*

[191] Treas. Regs. §1.512.(b)-1(c)(2)(ii).

[192] §408(e)(4) (stating that the effect of pledging an IRA as security for a loan will be treated as a distribution for the IRA owner).

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for rental property, unless such amounts are incidental to the total amounts received.[193]

State UBTI Issues

In addition to federal UBTI tax issues, the IRA owner should be aware that states may also assess a UBTI. Such tax should be factored into the overall cost of the investment. ERISA plans were generally not impacted by such state tax laws due to ERISA's preemption clause. However, a 2006 decision from the Second Circuit[194] held that the California law which taxes the UBTI of tax-exempt trusts was not to be preempted under ERISA with respect to trusts covered by ERISA. This decision is significant for two reasons: (1) it is the only federal circuit to address the issue, and (2) it differs from the only other federal decision from the New York State Tax Appeals Tribunal that held that ERISA did preempt New York's UBIT law with respect to ERISA trusts.[195] Although IRAs are not ERISA plans and, thus, are not affected by ERISA's preemption clause, many IRA owners may assume that, because IRAs are a creation of the federal tax code, state tax law does not apply. Obviously, this is not the case.

Investment Versus Business

Regardless of the receipt of UBTI or UDFI as taxable income, such tax consequence is not expected to affect the tax-exempt status of the IRA. However, when an IRA owner continuously enters into a variety of taxable activities (e.g., real estate transactions with short-term gains), one should query whether the tax-exempt status of the IRA could be affected. If the IRS finds that the IRA is serving a ''private purpose'' by engaging in a business of selling real estate, the tax-exempt nature of the IRA may be lost.[196] The resulting income would then be taxable as a business (e.g., corporate rates, not trust rates).

The purpose of the IRA is to invest in permissible investments to accumulate savings for retirement. Due to the tax-exempt nature of the IRA vehicle, it was not created to facilitate an IRA owner to engage in a ''trade or business.'' The issue of whether an entity is a trade or business is generally relevant in determining whether the taxpayer can enjoy certain tax advantages (e.g., deductions) afforded to trades or businesses. However, neither the Code nor the regulations define the phrase ''trade or business'' — resulting in case law to decipher the term for various purposes under the Code. There are a handful of cases in which taxpayer's investment activities were not found to be a trade or business.[197] Individuals who manage trusts or estates have also been held not to engage in a trade or business, nor were the estates or trusts themselves considered a trade or business.[198] Although none of these cases directly relate to a tax-exempt vehicle such as an IRA, they do illustrate the IRS's ability to negate the tax-exempt status of the entity if a greater trade or business purpose is being served.

This issue will obviously be more difficult to flag for clients until abuse become rampant and the IRS decides to curb such practices. *Of course, none of the marketers of self-directed IRAs mention this issue.*

Legal Requirement #5: Assignment of Income

Doctrine of Assignment of Income

As some websites encourage the IRA owner to rehab and fix-up the property of the IRA assets,[199] the IRA owner must realize that providing any services to

[193] §512(b)(3)(A)(ii).

[194] *Hattem v. Schwarzenegger*, 449 F.3d 423 (2d Cir. 2006).

[195] *See In Re McKinsey Master Ret. Plan Trust,* DTA No. 817551, 2003 WL 21133964, at *11 (N.Y. Tax. App. Trib. May 8, 2003). For a discussion of the *Hattem* case, see Note, ''*Hattem v. Schwarzenegger:* Terminating Preemption Challenges to State Taxation of ERISA Plans' Unrelated Business Taxable Income,'' 60 *Tax Law.* No. 1 (Fall 2006).

[196] *See* Blissard, ''Structuring Real Estate Investments by and with Foreign, Pension and Tax-Exempt Investors,'' 57 *N.Y.U. Ann. Inst. on Fed. Tax'n* §13.04 (1999).

[197] *See Higgins v. Comr.,* 312 U.S. 212 (1941), *reh'g denied*, 312 U.S. 714 (1941) (issue of whether taxpayer's activity in managing his investments constituted a trade or a business was a question of facts and circumstances); *Purvis v. Comr.,* 530 F.2d 1332 (9th Cir. 1976) (taxpayer was merely an investor and not a trader, as an investor holds securities for capital appreciation whereas a trader engages in frequent buys and sells of securities in order to make short-term profits); *Moller v. U.S.,* 721 F.2d 810 (Fed. Cir. 1983) (court considered investment intent of taxpayer, nature of income received, and frequency, extent or regularity of taxpayer's activities in determining whether he was a trader or investor); *Liang v. Comr.,* 23 T.C. 1040 (1955), *acq*., 1955-2 C.B. 4, and *acq*., 1955-1 C.B. 4 (nonresident alien's use of resident agency to transact securities trades over seven-year period demonstrated investing, not trading); C*leveland v. Comr.,* T.C. Memo 1983-299, *opinion amended on other grounds*, T.C. Memo. 1983-585 (using facts to determine that taxpayer engaged in personal investment, not a trade or business).

[198] *See City Bank Farmers Trust Co. v. Helvering*, 313 U.S. 121 (1941) (administration of two trusts for benefit of deceased son was not a trade or business); *U.S. v. Pyne*, 313 U.S. 127 (1941) (traditional duty of executors is to conserve an estate and protect the income, and thus, executors engaging in a trade or business were the exception and not the rule); *White's Will v. Comr.*, 119 F.2d 619 (3d Cir. 1940) (supervising an estate, whether one's own or another, does not constitute a trade or business); *Di Portanova v. U.S.,* 231 Ct. Cl. 623, 690 F.2d 169 (1982) (trusts' investment in fractional oil and gas interests was merely an investment as trust had no influence over oil and gas operations).

[199] *See* Mary Beth Frank, ''Invest Your IRA in Real Estate,'' *Kiplinger's Personal Finance Magazine* (March 2005), available at *http://www.kiplinger.com/magazine/archives/2005/03/IRA.html* (last visited May 5, 2007) (which provides an example in which

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the IRA beyond that of ''investment management'' is an attempt to assign the income resulting from his or her services to another entity, namely the tax-exempt IRA. This issue — labeled ''sweat equity'' [200] by practitioners — occurs where the IRA owner remodels or rehabs the property purchased by the IRA. Obviously, under the tax concept known as ''assignment of income,'' that income should be taxable to the IRA owner, with possible reporting and withholding tax penalties.[201] If, instead it goes to the IRA, it will be treated as an excess contribution, subject to penalty tax.[202] The IRS could also view this as a prohibited transaction (furnishing of services by a disqualified person) and, therefore, disqualify the entire IRA.[203]

Abusive Tax Shelters and Related Prohibited Transactions

Depending on the amount of time and services that the IRA owner is providing on the property beyond investment management time and services, the IRA could be held to be engaging in a home remodeling business. The resulting income would then be subject to UBTI. As pointed out by Natalie Choate, an IRA owner who is a professional home remodeler, using the owner's tools and facilities to rehab the owner's IRA-owned property is similar to the abusive Roth IRA transactions that the IRS declared to be ''tax avoidance transactions'' and treated as a ''listed transaction'' under Regs. §1.6011-4(b)(2).[204] In those transactions, the IRA owner's non-IRA business contracted with his Roth-owned LLC for goods, services and shares that were not ''fairly valued,'' thereby attempting to shift value improperly to the Roth IRA.[205]

Legal Requirement #6: Bankruptcy Issues

The protection of IRA assets from federal and state bankruptcy laws has changed over time and, thus, is certainly not uniform from the IRA owner's perspective. The federal bankruptcy rules were modified as recently as 2005, protecting IRAs and SEPs in Chapter 7 bankruptcy by excluding such property from the taxpayer's estate.[206] Generally, the assets of IRAs are exempted up to $1,000,000, but rollover IRAs enjoy an unlimited exemption.[207] States vary considerably as to whether they provide bankruptcy protection to IRAs. This issue was flagged earlier in this article — whether state law will follow federal tax law as to the property status of IRAs. The fact that the Code refers to IRAs as ''trusts'' for purpose of the tax code does not necessarily mean that such accounts qualify as ''trusts'' for state law purposes. Hence, the implication of IRA rollover accounts may have significant state law consequences in bankruptcy situations that an IRA owner may not be aware of. *Again, this is an issue rarely flagged by those marketing self-directed IRAs.*

CONCLUSION

The new distribution options created by PPA '06 afford more flexibility for participants and beneficiaries of qualified plans, §403(b) annuities, governmental

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an IRA purchases a house in need of repair for $62,000, the IRA owner spends $16,000 to remodel the house, and then the IRA resells the house at a profit of $98,000). *Also,* the Entrust website asks whether the IRA owner can use his weekend time and leftover building materials to rehab a house owned by the Roth IRA.

[200] The term ''sweat equity'' refers to the contribution that a person makes to a project as a result of their time and effort, in contrast with ''financial equity'' which refers to a financial contribution that a person makes to a project. In the context of real estate owners, it refers to the increased value in the real estate as result of the owner's labor. *See* the definition of ''sweat equity'' from Wikipedia, the free encyclopedia, available at *http://en.wikipedia.org/wiki/Sweat_equity* (last visited May 5, 2007).

[201] *See Lucas v. Earl*, 281 U.S. 111 (1930) (gross income from personal services is taxable to the person who renders the services).

[202] §§4973, 408(d)(5)(A) and 72(t).

[203] §4975(c)(1)(C). *See Marshall v. Snyder*, 572 F.2d 894 (2d Cir. 1978) (payment to union employees for service constituted a furnishing of service, prohibited under ERISA); *Gilliam v. Edwards*, 492 F. Supp. 1255, 1263-64 (D.N.J. 1980); *Donovan v. Williams*, 4 EBC 1237 (N.D. Ohio 1983); *Kim v. Fujikawa*, 871 F.2d 1427 (9th Cir. 1980); *Dole v. Formica*, 14 EBC 1397 (N.D. Ohio 1991).

[204] ''Estate Planning for Retirement Benefits: Recent Developments,'' ALI-ABA Sophisticated Estate Planning Techniques (Sept. 2005), available at *http://web2.westlaw.com/result/documenttext.aspx?blinkedcitelist=False&rs=LAWS2.0&s* (last visited May 5, 2007). An abusive Roth IRA transaction begins with the taxpayer who owns a business and a Roth IRA. The Roth IRA acquires substantially all the shares of the business. Then, the business and Roth IRA engage in transactions that are not fairly valued and, thus, have the effect of shifting value into the Roth IRA (e.g., acquiring property such as accounts receivable from the business at less than fair market value; contributions of property by a party without an adequate receipt of stock ownership; transactions between the business and the IRA owner or related party that have the effect of transferring wealth to the business, comparable to a Roth IRA contribution). *See* www.irs.gov/retirement/aricle/0,,id-119565,00.html (last visited Apr. 28, 2007). As the principal purpose of such transactions is the avoidance of taxation, they lack economic substance and have been attacked by the IRS as abusive tax shelters.

[205] *See* Notice 2004-8, 2004-4 I.R.B. 333.

[206] §224 of the Bankruptcy Abuse and Consumer Protection Act of 2005, P.L. 109-8 (providing a new exemption for retirement funds exempt from taxation under §§401, 403, 408, 408A, 414, 457 or 501(a) of the Internal Revenue Code). Before this change, the exemption for retirement benefits extended only to the ''right to receive a payment'' from certain retirement plans subject to the need for support.

[207] §224(e) of the Bankruptcy Abuse and Consumer Protection Act of 2005, P.L. 109-8.

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and tax-exempt entity plans and IRAs. One of these options — the qualified charitable distribution (QCD) — is only temporary but may be made permanent, depending on its success with charities and the strength of the charities' lobbying efforts. The nonspouse IRA rollover option may have limited appeal based on IRS interpretation, which may change if lawmakers become involved. The ability to make distributions from eligible plans directly to Roth IRAs, instead of first rolling over to a traditional IRA and then to a Roth IRA, may have a delayed impact — namely, until 2010, when the adjusted gross income dollar limitations are removed. Collectively, these new options will continue the growth of rollover IRAs.

As such wealth develops, there continues to be a growing interest in self-directed IRAs in which the owner has greater control over the IRA's investments. This article highlights that although, self-directed IRAs are permitted under the Code, IRA owners should seek the advice of an employee benefits counsel when selecting and directing the investments of such IRAs due to the significant potential legal consequences. Although such legal expenses do add to the IRA owner's costs, failure to procure such advice may lead to the permanent loss of the IRA tax shelter and possible tax penalties for premature distributions. Such costs must be factored into the initial decision by the IRA owner, between the ''all-in'' costs of self-directed investments, or the more ''cut-and-dried'' costs of mutual fund investments. To the extent the IRA custodians of self-directed accounts take a ''deaf ear'' approach to the investments of IRA owners, the IRS is expected to take a more aggressive approach in evaluating such accounts.

As an aside, a colleague of mine, Alison Sulentic,[208] laments that her children describe her role as a parent as that of a ''fun-sucker.'' Unfortunately, an employee benefits attorney advising an IRA owner as to the perils and pitfalls of self-directing the IRA owner's investments should consider his or her role in a similar fashion. Although the lure for enormous rates of return on IRA assets through creative and innovative investment schemes may be desirable and even pressing, depending on the owner's needs for sufficient retirement income, the attorney's role is to present all the potential problems that the IRA owner may face upon a federal or state tax audit.[209] After discussing the issues enumerated in this article, it may be helpful to direct the IRA owner to the language in the custodial agreement that will undoubtedly state that the custodian assumes neither liability for the IRA owner's selection of the investments nor the legal consequences for such investments. Once the IRA owner realizes that the custodian is not assuming any contractual fiduciary responsibility for the owner's investment choices, it may quell the owner's enthusiasm for an adventurous investment selection. There we go again — being a ''fun-sucker'' for the IRA owner's selection of investment options!

Appendix A: Types of Real Estate Investments

REITs: A REIT is a corporation, business trust or association that combines the capital of multiple investors to invest in income-producing real estate. It is generally a pass-through entity (i.e., avoiding double taxation) for holding real estate and mortgages, as long as it distributes at least 95% of its taxable income to shareholders each year. The benefit of the REIT for a shareholder is the ability to invest in real estate without paying a corporate-level tax on the gain.[210]

Direct Investment: This involves the outright purchase of the property or co-investment (e.g., when two or more pension funds or groups of funds share in the ownership of the real estate investment). If an individual's IRA is not sufficient to purchase a larger parcel of real estate (e.g., a shopping mall), then the IRA can purchase an undivided interest in the property, in which the income is allocated directly in proportion to the IRA's interest.

Commingled Real Estate Fund: A pooled investment vehicle designed for institutional tax-exempt investors. The fund may be structured as a group trust, partnership, corporation, insurance company separate account, or another multiple ownership entity. An open-end fund may have no finite life, permitting continuous entry and exit of investors; whereas a closed-end fund has a stated maturity date with few or additional investors after the initial formal date. A closed-end fund generally has a termination date such that few or no new investors can be added.

LLCs and LPs: The IRA owner can form a limited liability corporation (LLC) or a limited partnership (LP), which can then, in turn, purchase the real estate. This may be desirable if the IRA custodian is unwilling to assume the risks associated with the real estate (e.g., tort liability or tax liability) or if the IRA custodian is unable to perform the property management functions associated with the real estate. In the latter case, the IRA owner can perform those functions.

Joint Ventures: This is a venture formed with an entity that is not an institutional investor but, rather, a developer or private party.

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[209] Although qualified plans, §403(b) annuities and §457 plans are within the jurisdiction of the Tax Exempt/Government Entities (TE/GE) division of the IRS, IRAs are within the jurisdiction of the Small Business and Self-Employed Division of the IRS.

[210] In 1997, REITS completed over $45 billion in securities offerings. Blissard, fn. 196, above.

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Option to Purchase: The IRA pays consideration in the form of cash or property for the option to purchase real estate during a certain time frame. This is frequently used in the purchase of undeveloped real estate that may be developed in the near term.

Real Estate Operating Companies (REOC): A REOC has opted out of the tax status afforded by the federal tax code for REITs. Therefore, it is federally taxed at the entity level, but it may reinvest its earnings and is not limited to the type of real estate business it conducts.

Tax Lien Certificates (TLC): In the case of unpaid taxes by the property owner of record, an IRA can pay those taxes and receive a tax lien certificate from the taxing authority. This is usually accomplished at a public sale or auction. The property owner of record has the right to redeem the TLC, provided it pays the taxes with interest. When the TLC is redeemed, the IRA receives the proceeds.

Real estate mortgage investment conduits (REMICs): These were created by the Tax Reform Act of 1986 to reduce problems arising from the sale of mortgage-backed securities to investors. REMICs permit different classes of interests in a pool of mortgages in which the pass-through natures of the entity were preserved. (For a discussion of REMICs, *see* 741 T.M., *REMICs, FASITs and Other Mortgage-Backed Securities.*)

Appendix B: Process to Purchase Real Estate Within an IRA

1. IRA owner locates investment property and makes an offer in the name of his or her IRA (e.g., Custodian, for the benefit of John Smith IRA). The IRA owner can sign this offer as he or she is fiduciary of the IRA account.
2. If the offer is accepted, the IRA owner then submits a direction letter to the custodian. The information included in the direction letter includes: property address and location, parcel number, legal description of the land, purchase price, earnest money deposit, percentage of ownership, and names of lender and property manager.
3. The IRA owner or the IRA owner's attorney reviews the purchase agreement and, if approved, directs the custodian to sign the agreement on behalf of the IRA. The IRA owner then directs the custodian to wire transfer the earnest-money deposit to the title company. Flood and hazard insurance may have to be procured through an insurance company. The insured party is the IRA.
4. At closing, the IRA owner or the IRA owner's attorney must read and approve the documents (e.g., settlement statement, warranty deed, title report). The title company sends the documents to the custodian who signs them on behalf of the IRA.
5. The custodian forwards funds to the title company. The deed for the real estate states that ''Custodian, John Smith IRA'' is owner and is held by the custodian for safe keeping. All income (e.g., rental income) is paid to the custodian for the benefit of the IRA. Any expenses (e.g., property taxes) are paid from the IRA by the custodian.

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