

Self-Directed Individual Retirement Account – Q&A
Transactions & Consequences

Question 1: What is a “self-directed” Individual Retirement Account (IRA)?

Answer: It is an IRA that permits you to choose the assets with which to fund your IRA and direct the timing of purchases and sales of such assets. Traditional IRAs permit you to invest in cash, cash equivalents, and certain publicly listed securities. This kind of IRA allows you to invest in many other things. For example, you may invest in domestic and foreign real estate, non-public interests in companies, tax-sale certificates, FCC airwave licenses, commercial fisheries licenses, private-placement mortgage notes, boat slip condominiums, and many others. The Internal Revenue Code specifically prohibits investment only in collectibles, such as art, antiques, gems, most coins, or alcoholic beverages, life insurance, and certain precious metals, unless they meet specific requirements [IRC §408(a) (3) & (m)].

Question 2: May I own personal-use property, such as my home or boat, in my IRA?

Answer: No. The rules against prohibited transactions are complex and varied. You may not use the property that your IRA owns. For example, your IRA may own a house in Costa Rica if the house is for investment only. If you use the house at all, for any length of time, regardless of how short, your IRA will lose its tax deferred status. Similarly, if your IRA owns a boat slip in the Bahamas and you use the slip, your IRA will lose its tax free status. Only purely investment property should be held in an IRA.

Question 3: My daughter and her husband own their own company. May my IRA buy an office building and lease space to their company at fair market rent and reasonable terms?

Answer: This arrangement would constitute a prohibited transaction between your IRA and a disqualified person, i.e., the company of which your daughter and son-in-law own 100% (50% or more according to statute).

Question 4: What is a Prohibited Transaction?

Answer: Prohibited transactions include:

1. The sale or exchange or leasing of any property between an IRA and a Disqualified Person (DP)
2. Lending of money or other extension of credit between an IRA and DP
3. Furnishing of goods or services or facilities between an IRA and DP
4. Transfer to or use by or for the benefit of a DP of the income or assets of the IRA
5. Act by a DP who is a fiduciary whereby he deals with the income or assets of an IRA in his own interest or for his own account

6. Receipt of any consideration for his own personal account by any DP who is a fiduciary from any party dealing with the IRA in connection with a transaction involving the income or assets of an IRA.

Question 5: Who is a Disqualified Person?

Answer: Disqualified persons include:

1. Fiduciaries, e.g. IRA owner, custodian, investment advisor, any person with discretionary authority or control over property held by an entity the assets of which are treated as “plan assets.”
2. A person providing services to the IRA
3. The IRA owner’s employer
4. The IRA owner’s employee organization
5. Any entity more than 50% owned by a disqualified person
6. The spouse, ancestor, lineal descendants of an IRA owner and spouse of an IRA owner’s lineal descendants.
7. The spouse, ancestor, lineal descendants of a fiduciary, service provider, employer or 50% owner.

Question 6: If my daughter-in-law signs a promissory note and mortgage note bearing fair market interest and reasonable terms, including foreclosure and repayment, may my IRA loan money to her?

Answer: No. This is a prohibited transaction because it is a loan to spouse of your child.

Question 7: My IRA owns investment real estate. My father is a very talented carpenter and would like to replace the worn woodwork. May my IRA hire him and pay for his services?

Answer: No. This is a prohibited transaction because it is the furnishing of services between your IRA and your father, or his company, who is a disqualified person.

Question 8: My sister has invented a great product and she is forming a start-up company with a view to going public. May my IRA invest in her company?

Answer: Maybe. If your sister has been able to raise sufficient capital without your investment, then there should not be a problem. On the other hand, if your sister’s success depends largely on your investment, then the authorities might determine that your IRA has engaged in a prohibited transaction. Your sister should be able to document her other investments.

Question 9: My brother and I want to use our IRA funds to invest in an LLC Real estate Operating Company. Each IRA would be a 50% owner. Can we do this and accept a salary for our efforts?

Answer: The formation of the LLC Real Estate Operating Company would not be a prohibited transaction as long as both you and your brother can show that you each have enough assets to form and operate the company without the other. You may not take compensation. The LLC should hire an independent real estate management company to manage the properties. Further, if the properties require rehabilitation, you should hire independent workers and not do the work yourself.

Question 10: I own shares of stock in a company, and the shares are worth less than I paid for them. I believe that the price is only temporarily depressed and will exceed my basis within the year. May I sell my shares, take a capital loss deduction, and have my IRA buy an equal number of shares so that the capital gain is avoided?

Answer: According to Revenue Ruling 2008-5, if your IRA buys, or if your IRA enters into an agreement to buy, the shares within thirty days before or after you sell your shares you cannot take a capital loss deduction. You should consider if the transaction might be worth forgoing the deduction.

Question 11: What are the tax consequences of violating the rules against prohibited transactions?

Answer: The penalties for prohibited transactions are severe. The account is no longer an individual retirement account, and it is treated as if the assets were distributed on the first day of the taxable year in which the prohibited transaction occurred, i.e. all taxes and penalties are due.

Question 12: Does a self-directed IRA offer any protection against creditors?

Answer: Yes, if your state law offers such protection. In New Jersey, an IRA is protected by statute. The applicable statute protects principal, income, and distributions. This differs from an ERISA qualified plan, e.g. 401(k), which is protected to the extent the funds remain in the account and are not distributed.

Circular 230 disclaimer: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax information contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. The information contained in this communication is not legal advice

Prepared By Michael B. Mangini, J.D.
35 Court Street, Freehold, NJ 07728
(732) 409-3209
michael@njapts.net

www.njapts.net

© 2007 Michael B. Mangini – All Rights Reserved

and shall not be considered as such. It is for information purposes only. The use of a self-directed IRA is case specific. Whether or not this technique is appropriate for any individual depends on a complete analysis of the individual's assets and liabilities and personal circumstances. Consult knowledgeable professionals before employing this technique.

© 2007 Michael B. Mangini – All Rights Reserved