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Self-Directed IRAs—A Trap for the Unwary

Perhaps today more than ever, a significant percentage of retirement assets are held in Individual Retirement Accounts (IRAs). Although the amount that an individual can contribute to an IRA for any year on a tax favored basis is limited to a relatively small amount (a maximum of $5,000 in 2010 for individuals under age 50 and $6,000 for individuals age 50 or over) IRAs, nevertheless, often contain significant amounts of money due to portable distribution options required under the Internal Revenue Code for tax-qualified plans, which allow participants who receive distributions under these plans to continue to defer taxation on these amounts by rolling them over into IRAs.

Although rollover IRAs are typically invested in mutual funds and similar registered investment vehicles through financial institutions which act as custodians of the IRA, there appears to be a growing interest by IRA owners to self direct their IRA investments; i.e., to invest their IRAs in real estate, hedge funds and private investment vehicles which are generally not offered by a typical financial institution custodian.

While the investment opportunities in self-directed IRAs may seem attractive, it is important that IRA owners understand that the investments made through these IRAs pose traps for the unwary which may result in unintended tax consequences for the IRA owner. Under the Internal Revenue Code, if the owner of an IRA engages in a "prohibited transaction" with respect to the owner's IRA, the IRA ceases to qualify as an IRA and all assets held in the IRA are deemed to be distributed to the IRA owner as of the first day of the year in which the prohibited transaction occurred. The total amount in the IRA that is deemed distributed is subject to ordinary income tax (unless it is a Roth IRA) and, if the IRA owner is under age 59-½, the deemed distribution is also subject to a 10% excise tax.

Under the Internal Revenue Code, a prohibited transaction occurs if, for example, an IRA owner or other "disqualified person" borrows money from or lends money to the IRA, sells property to or purchases property from the IRA, or uses the assets or income of the IRA for their own personal benefit; i.e., engages in an act of self-dealing with the money held in the IRA. In addition to the IRA's owner, disqualified persons include (a) certain members of the IRA owner's family, such as a spouse, ancestor, lineal descendent or spouse of a lineal descendent, (b) any corporation in which the IRA owner has at least 50% of the combined voting power of all classes of stock, (c) any partnership in which the IRA owner owns at least 50% of the capital or profits interests and (d) any trust or estate in which the IRA owner has at least a 50% beneficial

interest. (In determining whether an IRA owner has a 50% interest in a corporation, partnership, trust or estate, certain family attribution rules apply.)

IRA investors should also be aware that under Department of Labor rules, when an IRA purchases a non-public equity interest in an entity, the assets of the IRA include both the equity interest and an undivided interest in the underlying assets of the entity. This will not be the case if it is established that the entity is an operating company (generally one that produces or sells a product or service other than the investment of capital) or that equity participation by benefit plan investors in the entity is not significant (i.e., less than 25% of the equity interest is held by benefit plan investors, which generally include all tax-qualified retirement plans and IRAs). If these rules apply to an IRA, any transaction by the entity which involves a disqualified person (e.g., a sale of property by the entity to the IRA owner) is considered to be a transaction by the actual IRA and would therefore be prohibited.

In view of both the complexities of complying with the prohibited transaction rules and the potential draconian tax result of a failure by an IRA owner to comply with these rules, IRA owners who seek to self direct their IRA investments should consider segregating the assets to be used in any transaction that might be considered a prohibited transaction into a separate IRA in order to reduce the tax exposure of their IRA as a result of the transaction. Moreover, IRA owners who seek to self direct their IRA investments should consult with counsel to determine whether the investments that they are contemplating may violate the prohibited transaction rules.

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