

## Potential Pitfalls in IRA Money Movement and Non-Public Investments

Owners of IRAs and other types of qualified plan accounts are allowed a great deal of flexibility in transferring account assets from one custodian/trustee to another or from one qualified plan account to another plan account, without triggering a taxable distribution to the account owner. Additionally, the investment vehicles permissible for IRAs are quite broad, and not limited to publicly traded securities. This Current Comment discusses the rules relating to the transfer or rollover of qualified plan accounts (including IRAs), and the limitations on IRA investments in private business ventures.

### **Rollovers and Transfers**

A "rollover" occurs when assets are transferred out of a qualified plan account to the owner, and the same assets are recontributed by the owner to another qualified plan within 60 days. (References in this discussion to "qualified plan" include employer-sponsored plans and IRAs, unless otherwise noted.) Rollovers may also be handled by direct transfers between qualified plan accounts; however, direct trustee-to-trustee transfers of IRAs are not considered rollovers, and thus, are not subject to the 12-month rollover restriction referred to below. A common example of the direct trustee-to-trustee transfer is when an IRA owner decides to switch his account from one stock brokerage or mutual fund firm to another, and the assets move directly between the two firms.

Perhaps the most common type of rollover transaction is when a participant in an employer-sponsored retirement plan transfers all or a portion of the plan account into an IRA. This gives the owner greater flexibility in managing the funds. One of the key requirements tax-free rollovers must meet is that assets transferred by the account owner to effect a rollover within the 60-day time period must be the same assets as those received in the distribution.

### **The Same-Asset Rule**

The same asset rule is narrowly interpreted, and can cause disqualification of an attempted rollover. For example, if securities are received in a qualified plan distribution, and the account

owner then sells the securities and contributes the entire net proceeds to a rollover IRA, this will not qualify—even though the account owner did not pocket anything of value as a result of the transactions.

In the Tax Court case of *Lemishow v. Comm’r.* [110 T.C. 110 (1998)], the taxpayer subscribed for the purchase of a large block of corporate stock which he intended as an IRA investment. He handled the transaction by withdrawing several hundred thousand dollars from two existing qualified plan accounts (a Keogh and an IRA), and he then remitted the funds to the corporation in payment for the stock. Within 60 days after the cash distributions, the taxpayer deposited the corporate stock that he had purchased into a new IRA account. The IRS treated the entire amount distributed as a taxable distribution, contending that the purchase and transfer of the stock to the new IRA did not qualify as a rollover, because the asset rolled over (the stock) was not the same as the assets received (the cash). The Court sustained the IRS’s position, with very costly tax consequences to the account owner.

It would seem that such a result could have been avoided in a variety of ways. For example, if the taxpayer had contributed the distributed cash into the new IRA (within the 60-day period), and the new IRA custodian/trustee had remitted the funds to the corporation for the purchase of the stock, the distribution and recontribution of the cash would have qualified as a rollover. However, getting an IRA custodian/trustee to make such an investment, outside of normal public market channels might not be easy.

### **Practical Problems in Investing IRA Funds in Non-Public Securities**

The overwhelming majority of IRA accounts are administered, as trustee and custodian, by large financial institutions, such as securities brokerage firms, mutual fund complexes, insurance companies, banks and trust companies. Although IRA owners are generally able to make their own investment choices, these institutions typically will only permit acquisitions of publicly traded securities or financial products of the type normally offered by the institution sponsoring the account. Yet, IRAs are not prohibited from investing in a broad range of non-public opportunities, including, for example, real estate, privately held companies, mortgages and others---provided that so-called "prohibited transaction" rules (discussed below) are not violated.

There are IRA trustees that will administer accounts that invest in non-traditional investment vehicles. Such accounts are sometimes referred to as "self-directed" IRAs. If the rollover IRA in the *Lemishow* case had been established with a trustee that accepted such self-directed accounts, the cash could have been contributed to the rollover account, and the trustee could have purchased the stock. (Since the trustee in the *Lemishow* case accepted the stock as a contribution from the taxpayer, it is quite possible that the trustee would also have accepted an instruction to purchase the stock directly from the corporation with the rollover cash provided by the taxpayer. It is not clear whether the problem was with the trustee or just poor planning by the taxpayer.)

The Ancira case illustrates how a taxpayer dealt with the unwillingness of his IRA trustee to directly acquire a non-public investment. In *Ancira v. Comm'r* [119 T.C. No. 6 (Sept. 24, 2002)] the taxpayer's IRA custodian was the Pershing division of Donaldson, Lufkin & Jenrette Securities Corp. The taxpayer wanted to invest \$40,000 of his IRA funds in stock of a privately held company, referred to as S.K., however, he was advised that Pershing would not purchase non-publicly-traded stock for an IRA. The taxpayer then arranged for the IRA's purchase of the S.K. stock in the following manner: He completed a Pershing "Distribution Request Form," requesting a check for \$40,000 payable to S.K. Upon receipt of this check he forwarded it directly to S.K., and S.K. deposited the check and issued 714.28 shares of its stock in the name of the IRA. After a delay for unknown reasons, the stock certificate was eventually delivered to Pershing, which accepted the stock and placed it in the taxpayer's IRA account.

Unfortunately for the taxpayer, as a result of Pershing's issuing the \$40,000 check in response to a "Distribution Request Form" (even though not payable to the taxpayer), Pershing issued a 1099-R form for that year, showing a \$40,000 IRA distribution to the taxpayer. The taxpayer did not report this as income, but the IRS eventually assessed income tax on the \$40,000. In the Tax Court the IRS, relying on the *Lemishow* case, maintained that the taxpayer had received a cash distribution and had not completed a qualified rollover, because the rollover contribution was in the form of stock. However, the Court concluded that this was not a question of a qualifying rollover, but rather, there was not actually a distribution of cash to the taxpayer. The check was made payable to S.K., and could not have been negotiated by the taxpayer. It was delivered immediately by the taxpayer to S.K., and therefore, the taxpayer was merely a conduit for the payment by the IRA for the S.K. stock.

Although the taxpayer dodged the bullet in the *Ancira* case, he was placed in the frustrating and costly position of having to dispute, all the way to the Tax Court, the accuracy of a 1099-R issued by a financial institution declaring that he had received a cash distribution. In any event, the case illustrates the potential difficulties that can arise when an effort is made to place IRA funds in an investment that the custodian is not willing to make directly.

### **Self-Directed IRAs and Prohibited Transactions**

Can funds in an IRA account be used to invest in, or make loans to, a business controlled by the account owner or a relative? While there is no requirement that IRA funds be invested only in publicly traded securities, there are restrictions relating to investments in companies or ventures in which the IRA account owner has a material interest other than merely as a passive investor. I.R.C. §408(e)(2) provides for disqualification of an IRA (with severe consequences, as described below) if the account owner or beneficiary engages in any transaction prohibited under Code §4975. This would include any of the following transactions between the IRA and its owner or beneficiary (or family member of either of them):

- sale or exchange or leasing of any property;

- lending of money or other extension of credit;
- furnishing of goods, services or facilities;
- transfer or use of the IRA's income or assets to, or for the benefit of, the IRA owner or beneficiary.

Prohibited transactions also include any act by an account owner whereby he or she deals with the income or assets of the IRA in his own interest or for his own account, or receives any consideration for his own personal account from any third party in connection with a transaction involving the income or assets of the IRA. An example would be, if the account owner directs the investment of IRA funds by the trustee into a private company, and that company later makes a payment to the IRA owner as a form of consideration for his directing the investment.

Other transactions that can cause the disqualification of an IRA are the following:

- A loan of any amount under an IRA annuity, made directly from the life insurance company that issued the contract or indirectly through a trustee or a custodian of an IRA [I.R.C. §408(e)(3)].
- An assignment of an IRA, or any portion thereof, to a bank or other entity as collateral for a loan [I.R.C. §408(e)(4)].

Attribution rules apply in the application of these prohibited transaction limitations. Thus, the transactions that are prohibited between the IRA and the account owner and the beneficiary(ies) are also prohibited between the IRA and the following family members of the account owner and/or beneficiary(ies): spouse, ancestor, lineal descendant, and any spouse of a lineal descendant [I.R.C. §4975(e)(6)]. The prohibition also applies with respect to dealings between the IRA and the following entities and affiliated parties:

1. a corporation, partnership, trust or estate in which the IRA owner, beneficiary or family member holds an equity, income or voting control interest of 50 percent or more [I.R.C. §4975(e)(2)(G)];
2. an officer, director (or individual having powers or responsibilities similar to those of officers or directors), a 10 percent or more shareholder, or highly compensated employee (earning 10 percent or more of the yearly wages of an employer) of an entity described in clause 1 above [I.R.C. §4975(e)(2)(H)].

### **Severe Consequences of Disqualification**

If an IRA becomes disqualified, its full value is considered distributed to the individual and such distribution is then subject to income tax (including the 10 percent additional tax if the disqualification occurs prior to the account holder's attaining age 59 1/2). In addition, no deduction is allowed for a contribution made in the taxable year in which an IRA was disqualified. (It should be noted that when the prohibited transaction involves a qualified plan

other than an IRA, the penalty is not disqualification of the plan, but a substantial excise tax on the amount of plan money involved in the prohibited transaction [I.R.C. §§4975(a) and 4975(c)(3)].

Thus, it can be seen that it will be difficult or impossible to channel IRA funds for the benefit of business ventures controlled by the account owner or specified family members, regardless of the merits of the transaction as an investment for the IRA.

The following are examples of situations that have been held to be prohibited transactions:

- A guaranty by the IRA owner of a loan to the IRA [I.R.C. §4975(c)(1)(B); DOL Op. Ltr. 90-23A].
- Purchase by an IRA of a personal residence for the account owner [Harris v. Comm'r., T.C. Memo 1994-22].
- Purchase by an IRA of real property from members of the IRA owner's family, to be leased back to the sellers [DOL Op. Ltr. 93-33A].
- Loans by qualified plan accounts to a corporation that was 57-percent owned by the owner of the plan accounts [Flahertys Arden Bowl, Inc. v. Comm'r., 115 T.C. 269 (2000)]

On the other hand, an IRA's purchase of 100 percent of the stock in, and subsequent receipt of dividends from, a corporation of which the IRA owner was a director was deemed not to be a prohibited transaction. The corporation was newly formed, and thus, the purchase by the IRA was not a purchase from an entity of which any party, prior to the time of purchase, owned 50 percent or more. [Swanson v. Comm'r., 106 T.C. 76 (1996)].

### **Conclusions Regarding Self-Directed IRAs**

Individuals wishing to establish a so-called self-directed IRA in order to be able to direct the trustee/custodian to invest in various types of non-publicly traded securities and other investment vehicles, such as, for example, real estate, non-public business entities and certain insurance company products, may, with some searching, be able to find a trustee offering such service. However, extreme care must be taken (a) in the manner in which existing IRA assets are transferred to a rollover IRA with the new trustee; (b) in the manner in which the trustee acquires the non-public investments (i.e., avoiding funds passing through the account owner); and (c) in avoiding channeling IRA funds to ventures in which the IRA owner or beneficiary or family members have material interests, such as would trigger a violation of the "prohibited transaction" restrictions.

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