BOB CARLSON'S
Retirement Watch

IRA INVESTMENT GUIDE:

A ROAD MAP FOR AVOIDING THE TAX TRAPS AND PENALTIES

Bob Carlson

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IRA Investment Guide: A Road Map for Avoiding the Tax Traps and Penalties

Published by:

Eagle Products, LLC.

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Washington, DC 20001

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Introduction

Individual Retirement Arrangements (IRAs) are among the most valuable assets most Americans have when they begin retirement. In addition to contributions made over the years, IRAs contain 401(k)s and other retirement accounts that were rolled over to them. IRAs comprise the bulk of most people's nest eggs.

Because of their importance, IRAs must be carefully managed. Yet, investors can find much advice about contributing to IRAs and investing them for the long term but little information about many other critical issues. Not knowing these facts can be expensive. IRA owners are at risk of penalties, higher taxes, and lower after-tax wealth to fund their retirements.

IRAs were supposed to be simple and flexible investment vehicles. You make contributions over the years, and the earnings grow tax deferred. When you need money for retirement, you take a distribution and include the amount in gross income. ***Unfortunately, IRAs are more complicated than most people think.*** Congress just can't help itself. It runs across situations it doesn't like and enacts new restrictions and prohibitions that cover far more situations than the ones that triggered attention. These rules complicate your IRA decisions. The complications are most likely to arise when you are managing the IRA and also when you are in the distribution phase.

In this report, we focus on the rules for investing IRAs. Many IRA owners don't realize the investment rules are complicated and restrictive. When you invest only in publicly traded stocks and bonds and in mutual funds, there rarely are special issues. The tax law, however, prohibits or penalizes some other investments by IRAs. These rules have been in the law for a long time and affected few investors. The pitfalls, however, are becoming more important as the investment options available to mainstream investors increase and as investors are attracted more to "hard assets" and other non-traditional investments. The many upheavals in the financial markets since 2000 cause many investors to seek alternatives to traditional investments.

Holding alternative investments in IRAs can trigger problems. ***The restrictions on IRA investments are not well-known and, as a result, investors often stumble into penalties or other problems.*** This report explains the restrictions, prohibitions, and penalties on IRA investments. You'll learn what the rules are and how to avoid problems.

Potential problem investments for IRAs fall under one of three categories: prohibited investments, taxable investments and transactions, and prohibited transactions. We cover each of them in turn. There are a couple of points to keep in mind when reading this report. This report focuses on IRAs, but most of the rules also apply to other qualified retirement plans, such as 401(k)s. Also, the rules apply to Roth IRAs unless the Roths are specifically exempted from them. That means there are times when Roth IRAs or their owners face taxes and penalties.

There is a lot of misinformation floating around on the issues. As a result, investors often stumble into penalties or other problems.

Avoiding these traps for IRA investors is critical because IRAs often are the most valuable investment assets of individuals. A misstep with the IRA can cause a lot of retirement wealth to be transferred to the IRS.

This report guides you through the tax code pitfalls for IRA investors. You'll learn how to invest your IRA in hard assets, partnerships, real estate, and more — safely.

The key to successful investing is maximizing your after-tax, after-expense income. Following this road map will minimize the amount of your wealth that is siphoned by the IRS. It will ensure that good investment and financial decisions aren't bad tax moves.

Reviewing the Basics of IRAs

We'll start at the beginning, with a quick review of the fundamental rules for IRAs and most other tax qualified retirement plans. We build on these to show the exceptions, ensuring you'll be able to develop the optimum strategies for your retirement, financial, and investment planning.

An IRA generally is treated as a separate taxpayer. Income and capital gains earned by the IRA are not taxed to the IRA owner while they remain in the IRA. If there are taxes, they are owed by the IRA, not the owner. Likewise, losses incurred inside the IRA can't be deducted by the owner. This rule applies to all qualified retirement plans, including traditional IRAs, Roth IRAs, 401(k) accounts, profit-sharing plans, and defined benefit pension plans.

The IRA generally is a tax-exempt taxpayer. As a general rule, it is not taxed on its earnings. The income and other earnings compound tax deferred as long as they remain in the IRA, though later we learn the exceptions to this rule.

Knowing When Distributions are Taxed

When money or property comes out of a traditional IRA or other qualified retirement plan, however, income taxes are likely to be owed by the recipient. (The following discussion does not cover the Roth IRA rules. Qualified distributions from Roth IRAs are tax-exempt.)

A distribution from a traditional IRA (a non-Roth IRA) is fully included in the gross income of the owner receiving the distribution in the tax year it is received, to the extent it exceeds the tax basis of the IRA (see the discussion of the tax basis below). The distribution will be treated as ordinary income, even if some or all of the distribution consists of long-term capital gains earned by the IRA. One of the prices paid for the tax deferral of the IRA is that long-term capital gains are taxed as ordinary income when distributed. In addition, any income earned by the IRA that would have been tax-exempt or had some other tax advantage if earned by a taxpayer outside the IRA is taxed as ordinary income when distributed. For this reason, it usually is best not to invest in tax-exempt or tax-advantaged investments through an IRA.

An IRA distribution does not have to be made in cash. Instead of selling a security or other asset and distributing the cash proceeds, the IRA can distribute property it owns. For example, most financial institutions that serve as IRA custodians will transfer securities from an IRA to a taxable account of the same owner at the firm, often at no cost. In such cases, the amount included in gross income is the fair market value of the asset on the date of the distribution. After the distribution, the taxpayer has a tax basis in the property equal to the amount included in gross income. If there were nondeductible contributions in the property, they also are included in the taxpayer's basis in the property.

The same basic tax rules apply when an IRA is inherited and distributions are made to the new beneficiary. An inherited IRA or other qualified retirement plan is treated differently than other types of inherited assets. The beneficiary of an IRA does **not** increase the tax basis of the account to its fair market value on the date of the owner's death. Distributions from the inherited IRA to a beneficiary are included in the beneficiary's gross income to the extent they would have been included in the gross income of the original owner. This means that an IRA potentially faces onerous double taxation after the first generation. The IRA is included in the estate of the owner. If the estate is large enough and the estate tax is in effect, the value of the IRA is subject to estate taxes. Then, the beneficiary pays income taxes as the account is distributed. The top estate tax rate plus the top income tax rate could combine to leave the beneficiary of an inherited IRA with a small portion of its original value after all the taxes. There also might be state death and income taxes.

Computing Your IRA's Basis

An IRA might contain contributions from the owner that were not deductible when contributed. These are known as **after-tax contributions** because the taxpayer had to pay income taxes on the money before contributing it to the IRA. A **before-tax contribution** is when the contribution is deductible from gross income (or in the case of a 401(k)-plan deferral, excluded from gross income). After 1986, IRA contributions could be fully or partially nondeductible. Contributions lose their deductibility when the taxpayer's adjusted gross income in the year of the contribution exceeds certain levels. An IRA also might contain after-tax contributions that were rolled over from an employer-sponsored retirement plan.

After-tax contributions are the taxpayer's basis in the IRA, and the basis is not included in gross income when it is distributed. An IRA owner is supposed to file Form 8606 with his or her income tax return when nondeductible contributions are made. The form records the cumulative after-tax contributions the taxpayer made to IRAs. It is important for the IRA owner to file Form 8606 and keep a copy of it, because it is the record that proves the basis and thus the amount to exclude from gross income when distributions are made from the IRA.

When there is a distribution from an IRA of less than its full value, the IRA owner can't choose how much is a distribution of the basis or after-tax contributions (and therefore tax free) and how much is of deductible contributions and accumulated returns (included in gross income). Instead, a distribution will be partially taxable and partially nontaxable, and a formula is used to determine the two portions. The formula is to divide the total lifetime nondeductible contributions in the IRA by the value of the IRA. The result is a percentage. Multiply the percentage by the amount of the distribution, and the result is the nontaxable portion of the distribution.

Example: Max Profits has an IRA with a total value of $10,000. It contains $2,000 of nondeductible contributions. Max withdraws $1,000 this year. The exclusion ratio is $2,000 divided by $10,000, or 20%. That means $200 of the distribution is tax-free; $800 is included in gross income.

The total amount of the distributions excluded from gross income over time cannot exceed the amount of nondeductible contributions. To return to the previous example, Max will continue to exclude from gross income a pro rata portion of each distribution until a total of $2,000 is excluded from gross income (assuming no additional nondeductible contributions).

When the taxpayer has multiple IRAs, they are aggregated to determine the amount of the year's distributions excluded from gross income as a return of basis.

<u>Example</u>: Max Profits has two IRAs. One has a value of $10,000 and contains $2,000 of nondeductible contributions. The other has a value of $20,000 and has no nondeductible contributions. He withdraws $500 from the first IRA and $1,500 from the second during the year. To determine how much to exclude he aggregates the two IRAs and divides $2,000 by $30,000 for a 6.67% exclusion ratio. Max excludes $133.33 of the distributions from gross income.

There is an exception to the pro rata basis rule when an IRA is rolled over to a qualified employer retirement plan. Notice this is not the frequently made rollover from an employer plan to an IRA; it is the opposite. This can happen when the account owner takes a new job, the employer's plan allows a rollover from an IRA or other employer plan, and the IRA owner decides to consolidate retirement plan assets in the new employer's plan. A qualified employer plan, however, cannot accept after-tax IRA money in a rollover. In that case, the IRA can roll over only the pre-tax contributions and the earnings of the IRA. The after-tax contributions must remain in the IRA.

This rule can allow for tax-free distributions from an IRA. The IRA owner rolls over to an employer plan all of the IRA except its basis. The amount remaining in the IRA then is distributed. Since there is no pre-tax money left in the IRA, the entire distribution is excluded from gross income as a return of basis. Or instead of being distributed, the basis could be converted to a Roth IRA. There would be no tax due on the conversion of the traditional IRA to a Roth IRA. This example assumes the owner has only one IRA. Remember if there are multiple IRAs, they are aggregated for determining the basis of a distribution.

Those are the basic rules for when IRAs and distributions from them are taxed. They are fairly simple, the way IRAs were meant to be. But things can become more complicated. Sometimes an IRA owes taxes on its income. Other times the owner of an IRA owes taxes or penalties or both. The taxes and penalties are triggered by the wrong investment in an IRA or transactions with the IRA. In other words, the money is not safe from taxes and penalties because it is held inside the IRA. You can't do whatever you want with an IRA or invest it in anything you find attractive.

In the rest of this report, we review the three major investment and transaction pitfalls into which IRA owners could fall. Before you make a move with your IRA assets, be sure you won't fall into one of the three traps.

Identifying Prohibited IRA Investments

There are only two types of prohibited investments for IRAs.

One prohibited investment is **life insurance**. Since life insurance already has tax benefits, Congress does not want pre-tax dollars paying the premiums. The prohibition on life insurance also applies to most employer retirement plans. There are some exceptions to the life insurance prohibition for employer retirement plans, but the rules are complicated, and you'll need professional advice to navigate them. For IRAs and 403(b) plans, however, life insurance contracts are prohibited outright.

Sometimes an IRA or 403(b) plans owns an annuity. Many annuities have a small amount of "life insurance" because they guarantee some amount will be paid to a beneficiary if the owner dies before annuity distributions begin. IRS regulations provide that this is an incidental life insurance benefit, and annuities with this type of provision are allowed in IRAs. The annuity must be issued in the name of the IRA owner and the benefits can only be paid to the owner or the surviving beneficiaries. Furthermore, the entire interest in the contract must be nonforfeitable, the contract can only be transferred back to the issuer, premiums must be flexible to adjust to changing compensation, and contributions cannot exceed the annual maximum for IRA contributions.

An investor also can set up an IRA through a life insurance company and hold an annuity that has incidental life insurance benefits.

Avoiding Collectibles

The other prohibited investment is **collectibles**. The prohibition on collectibles applies to any "individually-directed account," which includes 401(k)s as well as IRAs.

Collectibles as defined in the tax code are works of art, antiques, rugs, stamps, coins, metals, gems, and alcoholic beverages. The IRS is allowed to define other items as collectibles but has not done so.

The penalty for buying a collectible in an IRA is that an amount equal to the cost to the account of the collectible will be treated as a distribution to the owner. In most cases that means the cost of the collectible is included in gross income of the owner. The penalty is imposed no matter how short a time the IRA owned the collectible.

Example: Max Profits' IRA pays $10,000 for a collectible in 2010. The transaction must be treated as a $10,000 distribution to Max in 2010, even if the IRA no longer owned the collectible at the end of the year. Max is required to report the $10,000 as gross income. In addition, if Max is younger than 59½ and does not qualify for any of the exceptions to the early distribution penalty, a penalty tax of 10% of the value of the distribution will be assessed.

The collectibles penalty also is likely to result in double taxation. Eventually, the collectible or the cash proceeds from selling it will be distributed to the owner or a beneficiary. This amount also will be included in gross income. There is no credit or deduction for the penalty tax paid on the purchase of the collectible, and there is no provision that allows the IRA's basis to be increased by the amount that was previously taxed because of the penalty. The result is the IRA owner pays taxes twice on the same amount.

There are exceptions to the definition of collectibles. The details are in the sidebar. The bullion coins issued by the U.S. generally are the American Eagle gold, silver, and platinum coins. Also, any coins issued by any of the states are not collectibles. Finally, gold, silver, platinum, or palladium bullion are not collectibles when the metal equals or exceeds the minimum fineness required under a regulated futures contract and is in the physical possession of a qualified trustee. Details are in the sidebar.

You also can benefit from collectibles through your IRA by owning collectible-related investments that are not the physical collectibles. For example, your IRA can purchase securities of firms that produce or deal in collectibles, such as securities of precious metals mining companies, art dealers, and producers and distributors of alcoholic beverages. You also may purchase mutual funds and exchange-traded funds (ETFs) that buy such securities.

Owning Collectibles Indirectly

Collectibles also may be owned indirectly in IRAs, such as through ETFs.

Some ETFs purchase physical bullion (such as gold and silver) and have it stored under their names. The IRS has not issued public regulations or rulings on whether the purchase of these ETFs by an IRA is a prohibited transaction, but the agency has made taxpayers aware of its views through private letter rulings sought by issuers of bullion ETFs. The ETFs publish the substance of the rulings in their prospectuses.

Under the private letter rulings, when shares in a bullion ETF that is organized as a trust, such as **SPDR Gold Trust** (GLD), are added to an IRA, the transaction is not considered to be a purchase of bullion or a share of bullion. Rather, the transaction is considered simply to be the purchase of securities, the same as the purchase of shares in any other ETF, a mutual fund, or a company. The IRS reasoned that shareholders are not able to force the ETF to distribute bullion or take other actions, so the IRA is not the owner of the bullion. Shares of the bullion ETF are not a collectible subject to the prohibited investment penalty.

In the prospectuses of the ETFs you will find language almost identical to this statement in the **iShares® COMEX® Gold Trust (IAU)**: "The sponsor has received a private letter ruling from the IRS which provides that the purchase of iShares by an IRA or a participant-directed account maintained under a plan that is tax-qualified under section 401(a) of the Code, will not constitute the acquisition of a collectible or be treated as resulting in a taxable distribution to the IRA owner or plan participant under Code section 408(m)."

There is an exception buried in the rulings. Should the ETF distribute its bullion in-kind to shareholders, an IRA owning ETF shares would be treated as acquiring a collectible when the distribution is made to the extent of the distribution.

A private letter ruling applies only to the taxpayer to whom it was issued and may not be cited by others in litigation. But letter rulings do reveal the thinking of the IRS and usually are followed by its auditors. Tax advisors generally agree you can rely on the conclusions made in these private letter rulings to purchase bullion ETFs through your IRA.

The prohibited investment rules also do not apply to ETFs that use futures or derivative contracts to track the performance of metals or metal-based indexes, such as **Invesco DB Gold**, **Invesco DB Silver**, and **Invesco DB Precious Metals**. Mutual funds and ETFs that buy the securities of companies in the bullion business, such as gold mining companies, also avoid the prohibited investment rules.

ETNs and IRAs

An Exchange-Traded Note (ETN) is a cousin to the ETF. The ETN is a promise by the issuer to pay the investor an amount equal to the return of a specific index or other price benchmark, minus the ETN's fees and expenses. For example, the **iPath Series B Bloomberg Precious Metals Subindex Total Return ETN (JJP)** is intended to reflect the unleveraged returns from futures contracts comprising the index in the name of the ETN.

This is another collectible-based investment that does not involve ownership of the physical collectible. The ETN is not even a fund that holds investments, but rather is a debt of the issuer. Since ETNs do not hold physical assets, the IRS does not consider them to be a direct investment in collectibles when purchased with IRA funds. They can be purchased by an IRA without being considered the purchase of a collectible.

A Comparison: Collectibles in Taxable Accounts

Before we move to the other dangerous IRA investments and transactions, here is how collectibles are treated when purchased outside an IRA through a taxable account.

Collectibles are allowed to be purchased in non-IRA accounts. ***Collectibles held for more than one year, however, do not receive the same maximum 20% long-term capital gains rate (as of 2022) as other capital assets.*** Instead, collectibles have a maximum long-term capital gains rate of 28%.

Unlike in an IRA, a bullion ETF sold from a taxable account is treated as selling a pro rata share of the bullion owned by the ETF. Any long-term capital gain on the sale is treated as a sale of the bullion and taxed at the maximum 28% rate.

In addition, bullion ETFs may periodically sell some bullion to pay expenses. These sales are passed through to the shareholder and, if the bullion sold by ETF was held for more than one year, the transaction is taxed at a maximum rate of 28%.

Again, the IRS hasn’t issued regulations or public rulings on these issues. It did reach these conclusions in an internal opinion that was made public. The bullion ETFs state in their prospectuses this is the tax treatment of purchases of the funds.

Exchange-Traded Notes (ETNs), which hold contracts rather than physical assets (e.g. gold bullion) also have different tax treatment in taxable accounts. The tax treatment of ETNs can be complicated, and for some ETNs, uncertain.

The tax consequences vary depending on the structure of the note, promises made by the issuer, and investment actions taken by the issuer. For many ETNs, the tax treatment in taxable accounts is unknown, because neither the IRS nor Congress established firm rules.

The IRS has indicated, however, that for many ETNs the appreciation of the index each year is treated as interest paid the owner. ***The ETNs do not make distributions until maturity, but the IRS believes ETN owners must accrue the interest each year and report it in gross income, similar to the way zero coupon bonds are taxed.*** Investors who own ETNs in taxable accounts will owe taxes on interest income they do not receive. The treatment also converts what the investor considers capital gains into interest income.

When an ETN is sold from a taxable account, the sale results in a capital gain or loss. The gain or loss is the amount realized minus the tax basis in the ETN shares. The tax basis is the original cost of acquiring the ETN plus any accrued income that was included in gross income but not distributed. This prevents double taxation but places a recordkeeping burden on the ETN owner to avoid paying taxes twice on the same income.

In general, the tax law has not caught up with the financial innovations of ETNs. Because of the uncertainty of the tax treatment of ETNs, read the tax treatment section of the prospectus carefully. In many cases, the prospectus states the tax rules are uncertain and describes several possible tax outcomes. Until the IRS or Congress establishes rules, investors are on their own when reporting income and gains from ETNs.

Taking a Close Look at Prohibited Transactions

The previous section of this report discusses prohibited ***investments***. This section discusses prohibited ***transactions***.

The prohibited transaction rules generally apply to investments or transactions that normally are allowed for IRAs but become prohibited when they are engaged in with a "related or disqualified person." The tax code defines **related person** and has a list of transactions that IRAs and other qualified retirement plans can't engage in with related parties. The rules are designed to prevent self-dealing between an IRA and its owner. Often it does not matter whether the transactions are done at fair market value. The transactions are prohibited at any price.

The penalty for violating the prohibited transaction rule is severe. The entire IRA will be considered to be fully distributed when the prohibited transaction was made. The IRA owner must include its full value in gross income, regardless of the amount of the prohibited transaction. If the owner has multiple IRAs, only the IRA that engaged in the prohibited transaction is penalized. Other IRAs escape the penalty unless they also engaged in prohibited transactions.

There are six categories of prohibited transactions between IRAs and related parties. The first four are specific, and the last two are general.

The **specific prohibited transactions** are:

- A sale, exchange, or lease of property;
- A loan of money;
- Furnishing goods, services, or facilities; and
- A transfer of or the use of the income or assets of the IRA.

The **general prohibitions** are an act in which the related party deals with the IRA income or assets as his or her own; and the receipt of any benefit for the related party's personal account in connection with a transaction involving the income or assets of the IRA.

It is easy to state the prohibitions in clear, plain English: No deals are allowed involving the IRA and the owner or a person related to the IRA or its owner.

Tax law always is complicated. The details of the law are not as clear as that general statement, and there always are exceptions. ***It is possible to engage in "prohibited transactions" with an IRA without incurring penalties.*** Those instances are discussed later. First, we will look at the prohibited transaction rules in more detail.

Understanding Prohibited Transactions

The key to understanding prohibited transactions is knowing who is a related person to the IRA. A **related person** is the IRA owner; anyone who makes decisions for the IRA; anyone providing services to the IRA; an ancestor, spouse, or descendant of the IRA owner, of the owner's spouse, of a decision maker for the

IRA, or of anyone providing services to the IRA; a corporation, trust, partnership, or estate that is 50% or more owned by any of the above persons; an officer, director, highly compensated employee, or 10% or greater owner of any of the above; and a partner of any of the above.

That is a broad list, but it is not broad enough to exclude transactions with everyone related to the owner. Not included as related persons are brothers, sisters, step relatives, nieces, and nephews. Also not included are friends and neighbors. A "significant other" to whom the IRA owner is not married also is not a related person.

What about Roth IRAs? In this area, they are subject to the same rules as traditional IRAs and other qualified retirement plans. In addition, the IRS issued a notice in 2003 in which it stated that any transaction between a Roth IRA and a "related party" would be considered a tax shelter or an abusive transaction required to be registered with the IRS. For this notice, the IRS considered brothers and sisters as related parties. (IRS Notice 2004-8) So, Roth IRAs potentially are subject to a broader list of prohibited transactions than traditional IRAs.

Here's an example of a transaction that can be conducted by an IRA without violating the prohibited transaction rules.

Suppose the IRA owner has a stepchild who is ready for college. The IRA can lend the tuition money to the stepchild. Over time, the stepchild pays back the IRA with interest (perhaps using annual gifts from the owner). The loan plus interest goes back into the IRA, and the interest income is tax deferred. In addition, the interest might be deductible by the stepchild. The transaction also works for brothers, sisters, nieces, and nephews. It allows the IRA owner to help a relative while earning interest.

Another example: The IRA owner wants to help someone buy or retain a home or other property. The person does not fit the definition of "related person." The IRA writes a mortgage for the person. The IRA earns interest income as mortgage payments are received. The loan is secured by the property, protecting the IRA's principal to at least some extent. And the borrower should be able to deduct the interest payments if the mortgage is structured properly.

These are just the tip of the iceberg. There are many other interesting and profitable transactions IRAs are allowed to make.

Undertaking Penalty-Free “Prohibited Transactions”

The Department of Labor is allowed to grant **exemptions to the prohibited transaction** rules for specific taxpayers with specific transactions. In fact, the DOL is required to create a procedure for obtaining exemptions from the prohibited transactions rule and has done so. Under this procedure, the DOL grants a number of exemptions each year. Here is a sample of exemptions granted in the past:

- An IRA owner sold real estate to his IRA.
- An IRA owner sold stock to his IRA.
- An IRA owner purchased stock from his IRA.
- An IRA owner purchased real estate from his IRA.
- An IRA owner lent money to a corporation of which he was the sole owner. That means when the loan was repaid, the corporation paid tax deductible interest to the IRA.

The DOL, through its Employee Benefits Security Agency, reviews applications for exemptions. The office also grants "class exemptions." These describe exemptions for a certain type or category of transaction. The exemption describes the transaction in detail, and anyone engaging in that transaction does not have to apply for an individual exemption. When the transaction fits exactly the one described in the category exemption, the transaction is exempt.

To be granted an exemption, the IRA must show the office that a transaction is administratively feasible, is in the interests of the plan and its participants and beneficiaries, and that it protects the rights of plan participants and beneficiaries. An individual exemption is put on a fast track to approval if the transaction is substantially similar to two or more exemptions granted in the last five years.

Full details of past exemptions are on the web site www.dol.gov/ebsa/. Websites change over time, so you will have to search the website for the current page. Full details about exemptions and application procedures are in the booklet "Exemption Procedures Under Federal Pension Law."

The possibility of an exemption to the prohibited transaction rules widens an IRA owner's financial options. For example, if an exemption is obtained, an IRA might be able to write the mortgage on the owner's next home or vacation home.

Instead of writing mortgage checks and paying interest to a bank or other lender, the owner will be making the payments to his or her IRA. And the interest payments likely will be deductible. That's a pretty good deal. But be sure it won’t be treated as a prohibited transaction.

As stated earlier, the penalty for engaging in a prohibited transaction is severe. The entire IRA will be considered fully distributed when the prohibited transaction was made, even the portion of the IRA not involved in the prohibited transaction. The IRA owner must include the account's full value in gross income, regardless of the amount of the prohibited transaction. If the owner has multiple IRAs, only the IRA that engaged in the prohibited transaction is penalized. Don’t engage in a transaction without being sure that it either avoids the definition of a prohibited transaction or that you have a valid exemption.

You can’t engage in these types of transactions through a conventional IRA because the custodian limits the allowed transactions. You need a custodian that allows such transactions. IRA custodians that allow unconventional transactions often charge extra fees that could make the transactions not worth the cost. One way around the fees is to set up a limited liability company and have the IRA own the LLC. The strategy is discussed in more detail later in this report.

Before engaging in a transaction with your IRA, consult with an experienced tax advisor who is familiar with the prohibited transaction rules. Determine if the transaction is clearly allowed under the regulations or if you need to apply for and receive a waiver before undertaking the transaction.

Knowing When an IRA Will Be Taxed

An IRA is a separate taxpayer and is tax-exempt — most of the time. There are times when the IRA itself might be taxed. Remember that all rules that apply to traditional IRAs apply to Roth IRAs unless there is a specific exception for the Roth. Roths are subject to the rules that follow and could be taxed in these situations.

An IRA is most likely to be taxed when it earns what the tax code calls **unrelated business taxable income** (UBTI). The UBTI rules apply to all qualified retirement plans, not just traditional IRAs. If an IRA earns gross UBTI exceeding $1,000, it must file a Form 990-T and pay income taxes at the corporate tax rates. An IRA also must pay estimated income taxes during the year if the tax is expected to exceed $500. The return is filed and the taxes are paid by the IRA, not by the owner, and the custodian or trustee of the IRA is supposed to be responsible for filing the return and paying the taxes from the IRA. But the custodian might not receive the Form K-1 reporting the income or might not file the return. Be sure to check with your custodian and coordinate who is responsible for filing the form and paying the taxes. Most trustees and custodians will charge the IRA for filing the return. You can obtain Form 990-T and the instructions on the IRS web site at www.irs.gov.

The $1,000 limit applies to the IRA, not to each investment in the account. If all the UBTI earned by the IRA during the year exceeds $1,000, the tax obligation is triggered. Also, the $1,000 limit applies to the IRA, not per taxpayer. When you have more than one IRA, each IRA has its own $1,000 UBTI limit.

The IRA owner essentially will be taxed twice on UBTI. The IRA will be taxed on the income. Subsequently, the owner or beneficiary will be taxed on distributions of that income. There is no deduction or credit available for UBTI paid by the IRA and it is not added to the tax basis of the IRA.

Defining UBTI

The UBTI rules were created to prevent charities from using their tax-exempt status to compete with tax-paying businesses. The rules also apply to tax-exempt entities such as IRAs and pension plans. The UBTI rules are fairly broad and apply to situations in which the IRA is not in control of or operating a business and the IRA's tax-exempt status does not influence the business's operations. An IRA can have UBTI when it uses debt to buy property or investments and when it owns small interests in certain types of businesses.

An IRA potentially has UBTI if it does any of the following:

- operates a trade or business unrelated to its tax-exempt purpose,
- receives certain types of rental income,
- receives certain passive income from a business entity it controls,
- invests in a pass-through entity, such as a partnership, that conducts a business, or
- uses debt to finance investments.

A "trade or business" is any activity carried on for the production of income from the sale of goods or performance of services. Any business is considered unrelated to the exempt purposes of an IRA or other retirement plan. Fortunately, the tax code specifically excludes certain types of income from the definition of trade or business income for UBTI purposes. The exempt types of income include interest, dividends, capital gains, and profits from options transactions. Royalties also are generally exempt.

Even exempt income, however, can be converted into UBTI.

Real estate rental income generally is exempt from UBTI, but becomes UBTI if the amount of rent is computed as a percentage of the tenant's profits. The exception for excluding income from renting personal property (i.e., property other than real estate) is much narrower, making it difficult to exclude from UBTI income from renting personal property such as equipment or cars. Real estate rental income also becomes UBTI when the real estate is financed with debt.

Controlling a business entity also can convert exempt income into UBTI. When an IRA has greater than 50% control of a business entity, any rent, interest, or royalties paid by the entity to the IRA is UBTI if the payments have the effect of reducing the business income of the entity. Another way to look at this rule is that if the business entity deducts the payments to the IRA, they are UBTI to the IRA.

Investing in Master Limited Partnerships

Here’s the situation when a typical investor’s IRA is most likely to run afoul of the UBTI rules.

When an IRA owns an interest in a pass-through business entity (partnership or limited liability company), the IRA's share of the entity's income is UBTI. In this case, the IRA does not need to own a controlling interest to trigger UBTI treatment. (An S corporation is a pass-through entity, but it cannot have an IRA as a shareholder. Having an IRA as a shareholder would invalidate the election to be an S corporation.) Pass-through entities generally do not pay federal income taxes. Instead, their income and expenses are passed through to their owners' income tax returns.

This rule most often trips up individuals who invest their IRAs in **master limited partnerships** (MLPs) such as pipeline operators. MLPs are traded on major stock exchanges, and many people think of them as being the same as corporate stock. In fact, these are partnership units, and the income and expenses of the partnerships pass through to the owners at tax time. Owners receive K-1 statements each year to use in completing their tax returns, and the K-1 states the amount of UBTI attributable to the IRA.

Individuals generally are urged not to purchase MLPs through IRAs. Keep in mind that it is not illegal to own an MLP through an IRA. The ownership, however, triggers the UBTI rules and the requirement to possibly file a version of Form 990 and pay estimated taxes. Once the $1,000 income threshold is crossed, there is no tax advantage to owning MLPs through an IRA. (When MLPs generate more than $1,000 of UBTI in an IRA, some tax advisors recommend taking the easier and cheaper route of reporting any IRA-owned pass-through items on the individual tax return instead of taking the time and expense to file a separate return for the IRA. It's not clear this satisfies tax code requirements, and be sure your custodian is not also filing and paying the taxes from the IRA.) Also, UBTI is taxed at corporate rates, not individual rates.

There is another reason to make MLP investments outside of a tax-deferred or tax-free account. Most MLPs already have tax advantages. Their operations generate depreciation deductions or other write offs that make a high percentage of income distributions tax free. The advantages of these tax items are diminished when the MLP is owned inside a tax-favored account.

Keep in mind that paying taxes on UBTI is required when the aggregate of UBTI exceeds $1,000. The $1,000 limit is applied to the IRA, not to each investment in the IRA or to the taxpayer.

Using Debt in an IRA

Another time an IRA is very likely to have UBTI is when debt is used to finance investments. Any type of income can become UBTI when debt is used to finance the property that generates the income. For example, if an IRA receives a margin loan from the custodian or broker, income generated by the securities purchased with the loan proceeds would be UBTI. Real estate mortgages also are debts that convert exempt income into UBTI. An IRA can own real estate and earn rental income, and that rental income will be tax deferred. If the real estate is financed with a mortgage, however, the rental income becomes UBTI.

Selling securities short technically is a loan. The investor borrows securities from another investor (through a broker) and sells those securities. Eventually, the investor repays the loan by purchasing identical securities and giving them to the broker. The tax code and IRS rulings, however, generally exempt short sales of securities from the definition of debt-financed property.

What about when an investment that generated UBTI is sold? For example, an IRA has a substantial investment in master limited partnerships that generated a few thousand dollars of UBTI each year. The IRA sells the MLPs at a gain. Is the capital gain UBTI? No. Only the business income generated by an investment is UBTI. Any capital gains from selling that investment are capital gains, and like other capital gains, are not taxed to the IRA. When property that was financed with debt is sold, however, the capital gains from that sale are taxed as capital gains to the IRA. If the MLPs were purchased with margin loans, for example, the capital gains would be UBTI.

Some IRAs own **passive foreign investment companies** (PFICs). These generally are mutual funds organized outside the U.S. Most of these funds do not make annual distributions the way U.S. open-end mutual funds do. Gains and income accumulate and compound inside the fund, boosting its net asset value. These funds may periodically make "excess distributions" to shareholders. There could be taxes due when the PFIC is sold or when an excess distribution is received. Details of how to compute the taxes are on Form 8621 and its instructions.

The UBTI rules are broad and extensive. It is not possible to fully explain them here. This report highlights the investments that are most likely to trigger UBTI for IRAs. You have to be especially careful of debt-financed investments, business ownership, and ownership of pass-through entities. Keep the main categories of sources of UBTI in mind and seek tax advice before undertaking an investment that comes close to resembling one of the descriptions.

The responsibility for filing the tax return rests with the custodian of the IRA, not the owner, and to pay the taxes from the account. The custodian is likely to charge for filing the return and paying the tax. Be sure to coordinate with the custodian regarding filing the return and payment of taxes.

For additional details, in addition to reviewing the IRS forms and instructions cited above, you can review IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*. The publication is written primarily for tax-exempt organizations, such as charities, not IRAs, so you'll have to read around to find the sections that apply to investments you are considering. Partnership issues are discussed on page 13 of that publication in the current edition as of the date this report was completed.

Putting Real Estate, Mortgages, and Other Assets in an IRA

Most IRAs are allowed to invest only in publicly traded stocks and bonds or in mutual funds. They aren't able to invest in other assets. ***These restrictions are imposed by the custodian of the IRA, not by the tax law.*** Each IRA is required to have a custodian or trustee that meets qualifications in the tax code. These usually are financial services companies, such as banks, insurance companies, brokers, trust companies, and mutual fund companies.

An IRA custodian is allowed to put restrictions on accounts it supervises that are in addition to the tax law's restrictions. Many custodians limit the range of investments permitted in their IRAs. Most IRAs are allowed to be invested only in publicly traded stocks and bonds and in widely available mutual funds. The restrictions are imposed because holding other assets would increase costs to the custodian and require them to add additional infrastructure to handle these assets.

Yet, the law allows an IRA to be invested in a wide range of assets, essentially any investment that does not run afoul of the prohibited investment and prohibited transaction rules already discussed. Legally, an IRA can invest in real estate, private companies, hedge funds, separately managed accounts, mortgages, and a host of other assets. The tax law is far more flexible than most IRA custodians.

There are some IRA custodians who will allow their accounts to be invested in these other assets. These custodians charge higher fees to open and operate their accounts and impose fees for transactions that may be free at other custodians when the more liquid assets are involved. In addition, the owner must know the tax law restrictions already discussed and take some practical steps to receive full advantage of the flexibility offered by the unconventional IRA custodian. The IRA owner is responsible for complying with the law; the custodian doesn't vet the transactions before executing them. A false step when venturing into unconventional IRA investing could result in substantial penalties.

Include Unconventional Assets in the IRA

An IRA that allows unconventional or nontraditional assets is what I call a **true self-directed IRA**. Many financial institutions have IRAs that they label "self-directed." Their meaning is that the IRA owner can choose how the account is invested from among publicly traded stocks and bonds plus the mutual funds on the institution's approved list. A true self-directed IRA is much more flexible and has a broader range of permitted investments. The custodian of a true self-directed IRA allows the owner to purchase all or almost all legal investment assets.

True self-directed IRAs are not widely available, but there are a small number of IRA custodians that offer such accounts. Several of them have been in this business for decades. They started offering self-directed IRAs in the 1970s and 1980s when people wanted to put real estate and energy limited partnerships in their IRAs. These custodians can be located by typing "self-directed IRA" in your favorite Internet search engine.

Self-directed IRA custodians charge more for their services than do regular custodians. They also charge transaction fees exceeding those on conventional IRAs. Self-directed IRAs and their transactions also have additional paperwork requirements. These factors make the true self-directed IRA impractical for small IRAs and for investment strategies that generate a large volume of transactions in unconventional assets.

Keep in mind that the IRA custodian does not vouch for the investments you select. The custodian simply charges a fee for executing the transactions you direct, and it complies with IRS custodian and paperwork requirements. Some of the custodians may warn you that a transaction looks like it may be a prohibited investment or generate UBTI. But they aren't obligated to and don't take responsibility for your running afoul of those rules or the prohibited transaction rules.

The custodians also don't ensure your selected investments are legitimate. When you invest in nontraditional assets such as small businesses and separately managed accounts, you are more likely to be snared by fraudulent enterprises. For example, the historic Ponzi scheme of Bernard Madoff siphoned off a lot of IRA money. Investors who had most of their assets in IRAs were referred by Madoff to a particular self-directed IRA custodian. Those investors sued the custodian for failing to ensure that Madoff was legitimate and invested their assets as advertised. The custodian's defense is that it had no responsibility other than to process the transactions as directed by the IRA owners and it could accept Madoff's statement of how much he held for each account.

While the custodian allows you to invest in a small business, doing so could run afoul of the UBTI limit or could be a prohibited transaction. Also, each transaction you make could be assessed a fee. Too many fees make owning the investment through the IRA impractical. The custodian also is required to determine the value of your account each year and may charge you to perform an appraisal or otherwise determine the value of assets that aren't publicly traded.

Adding an LLC

Many of the apparent disadvantages of the self-directed IRA can be reduced or eliminated by taking another step in the creation and management of the IRA.

The IRA owner can create a **limited liability company**, and that company can be wholly owned by the IRA. The LLC creates its own bank and investment accounts. All the investment transactions are made through the LLC's accounts instead of through the IRA itself. The LLC is a separate taxpayer and investor, and the IRA simply owns the LLC the way a conventional IRA might own Microsoft or GE.

The LLC can buy any investment that is suitable for an IRA using its own funds and accounts. (It still cannot purchase investments that are prohibited for IRAs without triggering penalties.) Some people refer to this as the Checkbook IRA, because all the IRA investments are made through the LLC's checkbook or other financial account. Others refer to such structures as a Super IRA, Secret IRA, or LLC IRA. All these describe a true self-directed IRA that invests in unconventional assets through a wholly-owned limited liability company.

Through the LLC, the IRA can invest in real estate, hedge funds, private equity funds, small businesses, and other nontraditional IRA assets.

To review, here are the steps for investing an IRA in unconventional assets and in a way that limits IRA fees.

1. Select a true self-directed IRA custodian.
2. Transfer current IRA assets to the new custodian. All IRAs can be consolidated with the new custodian, only one IRA can be transferred, or any combination of IRAs can be transferred. Qualified employer retirement plans can be rolled over to the IRA. It is up to the owner.
3. Form an LLC. This includes creating the organizational documents, registering with the state, paying the state registration fee, getting an employer ID number from the IRS, and opening up a bank account or other financial account in the name of the LLC.
4. Have the IRA invest in and become sole owner of the LLC.

5. The IRA owner controls the LLC as managing member and makes all the IRA's investments through the LLC. The LLC can open a regular brokerage or mutual fund account, buy real estate, or make a number of other investments.
6. Prepare a tax return each year for the LLC. There shouldn't be any taxes due, if the LLC elects to be a "pass through" entity taxed as a partnership. All income, gains, and losses flow through to the LLC owner, which is the IRA. The IRA, of course, does not pay taxes except on UBTI, prohibited investments, and prohibited transactions.

Creating and managing the LLC are not essential to holding unconventional assets in an IRA. The assets can be purchased directly by a true self-directed IRA.

If the goal is to have the IRA own one or two specific pieces of real estate, for example, the owner might want to avoid the work involved in creating the LLC. If the owner plans a number of different investments and wants to reduce IRA fees and paperwork, creating the LLC might be in order.

Every step must be taken properly to produce the desired results and avoid penalties. Only an experienced self-directed IRA custodian should be used. The LLC should be created and managed only with the help of an attorney who knows the IRA rules. ***The LLC documents must have certain language to avoid being a prohibited investment by the IRA.*** Without the language, the plan could result in UBTI taxes and penalties. There are consulting firms that help with the process and make referrals to experienced attorneys. They can be found on the Internet or through referrals from the IRA custodians.

Keep in mind that all the UBTI, prohibited investment, and prohibited transaction rules apply to the LLC’s activities. Creating the LLC is primarily a way to reduce fees, not a way to get around the IRA rules.

Protecting IRA Assets

An additional benefit of an LLC IRA might be asset protection. In most states the LLC offers a layer of asset protection that is better than that of an IRA. This might be less important since the federal asset protection rules for IRAs were tightened a few years ago, but that protection applies only to actions in federal bankruptcy court. In other situations, the IRA is protected only by state law, and there are states where an IRA has limited protection outside of federal bankruptcy court. The extra layer of protection of an LLC might be a comfort. With an LLC, the creditor is at a disadvantage even if it wins a judgment against the IRA owner and can force distributions from the IRA. State law still might prevent the creditor from forcing a distribution from the LLC to the IRA. All the creditor could do is wait until the LLC makes a distribution to the IRA. The LLC doesn't have to be formed in the owner's state of residence. It can be formed in a state with strong asset protection.

Both traditional and Roth IRAs can use the LLC IRA strategy and the self-directed IRA strategy. The same rules also apply to virtually any qualified retirement plan. Someone who owns a business and controls how the 401(k) or other retirement plan is set up might want to create a true self-directed plan. In addition, recent tax laws created the single-person 401(k) plan. Set up the 401(k) with a true self-directed custodian, and the additional investment opportunities are available through a 401(k) plan.

Navigating Some More Hazards

The IRS has a range of other, less specific rules it can use to disrupt IRA transactions or investments it does not like.

For example, suppose the IRA engages in a transaction with someone who is related to the owner but does not fit the tax code definition of a related party or disqualified person under the prohibited transaction rules. ***The IRS can argue the transaction was not done at market value, so the IRA owner used the IRA to make a gift to that person.*** If the transaction was large enough, the IRS can impose gift taxes or require the IRA owner to use part of his or her lifetime gift tax exemption.

Here’s another difficult situation. Suppose a true self-directed IRA owns a real estate rental property. The owner personally does work on the property to maintain and improve it but does not receive compensation from the IRA for the work. (Taking a payment for personal services could run afoul of the prohibited transaction rules discussed earlier.) ***The IRS could claim that the owner's work was actually a contribution to the IRA, because it benefited the IRA.*** The contribution could be improper if the taxpayer already made the maximum contribution for the year. Alternatively, the IRS could argue it was the owner's efforts that produced any increase in the property’s value. It would then attribute that increased value or income to the owner instead of the IRA and require the owner to pay income taxes on that amount. The IRS even could attribute ownership of the property to the IRA owner and hold the owner responsible for taxes on all income earned by the property and even self-employment taxes. It is important to follow all the tax rules precisely and keep excellent records when making unconventional use of an IRA.

The IRS also uses the **anti-tax shelter "listed transaction" rules** against IRAs, especially Roth IRAs. The IRS believes that some taxpayers are using Roth IRAs improperly to shift business income to the IRA. In Notice 2004-8, the IRS issued a list of transactions between owners and Roth IRAs that it considers to be tax shelters that must be reported and against which the IRS is allowed to use greater weapons than are available against other transactions.

The IRS takes these actions in only a few situations where it believes the IRA owner is misusing the IRA or taking advantage of the tax law. But they show the IRS can be creative, and you or your tax advisor also must be creative when considering a proposed IRA transaction and deciding whether or not it is allowed under the tax law.

<u>Biography</u>

Bob Carlson is editor of the monthly newsletter and website, <u>*Retirement Watch.*</u> He has served on the Board of Trustees of the Fairfax County Employees' Retirement System since 1992 and been chairman since 1995. The system has more than $4 billion in assets. Carlson was a member of the Board of Trustees of the Virginia Retirement System, which oversaw $42 billion in assets, from 2001-2005. He was appointed to the Virginia Retirement System Deferred Compensation Plans Advisory Committee in 2011.

His latest book is the revised edition of "The New Rules of Retirement" (Wiley, 2016; first edition 2004). He also co-authored "Personal Finance after 50 for Dummies" (with Eric Tyson; Wiley, 2015) and wrote "Invest Like a Fox…Not Like a Hedgehog" (Wiley, 2007).

He has written numerous other books and reports, including "The New Rules of Estate Planning," "Securing Your Lifetime Stream of Income," "Tax Wise Money Strategies, Retirement Tax Guide," "How to Slash Your Mutual Fund Taxes," "Bob Carlson's Estate Planning Files" and "199 Loopholes That Survived Tax Reform." He also has been interviewed by or quoted in numerous publications, including *The Wall Street Journal*, *Reader's Digest*, *Barron's*, *AARP Bulletin*, *Money*, *Worth*, *Kiplinger's Personal Finance*, the *Washington Post*, and many others. He has appeared on national television and on a number of radio programs. He is past editor of *Tax Wise Money*.

Carlson also was a Commissioner on the Fairfax County Redevelopment and Housing Authority. Carlson is an attorney and passed the CPA Exam. He received his J.D. and an M.S. (Accounting) from the University of Virginia and received his B.S. (Financial Management) from Clemson University. He also is an instrument rated private pilot. He is listed in many editions of *Who's Who in America* and *Who's Who in the World*.