Self-Directed IRAs: A Tax Compliance Black Hole

Nontraditional investments favored by many self-directed IRAs can lead to unexpected taxation of unaware IRA account holders.

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The appeal of investing retirement funds outside of the typical securities market has driven a surge in the use of self-directed IRA (SDIRA) investment structures. These structures come in various forms, but they all start when an IRA account holder forms an SDIRA with a custodian (e.g., a bank or trust company) that is amenable to holding “nontraditional” types of investments. In other words, the feature that makes an IRA “self-directed” is not its general legal framework, but rather the fact that the SDIRA’s custodian permits a wide array of investments and maximum control by the account holder.

Investments within SDIRAs frequently include real estate, closely held business entities, and private loans and can include any other investment that is not specifically prohibited by federal law—anything other than life insurance and collectibles can be held in an SDIRA. The SDIRA itself can be structured as a self-employed plan (SEP), a savings incentive match plan for employees (SIMPLE), or a traditional or Roth IRA, and is normally funded by a transfer from an account holder’s other IRA or a rollover from a qualified retirement account (e.g., a 401(k)). However, one common theme is that the IRA account holder wants to diversify away from 100% stock market-based investments and/or believes that better investment returns exist outside the securities market.

Once the SDIRA is formed and funded, there are two general options for investing the SDIRA’s cash. The account holder can either instruct the custodian to execute an investment directly out of the SDIRA, in which case the SDIRA becomes the legal owner of the asset, or the account holder can invest substantially all of the SDIRA’s assets into a limited liability company (LLC). In the latter case, the SDIRA is usually, but not always, the 100% owner/member of the LLC (SDIRA/LLC). The SDIRA/LLC can then execute investments, generally with the LLC’s manager as the SDIRA account holder, and thus the LLC becomes the legal owner of the asset in question (e.g., real estate). Both investment methods are legally viable, but each leads to legal and tax challenges.

Based on the author’s conversations with thousands of SDIRA and SDIRA/LLC investors (and their advisers) throughout the country, without a doubt there are significant tax compliance problems within this colorful marketplace. In fact, it is likely that less than 50% of SDIRA and SDIRA/LLC investors handle the legal and tax issues correctly, and many of these investors are unaware that these problems even exist. Unfortunately, these pitfalls can result in the complete invalidation of the SDIRA due to a “prohibited transaction” and/or current tax consequences within the SDIRA itself.

The following two examples, which are based on real-life client scenarios (although details have been changed to protect client confidentiality), illustrate issues clients and their tax advisers must be aware of when investing using an SDIRA or SDIRA/LLC. Ideally, these traps are considered before venturing into the world of nontraditional retirement account investing.

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Example 1: IRA Invests in Closely Held Business Entity (Toy Company)

Setup. Sarah was a high-net-worth individual and a valued client of a multinational bank's private trust company. Although the trust company did not routinely facilitate the investment of IRA funds into nontraditional investments, Sarah requested that her IRA invest $500,000 into a new LLC.

The investment gave Sarah's SDIRA a 25% ownership interest in the LLC, and the trust company held all of the paperwork for the LLC unit purchase on the SDIRA's behalf. The LLC had three other owners, not related to Sarah, and none of the other investors were co-owners with her in any other business entity. Sarah was not involved in the LLC's day-to-day operations and did not otherwise personally benefit from the investment.

Investment. The LLC designed, manufactured, and sold children's toys. The toys quickly became hot sellers, and the LLC recorded a significant profit on its annual Form 1065, U.S. Return of Partnership Income. In turn, each investor, including Sarah's SDIRA, was issued yearly Schedules K-1, Partner's Share of Income, Deductions, Credits, etc., which showed ordinary business income. In Sarah's case, the K-1 forms were mailed directly to the trust company.

Legal and tax problems. Two fundamental legal and tax issues must be considered with any SDIRA investment. First, the SDIRA's investment could raise a prohibited transaction problem under Sec. 4975. If the investment is not a prohibited transaction, the second consideration is whether the SDIRA's investment results in current tax to the SDIRA as a result of unrelated business taxable income (UBTI) or unrelated debt-financed income (UDFI).

Sec. 512 imposes a tax on income earned by a tax-exempt organization in a trade or business that is unrelated to the organization's exempt purpose (UBTI). Unrelated debt-financed income (UDFI) under Sec. 514 is income earned by an exempt organization from property used for a nonexempt purpose that has been acquired by incurring debt. Although the prohibited transaction analysis involves many intricacies and hidden traps, this example assumes, based on the fact that Sarah's SDIRA investment did not directly involve or benefit a "disqualified person" (Sec. 4975(e)(2)), that the investment did not result in a prohibited transaction. The UBTI and UDFI issues, however, turn out to be much more problematic for Sarah.

Most IRA investments do not trigger current tax consequences, not because all income an IRA earns grows tax free, but because the types of income that an IRA typically earns are exempt from UBTI rules. For example, IRAs that invest in publicly traded securities (e.g., stocks, bonds, and mutual funds) do not owe current tax because gains from the sale of C corporation stock, dividends, and interest income are exempt from UBTI. For this reason, most IRA investors are unaware that an IRA can be required to file a tax return (Form 990-T, Exempt Organization Business Income Tax Return) and pay tax. The two key trigger events for current IRA tax consequences are (1) income from a business that is regularly carried on (whether directly or indirectly) and (2) income from debt-financed property.

Here, Sarah was shocked to discover, five years into the toy company's operations, that her SDIRA not only owed taxes on the LLC's yearly profit, but the tax rate on income over $9,750 was 35% (in 2005 when this tax liability was incurred) because IRAs are taxed at trust rates. (In 2013, trust income above $11,950 is taxed at the new, higher 39.6% rate.) Although Sarah's SDIRA benefited from the profitable investment, the SDIRA owed hundreds of thousands of dollars in income tax, penalties, and interest.

Compliance black hole. Several factors contributed to Sarah's failure to comply with her tax obligations. First, Sarah was unaware of and uninformed about SDIRA legal and tax issues before her SDIRA invested in the toy company. This normally occurs when an IRA account holder learns that an IRA can invest in almost any type of asset (which is technically true), gets excited about an investment opportunity, and then quickly sets up an SDIRA. Second, as is typically the case, the IRA custodian refuses to take any responsibility and includes language with its IRA custodian agreement stating that all legal and tax consequences of the SDIRA's investments are the IRA account holder's sole responsibility.

In fact, it is common for IRA custodians to receive tax documents (e.g., Schedules K-1) and send copies to the SDIRA owner without mentioning the potential UBTI tax consequences. Of course, the SDIRA custodian will claim that it cannot provide this guidance because it could be construed as legal or tax advice, but these same custodians actively promote the idea of nontraditional investing. The result is that SDIRA custodians frequently facilitate IRA investments that will undoubtedly trigger UBTI, but then avoid all responsibility when these tax consequences occur. In addition, because an IRA is not generally required to file a tax return and IRA account holders and their advisers are normally unfamiliar with these issues, no one is likely to realize that a tax has been triggered—including the IRS.

Example 2: IRA-Owned LLC Invests in Real Estate Partnership

Setup. Mark, a retired airline pilot with $1.5 million in his 401(k) account, was afraid of another stock market meltdown and viewed real estate investments as a safer alternative and a diversification technique for his retirement savings. After learning about SDIRAs from a friend, he did some preliminary research online. Mark quickly found numerous IRA custodians and companies that promoted "checkbook control IRAs" (i.e., the SDIRA/LLC concept discussed above) and decided that the lower annual custodian fees and overall control made the SDIRA/LLC the best option for him.

Mark executed a partial rollover of his 401(k) account into his new SDIRA. Subsequently, the SDIRA invested all but $300 into a newly formed LLC, thus creating an SDIRA/LLC structure (it is typical to leave the smallest amount of cash in the IRA as possible). From there, the IRA custodian had very little involvement because all of the investments were made at the LLC level, with Mark facilitating transactions as the LLC's sole manager.

Investment. Mark's goal for his SDIRA/LLC was to invest in residential rental real estate, either directly out of the LLC or through a "project LLC" (i.e., a partnership) with other investors. Mark found a real estate investment group that frequently organized partnerships and promised a "passive" investment (i.e., no direct involvement by Mark). The group also told Mark that "our partnerships are perfectly acceptable self-directed IRA investments." The real estate partnerships collected capital contributions from 20 investors and used the cash plus debt to purchase an apartment building. The apartment building was held as a rental property, with net income distributed to the investors, including Mark's SDIRA/LLC, quarterly.

Legal and tax problems. As stated above, it is possible for an SDIRA to invest in almost anything, and thus the investment organizer's statement that real estate partnerships are acceptable SDIRA investments is technically correct. However, this does not answer the question of whether there are more difficult legal or tax issues. For example, "rent from real property" is normally exempt from UBTI, and thus is not currently taxable when earned by an SDIRA or SDIRA/LLC. However, income from debt-financed property (whether held directly or indirectly by the SDIRA or SDIRA/LLC) is partially taxable under the UDFI rules because the income generated from the investment is not earned solely by investment of the SDIRA/LLC's capital, but rather by bank (or private) financing.

Here, the yearly rental income that is allocated to Mark's SDIRA/LLC is partially subject to tax under the UDFI rules. Fortunately, the tax consequences will likely be minimal due to the flowthrough of other tax items (e.g., depreciation) from the real estate held by the partnership. However, the SDIRA will likely be required to file a Form 990-T, and, even if no tax is due, it is likely a good idea to file the tax return so that the sale proceeds from the underlying apartment building (which will also be partially taxable due to the debt financing) are offset by the past losses.

Compliance black hole. The SDIRA/LLC structure in and of itself presents legal and tax compliance problems because the actual investments are outside of the IRA custodian's view (however, as mentioned in Example 1, the custodian's being directly involved is not a guarantee that legal and tax problems will not occur). This is particularly the case if the SDIRA/LLC is established by a low-cost promoter who cares more about "the sale" than providing the IRA account holder/LLC manager with appropriate advice. Also, because the SDIRA/LLC promoters are normally not law or accounting firms, they arguably should not be providing any advice whatsoever, and, even if they do, that advice cannot be relied upon by the IRA account holder. This has the potential to create a situation where an SDIRA/LLC is established for an IRA account holder who cannot handle the complexity of the structure and who has no way of finding help that he or she can reasonably rely upon.

Here, the LLC owned by Mark's SDIRA will be considered a "disregarded entity" for federal tax purposes, and thus will not be required to file a tax return. In addition, if Mark is unaware that the debt financing at the real estate partnership level is triggering current tax consequences to his SDIRA, he will not file a Form 990-T either.

HOW TO PROTECT SDIRA INVESTOR CLIENTS

The above examples demonstrate some (but certainly not all) of the potential problems that clients could face if they decide to invest their retirement account in “nontraditional” assets. Protecting clients from the perils of the SDIRA compliance black hole requires several essential steps.

First, before doing anything, the client (and likely his or her CPA and attorney) needs to get up to speed on the unique SDIRA legal and tax complexities. Care should be taken when relying on the statements of custodians and SDIRA/LLC facilitators, as they often are incorrect, incomplete, and/or biased in a way that promotes the particular company’s best interest (e.g., custodians promote the SDIRA because it results in more ongoing fees; facilitation companies promote the SDIRA/LLC because a basic SDIRA alone cuts them out of the equation).

In addition, the basic legal framework can sometimes seem relatively straightforward (e.g., no financial interactions with a disqualified person), but, as is often the case with tax law issues, the more subtle issues are misunderstood by casual observers (e.g., no direct or indirect personal benefits to a disqualified person). For example, see a recent Tax Court case in which two taxpayers personally guaranteed a loan to a company that their SDIRAs owned. The court held that the loan guarantee was a prohibited transaction, which caused the accounts to cease to qualify as IRAs. As a result, the sale of the company stock held in the SDIRAs was directly taxable to the taxpayers (and each taxpayer was liable for an accuracy-related penalty of more than $45,000) (Peek, 140 T.C. No. 12 (2013)).

Tax advisers can also protect clients from the dangers of SDIRA or SDIRA/LLC investing by putting an intensive focus on recordkeeping and, specifically, making sure that “every dollar in and every dollar out” of the SDIRA or SDIRA/LLC is accounted for. This might sound straightforward, but when the client controls numerous entities and/or real estate properties and the SDIRA gets involved in a venture similar to one the client is involved in directly, things can get messy. Commingling of SDIRA and personal assets is almost surely a prohibited transaction, and even what might appear to be a “minor” prohibited transaction can invalidate the client’s entire SDIRA. What makes good recordkeeping even more challenging is the fact that many SDIRA account holders plan to invest using an SDIRA for 20 or more years. In other words, for many clients, getting their retirement funds out of the stock market and into nontraditional assets is not a one-time transaction—it is a fundamental change in their investment plan.

Tax advisers can also protect their clients by asking what their long-term plans are for an SDIRA. Many clients rush into SDIRA or SDIRA/LLC investments without considering any of the following issues:

Will additional contributions or rollovers to the SDIRA be made, and, if so, how can those contributions be legally incorporated into the structure as a whole?

What happens to the SDIRA’s investments if the client dies? (Note: Estate planning raises several challenges with SDIRAs, e.g., how illiquid assets are divided among beneficiaries; who will manage the assets; and whether the beneficiaries understand the legal complexities of the SDIRA/LLC and can manage them accordingly; etc.)

What if the client wants to take a distribution of one of the SDIRA's assets "in kind"?

How is the SDIRA's value determined for purposes of a Roth conversion and/or required minimum distributions (i.e., withdrawals that must be made after the client turns age 70½)?

These issues, along with many others, should be considered and understood before any steps are taken to form and/or invest using an SDIRA or SDIRA/LLC.

In short, the world of SDIRA and SDIRA/LLC investors is growing rapidly, and advisers must understand the potential pitfalls those investment vehicles pose for clients. The tax adviser's role is particularly critical, given the lack of oversight by SDIRA custodians and SDIRA/LLC promoters and the potential for increased IRS scrutiny.