Don’t Let Clients’ Retirement Fall into This Trap

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Have you ever been at a party where the owner of a company was bragging about how he used a 401k to start his business? Or heard a story about how a couple’s individual retirement account (IRA) is invested in real estate and that’s going to allow them to live in the lap of luxury when they retire?

They’re talking about self-directed retirement vehicles. And much like real vehicles, when they are driven improperly, the result can be disaster.

What Are Self-Directed Retirement Vehicles?

Self-directed IRAs and self-directed 401ks are increasingly popular. While the usual custodians of IRA and 401(k) accounts will only allow certain investments (e.g., stocks, bonds, etc.), a self-directed IRA or 401(k) allows the owner to invest in such things as real estate, precious metals, businesses, etc. and make all the investment decisions. Profits from the investment build up tax-free until the owner reaches retirement and begins to take distributions, usually when the owner’s tax rate is much lower. Sounds good, right? What could go wrong?

Well, actually, a lot can go wrong. As a matter of fact, if you have clients in one of these situations, they could lose substantial amounts, if not all, of their retirement income. How can this happen and what can you do to help?

A Real-Life Example

The main culprit in a self-directed retirement plan gone wrong is the dreaded PT – prohibited transaction. Let’s look at a recent real-life example of how an accountant lost a sizable portion of his retirement account by using a self-directed 401(k).

John (not his real name) owned 100 percent of his accounting firm. The firm had a 401(k) profit-sharing plan, known as Kaplan 401(k). John, as the sole trustee and administrator of the 401(k), was responsible for investing, managing and controlling the plan's assets. Kaplan 401(k) lent money to a restaurant, a golf club and a corporation. John owned minority interests in all three. Unfortunately, the loans were considered prohibited transactions. By failing to file tax returns reporting these prohibited transactions, John ended up paying more than $200,000 in excise taxes and penalties.

What Is a Prohibited Transaction?

Code Section 4975 imposes a tax on a disqualified person who participates in a prohibited transaction. A disqualified person includes a plan fiduciary, a person providing services to a plan and an employer whose employees are covered by a plan. The following are considered prohibited transactions:

- sale or exchange, or leasing of any property between a plan and a disqualified person;

- lending money or other extension of credit between a plan and a disqualified person
- furnishing of goods, services, or facilities between a plan and a disqualified person
- transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;
- an act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account; or
- receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

Thus, for example, where a self-directed retirement plan pays investment management fees to an entity managing investments in the plan, as well as investments outside the plan in which the owner of the self-directed IRA has an interest, this would be a prohibited transaction. Or, if the entity managing the investments also has an interest in the same investments, this would be a prohibited transaction.

Consequences of Participating in a Prohibited Transaction

A disqualified person who takes part in a prohibited transaction must correct the transaction and pay an excise tax based on the amount involved in the transaction. The initial tax on a prohibited transaction is 15 percent of the amount involved for each year (or part of a year) in the taxable period. If the transaction is not corrected within the taxable period, and most often it is not, an additional tax is imposed… at ONE HUNDRED PERCENT. Yes, you read that right. So, if the amount of the prohibited transaction is $100,000, the tax could be as high as $115,000.

Both taxes are payable by any disqualified person who participated in the transaction (other than a fiduciary acting only as such). If more than one person takes part in the transaction, each person can be jointly and severally liable for the entire tax.

Not all prohibited transactions can be fixed. In that case, not only will the prohibited transaction penalties apply, the retirement fund will lose its tax-exempt status and the entire fund is considered distributed and subject to income tax. To put a cherry on top of all of this, if the taxpayers haven't yet reached age 59 ½, they will also be subject to a 10 percent early distribution penalty.

Fixing a Prohibited Transaction

If you have a client who participated in a prohibited transaction, the 100 percent tax can be avoided by correcting the transaction as soon as possible. If the prohibited transaction is not corrected during the taxable period, the disqualified person usually has an additional 90 days after the day the IRS mails a notice of deficiency for the 100 percent tax to correct the transaction. When this happens, the best course of action is hiring a professional who is trained in the Employee Retirement Income Security Act to help undo the transaction.

Obviously, it's best if a prohibited transaction doesn't occur at all. As their go-to trusted adviser, make sure you are educating clients who have self-directed IRAs or 401(k)s. Take your knowledge in retirement planning deeper by accessing the *CPA's Guide to Retirement Planning*, created by the AICPA Personal Financial Planning Division.

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