

IRA and QRP Prohibited Transactions



Learning Objectives

- ✔ Understand the sources of prohibited transaction rules
- ✔ Differentiate between different kinds of prohibited transactions and penalties
- ✔ Identify how to prevent prohibited transactions
- ✔ Recognize the concepts of unrelated debt-financed income (UDFI) and when it applies

Background



Background:

Why Do We Have Prohibited Transaction Rules?



Ensure transactions benefit plans, not owners



Prevent misuse of plan assets and conflicts of interest



Prevent unwarranted risks with assets



Prevent self-dealing by persons holding key positions (disqualified persons)



Ensure main purpose of plan is to maximize accumulation of retirement assets

Test Your Instincts #1

Gabby, whose business isn't doing well, uses her employees' 401(k) deferrals to cover payroll until business improves.

Prohibited Transaction

Not a Prohibited Transaction



Test Your Instincts #2

William directs his IRA custodian to purchase investment property, which the IRA owner expects to appreciate substantially in value over time. There will be no personal use of the property by William or his family. William will manage the property and make most of the repairs.

Prohibited Transaction

Not a Prohibited Transaction



Test Your Instincts #3

Katie gives \$25,000 from her self-directed IRA to her brother, Raymond, as a personal loan. Raymond signs a promissory note stating that he will make loan payments directly to the IRA custodian at a reasonable stated rate of interest.

Prohibited Transaction

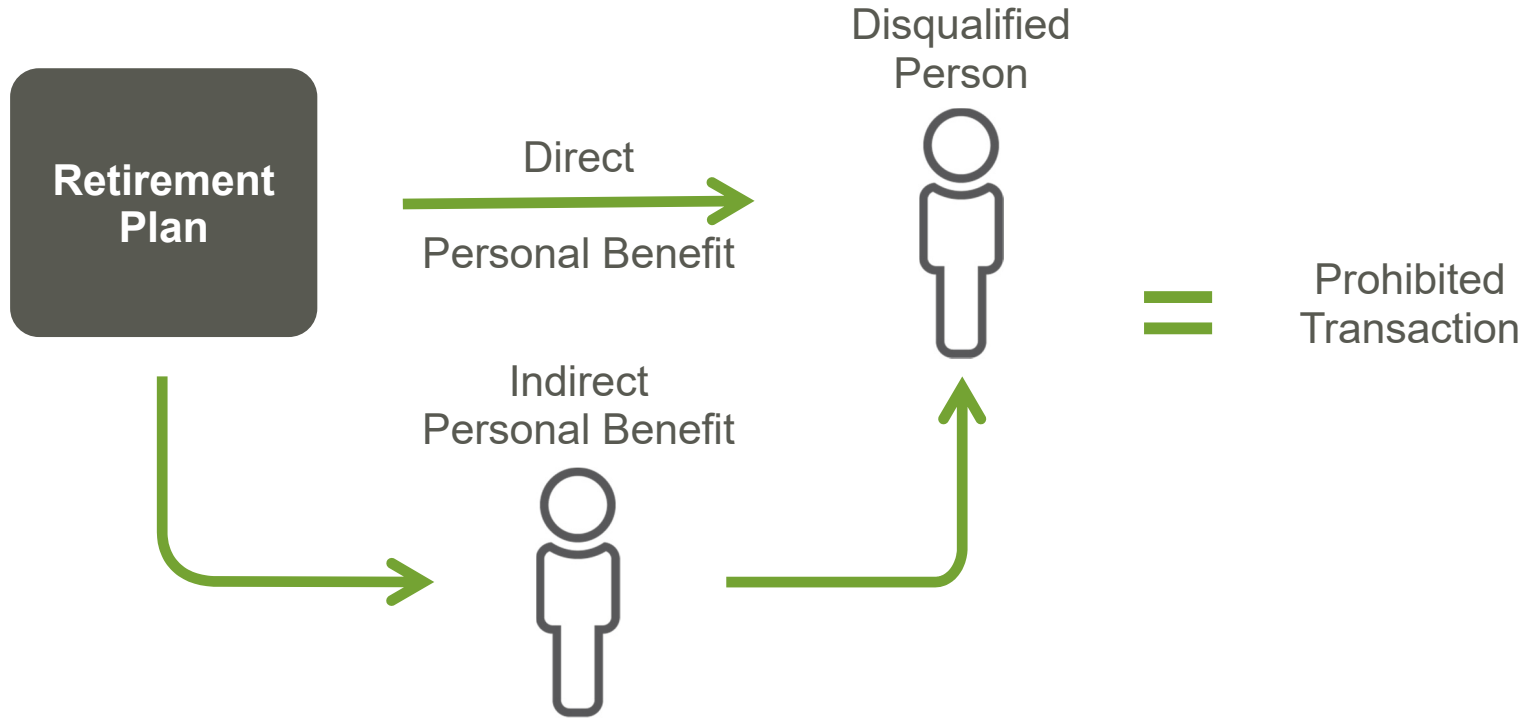
Not a Prohibited Transaction



Prohibited Transaction Ground Rules



Prohibited Transaction Ground Rules



Indirect Prohibited Transaction Example

John Robinson, employer, used his profit sharing plan assets to invest in an apartment building. He now wants to purchase the building from his profit sharing plan. John directs his plan trustee to sell the property to Joe Smith, a person unrelated to John. John agrees to purchase the property from Joe after the sale is completed. The result is still a prohibited transaction because John cannot circumvent the prohibited transaction rules merely by bringing in a third party.



What Is a Plan?



401(a) plans

(i.e., pension, profit sharing, including 401(k) and stock bonus plans)



Traditional IRA



Roth IRA



HSA & MSA



SIMPLE IRA



Coverdell ESA

Who Is a Disqualified Person?



Who Is a Disqualified Person?



- Plan participants
- IRA owners
- Beneficiaries



Service providers
(e.g. trustees or
custodians)



Employers
(including owners
of the business)



Employee
organizations that
have members
covered under the
plan (e.g. unions)

Who Is a Disqualified Person?



50% owner
of a company



Family member
of plan
participant or
IRA owner



50% owner
by a family
member



A company's
officers, directors,
10% or more
shareowners, or
highly compensated
employees



10% or more
owner of a
company

Ancestors/Lineal Descendants



IRA owner's grandparent

IRA owner's parent

IRA owner
(and IRA owner's spouse)

IRA owner's child
(and child's spouse)

IRA owner's grandchild
(and grandchild's spouse)



What Transactions Are Prohibited?



Sale, exchange, or leasing of any property between a plan* and a disqualified person



Lending of money or other extension of credit



Furnishing of goods, services, or facilities

*“Plan” means an employer-sponsored plan or an IRA.

What Transactions Are Prohibited?



Transfer to, or use by or for the benefit of, a disqualified person of a plan's income or assets



Act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in own interest or own account



Receipt of consideration for personal account by disqualified person who is a fiduciary from party dealing with plan in connection with transaction involving income or assets of plan.

Prohibited Transactions: Direct or Indirect?



Removing a disqualified person
from direct involvement
is not a solution



Enlisting a third party
to execute the transaction
does not insulate the parties
from a prohibited transaction

Applying the Prohibited Transaction Restrictions



Applying the Prohibited Transaction Restrictions



An employer working with a custodian or trustee, or a third party, that confines the plan to common or conventional investments, is more likely to stay out of danger.



A self-trusted plan, particularly with no rank-and-file employees, is common target market for boutique service providers that deal in unconventional investments, which may be “gray areas” for prohibited transaction exposure.



Taxpayers inclined to “push the envelope” work with nonbank trustees willing to get involved with and hold unconventional investments.

Sale or Exchange of Assets Example #1

Maude's Traditional IRA holds \$100,000 in cash. Her husband, Jeffrey, owns a local salvage business. Maude directs the trustee of her IRA to purchase a \$50,000 interest in the business.

Maude's IRA purchased an interest in property already owned by her husband—who is a disqualified person—which is impermissible.



Sale or Exchange of Assets Example #2

Michael holds a parcel of land in his owner-only 401(k) plan. Now that he is retiring, he wants to build a retirement home on the property. Michael submits an appraisal to the plan trustee showing that the value of the property is \$100,000, and he sends a cashier's check to purchase the property.

Michael, a disqualified person, purchased land owned by his owner-only 401(k) plan, which is a prohibited transaction.



Lending of Money Example #1

Donny's profit sharing plan account holds over \$200,000 in cash. His father recently started a new business and needs a short-term loan for equipment. Donny offers his father \$50,000 in exchange for a promissory note paying 7% interest in 54 monthly installments.

The lending of money between a plan and a disqualified person (Donny's father) is prohibited.



Lending of Money Example #2

Andrea's Roth IRA holds \$500,000 in cash. Andrea wants the IRA to purchase a new business, but the IRA does not have enough cash to purchase the business outright. Andrea consults with a financial organization that can loan the difference to the IRA. Andrea personally guarantees the debt.

Because a personal guarantee is an extension of credit, a prohibited transaction has occurred.



Furnishing of Goods, Services, or Facilities Example #1

Chloe's IRA purchases 1,000 shares of stock in a golf course so that she may receive a lifetime country club membership.

Because Chloe is a disqualified person, providing her with a free membership would be a prohibited transaction.



Furnishing of Goods, Services, or Facilities Example #2

Mark's IRA purchases a piece of commercial real estate from an unrelated third party. Thereafter, the IRA permits Mark's dental practice to operate out of the property for free.

The furnishing of facilities between a plan and a disqualified person (Mark) is prohibited.



Transfer to or Use of Plan Assets Example #1

Logan is a real estate agent. One of Logan's clients is selling an apartment building and Logan represents the client as the listing agent. Logan uses his IRA assets to purchase the apartment building and earns a commission as the real estate agent on the sale.

The IRA assets are used for the benefit of a disqualified person (Logan), which is a prohibited transaction.



Transfer to or Use of Plan Assets Example #2

Jordan's Traditional IRA holds property. Jordan's son, Will, lives on the property during the summer months when he's not at college.

This plan asset cannot be used by Will, who is a lineal descendant of Jordan, and is, therefore, a disqualified person (Will).



Fiduciary Dealing With Assets in His Own Interest

Example #1

Warren uses \$20,000 of his IRA assets to lend money to a limited liability company that he controls and manages.

Warren, as the IRA owner, is a disqualified person and a fiduciary. IRC Sec. 4975(c)(1)(E) prohibits Warren from dealing with the income or assets of the IRA for his own interest.



Fiduciary Dealing With Assets In Her Own Interest

Example #2

Dr. Regina Snow uses assets from her 401(k) plan to purchase 500,000 shares of a new private medical clinic. Because of this investment, Dr. Snow is elected to the board of directors and is named chief of internal medicine.

Dr. Snow, as the plan owner, is a disqualified person and a fiduciary. IRC Sec. 4975(c)(1)(E) prohibits Dr. Snow from dealing with the income or assets of the 401(k) plan for her own interest.



Receipt of Consideration for Personal Account Example #1

Stationary Plus, LLC, which is owned by Grace's Traditional IRA, hires Grace as a saleswoman on the weekends. Grace makes a commission on any of her sales and also receives an hourly wage paid by Stationary Plus, LLC.

A prohibited transaction occurs upon Grace's receipt of wages or commissions from Stationary Plus, LLC.



Receipt of Consideration for Personal Account Example #2

21st Century Bank is giving away tablets (valued at \$100) to anyone who opens a new IRA with a \$3,000 deposit.

This is a prohibited transaction because consideration is provided for opening the account. The prohibited transaction exemption that might have applied here (PTE 1993-1, which deals with gifts rather than services) does not apply because the tablet is valued at more than \$10.



Real Estate Investments and Prohibited Transaction Issues



Generally a long-term investment

Ways to Invest in Real Estate



Direct ownership



REIT

Real Estate Investment Concerns vs. Tax Benefits



Valuations



Expenses



Management of
real estate



Real Estate Investment Concerns vs. Tax Benefits



Prohibited transactions



Environmental concerns



Unrelated debt-financed income(UDFI)



When Does UDFI Come Into Play With a Real Estate Purchase?



- Not uncommon in the IRA world
- Occurs if property is purchased in an IRA **and** property is partially financed with debt (a mortgage)
- Rental income goes into the IRA and all expenses must be paid from the IRA
- No personal use of the property and IRA owner may **not** make property repairs
- Liquidity considerations
- Annual valuations for Form 5498 reporting

UDFI and Real Estate Purchase Concerns Example

Gwen buys a \$200,000 rental property with her IRA. The average value of her mortgage for 2019 is \$100,000. Gwen received \$20,000 in rental income in 2019. Because her average debt was 50% of the property purchase amount, 50% of the rental income (\$10,000) is taken into consideration when calculating her UDFI for the year.



UDFI and Real Estate Purchase Concerns



UDFI-generated income is currently taxable to the extent it exceeds \$1,000 for the year



Tax is paid by the IRA



Tax rates for trusts and estates apply



IRA trustee/custodian files Form 990-T to pay the tax

A man wearing a straw hat and a short-sleeved plaid shirt is watering plants in a garden. He is holding a hose and a watering can. The background shows a house and trees. The entire image has a blue tint.

Prohibited Transaction Prevention, Penalties, and Correction

Prohibited Transaction Prevention, Penalties, and Correction



Take the time to understand the nature of prohibited transactions and how they tend to arise



Avoid making any kind of prohibited transaction determination



Advise clients to seek their own competent tax, legal, and accounting professionals

Prohibited Transaction Prevention, Penalties, and Correction



Obtain specific
written direction
and/or hold
harmless
agreement



Refuse to permit
client's suspected
prohibited
transaction



Resign as trustee
or custodian

Prohibited Transaction Penalties



Qualified retirement plan
penalties and IRA
penalties differ

IRA Penalties for Prohibited Transactions

IRC Sec. 4975 prohibited transaction



IRA deemed distributed as of first day of year in which prohibited transaction occurred if prohibited transaction committed by IRA owner or beneficiary



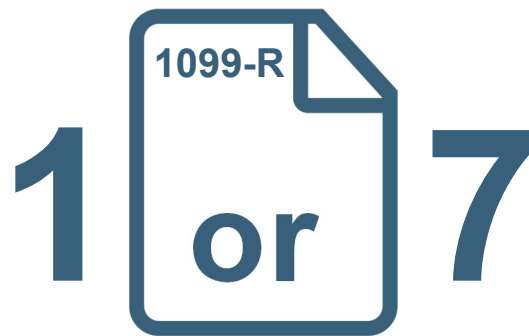
Enter code 5 on IRS Form 1099-R to report distribution

IRA Penalties for Prohibited Transactions

IRC Sec. 4975 prohibited transaction



Pledging IRA as security for a loan: only that portion of IRA pledged as security is deemed distributed



Enter code 1 or code 7 on Form 1099-R to report distribution

QRP Penalties for Prohibited Transactions

15%

Initial penalty tax on disqualified person = 15% of amount involved

100%

Additional penalty tax on disqualified person = 100% of amount involved



Potential plan disqualification



Disqualified person should file Form 5330 to report payment of penalty tax

Self-Correcting Certain Prohibited Transactions



Breaching party (fiduciary) is responsible for making the plan whole



PPA allows individuals to “self-correct” certain transactions within 14 days, however...



...no self-correction for real estate transactions, or where individual “knew or should have known” transaction was prohibited

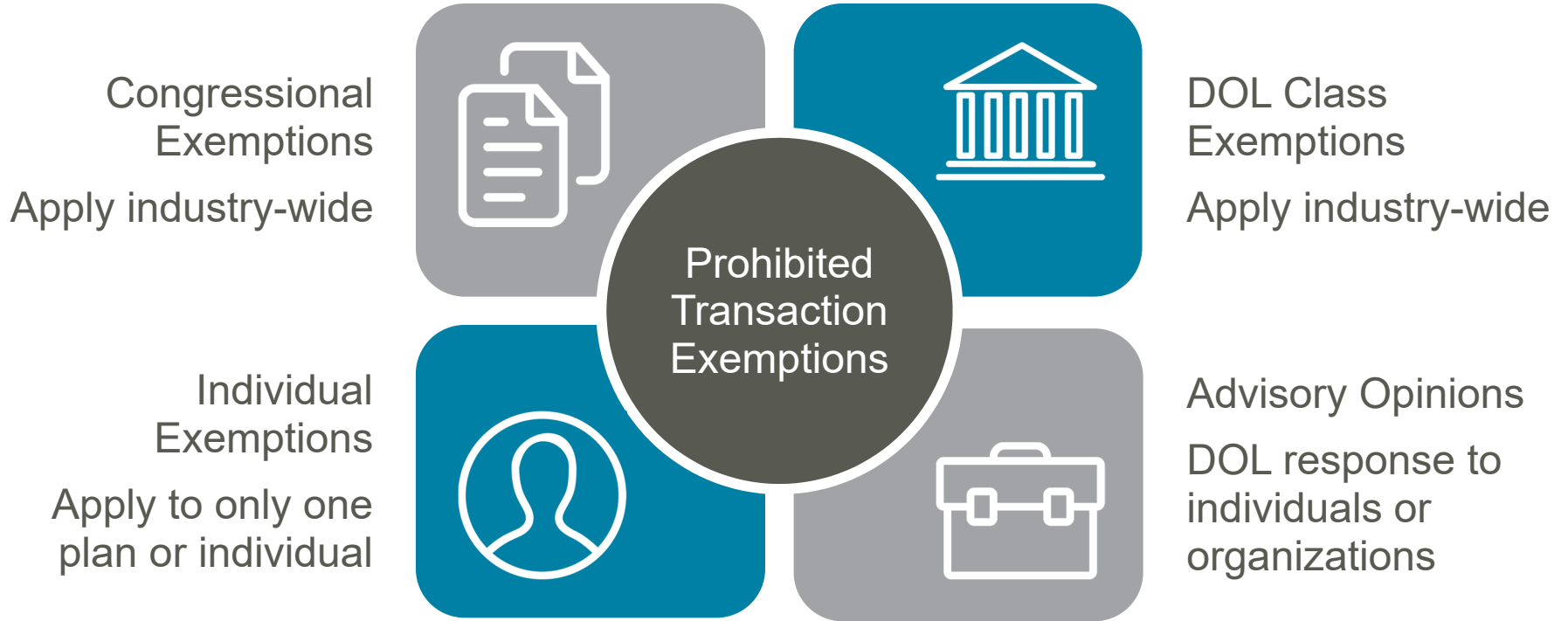


May involve disgorging “profits” even if plan was not harmed

Prohibited Transaction Exemptions



Prohibited Transaction Exemptions

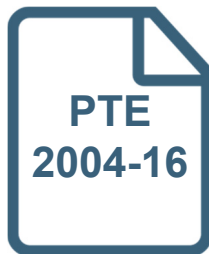


Statutory Exemptions



- Loans (if detailed requirements met)
- Providing office space or legal, accounting, and other necessary services for reasonable compensation
- Deposits in bank accounts or life insurance where the bank or insurance company is the employer
- Providing ancillary services to a plan by bank trustees

Prohibited Transaction Class Exemptions



Fiduciaries may designate themselves an IRA provider to receive automatic rollovers of mandatory distributions



Broker-dealers may provide free or low-cost brokerage services to IRA and owner-only plans

Prohibited Transaction Class Exemptions



Employers may lend money or extend credit to their QRPs

Trustees may provide free bank services in connection with opening or maintaining an IRA

Prohibited Transaction Class Exemptions



Allowed sale of property held by plan to a disqualified person



Allowed a loan to the plan from the union (a disqualified person) to finance the building of a training facility

Advisory Opinions: Insight Into DOL Interpretations



Advisory Opinions



- DOL response to a specific factual scenario requested by an individual or organization
- Like PLRs, AOs can be relied on only by the entity requesting the ruling
- Certain patterns may emerge in the rulings, giving some insight into the DOL's perspective
- Usually just a handful are issued each year, so AOs are scrutinized more heavily than PLRs

Advisory Opinion



Financial organizations that serve in a trust capacity to a retirement plan can offer overdraft protection (extension of credit) to the plan if an event (e.g., delayed settlement of a securities transaction) would otherwise result in account overdrafts.

IRA Incentives

A man wearing a straw hat and a short-sleeved plaid shirt is watering plants in a garden. He is holding a hose with a spray nozzle. The background shows a wooden building and trees. The entire image has a blue tint.

Questions?

Thank you for attending

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