

DEALING WITH ATYPICAL ASSETS IN IRAS AND QUALIFIED PLANS

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Agenda

- Is the investment legally permitted
- What issues make up this determination
- Can it be valued, and if in an IRA, will a custodian hold it
- Even if permitted, concerns and issues

2

Legally Permitted?

- Is it a Prohibited Transaction?
- Does it constitute Self Dealing?
- Can it be properly valued?
- Issues in purchasing a business through the IRA or qualified plan
- Impact on 5500

3

Prohibited Transaction

- Prohibits certain transactions between a plan and a "party-in-interest"
- Violation will result in an excise tax in the case of a qualified plan or loss of exempt status in an IRA

4

Prohibited Transaction

- View is that there are certain parties who are so inherently close to a plan that the parties cannot possibly deal at arms length
- Applies whether the transaction originates with the plan or with the party-in-interest
- Applies even if the transaction is profitable for the plan

5

Prohibited Transaction

- Parties in Interest include:
 - A plan fiduciary, counsel or employee of the plan;
 - Someone providing services to the plan
 - Employer whose employees are covered by the plan;

6

Prohibited Transaction

- Parties in Interest include:
 - Owner, direct or indirect of 50% or more of the employer;
 - A union whose members are participants
 - A spouse, ancestor, lineal descendant, or spouse of a lineal descendant of a: fiduciary; service provide, employer, or 50% or more owner of the employer

7

Prohibited Transaction

- Parties in Interest include:
 - Any other entity, of which 50% or more is owned (directly or indirectly) by a plan fiduciary, plan service provider, employer, union or by a 50% or more owner of the employer;

8

Prohibited Transaction

- Parties in Interest include:
 - An employee, officer or director (even if unincorporated—so those having the same authority) or a 10% or more shareholder (directly or indirectly) of: a plan service provider, employer, union, 50% or more owner of the employer or union, or an entity of which 50% or more is owned by a fiduciary, plan service provider, employer, union or 50% or more owner of the employer

9

Prohibited Transaction

- Note that in the case of a self-directed IRA, the IRA owner is a fiduciary and therefore a party-in-interest
- Note, also that the attribution rules of Section 267(c) apply in determining ownership and parties-in-interest

10

Prohibited Transaction

- The transactions that are prohibited:
 - 1 Sale, exchange or leasing of property
 - 2 Lending of money or other extension of credit (except for loans to participants)
 - 3 Furnishing of goods, services or facilities
 - 4 Acquisition of employer securities or employer real property (subject to a statutory exemption)

11

Prohibited Transaction

- The transactions that are prohibited:
 5. Transfer to, or use by or for the benefit of a party in interest
[ERISA Section 406(a); IRC Section 4975(c)(1)]
In addition, a transfer of property either subject to a mortgage or lien or previously so

12

Prohibited Transaction

- Consequences of a Prohibited Transaction:
 - Two tiered excise tax in a qualified plan: (1) 15% of amount involved until corrected; (2) increases to 100% of amount involved if not timely corrected
 - Loss of tax exemption from first day of the calendar year in an IRA

13

Prohibited Transaction

- Determine whether the potential investment will constitute a Prohibited Transaction
- Is the investment or investment vehicle itself a party-in-interest?
- If so, the investment may not be made

14

Prohibited Transaction

- EX: Lee wants to invest his self-directed IRA into the Lee Company owned 100% by Lee.
- Lee is the fiduciary of his IRA. 50% or more of Lee Company is owned by a fiduciary to the IRA. Therefore, Lee Company is a party-in-interest.
- The investment is either a prohibited sale or loan depending upon its structure.

15

Prohibited Transaction

- EX: Lee Company maintains a defined benefit plan but lacks funds to make its required contribution.
- Lee, a 10% owner of Lee Company, borrows \$50,000 as a participant in the pension plan and loans it to the company.
- Lee Company contributes the money to the pension plan.

16

Prohibited Transaction

- EX: The loan is prohibited transaction as it is an indirect loan from the plan to the Lee Company, i.e., an indirect loan from the plan to the employer maintaining the plan, a party-in-interest.

17

Prohibited Transaction

- Note that a participant directing the investment of his/her own account under a plan is a fiduciary for purposes of the Code although not for purposes of ERISA and is therefore a party-in-interest for purposes of the Code prohibited transaction rules.

18

Prohibited Transaction

- Ex: Lee is a participant in the ABC Law firm. Lee is not an owner of ABC.
- Lee is however the owner of 60% of the Bowl Company, a separate entity unrelated to ABC.
- Lee takes a loan from his self directed account under the ABC Law firm profit sharing plan and loans it to Bowl Company.

19

Prohibited Transaction

- Ex: Lee's loan to Bowl Company is a prohibited transaction.
- Lee, a fiduciary of his plan account, has loaned plan assets to a company in which he owns 50% or more.
- [Flahertys Arden Bowl, Inc. v. Comm., 115 T.C., No. 19 (09/25/00)]

20

Prohibited Transaction

- Ex: Lee owns 100% of ABC Co. which maintains a 401(k) Plan. Lee, as the trustee, makes several loans to new restaurant start ups of which he owns significantly less than 50% but the largest interest. His largest ownership interest in any restaurant start-up is 33%.

21

Prohibited Transaction

- Court found that the loans were Prohibited Transactions as a transfer to or use by or for a party in interest. The important factors:
 1. while Lee did not own a majority, he held the largest ownership in each;
 2. he signed the notes on behalf of the start ups;
 3. served in some official capacity for each entity

22

Prohibited Transaction

- Court found that the prohibited transfer to or use by or for a party-in-interest does not require that the funds actually go to a party-in-interest.

[Rollins v. Commissioner, TC Memo 2004-260]

23

Prohibited Transaction

- Special quick fix for a Prohibited Transaction that avoids the excise tax
- Available if Prohibited Transaction involves the acquisition, holding or disposition of any security or commodity and
- is corrected (i.e., undone) within the 14 day period beginning on the date the party-in-interest discovers or reasonably could have discovered that the transaction was prohibited

24

Prohibited Transaction

- Special quick fix for a Prohibited Transaction is not available if transaction is between plan and plan sponsor and involves employer stock;
- Also not available if party-in-interest knew or reasonably should have known at the time that the transaction was a Prohibited Transaction

25

Self Dealing

- Even if the potential investment would not constitute a Prohibited Transaction, it must be assessed for potential Self Dealing

26

Self Dealing

- Self Dealing means a fiduciary:
 1. Dealing with plan assets for his/her own interest or account;
 2. Acting in a transaction involving the plan on behalf of a party (or representing a party) whose interest are adverse to the plan's, or

27

Self Dealing

- Self Dealing means a fiduciary:
 3. Receiving compensation for his own account from a party dealing with the plan in connection with a transaction involving plan assets

28

Self Dealing

- Self Dealing may occur:
 - where an individual wants to invest plan assets in an entity where he/she had a prior relationship (i.e., owner, officer, director);
 - where the individual wants to invest both personally and plan assets in the same atypical investment such as a limited partnership or syndication;

29

Self Dealing

- Self Dealing can occur:
 - where an individual invests plan assets and either receives some personal compensation or benefit or the individual provides additional services for compensation

30

Self Dealing

- Concerns with concurrent investments or investments where the individual had a prior relationship:
 - plan assets may be invested or remain invested because needed to save the personal investment;
 - prior relationship may color view of investing plan assets;

31

Self Dealing

- Ex: Lee has a self-directed IRA and wants to make a loan to his corporate employer in which he owned (directly and indirectly) 48.14%
- Corporation is not a party-in-interest due to less than 50% ownership;
- DOL opines that level of ownership, prior relationship would likely result in self dealing [Advisory Opinion 88-18A, 12/23/1988]

32

Self Dealing

- Ex: A radiologist invest in a free-standing Physician owned medical center through his 401(k) Plan. The Medical Clinic allows only physician investors to provide services. The radiologists is allowed to provide services at the center.
- This could be viewed as Self Dealing.

33

Will the Look Through Rules Apply?

- If a qualified plan or an IRA invest in an equity interest that is not publicly traded, the plan's assets include, not just its interest in that investment, but an undivided interest in the underlying assets as well
- This is the look through rule
- Mutual funds are excepted so a plan's investment in a mutual fund includes only a share of the mutual funds

34

Will the Look Through Rules Apply?

- Exceptions from the look through rule:
 - 1 The investment is an operating company, or
 - 2 If equity participation by benefit plan investors is not significant

35

Will the Look Through Rules Apply?

- Investments that raise the look-through issue include:
 - 1 Partnerships including limited partnerships,
 - 2 Private equity;
 - 3 Hedge funds

36

Will the Look Through Rules Apply?

- Consequence of the look-through rule applying:
- Those who manage the look-through investment become fiduciaries of the benefit plan investors
- As fiduciaries, they must manage the entity and its assets adhering to ERISA's fiduciary rules

37

Will the Look Through Rules Apply?

- Consequence of the look-through rule applying
- Transactions by the managers of the entity will likely raise Prohibited Transaction concerns
- Essentially, makes investment impossible by plans if look-through rule applies

38

Will the Look Through Rules Apply?

- Operating company exception is available if:
 - Entity is primarily engaged, directly or through majority owned subsidiaries in the production or sale of a product or service other than the investment of capital
 - Includes a venture capital or a real estate operating company

39

Will the Look Through Rules Apply?

- Operating company exception
- The exception used most often by private equity to allow benefit plan investors

40

Will the Look Through Rules Apply?

- No significant benefit plan investors if
- Benefit investors hold less than 25% of each equity class determined disregarding interest of management
- Used most often by hedge funds to allow benefit plan investments

41

Purchasing a Business with Plan or IRA Assets

- Became more of a focus after the economic crises
- Techniques usually involve purchasing a new business (often a franchise) using rollover funds from a prior employer plan
- Ultimately rolling those funds into a newly established plan

42

Purchasing a Business with Plan or IRA Assets

- IRS does not like and will attack any perceived misstep
- Courts have supported some of the IRS' attacks
- Even if legal pitfalls are avoided upon establishment, lots of opportunities for foot faults and violations

43

Purchasing a Business with Plan or IRA Assets

- Increased interest triggered by Swanson v. Commissioner, 106 T.C. 76 (1996) which concluded that:
 - where newly issued stock was sold to plan before having been issued to any other shareholder, the sale was not a Prohibited Transaction because the company, not having any shareholders, was not then a party-in-interest

44

Purchasing a Business with Plan or IRA Assets

- Swanson gave rise to the following techniques:
 - 1 establish a shell C corporation
 - 2 have the corporation adopt a profit sharing or 401(k) plan;
 - 3 the plan specifically allows participants to purchase company stock;

45

Purchasing a Business with Plan or IRA Assets

- Swanson gave rise to the following techniques:
 - 4 generally, only the individual involved will be the sole participant and employee at this point;
 - 5 future owner rolls funds from prior employer's plan into the newly established plan

46

Purchasing a Business with Plan or IRA Assets

- Swanson gave rise to the following techniques:
 - 6 sole participant directs that his/her account be invested in stock of the newly formed corporation;
 - 7 a valuation report is produced reflecting that the value of the newly issued stock equals exactly what was paid for it;

47

Purchasing a Business with Plan or IRA Assets

- Swanson gave rise to the following techniques:
 - 8 rolled over funds now held by corporation are used to purchase business;
 - 9 If done with an IRA, often an LLC is established as a wholly owned subsidiary of the IRA

48

Purchasing a Business with Plan or IRA Assets

- How the IRS attacks:
- Form over substance
 - The IRS has had some success arguing that some of these transactions are merely to circumvent IRA contribution limits particularly where the IRA involved is a Roth IRA [see, e.g., Summa Holdings, Inc., TC Memo 2015-119]

49

Purchasing a Business with Plan or IRA Assets

- How the IRS attacks: Prohibited Transaction
 - Even if the initial purchase of the stock avoids Prohibited Transactions, other situations may arise for example, requiring the owners to personally guarantee a loan to a business owned by a plan or IRA is a prohibited extension of credit. Roth IRA [see, e.g., Peek v. Commissioner, 140 T.C. No. 12 (2013)]

50

Purchasing a Business with Plan or IRA Assets

- Insufficient Valuation--The IRS will attack paper thin valuations that do not adhere to all of the rigors for proper valuations as prohibited transaction. [Memorandum for Director, Employee Plans Examinations Director, Employee Plans Rulings & Agreements, from Michael D. Julianelle, Director, Employee Plans, SE:T:EP, October 1, 2008]

51

Purchasing a Business with Plan or IRA Assets

- Discrimination—If only the initial owner is allowed to buy company stock, the IRS will attempt to attack as violating the nondiscrimination rules that apply to qualified plans. [Memorandum for Director, Employee Plans Examinations Director, Employee Plans Rulings & Agreements, from Michael D. Julianelle, Director, Employee Plans, SE:T:EP, October 1, 2008]

52

Purchasing a Business with Plan or IRA Assets

- Practical Concerns
- If the business fails, retirement savings are also lost
- The arrangement will mean a greater chance of audit
- Success by the IRS means plan disqualification or IRA loss of exemption

53

Valuation and 5500 Issues

- An Atypical assets must still be valued annually if held by a plan;
- Failure to properly value can lead to other qualification failures
- Real estate means there must be sufficient other assets to pay for things like property taxes and insurance—particular for IRA or individual account plan

54

Valuation and 5500 Issues

- Small plans (fewer than 100 participants) are generally exempt from having to be audited each year;
- The exemption is lost, however, if more than 5% of assets are not “qualifying plan assets”
- Qualifying plan assets are those held by a bank or other financial institution

55

Valuation and 5500 Issues

- Where the small plan exemption is lost, the plan must either pay for an audit each year or pay for an enhanced fidelity bond
- The enhanced fidelity bond would have to cover those who handle the non-qualifying plan assets, such as the hedge fund manager, and cover the entire value of the non-qualifying assets

56

IRAs and Custodians

- Note that atypical investments held under an IRA must be held by a valid authorized custodian or trustee
- It is not sufficient to merely title in the name of the IRA—custodian must recognize and hold
- There are a few custodians that specialize in holding atypical IRA assets

57

Issues and Concerns

- Even if legally permitted, keep in mind:
 - Atypical investments can increase cost—valuation; potential loss of audit exemption; special custodian for IRA
 - Atypical investments can put Plan or IRA at increased audit risk—particularly if IRA used to purchase a business

58

Issues and Concerns

- Even if legally permitted, keep in mind:
 - Real estate in IRA—must have sufficient liquid funds in IRA to pay ancillary cost such as property insurance and taxes
 - Risk in an IRA is potential loss of exempt status—if will use some but not all IRA funds, first break out into two or more IRAs

59

Issues and Concerns

- Even if legally permitted, keep in mind:
 - Businesses purchased in an IRA must continue to avoid prohibited transaction and other issues through life of the investment
 - Businesses purchased through qualified plans can result in unrelated business taxable income

60