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You can't do that with an IRA

Terry Ellis decided that his next job would be selling used cars. To that end, he formed a limited liability company (LLC), which was to be 98% owned by his IRA. The other 2% would be owned by an unrelated third party working for the LLC. Ellis was designated as the general manager of the LLC, with full authority to act on its behalf.

A month later Ellis' IRA was established when $254,000 was rolled into it from his 401(k) plan. He directed the IRA custodian to spend the entire amount purchasing shares of the LLC. Two months later he received the balance of his 401(k) plan, $67,000, which he deposited into the IRA. In turn, the IRA bought an additional $65,000 worth of LLC shares.

The plan did not work out as expected. The law governing qualified retirement plans, including IRAs, has a number of safeguards intended to preserve these retirement assets specifically for retirement. In particular, the law prohibits transactions between the retirement plan and "disqualified persons." Ellis was in that category because he was a fiduciary; he had discretionary authority over the IRA. What's more, Ellis was the beneficial owner of the IRA's LLC holding, and that amounted to more than 50% of the voting power in the company.

So, what was the transaction that was prohibited? Ellis had the LLC pay him a salary, $9,754 the first year and $29,263 the second year. He reported the income and paid taxes on it. The wages were paid from the funds that the company had received from the IRA. That amounted to an attempt to transfer assets indirectly from the IRA to Ellis for his own benefit.

The tax consequences for Ellis were severe. When a prohibited transaction occurs, an IRA loses its tax-qualified status. The entire contents of the IRA are treated as distributed in that year. For Ellis there was a $135,936 tax deficiency, as both 401(k) distributions became taxable. Adding insult to injury, an additional $27,187 penalty was assessed for the inaccuracy of the tax filing that didn't timely report the distributions.

Self-directed IRAs are increasingly popular, but they cannot be treated as personal accounts, a way to "be your own banker."

A real estate context

Barry Kellerman and his wife each owned 50% of Panther Mountain Land Development, LLC. To facilitate a new development project, a new partnership was created, in which Panther Mountain was a 50% owner, and Kellerman's IRA was the other 50% owner. The IRA was to contribute certain real property and some $40,000 in cash to the partnership. Panther Mountain was to contribute $160,000 to the partnership upon the completion of certain construction projects.

Kellerman then ordered his IRA custodian to liquidate $123,000 in assets and purchase the real property that was to be contributed to the partnership. Additional funds were paid from the IRA to the partnership over the next two years in furtherance of the development.

Unfortunately, the project did not reach a successful conclusion. Both Panther Mountain and the Kellermans ended up in bankruptcy court. The Kellermans petitioned to have the IRA treated as an exempt asset.

The analysis by the court was much the same as in the Ellis case. Kellerman was a fiduciary with respect to the IRA because of his discretionary control over it. As such, he was a "disqualified person." The prohibited transaction was using the IRA as a lending source for the funds to acquire the real estate. The consequence for the Kellermans is that the IRA is not shielded in the bankruptcy proceeding.

Their financial hardship may not be over, however. The IRS is likely to come knocking at some point, claiming that they should have included the entire value of the IRA in their taxable income in the year of the prohibited transaction—plus penalties.

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