SELF DIRECTED IRA

KNOW MORE THAN YOUR ATTORNEY IN 15 MINUTES

by Scott Royal Smith

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INTRODUCTION

OVERVIEW

If you are looking to save money for your retirement, you probably know about the individual retirement account (IRA).

IRAs allow you to make tax-deferred investments while you are working so you'll reap the rewards after retirement. Typically, someone else manages those investments for you. That's your custodian. Charles Schwab, eTrade and TD Ameritrade are big names in the industry. These custodians typically put your money in mutual funds, stocks and bonds.

But what if you want to invest in real estate instead? How can you bypass the custodian and keep your hard-earned retirement money off Wall Street and in the kind of assets you know?

A Self-Directed IRA, also known as a SDIRA or solo IRA, gives you TOTAL control over your plan. Rolling over your retirement assets into a Self-Directed IRA opens up a lot more possibilities in terms of investment options.

Including our favorite: real estate.

Those big companies are great at the things they do, but the ins-and-outs of investing in real estate is not one of those things. YOU know about negotiating contracts, performing due diligence, and finding deals in up-and-coming markets.

Financial advisors will usually steer you away from alternative assets and towards Wall Street investments, but if you're a smart real estate investor, don't you want control over how your IRA is invested?

IRA companies sometimes use the term "self-directed" to describe what they offer. But this is wrong. Their robo-advisors aren't going to give you the control you need to put your money in investments that will outperform the stock market.

Even if you have a human advisor, it's not likely he or she really understands the Self-Directed IRAs. Many of the brokers and attorneys that claim to be experts simply aren't familiar with the tools needed.

What tools am I talking about? **The SDIRA LLC or SDIRA Business Trust.**

Why It Matters

You see, The SDIRA allows you to select the investments you want, but a third-party custodian executes on the contracts and other things to make that happen. How do you work around this?

The SDIRA LLC or SDIRA Business Trust gives you “checkbook control,” which means you can select your investment and execute through an LLC or Trust wholly owned by you. This lets you sign for your own investment decisions. We’ll review each option in the pages ahead, but here’s the high-level breakdown:

The LLC has great asset protection for account holders; the Business Trust is the more affordable option but doesn’t come with the same level of asset protection built in.

Again: If you don’t have an LLC or Business Trust, you must have a third-party custodian sign for the investment decision on your behalf directly for the IRA.

Ready to learn more? Buckle up and get ready to find out all about the investing powerhouse masquerading as a retirement plan: **The Self-Directed IRA.**

Benefits

Tax-Free Profits

With traditional IRAs and Self-Directed IRAs (SDIRAs), you contribute pre-tax dollars to an account that grows tax-deferred until you withdraw your money at retirement. Withdrawals are taxed at your income tax rate at the time you retire. This means you have more money to start your investment with and you won’t pay a dime in taxes until you begin taking distributions.

Then there’s the Roth. Roth IRAs and Roth SDIRAs are essentially tax-free as long as certain rules are followed. Roth IRAs (and the self-directed version) are taxed on their way into the account. You won’t pay taxes on either distributions or gains. With a Roth SDIRA, (since Roth IRAs are funded with after-tax dollars) you can reap tax-free profits on real estate and a wide range of other investment types.

Note: Contributions to the Roth, however, are not deductible. There are also limitations on what you’re allowed to contribute depending on how much you make in a year. This is something to bear in mind when considering a Roth IRA.

Asset Protection

If you open a business entity with your SDIRA, you can shield your account assets and personal assets from lawsuits and bankruptcy rulings.

Inflation Protection

Nobody knows for sure what effects inflation will have on their investments, but diversifying your dollars into real estate or other physical investments can help protect your assets from inflation. There is no guarantee that $100 today will be $100 in five, ten, or even twenty years. Assets like real estate are less sensitive to inflation, which means the Self-Directed IRA gives you a way to diversify your portfolio against this threat.

Total Control

The IRS specifies that any self-directed account is the responsibility of the account owner. This means you make all of the decisions. While your custodian acts on your direction, you can gain even more control. Through opening a LLC or business trust in the name of your SDIRA, you also gain **checkbook control**. This means you can make investments instantaneously without running it through your account custodian.

More Investment Options

Most Wall Street IRA custodians only allow you to invest in stocks, bonds, mutual funds, annuities, CDs and other traditional investments.

As a Self-Directed IRA investor, it's up to you to evaluate the merits and suitability of all investments you are considering as well as investigating the individuals who may be selling or recommending those investments.

The SDIRA lets you in real estate, precious metals, private placements and renewable energy sources. Private placements, foreign currency and many other things are also allowable investments. Because of the greater investment options available, you have more opportunities to reap a larger reward.

THINGS YOU CAN INVEST IN

With a Self-Directed IRA, you are free to invest in both traditional and nontraditional investments. Traditional investments are things like stocks, bonds, and mutual funds, which you may already hold in a traditional IRA account.

Nontraditional investments are where investors can really get creative. Self-Directed IRAs can invest in:

- **Real Estate**
- **Precious Metals**

- **Stocks, Bonds and Mutual Funds**
- **Tax Liens**
- **Private Businesses**
- **Loans and Notes**
- **Cryptocurrencies**
- **Foreign Currencies**
- **Hard Money Lending**

Real Estate

While you can invest in almost everything with a SDIRA, real estate tends to be one of the biggest draws. I'll be covering this in much greater detail later on in this book.

You can use your SDIRA to purchase homes, condos, duplexes, penthouses, raw land, office buildings, shopping centers, factories, mobile home parks and all other types of commercial and residential real estate.

Precious Metals

While the IRA expressly prohibits the use of your IRA to invest in coin collections and other collectibles, there are certain kinds of coins that gain their value intrinsically (from what the coin is made of). Instead of being an investment in the coin, it's considered a precious metal investment.

The U.S. government mints such coins for this express purpose. So do most major countries across the globe. These coins are largely considered an acceptable form of investment for your IRA.

Stocks, Bonds and Mutual Funds

IRAs are set up to receive passive income from such things as dividends. In fact, the IRS prefers that you pad your IRA with passive earnings. Traditional (non-self-directed) IRAs relied on bonds and mutual funds to accrue value.

You can still invest in stocks, bonds, and mutual funds with a Self-Directed IRA, but you will have much greater freedom to choose which ones you invest in.

Tax Liens

For the last decade or so, tax liens on real estate have become a lucrative investment. To recoup lost revenue, the government will sell liens on real estate where the owners have failed to pay property taxes. Interest keeps building on those unpaid taxes. If the owner fails to pay at all, the real estate will become property of the IRA. With your Self-Directed IRA, you can reap the rewards tax-deferred.

Private Businesses

The IRA can own an interest in a business and have profits paid to the account. You need to be aware of IRS rules on **prohibited transactions and disqualified persons**. Your IRA cannot engage in any transaction with a disqualified person or it could lose its tax-advantaged status, which could lead to forcing distribution of—and taxing—the asset. This basically includes anyone in your family or yourself. More on disqualified persons later.

Loans and Notes

You can use your Self-Directed IRA to invest in promissory notes (agreements to pay a person or business a certain amount, with interest and a maturity date). This includes mortgage notes and trust deeds. As always when investing with your Self-Directed IRA, some due diligence is required.

Cryptocurrencies

Cryptocurrency is all the rage. Speculations about an imminent crash have been going on for years, but it hasn't come yet. In the eyes of the IRS, Bitcoins and other cryptocurrency are not considered currency. Which means you have more than a few excellent & barely taxed investment opportunities as far as Bitcoins go.

Foreign Currencies

Foreign currencies also represent an excellent investment option as they offer easier liquidity than stocks or bonds.

Hard Money Lending

Since most banks require good credit scores and take too long reviewing financial statements, tax returns and business plans, there is a growing need for quick and easy financing for small business, investors, and real estate developers and builders for their real estate projects.

Use your SDIRA to make secured or unsecured loans (to anyone who is not a disqualified person … more on that later). The following hard money lending investments have been popular with our Self-Directed IRA clients:

- Secured loans to individuals
- Short non-secured loans to real estate developers
- Hard money lending investment funds
- Loans to individuals recovering from hurricanes

THINGS YOU CAN NOT INVEST IN

Individual retirement accounts (IRAs) were designed as vehicles for passive earnings and more specifically, for retirement security. Passive earnings can include things like rent, interest, the appreciation in value of real estate, stocks, or bonds, dividends, monies being paid off on a debt, and so on.

There are, however, key restrictions you should know; the IRS expressly prohibits certain kinds of transactions from making their way into your IRA trust.

Why does the IRS prohibit active earnings from an IRA?

An IRA is designed for the express purpose of being a retirement account, not necessarily a tax loophole. Consider what would happen if individuals put their homes or their businesses into their IRA. The government would never collect a dime in taxes. The IRS, therefore, prohibits you from using an IRA to claim tax-deferred or tax-free status on your own personal ventures.

Self-Directed IRAs allow individuals to claim tax-deferred and tax-free status, but they saddle those individuals with a handful of rather complicated guidelines that must be followed. Failure to follow these guidelines can enable the IRS to revoke the IRA's tax-preferred status.

There are generally two kinds of investments prohibited for IRAs. Those that fail the metric for passive income, and those in which you are conflicted out of tax-preferred status. IRA investments that the IRS does not allow include:

- **Life insurance.** *IRC 408(a)(3)*
- **Items classified as a collectible such as cars, artwork, furniture, stamps, rare wines and antiques.** *IRC 408(m)*
- **Any investment owned by someone in your close family (parents, grandparents, spouse, children).**
- **Stock in an entity taxed under subchapter S of the Internal Revenue Code. (This includes membership interests in an LLC taxed as an S corporation.)** *IRS Letter Ruling 199929029, April 27, 1999, IRC § 1361 (b)(1)(B)*

Life Insurance Policies

Life insurance policies, generally speaking, cannot be held in an IRA. This includes:

- **Whole life**
- **Universal**
- **Term and variable**
- **SEP**
- **SIMPLE**

Since IRAs are meant to act as a retirement fund, this makes a certain kind of sense. There is, however, one exception known as the **incidental benefit rule**. There are some qualified plans that are allowed to purchase a small amount of death benefit insurance, but the payoff does not constitute any form of lucrative investment, so it's not really worth investigating.

Collectibles

In order to enjoy tax-deferred status, the IRS mandates that you defer any form of use or enjoyment from the investments held in your IRA. Any collectibles, antiques, sports memorabilia, or fine art that you purchase or possess can, thus, not be held in your IRA.

As I said earlier, there are certain kinds of coins that are issued by the government as precious metal investments. While you would be prohibited from investing in antique coinage, you are not prohibited from investing in precious metals. Therefore, coins that are minted for their value as a precious metal are excluded from the collectible restriction.

Real Estate For Personal Use

Despite what you may think, real estate has become a very popular investment vehicle for Self-Directed IRAs. The one major restriction is that you cannot directly benefit from the real estate. That is to say, neither you nor your family can personally reside on the real estate. This is considered a prohibited transaction and it conflicts you out of tax-preferred status.

How does this work?

You yourself cannot receive the benefits of the property. You personally cannot collect rent. The rent must be paid directly to the IRA trust. In order for that to work, it must be held in the trust's name and not your own.

Furthermore, you can't purchase your primary home or a vacation home using your IRA. Nor can you purchase or sell property to members of your family.

Nonetheless, real estate is becoming an attractive option due to recent booms in the market.

Derivative Trading

There are a number of other prohibited transactions to be aware of. Those (generally) include any kind of derivative trade that has undefined risk. Again, the function of an IRA is retirement security so, more often than not, speculation of this sort is prohibited.

Certain Business Interests

You can invest in business interests with your SDIRA. However, you cannot be engaged in the management or running of the business in any way. Some folks want to use their IRA to start their own small business or use their IRA as collateral for a loan to start their own business. This is a prohibited transaction.

SECTION I: SOLUTIONS

INVEST IN BITCOIN

It's hard to miss the stories of the crypto-savvy investor buying Bitcoin in its early years and becoming a millionaire. As Bitcoin becomes mainstream, more investors are asking, "Why not me?" In fact, IRA investors are increasingly diversifying with Bitcoin and other cryptocurrencies.

With a Self-Directed IRA you can apply the tax-deferral benefits enjoyed by other alternative investments towards Bitcoin. Bitcoin investments can grow unhindered, as taxes aren't applied till funds are disbursed, which can mean decades of growth.

Basics of Bitcoin

Bitcoin is a type of cryptocurrency released in 2009 by Satoshi Nakamoto. Bitcoin turned heads in the investment world by going from a price of under $1 in 2011 to a high of $20,000 by the end of 2017. Bitcoin's wider adoption and impressive gains led to the "Bitcoin IRA."

Bitcoin is one of thousands of different cryptocurrencies and is considered the most popular. With cryptocurrencies, encryption is used to make new currency units and perform transactions. All this is done in a decentralized system and records are kept in a blockchain, which is a type of digital ledger. Bitcoin must be stored using an online digital wallet or in a personal computer. Due to hacking concerns, some owners use a hardware wallet. This is a USB-like device equipped with a PIN code.

By default, any IRAs dealing with Bitcoin are self-directed, since traditional IRAs don't permit alternative investments. This leads us to the obvious question of whether the IRS permits Bitcoin investments, even under the Self-Directed IRA's more flexible structure. The answer to this question isn't so cut and dry. The IRS doesn't explicitly name Bitcoin as a permissible IRA investment. However, it also doesn't list Bitcoin as a forbidden investment.

Do your own due diligence. Be prepared for the uncertainty that surrounds Bitcoin as a new investment. Also, since Bitcoin isn't under a regulated system, don't expect the same type of publically available financials you'd find with traditional stocks. However, you can educate yourself on how the IRS deals with Bitcoin investments. A good resource is Investopedia's Bitcoin Investment Guide.

Choose the Right Custodian

Make sure the custodian is IRS approved and allows Bitcoin investments. This can be a

challenge during cryptocurrency's early stages. Even if you do find a capable custodian, you won't enjoy checkbook control over your account. Your IRA is self-directed, but isn't "self-managed." This means you can't write a check out yourself for a Bitcoin transaction without custodian involvement. The processing time and fees can add up when choosing this route.

This doesn't mean you should give up on Bitcoin investing with a Self-Directed IRA. We eliminate the custodial overhead by allowing Bitcoin investors direct access to their IRA funds on our online platform.

Choose the Right Cryptocurrency Exchange

Choose a reputable exchange and understand its fee structures. More importantly, be aware of any security flaws and hacking issues. Currently, Coinbase and Kraken are some of the most reputable exchanges.

Choose the Right Cryptocurrency Wallet

For those new to cryptocurrency, this step may seem like the hardest to understand. A cryptocurrency wallet isn't a physical wallet, although it can take physical form as a hardware digital wallet. Wallets are accessed via a private key, which is a hexadecimal code that you should guard just as you would a security box key. Like a bank account, the wallet holds your balance and a reference to all transactions. It's also where you can send and receive currency. Think about security when choosing a wallet. Online wallets are convenient and usually offer a mobile version. However, they are susceptible to hackers. Hardware wallets are more secure because they hold the private key in an offline, unhackable device.

Keep Bitcoin Investments in Compliance

The "self-dealing" rules that apply to other alternative assets also apply to Bitcoin. For instance, an investor can't sell Bitcoin to his own IRA nor can any of his family members. This can disburse the IRA or lead to a taxable event. Also, be mindful of annual reporting requirements, which require market valuations similar to real estate properties.

The unique steps Bitcoin investors need to make to stay compliant may be overwhelming at first. They include choosing a cryptocurrency exchange and digital wallet. However, once investors get their feet wet, they'll be a step ahead in expanding their Self-Directed IRA towards other cryptocurrencies.

Consider Other Cryptocurrency Investments

Bitcoin is the most widely-known cryptocurrency. The SDIRA investor has other crypto currencies to consider, such as Ethereum and Litecoin. Like Bitcoin, Litecoin has enjoyed tremendous growth. It's second to Bitcoin in market capitalization followed by Ethereum and Ripple.

When expanding your Self-Directed IRA, consider what advantages rival currencies have as an alternative to Bitcoin. For instance, Litecoin enjoys faster transaction times and a larger coin supply limit of 84 million compared to Bitcoin's 21 million.

Cryptocurrencies get a lot of buzz, but the jury is still out on whether or not they constitute a good long-term investment. Cryptocurrency investments such as Bitcoin are risky and highly volatile. Any investor interested in learning more about Bitcoin should do their diligence and proceed with caution.

INVEST IN REAL ESTATE

I love real estate investing. What's not to love? Generally, property goes up in value every year, right?

Below is a small list of real estate related investments you can make with a Self-Directed IRA LLC :

- **Commercial property**
- **Shopping Centers**
- **Office Parks**
- **Duplexes**
- **Residential homes (sales and flips)**
- **Tax deeds**
- **Condos/townhomes**
- **Real estate notes/mortgage notes**
- **Tax liens certificates**
- **Purchase options**
- **Raw land**

- **Apartments**
- **Mobile homes and mobile home parks**
- **Vacation rentals**
- **Joint venture investments**

And that's actually the short list. There are many more opportunities available.

Buying real estate with a Self-Directed IRA is essentially the same as buying real estate personally. Except you have way more benefits.

But there are a few differences as far as the "backend" is concerned:

- **All expenses paid from the investment property go through your Self-Directed IRA LLC or Business Trust. Likewise, all rental income checks must be deposited directly into your Self-Directed IRA LLC (or Trust) bank account.**
- **Title to the investment property and all transaction documents should be in the name of the Self-Directed IRA LLC (or Trust). Documents pertaining to the property investment must be signed by the LLC manager. The manager can be you.**

When using a Self-Directed IRA LLC (or Trust) to make a real estate investment there are a number of ways you can structure the transaction:

- **Use your SDIRA funds to make 100% of the investment**
- **Partner with your family, friends, etc.**
- **Borrow money for your SDIRA**

Partnering with your family and friends to make a real estate purchase won't trigger a prohibited transaction if your Self-Directed IRA LLC or Business Trust is set up correctly. For this reason, it's important that you get professional help when you're setting everything up.

Also, when it comes to borrowing money, you must use a **non-recourse loan**. That is, unless you want to trigger a prohibited transaction and pay the taxes below.

If you do trigger a prohibited transaction, you will be paying **UBTI (Unrelated Business Taxable Income) Tax.** You will be taxed at the trust tax rate because your IRA is considered a trust.

Buy A Retirement Home

With a Self-Directed IRA you can buy an investment property and distribute later for per-

sonal use. In other words, you can use your account to acquire the perfect home for your retirement years. **This is black-belt level stuff.**

To do this you need to purchase the property through your IRA, which will own it as an investment until you retire. You can rent the property in the meantime, so you are still making money off of it until you are ready to retire and move in.

This makes your retirement home a retirement benefit.

Remember: You cannot use the property. Your family cannot use the property. You do not own the property. It is the IRA's property. It rents the property; you don't.

The rental income accrues in your account because, I repeat, y*our IRA owns the property.* You can lease the property, of course—that's how investments work. They make income. You will have to lease it to someone outside the family until it's been distributed, but after that, your dream home is all yours.

When that time comes, you will distribute the property via title transfer from your self-directed to your traditional IRA. It is an "in kind" distribution and it means taxes are due for traditional IRAs. If your future retirement home was appraised at $250,000, you will receive a 1099-R for $250,000 from your custodian upon distribution.

Distribution taxes can be high. You might prefer to take partial distributions over time, to spread out the pain, but it's going to sting no matter what you do and this can be a trap. You need appraisals every year for fair market valuation, and these valuations aren't free, either.

Whatever you decide, you and your family cannot use the property until it has been 100% distributed.

As with most things retirement related, if you take a distribution before you are 59½, you're going to pay a penalty. Ten percent is stiff. Be patient.

Invest Overseas

Not only can you use your SDIRA to invest in real estate in the United States, but you can also invest in residential and commercial properties overseas as well. I'm not going to go into the nuts and bolts of this (that could be its own book), but here are just a few scenarios where you might want to invest overseas:

Do you want to have a vacation home on the Australian coast? If you buy a residence now, rent it out until you turn 59½, you can take residence of the property tax-free when your SDIRA becomes available for distribution.

Were you born in a different country? Did you come to the U.S. for opportunities unavail-

able in your country but have a desire to eventually return? You could buy a property in that country now, develop it over the years, rent out the home, and at the age of 59½, take up residence in your homeland.

Do you see the potential in establishing a string of rental homes throughout several countries for vacationers to rent throughout the year? You can enjoy the profits generated by high-end vacation home rentals in hot spots like Venice, Amsterdam, Cancun and the Bahamas.

As you see, there are plenty of reasons to invest in property overseas, aside from the potential profits.

SECTION II:
OWNERS MANUAL

HOW TO STRUCTURE

One way to achieve greater discretionary and more immediate control over the funds in your Self-Directed IRA is to form an IRS-approved legal entity into which the funds of the IRA are invested and you (as the IRA owner and the manager/trustee of that legal entity) can assume direct control over those funds by your management role with that entity.

Business trusts and limited liability companies ("LLCs") are the two types of entities typically selected for this purpose for which the Self-Directed IRA would transfer the funds for investment. With a Business Trust the IRA owner will serve as the Trustee. With a LLC, the IRA owner will serve as the Manager.

With both structures, checkbook control is the name of the game. That means no custodian fees, you control investments yourself, and it's fast to invest and make deals.

The LLC gives you checkbook control and the ability to compartmentalize liability. The Trust gives you checkbook control, anonymity, and the power to avoid franchise taxes and LLC maintenance fees

Let's look at each in turn.

The Self Directed IRA-Owned LLC

For those of us concerned about protecting our real estate assets, the liability-limiting powers of the LLC offer an elegant fix. This variation of the retirement plan is hybridized into an entity, a more secure option for investors. This entity boasts a massive variety of benefits that our clients love.

Real estate investors are attracted to the LLC option because of its strong liability protections. They get the flexibility to buy real estate with IRA funds and the protection of an LLC—the best of both worlds.

Benefits Of The Self Directed IRA-Owned LLC

Here are some of the most popular perks of the Self-Directed IRA LLC:

Asset Protection

Just like the Traditional LLC and Series LLC, the Self-Directed IRA LLC offers asset protection. If someone ever wants to sue you, you are not making it easy on them, because your investments are held within the LLC structure rather than your own name. The LLC structure isolates your assets, while you personally appear to not own anything.

However, there are rare instances where an LLC member's personal assets can be pursued by creditors, such as if they act as a guarantor for a loan to fund the LLC and fail to pay it back. Read on ...

Creditor Protection

Should you find yourself filing for personal bankruptcy, the value of your IRA-owned LLC's assets will be protected up to $1 million.

The Ability to Pool Assets

A major challenge for real estate investors is securing capital to acquire property. Combining your money with other investors through an IRA LLC gives you the benefit of having your money combined under legal and contractual guidelines, but you also get the aforementioned protection an LLC offers, such as protection from creditors and lawsuits.

Your IRA and other investors contribute money to the IRA LLC and then use the LLC funds to purchase the asset. An IRA LLC can have multiple members (including more than one IRA, people and entities) as long as the prohibited transaction rules are not violated.

An IRA LLC provides a legal governing structure, rules and policies to how the joint owners will operate the company and deal with its assets.

You shouldn't rely on oral statements or agreements. An Operating Agreement signed by all of the members of your LLC will provide the firm foundation from which you all can make decisions together.

For example, an Operating Agreement will prevent members from being "lone wolves" and doing something that the majority of the members disagree with, such as entering into an unprofitable contract.

Easier Asset Management

If you purchased a complex asset, you will want a Self Directed IRA LLC to be the owner of that asset. For example, if you want to purchase a thirty unit apartment complex, you should form an IRA LLC to own and operate the apartments. Why?

Because you and your IRA custodian don't have time to be involved in the day to day operations of a thirty unit apartment complex, such as paying utilities, depositing rent checks, or evicting tenants.

And then think of the liability involved. Anyone of those tenants could sue you for a variety of reasons. An LLC will protect you.

Tax Advantages

All of the investments within a SDIRA grow tax-free until the account holder takes distribution. This includes real estate investments, which are notoriously costly in terms of taxes.

When an IRA-owned LLC holds a real estate investment, the property owner gets to defer these payments and the savings can be massive. Note that you will eventually have to take distributions, but this isn't mandatory until you reach the age of 72. The Roth version of the Self-Directed IRA LLC is funded entirely with after-tax income, meaning you don't have to pay taxes on your distributions at all.

How to Form

The IRA-owned LLC is formed by filing a Certificate of Formation with the Secretary of State. Then an Operating Agreement is created designating the Self Directed IRA as the owner and you as the Manager of the LLC. The Operating Agreement is also required to have restrictions to ensure that certain prohibited transactions do not take place.

The effectiveness of this tool lies in the fact that you remain in control of your investments without being the nominal owner of the account. Although the IRA does officially own this type of LLC, as the account holder, you will direct its use as the "Manager" of the structure. The IRA will officially "own" the LLC, but you will control it.

The Self Directed IRA Owned LLC has upfront costs as well as yearly costs that are just like any other LLC. These fees vary from state to state but generally will include: a registered agent fee ($99/year), a Franchise Tax and Franchise Tax filing an annual fee ($300 on average), and ongoing corporate compliance fees.

Work with financial and legal planners who can advise you on the best banking practices for, as well as how to avoid prohibited transactions and their costly penalties. At Royal Legal, we have relationships with almost every custodian (CamaPlan, uDirect, NuView, Kingdom Trust, and more) to ensure a smooth process. We also have banking and other contacts in place for you to set up, establish, and fund your new company all without ever leaving your home.

The Self-Directed IRA Business Trust

The Self-Directed IRA Business Trust comes with all the usual SDIRA benefits, including the ability to make nontraditional investments, faster transactions, confidentiality and asset protection. Unlike with an LLC, you do not need a Registered Agent for an Self Directed IRA Business Trust. This means you also do not have to pay the fees typically associated with hiring a Registered Agent.

IRA Business Trusts are "disregarded entities" for federal income tax purposes. No federal tax returns needed! The Franchise Tax that is regularly imposed on LLCs by states such as California does not apply to the IRA Business Trust.

When a Business Trust is used as the holding entity for a self directed IRA with checkbook control, you as the Trustee and Owner can enjoy the best of both worlds—freedom to

invest, divest, manage any qualified investments at any time from your retirement funds and also be able to prevent unnecessary overheads from fees, taxes and expenses with full confidentiality.

Benefits Of The Self Directed IRA-Owned LLC

We believe that the Business Trust is a better type of entity to choose for your self directed IRA with checkbook control for the following reasons:

Confidentiality

When an LLC is formed, it must designate (1) Name and Agent for Service Of Process in the Articles Of Organization and (2) File the Articles Of Organization with the Secretary of State in the state of organization. The IRA owner is typically going to list himself or herself as the Agent. Once the filing is complete, the LLC and all details of the owner become public record and there goes the confidentiality of the owner. If there are substantial funds in the LLC transferred from the Self-Directed IRA, this transparency could compromise the privacy for the owner.

In contrast, there is no public filing requirement when forming a business trust. The Declaration of Trust, or Trust Agreement, remains a private and confidential document. Moreover, while the IRA owner will typically serve as the trustee of the business trust, there is no automatic publication of the name of trustee.

This is not true for LLCs. In fact, when an LLC is formed, not only does the Articles of Organization have to be filed with the Secretary of State where you are located, but your name and address must be as well as the manager of the business itself. Thus there is a higher level of privacy and confidentiality available with a business trust.

A “True” Disregarded Entity

Both a business trust and an LLC will be classified for tax purposes as a partnership under federal and state income tax regulations. If classified as a partnership, then the business trust and LLC must file income tax returns with the IRS and the respective state agency. However, an entity classified as a partnership that has only one owner will be “disregarded as an entity separate from its owner.” Once classified as a “disregarded entity” then that entity will not have to file federal income tax returns.

A limited liability company with just one member will be classified for federal and state income tax purposes as a “disregarded entity.” With this classification, the LLC will avoid having to prepare and file a federal income tax return. But not so at the state level, at least not in California. Despite being a “disregarded entity” for California state income tax purposes, the LLC must still comply with California return filing requirements because this is a method for the LLC to pay the California minimum franchise tax imposed on LLCs.

In contrast, if a business trust has only a single holder of its "beneficial interests," it will then be classified as a "disregarded entity" and, as a result, not have to file either a federal or state income tax return. Thus the fees and costs of preparing a state income tax return, as well as a federal income tax return, are avoided.

With a business trust, when you invest in a property's title, you are investing in the "beneficial interest" of the entity. Often, a SDIRA owner acquires 100% of the beneficial interests of a business trust. In this case, the IRA account has now become both the "trustor," or "settlor," of the business trust (i.e. the party that has transferred assets into the business trust) and the "beneficiary" (i.e. the party that holds the "beneficial interests" of the business trust).

Acquiring the beneficial interests of the business trust is similar to an IRA account acquiring the "membership interests" of a limited liability company or shares of a corporation. Essentially, the term "beneficial interests" is what we call the "equity interests" in the business trust that are acquired when an investment is made in a business trust.

It is important to remember that the IRS has complex regulations that govern a SDIRA account. While you, the owner, are the account manager, it is always a good idea to get professional legal help to ensure you do not violate any regulations.

No Registered Agent Needed In A "Foreign Jurisdiction"

As we've seen, making investments in commercial and residential real estate is easy with an SDIRA. If that real estate investment is in a property in a state that is different than the state where the LLC is formed, then the LLC would have to file appropriate documents in that "foreign" state in order to "qualify to do business" in that state.

For this purpose, unless the IRA owner/LLC manager has someone willing to serve as the registered agent for the LLC in that state, the LLC owner would need to hire an independent registered agent in that state to remain compliant. Although the fees for such registered agents are in the low $100s, it is an annual expense taken from your retirement funds.

But if a Business Trust is the holding entity used to make these real estate investments in states other than the IRA owner's state of residence, there is no requirement or need to hire an agent in that "foreign" state. This is because the business trust does not have to file any documentation to "qualify to do business" in that state in order to purchase real estate for investment purposes.

Thus you (as the IRA owner) can avoid having to pay the fees typically required with such filing as well as avoiding having to pay any annual fees to an agent in that state. These all add up in the long run as hard money that goes directly to increase your account balance.

No Franchise Tax

The IRA-Owned Business Trust gives you all of the benefits of an Self Directed IRA-owned

LLC but without the yearly costs of the LLC. Unlike a Traditional LLC, there is no registered agent, no franchise taxes, and no yearly fees.

As Wikipedia states so correctly, “Franchise tax is a tax charged by some U.S. states to corporations with a nexus (aka a filing obligation) with those states.”

The common feature of a state’s franchise tax is that it is not based on income. “This is a mandatory requirement for any LLC that wants to be “qualified to do business” in that state. Depending on the state, these fees can be quite high, which erodes the funds in your Checkbook IRA account year after year or as long as your LLC wants to remain “qualified to do business” in that other state.

There is no such franchise tax requirement for Business Trusts.

The only yearly fee is $250 per year to ensure that your Trust is not making prohibited transactions and that it is maintained in accordance with any changes in the law.

Reduced Personal Liability

Unfortunately, there are a lot of ways in which your assets, IRA-related or personal, can be at risk. Filing for bankruptcy, divorces, and civil lawsuits are all possible ways to lose your assets. In fact, if your minor causes a car accident, you will likely be the one to pay the price. You are also considered at fault even for accidental injuries that occur on your property, like a slip and fall.

When you use a business trust to invest, all investments and gains are legally separated from your personal assets. This is beneficial for two reasons. If you use your business trust to invest in a property and default on the loan, this separation will protect your personal assets from any sort of legal ramifications. On the other hand, if you file for personal bankruptcy, your business trust assets are protected from the proceedings.

LLCs, on the other hand, have limited personal liability. These protections are only active for as long as your LLC remains in compliance with regulations. All annual filings, fees, and requirements must be made or you lose this protection and invalidate the separation of assets.

Simple To Set Up

A business trust is relatively simple to set up. They have no set up fees or annual feels related to their formation. Because they do not require public filing, they are not subjected to approvals, registrations or other things that can cause set up to take time.

By comparison, setting up a LLC is a bit more complex. LLCs require name reservations, application approvals, and waiting periods. They also have somewhat costly government filing fees that are required during start up and annually (or biennially). LLCs are also required to file reports with the Secretary of State per their state’s statute. When all is said and done, an LLC can take one to three months to officially complete the approval process and become a legal entity you can use for investments.

Taxation Classifications

When it comes to filing tax returns, a business trust is classified as a *partnership*, which is subject to both federal and state income taxes. However, if you are the sole owner and investor of the beneficial interests, the business trust becomes a “disregarded entity.”

As such, the business trust becomes exempt from filing federal or state income tax returns. Additionally, there are no franchise taxes for a business trust. Avoiding a franchise tax, which is typically charged by a state in order to gain approval to do business within its borders, means you keep more money in your account for investment purposes.

Tax regulations can be quite complicated and hard to understand, which is why hiring a custodian is highly recommended.

How to Form

Establishing your IRA-Owned Business Trust is fairly easy. In fact, while state laws and banking institutions may have their own rules, the process can be typically broken down into four steps.

Step 1: Establish the “Declaration of Trust”

Unlike many other entity options, you do not have to publicly file when you form a business trust. This helps to protect your confidentiality and identity.

Therefore, the first step of forming a business trust is to prepare a document known as the “Declaration of Trust”. Often referred to as a trust agreement, this document establishes the purposes and objectives of the trust itself. Making appropriate investments that are for the exclusive benefit of the SDIRA is, of course, the purpose of the business trust. The trust agreement will also establish the rights and duties of the beneficiary and trustee.

Typically, both the beneficiary and trustee will be given broad powers. Because the SDIRA itself is the beneficiary, the trustee will be granted independent authority to make investment and management decisions. Doing so means that, if you want to make an investment, you do not need the approval of your custodian to do so. (This is particularly important because your custodian is prohibited by the IRS from making financial decisions regarding your SDIRA.)

Step 2: Obtain an EIN

Once you have created the trust agreement, you will want to file for a tax identification number, also known as an **EIN**. This number, provided by the IRS, is required. You can easily file the required SS-4 Form online to request your EIN.

Step 3: Open a Bank Account

After you obtain an EIN, your business trust should establish a bank account in the name

of the business trust itself. This account will authorize the trustee to be the signor. As you are filing for an account on behalf of a business trust, the bank will require that you fill out a "Certification of Trust." This form establishes several things: you are the trustee, there is a Declaration of Trust, and you have the authority to open the account. In providing a Certification of Trust, you do not have to provide the actual trust agreement.

In the end, opening a bank account in the name of your business trust will give you complete checkbook control over investment decisions.

Step 4: Transfer the SDIRA Funds

Finally, you would provide your custodian with the directions necessary to transfer the funds from your SDIRA account to the business trust's bank account. For most account owners, a wire transfer of the funds is the preferred method and can be quite easily accomplished.

HOW TO FUND

Roth SDIRAs

If you are eligible for a typical Roth IRA, you are almost certainly eligible for the Roth Self-Directed IRA. Many investors, small business owners, and self-employed individuals are drawn to the Roth IRA because account holders pay taxes up-front.

This means that all funds inside of the account have already been taxed, and you won't have to pay taxes "on the back end" when you take your distributions upon retirement. With the Self-Directed version of a Roth account, you can pass these tax savings on to your investments as well.

You can use a traditional or Roth SDIRA to invest in real estate. However, you should note some differences.

Traditional SDIRAs are tax-deferred. This means you will have to pay taxes on your distributions. If you plan to take residence in a SDIRA-purchased property once you turn 59½, you will owe taxes. While this is still a smarter home-investment than buying a new home outright when you turn 59½, a Roth account will let you avoid this. True, property taxes are owed every year regardless of how you came to own the real estate. However, the asset's value is not subjected to income taxes with a Roth SDIRA.

The advantage of purchasing real estate with your Self-Directed IRA LLC is that all gains are tax-deferred until a distribution is taken (pre-tax 401k distributions are not required

until you turn 70 1/2). In the case of a Roth Self-Directed IRA, all gains are tax-free.

For example, if you purchased real estate with your Self-Directed IRA LLC for $500,000 and you later sold the property for $800,000, the $300,000 of gain appreciation would generally be tax-deferred.

If you purchased the property using personal funds (non-retirement funds), the gain would be subject to federal income tax and probably state income tax as well.

Remember: When you open a traditional SDIRA, you make pre-tax contributions. These dollars, and any profits generated by them, are taxed later, when you begin to take distributions. However, if you open a Roth SDIRA, you use post-tax dollars to make contributions. This means your gains and later distributions are made tax-free. For both traditional and Roth accounts, profits generated by a SDIRA-owned property flow right back into the account.

That's why using your SDIRA to invest in real estate can generate incredible profits. Whether you rent or sell your SDIRA property, you can substantially increase your retirement account funds through real estate investments.

Roth SDIRA Conversions

A conversion is a taxable movement of cash, real estate or other assets from a traditional IRA, SEP IRA, or a Savings Incentive Match PLan for Employees (SIMPLE IRA) to a Roth IRA. Most of the time, Roth IRA conversions and retirement plan rollovers to a Roth IRA are taxed. This is offset by the fact that you won't have to pay tax on your future distributions.

There are no eligibility requirements for making a Roth IRA conversion. If you earn too much to make a Roth IRA contribution, you can contribute to a Traditional IRA instead and then do a Roth IRA conversion.

If you decide to convert your Roth account to a Self-Directed Roth IRA LLC structure, you will have to pay tax on the Roth IRA conversion on a "pro rata basis". This means the portion representing pre-tax assets is taxable in the year of the conversion, and the portion representing after-tax assets is not taxable.

Also, you will need to file Form 8606 to determine the taxable portion of the conversion. You will need to list all the pre-tax IRA assets to determine the taxable and nontaxable assets.

A Roth IRA conversion can be completed either via a **direct or indirect rollover**. So what's the difference? With a direct conversion, the check is made payable to the receiving financial institution for the benefit of your Roth IRA. An indirect conversion occurs when you request and receive a distribution from your pre-tax IRA custodian and deposit the amount into a Roth IRA account within 60 days.

Since most conversions are generally subject to taxation, your financial organization distributing the pre-tax IRA assets will probably apply withholding rules to the account. However, an exception applies to IRA funds being converted to a Roth IRA.

Note: A Roth IRA conversion is a reportable transaction regardless of whether it was handled directly or indirectly.

Direct Rollover to a Self-Directed Roth IRA

When you directly roll over your employer sponsored retirement plan distribution to a Self-Directed Roth IRA (excluding a designated Roth account rollover to a Roth IRA), your financial institution transferring the retirement funds must report the tax-free direct roll-over distribution.

Note: The receiving Self-Directed Roth IRA custodian must report the amount as a rollover contribution in Box 2 of IRS Form 5498.

Indirect Rollover to a Self-Directed Roth IRA

If you're eligible and take a distribution from your employer sponsored retirement plan (401k Plan) the financial institution sending your distribution should make the check payable to you. If your distribution is eligible for a rollover, your financial institution will apply withholding rules.

You would then be required to deposit your money into a traditional IRA account within 60 days. Once your funds have been deposited in a traditional IRA account, your IRA funds can be converted into a Roth IRA.

Note: The new Self-Directed Roth IRA custodian receiving the rollover assets must report the amounts on IRS Form 5498 as a rollover contribution (in Box 2).

HOW TO MANAGE

Checkbook Control

Checkbook Control is a term from the 401(k) world, but it applies to IRAs as well. Rarely is there a literal checkbook involved, but it can be helpful to think of the "checkbook" as a metaphor for how your plan's assets are managed.

Checkbook Control for SDIRAs simply refers to the ability to invest in anything that the IRS allows, including nontraditional investments. It lets you break free from the shackles

of custodians and traditional investments. If you want the freedom to control how your retirement assets are invested and ability to diversify these investments, then you need this feature.

If you read through IRS regulations on self-directed 401(k)s, you'll actually see that most of the "control" of the account goes to the custodian. They're the one holding that metaphorical checkbook.

As we've seen, many SDIRA plan owners establish a limited liability company (LLC) or business trust in their account's name. This gives THEM full checkbook control.

When you establish an IRA LLC or IRA business trust, you can open a banking account to access your SDIRA funds. Of course, this saves time. Time can be a major factor with non-traditional investments like cryptocurrency, where the value can change dramatically in mere minutes or even seconds.

With checkbook control, you are essentially the manager of the account and take over some of the responsibilities of the custodian. You can immediately use your IRA LLC bank account to invest in stocks, bonds, real estate, precious metals, tax liens, and cryptocurrencies. You do not need the consent of a custodian to execute any of these transactions.

What you are doing is using a business structure that is owned by the IRA to execute transactions. In this case, the entity is an LLC or trust. Since you are authorized to act on behalf of that entity, you essentially have complete control of your IRA.

Note: While custodianship still resides with whoever has set up your IRA, this allows you to perform the most important duties of the custodian without either their action or consent.

You can be the manager of your own IRA LLC, but you can't be compensated for services or use your funds to pay any of the IRA LLC's expenses. Doing so would make your friends at the IRS angry and cost you big time.

The most exciting aspect for owners of a Self-Directed IRA with checkbook control is to have more direct authority and oversight over the investment and management decisions regarding the funds and investments held in the retirement account. The driving factor is to avoid having to submit documentation for each investment transaction or transfer of funds to the IRA custodian for their review and approval. This review process can take up to 2-3 days and moreover, the custodian usually charges a fee for both this review and approval process and the transfer of funds to the investment.

Plan Asset Rules

The Department of Labor (DOL) established Plan Asset Rules as a way to define what is considered an IRA asset. By understanding this rule, you can avoid participating in a pro-

hibited transaction. The Plan Asset Rules are also referred to as "Look-Through" Rules.

Two main things can trigger the Plan Asset Rules. These are:

- **Operating Company**: If an IRA (or group of them) and a disqualified person own 100% of an "operating company," the assets of that company are considered to be belonging to the plan.
- **Investment Company**. If an IRA and disqualified person owns at least 25% of an investment company, all assets belonging to the company also belong to the IRA.

There are certain exceptions to the DOL Plan Asset Rules. We noted the rules as they apply to an operating company—a partnership or limited liability company (LLC) that typically engages in the development of real estate as well as venture capital or companies that provide various goods and services. When it comes to an operating company, if the plan does not own 100% of the partnership or LLC, then the DOL rules do not apply.

However, you should still review and understand prohibited transactions as defined by the IRS. These transactions can cause the IRS to treat your actions as an early distribution. This will result in penalties! The Plan Asset Rules will also not apply if the operating company, or the interests of the partnership or membership, are publicly offered. The same is true if the interests are registered under the Investment Company Act of 1940.

Disqualified Persons

As we said, you can use your SDIRA to invest in real estate. One restriction, however, is that neither you nor anyone in your family is allowed to reside in or take advantage of the property in any way. That would create a conflict of interest and potentially void your IRA.

The Department of Labor rules disqualify certain individuals, such as relatives, spouses, and other types of people you might form "sweetheart deals" with. So to keep everyone playing fair, plan participants can't allow their plan to make transactions with anyone the DOL labels a "**disqualified person**." Expect to pay hefty penalties if you do.

What does this mean for you? You can not hold property in your IRA that either you or your family members benefit from. This includes homes, businesses, and loans. You can't borrow against your IRA to start your own business. Generally speaking, if you or your family reap immediate rewards from the holding of an asset in your IRA, that is disqualified.

While certain assets are restricted by the IRS, the IRS is most concerned with who is benefitting from the holding of the assets in an IRA. If it's you or a member of your family, that will raise their eyebrows.

The sticky reality is that for real estate investors, Self-Directed IRAs can be riskier when

they own assets (including REI property) that have liabilities attached.

The Internal Revenue Code (IRC) Section 4975 defines a “disqualified person” as:

- IRC 4975(e)(2)(A) A fiduciary, which is the IRA owner, participant, or investing authority connected to the account;
- IRC 4975(e)(2)(B) An individual who provides a service to the plan, such as a trustee or custodian;
- IRC 4975(e)(2)(C) An employer with employees covered by the plan;
- IRC 4975(e)(2)(D) An employee organization with members who are covered by the plan;
- IRC 4975(e)(2)(E) Any individuals who own at least 50%, if not more, of C and D;
- IRC 4975(e)(2)(F) Any family members of all individuals listed above, which includes spouses, parents, grandparents, children, and grandchildren;
- IRC 4975(e)(2)(G) Any entities, including corporations, partnerships, trusts, LLCs, or estates, that are at least 50% owned or controlled by the individuals listed above;
- IRC 4975(e)(2)(H) Anyone who is highly compensated by or at least owns 10% of C, D, E, or G. This includes officers and directors; or
- IRC 4975(e)(2)(I) An individual who has 10% or more invested as a partner or joint venture of C, D, E or G.

Prohibited Transactions

The only downside to the SDIRA’s freedom from custodians is such freedom means you are responsible for dodging **prohibited transactions**. Indeed, the biggest way you can be a danger to yourself and your Self-Directed IRA is by performing prohibited transactions. There are things you can’t do in a business context with your SDIRA, including doing business with yourself via your Self-Directed IRA or other qualified retirement plan (QRP). This is called self-dealing, and you can’t do this, frankly, because of too many opportunities for corruption.

In general, the IRS prohibits any transaction that occurs between individuals on the “disqualified person” list and the IRA.

I’ve already talked a lot about prohibited transactions, but this is important stuff. Let’s just say you don’t want to get caught being involved in one. This is vital information for anyone who invests with a Self-Directed IRA to understand.

The types of transactions that could fall under the prohibited transaction rules can be grouped in three different categories: **Direct, Conflict of Interest, and Self-Dealing**.

Direct Prohibited Transactions

These types of prohibited transactions typically involve the sale, exchange or leasing of a property between a disqualified person and the IRA. It also includes lending money or credits between the IRA and any disqualified persons.

- You sell real estate owned by your Self-Directed IRA to your father.
- You lease an interest in a piece of property owned by your Self Directed IRA to your son.
- You sell real estate you own personally to your Self-Directed IRA.
- You transfer property you own personally to your Self-Directed IRA.
- You purchase real estate with your IRA funds and lease it to your mother.
- You use your Self-Directed IRA funds to purchase an interest in an entity owned by your wife.
- You transfer property you own personally that is subject to a mortgage to your Self-Directed IRA.
- You use personal funds to pay expenses related to your Self Directed IRA real estate investment.
- You use personal funds to pay taxes and expenses related to your Self-Directed IRA real estate investment.

Goods, services, or facilities furnished between the IRA or a disqualified person is also a direct prohibited transaction. The direct or indirect furnishing of goods, services, or facilities between an IRA and a “disqualified person” can take on many forms. Here are some more examples.

- Dan purchases real estate with his Self-Directed IRA funds and personally makes repairs on the property
- Larry purchases a condo with his Self-Directed IRA funds and paints the walls without receiving a fee
- Kris buys a piece of property with his Self-Directed IRA funds and hires his son to work on the property
- Karen buys a home with her Self-Directed IRA funds and her son makes repairs for free

- Lisa owns an office building with her Self-Directed IRA and hires her son to manage the property for a fee
- Shari owns an apartment building with her Self-Directed IRA funds and has her father manage the property for free
- Joe receives compensation from his Self-Directed IRA for investment advice
- Troy acts as the real estate agent for his Self-Directed IRA

The direct or indirect lending of money or other extension of credit between an IRA and a “disqualified person” is also prohibited:

- KJ lends his daughter $4,000 from his IRA
- Alicia uses the assets of her Self-Directed IRA as security for a loan
- Marshall and his wife personally guarantee a business loan owned by their Self-Directed IRA
- Mattias personally guarantees a bank loan to his Self-Directed IRA
- Mark uses his personal assets as security for an Self-Directed IRA investment
- Robert uses Self-Directed IRA funds to lend an entity owned and controlled by his father $25,000

The direct or indirect transfer to a “disqualified person” of income or assets of an IRA also constitutes a prohibited transaction. In real life, this might look like any of these examples:

- Steve uses a house owned by his Self-Directed IRA for personal uses
- Tim deposits Self-Directed IRA funds in to his personal bank account
- Pat is in a financial jam and takes $12,000 from his Self-Directed IRA to pay a personal debt
- Mark buys precious metals using his Self-Directed IRA funds and uses them for personal gain
- Jack purchases a vacation home with his Self-Directed Self Directed IRA funds and stays in the home on occasion
- Amy buys a cottage on the lake using her Self Directed IRA and rents it out to her daughter and son-in-law
- Stallone purchases a condo on the beach with her Self Directed IRA funds and lets her son use it for free

- Patt uses his Self-Directed IRA to purchase a rental property and hires his friend to manage the property. The friend then enters into a contract with Richard and transfers those funds back to Richard
- Houston invests her Self-Directed IRA funds in an investment fund and then receives a salary for managing the fund.
- Bloomberg uses his Self-Directed IRA funds to purchase real estate and earns a commission as the real estate agent on the sale
- Edison uses his Self-Directed IRA funds to lend money to a company he owns and controls
- John invests his Self-Directed IRA funds into a business he owns 75% of and manages

Note: Indirect prohibited transactions include using income or assets from the IRA for personal reasons, which includes providing them to a disqualified person. In lay terms, using your IRA funds to cover your mortgage is not allowed.

Conflict of Interest Prohibited Transactions

If you use your IRA to gain consideration between yourself and a disqualified person, you are in breach of the IRC. An example of this would be lending your IRA funds to your company in order to receive a promotion. A "Conflict of Interest Prohibited Transaction" often involves one of the following:

- Trey invests his Self-Directed IRA funds into a corporation in which he manages and controls but owns a small interest in
- Lee uses her Self-Directed IRA funds to loan money to a company she owns a small interest in but manages and controls the daily operations of the company
- Sally uses her Self-Directed IRA to lend money to a business that she works for in order to secure a promotion
- Harry uses his Self-Directed IRA funds to invest in a real estate fund that he manages and where his management fee is based on the total value of the fund's assets.

Self-Dealing Prohibited Transactions

These transactions are typically those where the IRA owner, or other disqualified person, earns an income through an IRA asset's transaction. For example, if you are a real estate agent and you earn a commission for selling your IRA asset through your company, this is prohibited. "Self-dealing" refers to the direct or indirect act by a disqualified person who is a fiduciary whereby he/she deals with income or assets of the IRA in his/her own interest or for his/her own account.

- Sara makes an investment using her Self-Directed IRA funds into a company she controls which will benefit her personally
- Jason uses his Self-Directed IRA funds to invest in a partnership with himself personally in which he and his family will own greater than 50% of the partnership
- Helen uses her Self-Directed IRA funds to invest in a business she and her husband own and operates and her and her husband earns compensation from the business
- Steve uses his Self-Directed IRA funds to lend money to a business in which he controls and manages
- Victor invests his Self-Directed IRA funds in a trust in which Victor and his wife would gain a personal benefit
- Brenda uses her Self-Directed IRA funds to invest in a real estate fund managed by her Son. Brenda's son receives a bonus for securing her investment.
- Frank invests his Self-Directed IRA funds into a real estate project that his development company will be involved in order to secure the contract
- Ryan uses his Self-Directed IRA funds to invest in his son's business that is in financial trouble
- David uses his Self-Directed IRA funds to buy a note on a piece of property for which he is the debtor personally

Prohibited Transaction Penalties

Essentially, if you use your IRA to engage in a prohibited transaction, the IRS will treat your IRA as if it were distributed. In other words, they will say you've cashed out your IRA. They will then subject you to:

- **Income tax on the entire contents of the account**
- **A 10% early withdrawal penalty**
- **Capital gains tax on the increased value of your account**

In other words, the penalties are severe and it's not something you want to experience.

In order to avoid the steep penalties for triggering a prohibited transaction and an IRS reprisal, you should ask yourself the following questions:

- **Is this an active or a passive investment?**
- **Are holdings being held in my name or the IRA trust's?**
- **Am I directly benefiting from items held in the IRA?**

- **Does holding this item in an IRA trust produce a conflict of interest?**

While the Internal Revenue Code is not necessarily accessible to laypeople, there is plenty that an individual with solid common sense can take away from these general principles. For the most part, those who use their IRA as a retirement account or operate it within the acceptable parameters which govern its tax-preferred status aren't going to have very much to worry about.

One last thing worth noting is that there is some wiggle room in terms of the language that provides exceptions for certain kinds of investments. These types of transactions, however, should not be executed without the oversight of a competent retirement planning professional.

Prohibited Transaction Case Studies

As we've seen, The IRS provides a detailed list of prohibited transactions and specifies what individuals are not allowed to invest in. Generally speaking, you cannot directly benefit from any investment you make with your IRA. For those that own property, the property must be held in the name of the IRA trust and not your own. Rent, for example, would be paid directly to the trust.

Want to read more about Prohibited Transaction cases? Check out these Case Studies:

- **A Series Of Landmark Prohibited Transaction Cases: Dabney Vs The IRS**
- **A Series Of Landmark Prohibited Transaction Cases: The Kellermans**
- **A Series Of Landmark Prohibited Transaction Cases: Peek & Fleck Vs The IRS**

HOW TO HANDLE TAXES

Income or gains generated by a Self-Directed IRA LLC are tax-deferred. Which means you can invest tax free and not have to pay taxes right away—or in the case of a Roth IRA, ever. This lets your savings grow quickly.

The key to investing in real estate with a traditional Self-Directed IRA LLC is to do so when you're earning high income (and being taxed at a higher rate.) Then when you start making less money (and get taxed at a lower rate) you can make withdrawals because your withdrawals will be taxed at a lower rate.

- Let's say you establish a Self-Directed IRA LLC with $200,000 to purchase real estate and make other investments.

- Assume you kept your Self-Directed IRA LLC open for 20 years and that you were able to generate an average annual pre-tax rate of return of 8% at a 25% tax rate.

After 20 years your $200,000 investment would be worth $349,572 after taxes on your earnings. Whereas, if you had made the investments with taxable, personal funds (non-retirement funds), in 20 years your investment would only be worth $320,714.

Ways To File

Both business trusts and LLCs allow you to file taxes as a partnership or corporation. An LLC will permit personal filing. A business trust also allows you to file as a trust. When your business trust or LLC is filed as a partnership, they are required to file federal and state income tax returns.

When a partnership consists of only one owner, they can be "disregarded as an entity separate from its owner." When this occurs, the entity will not need to file certain income tax returns. For business trusts, being a "disregarded entity" means you will not have to file a federal nor a state tax return. For LLCs, however, most states will still require you to file income tax returns.

Tax Rules

Nothing is ever simple when the IRS is involved. When you take money out of your IRA or 401K, the following income tax rules apply.

- **Your distributions are taxable immediately**. All distributions will be taxed in the year they come out of the plan. There is an exception when you roll over your distribution into another retirement plan or a traditional IRA or when your employer transfers the distribution directly into another plan or traditional IRA.
- **Your basis is not taxable**. If you made contributions to an IRA or 401k and you were not permitted to take a tax deduction on your tax return, then you will have what is called "basis" for tax purposes. You will not have to pay taxes on those amounts a second time when you take the money out of your plan. However, if you have a traditional IRA every time you take a distribution, part of it is taxable and part of it is not.
- **You may not claim a loss**. You may not claim a loss on your tax return for any loss incurred inside your IRA or 401k. Instead, you pay tax on each distribution based on the cash value or the fair market value of the property on the date it is distributed from the plan.

- Distributions from a traditional IRA are taxed as ordinary income, but if you made non-deductible contributions, not all of the distributions will be taxable.

Calculating Tax on UDFI

Your individual retirement account (IRA) is typically considered to be tax-exempt. However, when your IRA borrows money in a non-recourse loan, you must file IRS Form 990-T and a Schedule E. You also must report the income generated by the loan, as it may be subject to taxes.

Unrelated Debt Financed Income (UDFI) is generated when an IRA borrows money to purchase real estate. UDFI also requires the account holder to file Form 990-T with the IRS, similarly to UBIT.

You will find eight columns under Section E of IRS Form 990-T. These are as follows:

Column 1. During the year, if there was an outstanding loan on the property owned by the IRA, that property would be considered debt financed. This is true even if the property is sold at a gain before the end of the taxable year.

Column 2. Income cannot be taxed twice. If your IRA generated an income via a business investment through the use of a limited liability company (LLC), this income cannot be taxed again.

Column 3. These are your deductions.

Column 4. The average acquisition indebtedness can be tricky to calculate. Start with figuring out which months your IRA owned the property during the year. Once you do this, figure out the outstanding principal debt on the first of each of those months. Add them together then divide that sum by the number of months.

Column 5. Section 1011 of the IRS Code can help to explain how to find the adjusted basis for the debt financed property owned by your IRA. Once you determine this value, you would need to adjust it for the depreciation of the previous tax years.

Column 6. To find the value of column 6, simply divide column 4 by column 5.

Column 7. Calculating the amount of income generated by your debt-financed property can be confusing. First, divide the property's average acquisition indebtedness for the tax year by the property's average adjusted basis. Once you have this number, multiply it by the property's gross income. (This percentage cannot exceed 100%.)

Column 8. Sum up your total deductions from column 3. Multiply this by your response to column 6.

Unrelated Business Taxable Income (UBTI)

Your Self-Directed IRA (SDIRA) is subject to the IRS UBTI tax rates. Why? Because the IRS treats your SDIRA as a trust.

UBTI Transactions

IRAs and SDIRAs are typically exempt from the Unrelated Business Taxable Income (UBTI) tax. This rule, as established by the IRS in 1950, was introduced to prevent tax-exempt businesses from unfair competition related to their profits.

Most passive investments made with your SDIRA LLC or business trust are considered tax-exempt. However, real estate in particular can trigger the UBTI tax. Why?

UBTI taxes are generally applied to income generated by "any unrelated trade or business" that is "regularly carried on" by an organization that would be subjected to the tax. To better understand this, let us take a look at the main components of this regulation.

"Trade or Business"

The Internal Revenue Code (IRC) Section 162 defines "trade or business" as profit-oriented activities that involve regular actions by a taxpayer. There are very few cases in which activity needs to be attributed to a trade of business, however. This is because most expenses that are incurred from the profit-oriented activities of a taxpayer can be listed as deductibles under IRC 212.

"Regularly Carried On"

For an activity to be considered "regularly carried on", it is compared to those activities of a competitive, taxable business. There are some nuances to this. A short-term activity are typically tax-exempt if a similar commercial occurs all year. An example of this would be an ice cream stand operated by a tax-exempt organization during a state fair. Seasonal activities, however, are likely to be subjected to the UBTI tax. Intermittent activities are typically exempt if they are done so without the same type of promotional actions taken by a commercial enterprise.

UBTI Tax Triggers

It is important to identify and quantify the types of activities your SDIRA LLC has used to generate profits. This will help you to determine whether the activity and its profits are exempt or not. As previously stated, most passive transactions associated with your SDIRA LLC would not be subjected to the UBTI tax. However, there are several that could.

- Income generated by the actions of a trade or business that would be considered active but the IRS;

- Income that is generated by a convenient store
- Income generated by a manufacturing company
- Business income that is generated by an LLC that is used as a pass through entity
- Income that is generated by a business that is owned by your SDIRA LLC and you, the plan owner, are an investor
- Unrelated Debt Financed Income (as defined by IRC Section 514(e))
- When a nonrecourse loan is used to purchase property
- Income generated by a real estate investment, which is treated as a business inventory vice an investment.

UBTI Tax Rates

UBTI rates for 2020 are:

- **Up to $2,600: 10% of the amount over zero**
- **$2,600 up to $9,450: $260 + 24% of the amount over $2,600**
- **$9,450 up to $12,950: $1,904 + 35% of the amount over $9,450**
- **$12,950 and over: $3,129 + 37% of the amount over $12,950**

Legal Examples

There are plenty of examples of taxpayers and the IRS, referred to in court proceedings as the "Commissioner of Internal Revenue", going to court over taxes. However, let us take a look at two similar examples that resulted in very different court rulings.

- *Brown v. Comm.*, 143 F.2d 468 (5th Cir. 1944): In this case, the taxpayer (Brown) inherited 500 acres of land from a deceased relative. This land was used for grazing purposes only and, as such, was considered tax-exempt. After taking ownership of the property, the taxpayer decided to sell it. They listed it with a real estate broker. The broker was instructed to subdivide the property into lots and develop the land for sale by the tax-exempt organization. The broker did as directed. Streets were constructed, wells were installed, gas and electric lines were laid, and storm sewers were put in. Every year, between 20 and 30 lots were sold. In this ruling, the court found that the lot sales were being conducted as a regular course of business. The court ruled in favor of the IRS.
- *Farley v. Comm.*, 7 T.C. 198 (1946): In this case, the taxpayer (Farley) owned a tract

of land that was being used as a part of his nursery business. Without further developing the land, the taxpayer sold off 25 lots for residential development. Unlike the Brown case, the court ruled in favor of the taxpayer. Because the taxpayer did not further develop the land, the court viewed it as a "gradual and natural liquidation of an asset".

HOW TO TAKE DISTRIBUTIONS

You saved up for retirement, now it's time to get your money.

Whether your SDIRA was inherited or you've reached the maximum age, the IRS mandates that distributions be taken in order to satisfy the tax-deferred or tax-free status of the retirement account. This is generally known as an **RMD (required minimum distribution).**

Note: When you take a distribution from an IRA, you may choose the assets you want to withdraw. You are not required to take cash!

When you receive a distribution from a 401k or IRA you should weigh the following options:

- Report the distribution as **ordinary income**. Anyone who receives a distribution from a 401k or IRA can choose to pay ordinary income tax on the distribution—unless you have a Roth IRA.
- **Roll over** the distribution to another retirement plan. If you have not yet reached age 59½ and you receive a distribution from a qualified plan, you can roll over the distribution into a traditional IRA or another retirement plan to continue deferring tax. If the funds are distributed directly to you, you have 60 days to deposit them into another plan or an IRA. The portion that is rolled over will continue to be tax deferred and will be subject to all the rules of the new plan or IRA.
- If you are elderly, take advantage of **forward averaging**. You are eligible to use forward averaging if you satisfy all of the following:
    - **You were born before 1936.**
    - **You have not used ten-year averaging on any distribution since 1986.**
    - **You participated in your plan for at least five years.**

Early Distributions

If you withdraw funds from your IRA before the age of 59½, the Internal Revenue Service will consider it an early distribution. That means your funds are subjected to regular income taxes as well as an additional 10% penalty.

The 10% penalty applies to all IRA distributions except the following:

- **Qualified first time homebuyer distributions.**
- **Distributions to the estate or beneficiary of an IRA contributor after the contributor's death.**
- **Distributions not exceeding the deduction allowed to the taxpayer for the year for medical expenses.**
- **Distributions to alternate payees under qualified domestic relations orders.**
- **Distributions after the owner's "separation from employment" not exceeding amounts he or she pays for health insurance (assuming the owner has received 12 weeks of unemployment compensation and not been employed for a period of more than 60 days since receiving unemployment compensation.)**
- **Distributions to an IRA contributor after age 59½or due to his or her disability.**
- **Distributions not in excess of the owner's "qualified higher education expenses" for the taxable year.**
- **A series of substantial, equal periodic payments, regardless of the taxpayer's age when they begin.**
- **A distribution ordered by the IRS (levies, for example.)**

If you are facing a short-term financial crisis, an early IRA withdrawal should not be your first course of action. However, if you are considering using your retirement account, the **substantially equal periodic payment (SEPP)** gives you the chance to take an early distribution without having to pay hefty taxes.

SEPP Withdrawals

Rule 72(t) refers to code 72(t), section 2, which specifies exceptions to the early-withdrawal tax that allow IRA owners to withdraw funds from their retirement account before age 59½, as long as SEPP regulations are met.

To take advantage of this rule, you must take at least five substantially equal periodic payments (SEPPs), and the amount of the payments depend on your life expectancy (calculat-

ed by IRS-approved methods). These payments must thus occur over the span of five years or until the owner reaches 59½—whichever period is longer.

There are some things to know before you opt for using the SEPP method for an early IRA distribution. These include:

- **There are no age restrictions under a SEPP**
- **All payments must be "substantially equal," which means that you cannot modify them every year**
- **Payments must be computed as if you were intending to distribute your IRA's funds over the course of your entire life (or the combined life of you and your spouse in a joint account)**
- **You cannot discontinue or alter your payments for at least five years**
- **If you have not turned 59½ after those five years have passed, you must wait until you reach that age to make any changes**

The IRS has three approved ways of calculating your SEPP amounts. All three can result in varying payments. By offering these various calculation methods, the IRS allows you to pick the repayment plan that works best for you. These options include Amortization, Annuitization, and Required Minimum Distribution (RMD) methods.

Taking Distributions Directly From the IRA Trust or LLC

It may not be readily apparent to anyone but a financial advisor, a tax attorney, or your IRA custodian for that matter, but IRA Trusts and LLCs are not themselves the retirement accounts. The LLC or trust is merely the means by which the IRA makes investments. It's a vehicle. This distinction is useful because some IRA custodians believe that you can take distributions directly from the trust or the LLC.

Your distribution needs to be distributed from your account the exact same way that it's reported to and enforced by the IRS. It also needs to be drawn directly from the IRA, not from the IRA Trust or the IRA LLC.

How the IRS would respond to an IRA owner receiving distributions, approved by the custodian, from the IRA LLC or Trust is your anybody's guess. But why risk it? Why some custodians would risk distributing from investment vehicles is beyond me. I can't think of any benefit of distributing through the LLC or trust, aside from maybe less paperwork.

There are certainly times when custodians do things that the IRS doesn't necessarily

approve of, but there's generally a potential payoff and a very good reason for fighting that battle. The IRS is the authority, but they are still beholden to the law. They enforce the law, they don't create or interpret it. Nonetheless, you want to pick your battles.

Safely taking a distribution from your IRA entails going through the process the right way. The process is as follows:

1. **Complete a deposit form that sends IRA Trust or LLC funds back to the custodial account.**
2. **Take the distribution.**

See? It's really not that hard, and the best part is, it won't flag the IRS into looking more deeply into your investments.

SECTION III:
THE BIGGER PICTURE

ASSET PROTECTION

There are certain professions that attract litigation like honey attracts flies. Doctors, corporate executives and other such professions fall into this category.

However, litigation is not the only way in which your SDIRA assets can be at risk. Claiming bankruptcy, going through a divorce, or being the defendant in a civil lawsuit can all result in the loss of your assets. As a parent, if your child causes another person's injury, you are liable. In the case of a car accident, injury on your property, or wound aboard your boat, the resulting lawsuit could financially ruin you.

While your assets can be put at risk through any of the above, there are state and federal laws that provide some level of protection. For IRAs, both contributions and gains up to $1 million are protected from bankruptcy proceedings. Qualified employer-sponsored plans, such as SEP and SIMPLE IRAs, are also protected from bankruptcy. For plans that are subject to the Employee Retirement Income Security Act (ERISA), your assets are protected from bankruptcy and all other forms of litigation.

Additional asset protection is a smart way to further ensure your property and finances stay in your hands, regardless of the legal situations occurring in your life. To do this, most financial advisors recommend you create a legal entity, of which you are the manager or trustee, through which you invest your IRA funds. This IRS-approved strategy separates your personal assets from those owned by your trust.

We're talking about exactly what you've been reading about—the Self-Directed IRA LLC or Business Trust. There are many benefits related to using a business trust or LLC. Business trusts, however, go beyond the protections afforded by a LLC.

One of the many reasons real estate investors love the Self-Directed IRA is the control they have over both their assets and participation with traditional custodians. But many investors are also aware that the SDIRA protects them in two ways:

- **From personal lawsuits targeting plan assets**
- **From direct attacks, as IRAs are extremely difficult to sue compared to individuals or companies**

Fortunately, there are state and federal laws that protect many of your IRA assets. Whether you have a traditional or Roth IRA, you have certain inherent protections. In particular, the contributions and gains in your IRA are protected from bankruptcy proceedings through an inflation-adjusted cap. Up to $1 million of your IRA funds can avoid bankruptcy judgements and remain in your account. If your contribution steps from the rollover of a qualified plan, like a 403(b) or 457(b), they are completely protected, regardless of amount.

Employer-Sponsored SDIRAs

Plans that are employer-sponsored, like SEP and SIMPLE IRAs, are exempt from bankruptcy garnishments as well. If your plan is also subject to the Employee Retirement Income Security Act (ERISA), it is protected from any case that may award your assets to another party.

SEP IRAs

Simplified employee pension (SEP) plans have been around for years. SEP accounts are available to any business owner, with one or more employees, or anyone who earns a freelance income. A SEP approach to retirement funds offers employers an easy means of contributing toward both their employees' and their own retirement accounts.

SEP SDIRAs are considered traditional accounts because they are established with pre-tax wages. As such, SEP SDIRAs are subjected to the same regulations that govern a traditional SDIRA account, as established by the IRS. These regulations, established through the IRS Internal Revenue Codes, govern investment, distribution, and rollovers.

As with any other type of SDIRA, the SEP account owner can establish a business entity to act on its behalf.

SIMPLE IRAs

Savings Incentive Match PLan for Employees (SIMPLE) IRAs are essentially traditional IRAs that are set up by an employer or a self-employed person. To qualify to establish a SIMPLE IRA program, an employer must have 100 or fewer employees who were paid $5,000 or more in the last year.

Here are some of the defining features of a SIMPLE IRA:

- **Contribute pre-tax dollars**
- **Taxed on distributions down the road**
- **Established by employers**
- **Cannot use 401(k) or Roth IRA**

For those employees and employers who know their way around alternative investments or who wish to make their own investment decisions, a self-directed SIMPLE IRA lets them invest in the broad array of alternative assets allowed through self-direction—real estate, precious metals, commodities, unsecured loans, and much more.

ESTATE PLANNING

There's no way around the fact that an IRA, whether an SDIRA or any other kind, is part of its owner's estate. When the IRA is inherited, the beneficiary is required to include each distribution as part of their yearly income tax. The distributions can be stretched out for the individual's entire life expectancy, but yearly distributions are mandatory.

Traditionally, contributions to our IRAs were meant to be used once we reach the age of 59½. However, life does not always go according to plan. When an IRA plan owner dies, the account is passed to his or her beneficiary. Often, this is a spouse or family member, but not always. When no beneficiary is named for the plan, the account will go through probate.

Converting an Inherited IRA

In a traditional account, contributions are made with pre-tax dollars. This means that any withdrawals will be subject to income taxes. For traditional IRAs, non-spousal beneficiaries must withdraw all funds from an inherited IRA within 10 years of the original owner's death. Spousal IRA beneficiaries have different rules and more options to consider when taking their RMD. They can contribute to an inherited traditional IRA at any age (thanks to the SECURE Act).

For Roth accounts, however, the contributions were made with post-tax dollars. Because the IRS cannot tax money twice, qualified withdrawals from these accounts are generally tax-free. Roth accounts also do not have RMDs and there are no age limitations imposed on contributions.

There are significant estate planning benefits to converting to a Roth:

- **Distributions are no longer taxable**. You're going to be basically paying off the taxes on behalf of those who will inherit the account when you convert it to a Roth. In fact, you can leave this as a notice upon your passing to pay off the taxes for the conversion and that would reduce the amount of taxes you would pay on your estate. Each time your beneficiaries take a distribution, the money would not be taxed.
- **You are not required to take Roth distributions** during your lifetime. With a traditional IRA, you must begin receiving distributions once you hit 72 years of age. Not so with a Roth IRA.
- **Growth is not taxable**. Traditional IRAs have tax-deferred status. Roth IRAs are essentially tax-free. The longer the IRA has had time to mature, the better the potential payoff. The growth of the IRA is tax-free and so are the distributions, giving you

and your heirs non-taxable income for the remainder of your lives.

- **It's a great time to convert**. The new Tax Cuts and Jobs Act has made converting from a traditional to Self-Directed Roth IRA historically cheaper than it's ever been before. It's a great time to take advantage of low tax rates in order to save money on the cost of converting.

If you decide to convert a traditional IRA to a Roth IRA, you will have to pay taxes on the amount going into the account, since Roth accounts for tax contributions and not distributions. You also don't have to convert the entire account over to the Roth, but whatever you convert will be taxed, so bear that in mind.

Beneficiary Options

What happens to the account once it is passed to a beneficiary depends on who receives it. Spouses have the most options. As a spouse who inherits an IRA, you can:

- **Designate the account as your own (if you are the sole beneficiary) and treat is as if it is your own account**
- **Roll the IRA into your own like-type IRA account as a rollover and continue to contribute**
- **Take a distribution**

Non-spouses do not have these options. They cannot rollover the funds or continue to contribute to the account. In fact, the only option available to non-spouses are RMDs.

If the original account owner had already started taking RMDs, the non-spouse must continue them. If they have not, the non-spouse inheritor must start taking RMDs by Dec. 31 the following year after the original owner died. The non-spouse beneficiary has five years to cash out the entire IRA.

Executing a Stretch

A stretch IRA is an estate planning strategy that extends the tax-deferred benefits of an IRA inherited by a non-spouse beneficiary. The beneficiary must take distributions—but at a rate based on his or her life expectancy, not the original account owner's.

To execute a stretch, simply pass the IRA to the youngest person in your family. A good example is a grandchild. Since the value of the distribution is prorated over the course of the child's life, it stands a good chance of being less than the account's annual earnings. Another option would be leaving the Roth IRA to a spouse who would not be required to take any distribution at all. When the spouse passes, the Roth can then be handed over to the youngest child in the family.

SECTION IV: FAQS

The SDIRA sounds great … So what's the catch?

The main reason most people don't use Self-Directed IRAs is because the large financial institutions who administer most U.S. retirement accounts don't think it's a good idea to hold real estate or non publicly traded assets in retirement plans.

Can I roll over or transfer my existing retirement account to a SDIRA?

This depends on your situation:

Your Situation:	**Transfer/Rollover?**
I have a 401k or other company plan with a current employer.	No, in most instances your current employer's plan will make it impossible until you reach retirement age.
I inherited an IRA and keep the account with a brokerage or bank as an inherited IRA.	Yes, you can transfer to a self-directed inherited IRA.
I have a Traditional IRA with a bank or brokerage.	Yes, you can transfer to a self-directed IRA.
I have a Roth IRA with a bank or brokerage.	Yes, you can transfer to a self-directed Roth IRA.
I have a 403(b) account with a former employer.	Yes, you can rollover to a self-directed IRA.
I have a 401k account with a former employer.	Yes, you can rollover to a self-directed IRA. If it is a Traditional 401k, it will be a Self-Directed IRA. If it is a Roth 401k, it will be a self-directed Roth IRA

What restrictions are there on using a Self-Directed IRA?

When self-directing your retirement account, you must be aware of the prohibited transaction rules found in IRC 4975. These rules don't restrict what you can invest in, but whom your IRA may transact with.

The prohibited transaction rules restrict your retirement account from transactions with someone who is disqualified. Disqualified persons include: The account owner, their spouse, children, parents, and certain business partners.

On the other hand, your retirement account could buy a rental property from your distant cousin, college roommate, friend, or a random third-party.

Can my Self-Directed IRA invest in my personal company, business, or deal?

No, that would violate the prohibited transaction rules if your IRA transacted with you personally or with a company you own.

What is Checkbook Control?

Many self-directed retirement account owners, particularly those buying real estate, use an IRA LLC, also known as a "checkbook-control IRA", to hold their retirement assets so that they have fast access.

There are many restrictions against the IRA owner being the manager (such as not receiving compensation or personal benefit) and many laws to consider. You definitely want to consult with your attorney.

See our section above to learn more.

How is the SDIRA different from other retirement plans?

IRAs, 401(K)s, and SDIRAs are all used to earmark funds you intend to use during your retirement. These accounts allow for unhindered growth as the invested funds and their earnings are generally tax-deferred. Each allows for investments in publicly traded securi-

ties and derivations of them, including stocks, bonds and mutual funds. However, SDIRAs allow you to invest in much more than that. These alternative assets, like real estate, precious metals, and renewable energy, allow for you to have a much more diverse portfolio. IRAs and 401(K)s are typically held at banks, insurance companies, or general investment firms and managed primarily by investment professionals.

Investment firms that offer custodial management of your SDIRA, on the other hand, tend to specialize specifically in these types of accounts. Also unlike IRA and 401(K) accounts, you control every aspect of your SDIRA. The investment professionals who retain custodial-only access are simply there to ensure you do not unintentionally break rules set out by the IRS.

My employer offers a retirement plan, but I want to start my own. Now what?

You are still allowed to make the maximum contribution of $6,000 per year to your Self-Directed IRA (if you're under the age of 50). This is true regardless of whether or not you have an employer-sponsored retirement plan, even if it is an IRA. There may, however, be a limitation regarding whether or not you're allowed to claim these funds as a deduction on your tax return.

How long does it take to open an SDIRA?

The account process can take between two days and three weeks. The main drivers that dictate this timeline are how you plan to fund your account and, if you have a current retirement plan, who the custodian is

Does having a SDIRA make me more likely to be audited by the IRS?

Currently, the IRS cannot legally target taxpayers for audits based on the type of investment accounts they have. In 2015, the IRS began asking for additional information on IRA reports in the form of Form 5498. However, because not all investors digitally submit their reports and the IRS cannot presently support manual submissions, targeting SDIRA owners would be considered a discriminatory practice. While this may change in the future, a SDIRA will not trigger an audit.

My CPA says there is a 39% tax if I switch to a SDIRA and has warned against doing so. Is this true?

Your CPA is likely not familiar with the SDIRA process. They may also be assuming that you want to take an early distribution from your current IRA in order to fund your SDIRA. This is untrue. Opening a SDIRA is typically considered a custodian-to-custodian transfer. Because of this, the startup process and investments are non-reportable and non-taxable.

Can I claim all of my IRA contributions?

If you have an IRA account through your employer, you may not be able to deduct the total of your traditional IRA contributions due to IRS threshold constraints.

How can I transfer funds into my new account?

There are two ways to roll funding between your accounts. For a non-taxable and non-reportable option, you can elect to make a direct custodian-to-custodian transfer from your old account to your new one. You may also opt for a distribution-and-rollover transfer. These events are reportable, but are not taxable when the old funds are rolled into a new account within 60 days of distribution from the previous custodian.

How long does a transfer take?

For the custodian-to-custodian option, a transfer may take between seven and twenty days. If you are considering a distribution-and-rollover method, it only takes a couple business days for your bank to transfer the distribution to your new IRA.

What tax liabilities should I watch out for?

The Unrelated Business Income Tax, or UBIT, applies when your IRA receives unrelated business income. If your IRA receives investment income, that income is exempt from UBIT tax. Investment income exempt from UBIT includes the following.

- **Real Estate Rental Income:** Rent from real estate is investment income and is exempt from UBIT.

- **Interest Income:** Interest and points made from money lending is investment income and is exempt from UBIT.
- **Capital Gain Income:** The sale, exchange, or disposition of assets is investment income and is exempt from UBIT.
- **Dividend Income:** Dividend income from a C-Corp, where the company pays corporate tax, is investment income and exempt from UBIT.
- **Royalty Income:** Royalty income derived from intangible property rights, such as intellectual property, oil, gas, or mineral leasing activities is investment income and is exempt from UBIT.

So make sure your IRA receives investment income as opposed to “business income”.

What is unrelated debt-financed income (UDFI)?

If an IRA buys an investment with debt, then the income attributable to the debt is subject to UBIT. This income is referred to as “unrelated debt financed income” (UDFI), and it triggers an UBIT tax. This often occurs when an IRA buys real estate with a non-recourse loan.

For example, let’s say an IRA buys a rental property for $100,000, and that $40,000 came from the IRA and $60,000 came from a non-recourse loan. The property is now 60% leveraged, and as a result, 60% of the income is not a result of the IRAs investment, but the result of the debt invested. This debt is not retirement plan money, so your friends at the IRS will require you to pay tax on 60% of the income. So, if there were $10,000 in net rental income on the property then $6000 would be subject to UBIT taxes.

Can I get a loan to buy real estate with my SDIRA?

Your IRA can buy real estate using its own cash and a loan or mortgage. To do this, you must obtain a non-recourse loan.

A non-recourse loan is made by the lender against the asset. In the event of default, the sole recourse of the lender is to foreclose and take back the asset. The lender cannot pursue the IRA or the IRA owner for any deficiency. Also, your IRA may be subject to a tax known as unrelated debt financed income tax (UDFI/UBIT).

What is the difference between an indirect and direct rollover?

Indirect rollovers occur when the funds from your current plan are distributed directly to you. A 20% tax withholding fee will be taken from your total by your administrator. Once you deposit your distribution, you have up to 60 days to invest any percentage of those funds into your new IRA or 401(K) without an additional penalty tax. Direct rollovers bypass these taxes. With these, your current administrator issues your funds directly to your new plan.

What rules apply to an LLC I invest in?

If your investments include owning a percentage of an LLC, all transactions must meet IRA guidelines. When LLC returns are distributed to investors, including you, they need to be issued at the same time and pro-rata.

How much can I contribute annually to my IRA?

Contributions to your IRA and 401(K) are subjected to annual limits as dictated by the IRS. The SDIRA Maximum Contribution for 2020 is $6,000 if you’re under the age of 50. If you’re 50 and over, you can make an additional $1,000 catch-up contribution. The maximum contribution is $7,000 if you’re at least age 50.

What is a RMD?

RMD, or Required Minimum Distribution, is the lowest amount of money you must withdraw from your retirement account once you reach the age of 72 (Roth IRAs differ. They do not require any withdrawals until after the owner has died.) Your RMD is calculated by the IRS-published life expectancy factor and your balance as of Dec. 31 of the previous year. RMDs are calculated on an annual basis with the first one starting on April 1 once you turn 72. You are required to withdraw your annual RMD amount by Dec. 31 every year.

Do I pay taxes on RMDs?

Yes, the account owner is taxed at their income tax rate when they withdraw their RMD.

What if I fail to withdraw my RMD?

Regardless of whether the IRA is yours or you inherited it, failure to withdraw the designated RMD by Dec. 31 will result in a 50% penalty.

What is the maximum contribution for my SDIRA?

The maximum contribution for a Self-Directed IRA remains $6,000 per year for those who are under 50 years of age and $7,000 per year for those who are 50 or over.

Roth IRAs can also be limited depending on your income. For a Roth IRA, the more you make, the less money you are allowed to put into the account. That amount diminishes until you've crossed a threshold which limits your contributions to zero dollars per year.

Are my contributions still tax-deductible?

It seems like each time a new president takes office and passes their tax plan, there ends up being a great deal of confusion over what you can or cannot claim. While it's true that the Tax Cuts and Jobs Act limits the amount of deductions you can claim in property taxes, retirement accounts were left largely untouched.

So the answer for now is yes, you can still claim contributions to your retirement accounts on your taxes, but there are other changes to the tax code relevant to IRAs that are no longer deductible. Those include:

- **Costs associated with maintaining the IRA**
- **Other miscellaneous fees related to the IRA**

I filed a joint return with my spouse, but only one of us works. Now what?

Both you and your spouse can make separate contributions to your IRA regardless of the fact that only one of you works and thus has taxable revenue. So long as the combined amount does not exceed the limit of $6,000, Uncle Sam doesn't care where the money came from. You can also write off the contribution on your joint tax return.

I filed a joint return with my spouse. How does this affect our Roth IRA?

Roth IRAs are capped for both single and married couples. For married couples, the threshold begins at $181,000 of cumulative gross income. Once that threshold is crossed, the amount you are allowed to contribute diminishes until it reaches zero. The IRS provides a formula for calculating this amount.

Converting a Traditional IRA to a Roth IRA

Before 2018 there was a loophole that allowed people to make contributions to their traditional IRA and then characterize the account as a Roth IRA. The Tax Cuts and Jobs Act closed this loophole, at least partly. You can no longer convert your traditional IRA back to a Roth. Nonetheless, the new tax bill lowered the amount of taxes you would have to pay in order to transfer funds from a traditional IRA to a Roth.

Remember, Roth IRAs are built on contributions that are taxed on their way in, while traditional IRAs are taxed on their way out. In order to convert the account, you will need to pay taxes on the entire contents of your traditional IRA. For some, this will be worth it. For others, not so much.

Does the Manager of an IRA LLC Need a Real Estate License?

A real estate agent or someone who oversees the management of rental properties needs a real estate license. If the principal function of your job is the sale, management, renting, or leasing of a real estate property, then you need a real estate license.

However, if you own a company that performs these services, are performing these services for yourself, or are the principal in an LLC that performs these services, you have no need for a real estate license.

Be careful. If you do have a real estate license and manage a self-directed 401(k) or Self-Directed IRA, it can actually trigger a prohibited transaction. In other words, the IRS will flag the transaction as illegal for the purposes of tax-deferral. For example, you cannot own a business with your IRA that either you or a close family member runs or operates. You cannot own property with an IRA that either you or close family members rent or reside in. You cannot directly benefit from business transactions executed by your IRA. The only benefit you get is when it's time to distribute the holdings. That would be when you reach the ripe old age of 59½.

Suffice it to say, having a real estate license and using your IRA to execute real estate trades could be seen as a conflict of interest. Not only do you not need it, but you don't necessarily want it.

You CAN hold real estate in your IRA and then earn a passive income from rent or the sale of the property. You can still use your IRA LLC to hire a property manager or have the IRA custodian handle expenses directly.

Is my SDIRA contribution tax-deductible?

The answer is: it depends. Your eligibility depends on your income, marital status, employment benefits and more. Depending on those variables, you'll be placed into one of three categories.

No tax deduction. Contributions to a Roth IRA aren't deductible. Not ever. That said, contributing to your Roth account is still a solid plan. Just make sure your modified adjusted gross income (MAGI) isn't higher than the Roth contribution limit. Also, if you're looking for tax deductions, then consider maximizing out your 401(k) or 403(k). These plans accomplish much the same thing as traditional IRAs in terms of taxation.

Limited deduction. There are two scenarios where your contributions may be limited.

1. **If you or your spouse are covered by a retirement plan at work**
2. **If you or your spouse fall outside the allowed income range**

Remember, the IRS frequently updates income ranges, so double check the date before assuming you're good to go. Better yet, consult an attorney.

Full tax deduction. You can deduct the full contribution amount from your taxes if both of the following things are true.

1. **Neither you nor your spouse have an individual retirement account through your employer.**
2. **Your income(s) falls under the IRS cutoff point.**

Can I establish a Self-Directed IRA if my spouse is the only one who earned income this year?

Yes. If you file a joint return, you and your spouse can each contribute, even if only one of you has taxable compensation, regardless of which of you earned the compensation. The amount of your combined contributions can't be more than the taxable compensation reported on your joint return or exceed the maximum IRA contributions for the year.

How much can I contribute to my Roth IRA if I earned too much money this year?

That's a nice problem to have!

If your modified adjusted gross income is below the cutoff point and you file a joint return, you can make a Roth IRA contribution. However, if you earned more than that during the year, you will see your maximum Roth IRA contributions reduced or completely eliminated.

One way to "get around" the Roth income threshold rules is to make an after-tax contribution and then convert it into a Roth IRA. Since the traditional contribution was made after-tax there would be no tax on the Roth IRA conversion.

Fun fact: This tactic was made possible when the IRS removed the income level restrictions for making Roth conversions in 2010.

Can contribute to my SDIRA after I turn 72?

Thanks to the SECURE Act, as of January 1, 2020, there are no longer age restrictions for contributing to a traditional or Roth IRA.

CLOSING

When you establish your Self Directed IRA Business Trust or LLC with Royal Legal Solutions, you get the fully-prepared trust document, the EIN number, and bank account setup. We also manage the interaction with your custodian to ensure that everything is properly established and compliant with all laws and regulations.

The experts at Royal Legal Solutions are well versed in the investment benefits of the Self Directed IRA Business Trust and LLC. We also are intimately familiar with the lengthy list of prohibited transactions, and we use this knowledge to make sure that your account does not engage in them or incur any unnecessary and costly penalties.

Additionally, we have strong business relationships with almost every custodian (CamaPlan, uDirect, NuView, Kingdom Trust, etc.) to ensure a smooth process. We also have banking and other contacts in place for you to set up the Business Trust, establish, and fund your new company all without ever leaving your home. Royal Legal Solutions does the heavy lifting while you focus on your investments.

Scott Royal Smith

Scott Royal Smith is an asset protection attorney, real estate investor and the founder of Royal Legal Solutions. Scott's background in litigation means he knows how to best use the law for your maximum advantage to streamline your operations, reduce taxes and stay in compliance.

Royal Legal Solutions offers real estate investors the most advanced litigation protection via anonymous asset-holding structures. While we focus on asset protection and real estate law, our other practice areas include estate planning, retirement planning and general practice areas that affect real estate investors in the United States and Canada.