LEGAL UPDATE

IRAs and Prohibited Transactions

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The controversies with respect to the fiduciary rule over the past decade have focused attention upon the prohibited transaction rules of the Internal Revenue Code and ERISA with respect to dealings with tax-qualified plans and IRAs. A "disqualified person," the IRS counterpart of an ERISA "party in interest," is subject to a 15 percent excise tax (100 percent excise tax if not corrected in a timely fashion) and will need to disgorge any profits derived from such transaction. Those sanctions are certainly severe, but in many instances not as severe as the consequences to the owner of an IRA if his or her IRA enters into a prohibited transaction. The consequence is that the IRA will cease to be an IRA, and the grantor of the IRA will be subject to federal income tax on the value of his or her IRA. The individual owner of an IRA is subject to the same restrictions on dealing with parties in interest as the fiduciary of a tax-qualified plan, but, as a practical matter, some of the fiduciary self-dealing provisions are more difficult to apply. As the owner of an IRA, he or she is a fiduciary to the IRA and therefore cannot use the funds of the IRA to benefit himself or herself in a capacity other than as a beneficiary of the IRA.

The fiduciary self-dealing issue may arise when an IRA owner invests in an entity in which he or she has some affiliation, for example, an individual may wish to have his or her IRA invest in a corporation of which he is an officer or director. In many instances, on the surface, the transaction will appear benign, but there is an underlying issue of which clients should be aware. For example, in one DOL advisory opinion, the IRA owner directed the IRA trustee to purchase stock of a corporation for which the IRA owner was an officer and a shareholder of one percent of the total shares of the corporation. Due to the small number of shares involved, the DOL concluded that there was not a party in interest prohibited transaction. However, because of the factual nature of the transaction, the DOL expressed no opinion as to whether the IRA owner was using the IRA assets to benefit himself or herself in some capacity. Similarly, in an Internal Revenue Service private letter ruling, a taxpayer of a self-directed IRA directed the trustee to purchase up to 5 percent of the shares of Corporation A, of which he was the director. The IRA owner was also the president of Corporation B which owned 35 percent of Corporation A. Based upon certain representations of Corporation A, the IRS concluded that the transaction was not a party in interest transaction. However, the IRS further concluded that if the settlor (owner) of the IRA were to benefit from the transaction, either directly or indirectly, in any capacity other than as a plan participant, for example, if the plan's acquisition of the stock ensured the taxpayer's re-election as a director of Corporation A or benefited him or her in his/her position as president of Corporation B, the stock acquisition would be a prohibited transaction. However, whether the IRA owner in fact derived such an impermissible benefit was a question of fact to be determined from the surrounding facts and circumstances, the type of issue upon which the IRS will not render an opinion.

The practical consequence of these rulings for IRA owners is that there is no legal precedent upon which they can take into account in determining the action that a regulator might take if they were to invest in an entity in which they have an affiliation. While the benefit to be derived must be personal in nature, as compared to a legal benefit from entering into a transaction, and the DOL has opined that a fiduciary's deriving some incidental benefit from a transaction involving IRA assets will not constitute a prohibited transaction, that concept is not well defined. Add to this the IRS' increased attention and some Tax Court successes in dealing with IRAs, and IRA owners should be advised to proceed cautiously, because by definition almost all such transactions will lie in the grey area.

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