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The Perils of Self-Directed IRAs

Kathryn Kennedy

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THE PERILS OF SELF-DIRECTED IRAS

By Kathryn J. Kennedy*

ABSTRACT

Individual retirement accounts were created in 1974 as tax-sheltered retirement savings for employees whose employer did not offer an employer-provided retirement vehicle. Since then, they have been used primarily as rollover vehicles, such that amounts accumulated under employer-provided retirement plans can be rolled over into an individual retirement account. This Article examines the perils involved with a rollover IRA owner decides to invest his IRA assets in non-traditional assets.

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INTRODUCTION

Individual retirement accounts ("IRAs") are now the preferred vehicle for individuals to use in order to continue tax-exempt savings for retirement and are increasingly being used to roll retirement savings from employer-provided pension plans. At the end of the second quarter of 2018, there was $9.3 trillion in assets in IRAs, which represents 33% of the total retirement market assets. A General Accountability Office ("GAO") report released as early as 2014 expressed concern about the magnitude of loss of tax revenue from IRAs due to the use of mega IRAs and self-directed IRAs. This prompted the then-Senate Finance Committee Chair Ron Wyden to request Congress to re-examine the IRA rules and to make changes to prevent a small group of wealthy taxpayers from taking advantage of these tax-sheltered retirement vehicles. The GAO report also recommended the Internal Revenue Service ("IRS") to compile data regarding IRA accounts that hold nonmarketable securities, for fear that transactions otherwise prohibited under federal law may be occurring (referred to as prohibited transactions).

Until recently, IRS collection efforts have gathered little information regarding IRAs that hold unconventional or alternative assets – such as real estate, precious metals, private equity, and virtual currency. In this article, reference to such assets will be labeled "alternative assets." That changed in 2015, as the IRS began to require trustees and custodians of IRAs to report information about these assets. 

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1. See Sarah Holden & Daniel Schrass, The Role of IRAs in US Households’ Saving for Retirement, 2018, Vol. 24, No. 10 ICI RES. PERSP. 1, 1 (2018) (indicating that more than half of traditional IRA households contained rollovers from employer-sponsored retirement plans). ICI is a national association of United States mutual funds and other investment companies, dating back to the 1940s.

2. ld. at 2.


5. U.S. Gov’t Accountability Off., supra note 3, at 1.

alternative assets. In its instructions to the tax forms (i.e., Forms 1099-R and 5498 used to report and disclose information about the IRA), the IRS now requires special coding to report IRA assets that do not have a readily available fair market value, such as: stock, other ownership interest in a corporation, or short- or long-term debt obligations, not readily tradable on an established securities market; ownership interest in a limited liability company ("LLC"), partnership, trust, or similar entity (unless the interest is traded on an established securities market); real estate; option contracts or similar products not offered for trade on an established option exchange; or other assets that do not have a readily available fair market value. Presumably, such data will better enable the IRS to target audits of IRAs that improperly value their assets (as a readily fair market value is not available) and that engage in prohibited transactions. Given the current size of the IRAs’ holdings, they will continue to be subject to IRS scrutiny.

In a more recent 2016 report issued by the GAO, it made recommendations to the Commissioner of the IRS to do more in educating IRA owners of the potential dangers that exist when investing in alternative assets, as such investments may involve prohibited transactions. As such, the IRA owner risks losing the tax-advantaged status of the account; increased income tax liability; ongoing tax liability that may be owed by the IRA if the IRS owner invests in active businesses or debt-financed properties; and the need to provide updated fair market value information for tax reporting purposes. In the self-directed context, trustees and custodians of IRAs routinely set forth in the sell letter that they will not review the merits or legality of any investment made by the account holder, and that the account holder will hold the trustee or custodian harmless and without liability if the investment later proves to be unacceptable under the Employee Retirement Income Security Act ("ERISA") or the Internal Revenue Code ("Code"). Hence, the IRA owner remains responsible for

8. U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 3, at 56.
9. See In re Kellerman, 531 B.R. 219, 221 (Bankr. E.D. Ark. 2015) (noting that the sell letter between the IRA owner and the custodian makes the custodian’s role clear, stating “I understand that my account is self-directed and that Entrust … will not review the merits, legitimacy, appropriateness and/or suitability of any investment in general, including, but not limited to, any investigation and/or due diligence prior to selling any investment, or in connection with my account in particular …. I understand that neither the Administrator nor the Custodian determine whether this investment is acceptable under the Employee Retirement Income Security Act (ERISA), the Internal Revenue Code (IRC), or any applicable federal, state, or local
determining the legality of its plan investments, something they may not be in a position to do.

A very recent 2019 GAO report on self-directed IRAs reviewed the Department of Labor’s (“DOL”) process for granting administrative exemptions from the prohibited transaction rules for IRAs.\(^\text{10}\) The report made two recommendations: (1) that the DOL sufficiently document its internal policies and procedures regarding this process to ensure effective internal control and greater transparency and (2) that the IRS and DOL do more collaborative efforts in the context of prohibited transaction exemptions to provide greater education to IRA owners, as only 8 of the 124 IRA applications reviewed by the GAO reflected DOL contact with the IRS.\(^\text{11}\) The report noted that there were very few prohibited transaction exemptions that were sought by IRA owners—a total of 63 between January 1, 2006 and May 16, 2017—roughly half of which were withdrawn before the review process was completed.\(^\text{12}\) The most common application involved the sale of IRA assets involving securities or real property; the remaining involved leases, loans, and extensions of credit.\(^\text{13}\) One practitioner critiqued the report as IRA owners rarely use the prohibited transaction exemption process, demonstrated by the fact that only 48 exemptions have been granted over the past 11 years, and that the process takes 6 months to 1 year for approval with associated legal fees in the neighborhood of $5,000.\(^\text{14}\) This GAO report was in response to Senator Wyden’s concerns that IRA owners have accumulated extremely large IRA balances invested in unconventional assets such as non-publicly traded securities and partnership interests.

**What are IRAs?**

IRAs are a creation of I.R.C. § 408, initially designed to provide tax-sheltered retirement savings for those individuals that were not laws, including securities laws. I understand that it is my responsibility to review any investments to ensure compliance with these requirements.”)


\(^\text{12}\) *Id.* at 16.

\(^\text{12}\) *Id.* at 1.

\(^\text{13}\) *Id.* at 19.

offered an employer-provided retirement plan. They were fashioned similarly to the defined contribution model, shifting the investment risk to the IRA owner and targeting the level of annual contributions to be made, not the ultimate benefit to be received. Thus, benefits payable from the IRA were to be based solely on the value of the account balance upon retirement. The initial maximum annual dollar limit applicable to an IRA was the lesser of $1,500 or 100% of pay, considerably less than the initial maximum annual dollar limit applicable to qualified defined contribution plans sponsored by an employer, which was the lesser of $25,000 or 25% (now 100%) of pay. Individuals establishing a traditional IRA are permitted to make tax deductible contributions to their IRAs, whereas individuals establishing a Roth IRA are limited to making after-tax contributions to their IRAs. Both types of IRAs permit rollovers of funds from an employer-provided qualified retirement plans, often preferred for participants and beneficiaries in order to consolidate retirement assets and to exercise greater control over the selection of investments provided by the IRA.

Alternatively, an individual may establish an individual retirement annuity issued by an insurance company if he or she wishes the protection of an annuity guarantee so as not to outlive one’s retirement savings. These forms of IRAs are generally not ERISA plans due to statutory exemptions under Title I of ERISA. As such, they are not

16. Traditional IRAs are governed by I.R.C. § 408 (2018), whereas Roth IRAs are governed by I.R.C. § 408A (2018). Whereas the Roth IRA would appear to be less desirable than a traditional IRA, it allows all contributions to accumulate tax-free and all distributions to be tax-free upon withdrawal. Eligibility for a traditional IRA versus a Roth IRA are considerably different.
17. I.R.C. § 408(b) (2018). Such annuities have restrictions regarding the use of life insurance, nontransferability clauses, no fixed premiums, and maximum annual premiums.
18. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in various sections of 26 and 29 U.S.C.). ERISA is the federal labor law that regulates the establishment and maintenance of voluntary employer-sponsored retirement plans. ERISA’s provisions were codified in title 29 of the United States Code, whereas the related tax provisions of the Code were codified in Title 26 of the United States Code. IRAs are exempt from Title I of ERISA, including the reporting and disclosure rules of Part 1, ERISA § 101(a); the participation, benefit accrual, and survivor annuity rules of Part 2, ERISA § 201(6); the funding rules of Part 3, ERISA § 301(a)(7); and the fiduciary standards of Part 4, ERISA § 401(a). This act may be referred to as ERISA in the text. According to the Department of Labor’s (DOL) regulations, IRAs are generally not employee benefit plans and thus, not subject to Title of ERISA, unless they are sponsored by an employer who does more than facilitate the payroll deduction of contributions to an IRA. 29 C.F.R. § 2510.3-2(d)(1)
subject to ERISA’s preemption clause and thus could be subject to state laws, especially state property laws. This article will not generally discuss the rules applicable to IRAs that are ERISA plans.

There is a heightened interest by IRA owners to self-direct their investments – but the term “self-direct” can mean many things. Generally, it refers to the IRA owner’s ability to select his or her investments of the IRA beyond those investments offered by the trustee’s or custodian’s platform of investments. Contributing factors to the growth of self-directed IRAs include the bear market of the early 2000s, low interest rates, and concerns about mutual fund fees. When IRA owners invest in less conventional non-publicly traded assets, such as real estate, precious metals, and private equity, they may be endangering the tax-favored status of their accounts, thereby placing their retirement savings at risk. The more common types of alternative assets for IRAs include:

- Real estate (e.g., vacation homes, commercial real estate, rental housing, and undeveloped land);
- Tangible and intangible personal property (e.g., precious metals, digital money existing in cyberspace such as bitcoin, patents and copyrights);
- Energy investments (e.g., oil and gas interest, solar energy, wind energy, energy-efficient housing);
- Equipment leasing (e.g., equipment leased to a business for a fee and over a period of time);
- Farming interests (e.g., lumber or milk and wool from animals);

provides that “(1) For purposes of Title I of the Act and this chapter, the terms ‘employee pension benefit plan’ and ‘pension plan’ shall not include an individual retirement account described in section 408(a) of the Code, an individual retirement annuity described in section 408(b) of the Internal Revenue Code of 1954 (hereinafter ‘the Code’) and an individual retirement bond described in section 409 of the Code, provided that—(i) No contributions are made by the employer or employee association; (ii) Participation is completely voluntary for employees or members; (iii) The sole involvement of the employer or employee organization is without endorsement to permit the sponsor to publicize the program to employees or members, to collect contributions through payroll deductions or dues checkoffs and to remit them to the sponsor; and (iv) The employer or employee organization receives no consideration in the form of cash or otherwise, other than reasonable compensation for services actually rendered in connection with payroll deductions or dues checkoffs.”

Private equity (e.g., investment in privately held businesses such as private company stock or interests in limited liability companies (LLCs) or limited partnerships; and

Promissory notes (e.g., debt backed or not backed by collateral, such as a mortgage or deed of trust).  

This article will focus on the applicable federal rules that IRA owners must be aware of when investing in alternative assets in order to avoid disqualifying the IRA and losing its tax-shelter. Other issues generated by these types of investments include: who maintains custody of the investment; the lack of liquidity of these assets for purposes of distributing minimum required distributions; the DOL’s plan asset rules; fair market valuation concerns; and other applicable federal taxes that could be assessed against the IRA.

Requirements of I.R.C. § 408

There are a variety of requirements under I.R.C. § 408 that must be satisfied for an IRA:

- The IRA must always be fully vested;
- The account must be governed by a written instrument such that the IRA owner understands his legal rights, as well as the obligations of the trustee or custodian holding the IRA’s investments;
- Non-rollover IRAs are subject to maximum annual contribution limits;
- The IRA must be created or organized in the United States and must be maintained as a domestic trust or custodianship.

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20. *Id.*
22. I.R.C. § 408(a) (2018); Treas. Reg. § 1.408-2(b) (2020). Normally a trustee is the owner of the trust, whereas the custodian merely holds the assets of the trust. But for IRA purposes, there is little difference. Banks generally serve as trustee for the IRA, whereas financial institutions generally serve as custodian. However, I.R.C. § 408(h) states that the IRA custodial account is to be treated as an IRA trust provided the assets are held by a bank, trust company, or other approved entity. Thus, the IRA custodian is to be treated as a trustee for all Code requirements.
• The IRA trust or custodial account must be established “for the exclusive benefit of an individual or his beneficiaries;”\(^{25}\) and
• The IRA owner cannot use his account as security for a loan (i.e., pledging the IRA); to do so will result in that portion being deemed to have been distributed to the owner.\(^{26}\)

Under I.R.C. § 408(a), an individual retirement “account” is a “trust,” and the trustee is defined as a bank or other person deemed satisfactory by the IRS to administer the trust.\(^{27}\) The regulations provide rules whereby a non-bank entity can obtain IRS approval to serve as a non-bank custodian.\(^{28}\) They reinforce the notion that only a legal person, (e.g., corporate entity) and not an individual, can satisfy these rules.\(^{29}\) A custodian, in lieu of a trustee, can hold IRA assets. I.R.C. § 408(h) provides that a “custodial account” shall be treated as a trust (and similarly, the custodian will be treated as a trustee) to the extent the account is administered consistent with the requirements of I.R.C. § 408. The duties and obligations of an IRA trustee or custodian include holding legal title to the IRA assets and maintaining control and possession of the IRA assets.\(^{30}\) An unresolved question remains whether a bank or custodian can delegate custody of the IRA assets to someone who is not a bank or an otherwise approved custodian. Additional duties of an IRA trustee or custodian include, for example, reporting accurate fair market value of all IRA assets in its reporting to the IRS.\(^{31}\)

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25. I.R.C. § 408(a) (2018); Treas. Reg. § 1.408-2(b) (2020). As an example of the exclusive benefit requirement, see I.R.S. Priv. Ltr. Rul. 8241079 (July 16, 1982), where the IRA owners as members of a church wished to invest in church bonds, and the IRS held that payment of an amount in excess of the fair market value of the bonds would result in a violation of the rule.

26. I.R.C. § 408(e)(4) (2020). This prohibition clearly applies when the IRA owner uses his or her IRA as security for a personal loan; what is unclear is whether it extends to pledging other assets of an IRA for a loan to another IRA.


29. Treas. Reg. § 1.408-2(e)(2)(i) (2020). In order to demonstrate the non-bank’s ability to act within the accepted rules of fiduciary conduct, it must demonstrate sufficient diversity in the ownership of the applicant to ensure that the death or change of ownership will not interrupt the conduct of its business. See Schoof v. Comm’r, 110 T.C. 1 (1998) (holding that an individual cannot act as trustee).


31. See I .R.S. Instructions to Forms 1099-R and 5498, Cat. No. 27987M (Dec. 18,
Restrictions on IRAs

There are several restrictions on the types of investments that IRAs may take advantage of:

- The IRA must prohibit the investment of its assets in “life insurance contracts;”\(^{32}\)
- The IRA assets must not be “commingled with other property,” except in a common trust fund or common investment fund;\(^{33}\)
- Investment in collectibles (e.g., works of art, antiques, metal, stamps or coins, alcoholic beverages, or other tangible personal property) by the IRA will be treated as a distribution from the account in an amount equal to the cost of such collectible;\(^{34}\) and
- An IRA may not be a permitted shareholder of an S corporation for purposes of I.R.C. § 1361.\(^{35}\)

As will be discussed below, the prohibited transaction rules themselves do not prohibit certain investments of assets by IRA; however, an investment of an IRA that constitutes a prohibited transaction (e.g., purchase of an investment from a disqualified person to the account) will result in a permanent loss of the IRA tax-favored status.

Contributions to an IRA of property other than cash are generally prohibited, but distributions from an employer-provided qualified retirement plan may be rolled over into an IRA, provided the

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\(^{33}\) I.R.C. § 408(a)(5) (2018); Treas. Reg. § 1.408-2(b)(5) (2020). There is not a consistent interpretation as to what constitutes prohibited commingling of IRA assets. The legislative history suggests that the assets of an IRA may not be commingled with other property except in a common trust fund (i.e., group trust), solely for the purposes of diversifying investments and that the assets of IRAs may be pooled with the assets of qualified plans without adversely affecting the qualification of either type. ERISA Conference Report, Requirements for an IRA.

\(^{34}\) I.R.C. § 408(m)(1)-(2) (2018). Exceptions to the collectible prohibition include certain gold, silver and platinum coins. See I.R.C. § 408(m)(3) (2018).

custodian agrees to the distribution, with some exceptions. Alternatively, if a custodian is unwilling to accept distributions of property from a qualified plan, the property received in the distributions can always be sold and reinvested in the rollover IRA in “an amount equal to any portion of the proceeds.”

**Investment Issues to Consider When Investing in Alternative Assets**

**Prohibited Transactions in General**

The Code’s prohibited transaction rules are set forth in I.R.C. § 4975, which state that an IRA is a “plan” for purposes of those rules. I.R.C. § 408(e) provides that an IRA is exempt from taxation unless it ceases to be an IRA under two conditions: (1) if the IRA owner or his beneficiary engages in a prohibited transaction as defined in I.R.C. § 4975 with respect to the account or (2) if the IRA owner borrows any money under or by use of an annuity contract. Once the IRA ceases to be exempt from taxation, it does so retroactively as of the first day of the taxable year in which either the prohibited transaction occurred, or the owner borrowed monies under the annuity contract. As a result, a deemed distribution is said to occur on the first day of the taxable year equal to the fair market value of all assets in the account or annuity, causing the entire amount to be included in gross income (to the extent the monies are not Roth monies, which have already been taxed). Hence, the consequence for engaging in a prohibited transaction is severe – tax disqualification of the entire IRA. In contrast, if the IRA owner pledges the account as security for a loan, that portion is deemed to have been distributed to the owner, but the remaining portion of the account may be saved from disqualification.

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36. I.R.C. § 402(c)(6) (2018). See also 26 C.F.R. § 1.402-1(a)(1)(iii) (2020), which regarding the value of such distributions to be at the fair market value on the date of distributions.
38. I.R.C. § 408(e)(2) (2018). Once an IRA is disqualified under I.R.C. §§ 408(e)(2) or (e)(4) (2018), I.R.C. § 4975(c)(3) (2020) exempts the IRA owner from the 15% and 100% excise taxes otherwise imposed for committing a prohibited transaction.
41. I.R.C. §§ 408(e)(2)(B), 408(d) (2018) (causing the entire distribution to be taxable under I.R.C. § 72, with possible excise taxes for premature distributions under I.R.C. § 72(t)).
For other parties (e.g., a bank trustee or custodian) who have engaged in the prohibited transaction, the Code imposes a 15% initial excise tax on the amount involved, plus a potential 100% excise tax if the transaction is not timely corrected.\footnote{43} This excise tax is not applicable to a fiduciary to the plan who is acting only as a fiduciary.\footnote{44} The IRA owner and his beneficiaries are exempt from the tax because their penalties involve the disqualification of the IRA upon the occurrence of a prohibited transaction.\footnote{45} The prohibited transaction rules of I.R.C. § 4975 are enforceable by the IRS, but the DOL has jurisdiction over the interpretation of the prohibited transaction rules and the issuance of exemptions to these rules as there are also prohibited transaction rules under Title I of ERISA.\footnote{46} Hence, while traditional IRAs, Roth IRAs, and Rollover IRAs are generally not ERISA plans, the DOL does have jurisdiction over them for purposes of the prohibited transaction rules.

For employer-provided retirement plans, ERISA imposes certain fiduciary duties on plan fiduciaries (i.e., standards of care), including acting solely in the interest of plan participants and beneficiaries and for the exclusive purposes of providing benefits to participants and beneficiaries.\footnote{47} Thus, ERISA sets up the presumption for these plans that the fiduciary is to have no other motive in its

\footnote{43. I.R.C. § 4975(a), (b) (2018).}
\footnote{44. I.R.C. § 4975(a) (2018) (stating “[T]he tax imposed by this subsection shall be paid by any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such.”)}
\footnote{45. I.R.C. § 4975(c)(3) (2018) (stating “An individual for whose benefit an individual retirement account is established and his beneficiaries shall be exempt from the tax imposed by this section with respect to any transaction concerning such account (which would otherwise be taxable under this section) if, with respect to such transaction, the account ceases to be an individual retirement account by reason of the application of section 408(e)(2)(A) or if section 408(e)(4) applies to such account.”)}
\footnote{46. Reorganization Plan No. 4 of 1978, 43 Fed.Reg. 47,713 (Sept. 29, 1978), and in 92 Stat. 3790 (1978), “[T]he authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Code, subject to certain exceptions ... has been transferred to the Secretary of Labor and the Secretary of the Treasury is bound by such interpretations.” The IRS has jurisdiction in its determination as to whether IRAs and other plans are subject to the Code’s prohibited transaction. The DOL has jurisdiction in its determination as to whether other plans are subject to ERISA’s prohibited transaction rules and the issuance of exemptions to such rules. But a determination by the DOL that a prohibited transaction has not occurred does not prevent the IRS from finding I.R.C. § 4975 liability. See O’Malley v. Comm’r, 972 F.2d 150, 154-55 (7th Cir. 1992); Thoburn v. Comm’r, 95 T.C. 132, 140 (1990). Note: Section 102(a)(iii) of the Reorganization Plan reserves to the Secretary of Treasury the authority to issue “exemptions with respect to transactions that are exempted by subsection 404(c) of ERISA from the provisions of Part 4 of the Subtitle B of Title I of ERISA.”}
\footnote{47. 29 U.S.C. § 104(a) (2018).}
activities surrounding the plan. The prohibited transaction rules prohibit certain transactions between the plan and a “party-in-interest,” so as to avoid any conflicts of interest.\textsuperscript{48} In contrast, the Code does not impose any fiduciary duties on an IRA fiduciary but does prohibit certain transactions between the IRA and a disqualified person, similar to ERISA’s requirements. The prohibited transaction rules under Title I of ERISA are similar but not identical to the prohibited transaction rules under the Code, as well as the statutory exemptions, and the definitions of certain terms under each vary. Thus, they are complicated to understand.

The focus of this article will be on the Code’s prohibited transaction rules and definitions, but the differences between the Code’s rules and ERISA’s rules will be discussed. Both ERISA and the Code state the prohibited transaction rules in the following contexts: (1) transactions between the plan and a disqualified person,\textsuperscript{49} and (2) transactions involving the fiduciary to the plan dealing with the assets of the plan or transactions where the fiduciary receives consideration for his own personal account.

Disqualified Persons

Definitions

Under the Code’s prohibited transaction rules, a disqualified person is defined as follows:

- A fiduciary to the plan (which would include the IRA owner who self-directs his or her investments)\textsuperscript{50}


\textsuperscript{49} ERISA’s prohibited transaction rules involve transactions between the plan and a party-in-interest, whereas the Code’s prohibited transaction rules involve transactions between the plan and a disqualified person.

\textsuperscript{50} I.R.C. § 4975(e)(2)(A) (2018). See I.R.C. § 4975(e)(3) (2018), which defines a fiduciary as “any person who—(A) exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (B) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (C) has any discretionary authority or discretionary responsibilities in the administration of such plan The U.S. Dep’t of Labor, Pension and Welfare Benefits Admin., Opinion Letter 89-03A (Mar. 23, 1989) stated that the taxpayers in question were disqualified person with respect to their IRAs because they had the authority under the IRAs to direct investment. Similarly, the IRS takes the position that an IRA owner who personally manages the investments of his IRA is a fiduciary, and thus a disqualified
Anyone providing services to the plan, including the IRA trustee or custodian and any investment managers or advisors.\(^\text{51}\)

An employer any of whose employees are covered by the plan; an employee organization any of whose employees are covered by the plan; or an owner, directly or indirectly, of 50% or more of (1) the combined voting power of all stock or the total value of all stock, (2) the capital interest or profit interest of a partnership, or (3) the beneficial interest of a trust or unincorporated enterprise) which is an employer or employee organization described above;\(^\text{52}\)

A member of the family of a plan fiduciary, service provider, employer, or a majority owner of the employer, which is defined to include the spouse, ancestor (e.g., parents), lineal descendants (e.g., sons or daughters), and spouses of lineal descendants (e.g., daughters-in-law, sons-in-law) [note that the siblings and their lineal descendants, such as nieces and nephews, are not regarded as family members];\(^\text{53}\)

A corporation, partnership, trust or estate of which 50% or more (1) the combined voting power of all stock or the total value of all shares of a corporation, (2) the capital interest or profits interest of a partnership, or (3) the beneficial interest of a trust or estate is owned, directly or indirectly, by a fiduciary, service provider, employer or employee organization, or controlling owners of the business of the employer or employee organization (but not the IRA’s family members);\(^\text{54}\)

An officer, director (or individual with powers and responsibilities similar to those of an officer or

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person. See I.R.S. Priv. Ltr. Rul. 8009091 (Dec. 7, 1979). It also has stated that an IRA owner who has the option to self-direct the IRA investments but does not elect to do so, is a fiduciary, and thus a disqualified person. See I.R.S. Priv. Ltr. Rul. 200324018 (June 13, 2003). It has extended this position in private letter rules to state that an IRA owner who is not a fiduciary would nevertheless be a disqualified person, although the statute does not state that to be the case. See I.R.S. Tech. Adv. Mem. 88-49-001 (Dec. 9, 1988); I.R.S. News Release IR-81-37 (Dec. 18, 1981).

director), a 10% or more shareholder, or highly compensated employee (earning 10% or more of the annual wages of an employer) of a person described as an employer; employee organization; majority owner of such employer or employee organization; or corporation, partnership, trust or estate as defined in the fifth bullet above;\(^{55}\) or

- A 10% or more (in capital or profits) partner or joint venture of a person described above as an employer; employee organization; majority owner of such employer or employee organization; or corporation, partnership, trust or estate as defined above.\(^{56}\)

Thus, with respect to an IRA, one would look to transactions between the IRA and its owner; between the IRA and fiduciaries of the IRA (e.g., persons giving advisory services); and between the IRA and service providers to the IRA (e.g., attorneys, accountants, and brokers, and their family members).

**IRA Owner as a Disqualified Person**

In the context of IRAs, would a disqualified person automatically include the IRA owner? While the IRA owner is not listed as a disqualified person, the legislative history suggests that he would be a disqualified person as he “created” the account.\(^ {57}\) The IRA owner may not necessarily be a *per se* disqualified person as he or she may not be a fiduciary, but in the self-directed context where the IRA owner personally manages the IRA’s investments and thus has discretionary authority and control over those assets, the owner would be a fiduciary; and thus, a disqualified person. The IRS’ position is that an IRA owner who has the option to self-direct the IRA assets, but does not elect to do so, is nevertheless a fiduciary.\(^ {58}\) The DOL

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\(^{56}\) I.R.C. § 4975(e)(2)(I) (2018). The Secretary of Labor may be regulation prescribe a percentage lower than 50% or 10% for purposes of the above rules.

\(^{57}\) See I.R.C. § 4975(e)(2) (2018) (describing IRA owners as “creators” of their accounts). The statutory language is ambiguous. In drafting ERISA, the House of Representative’s approach would have applied the Code’s prohibition transaction rules of I.R.C. § 503 (which applied “creators” of certain types of entities to be subject to the prohibited transaction rules). See H.R. REP. NO. 93-1280, at 161 (1974) (Conf. Rep.). Instead the definitions were set forth in I.R.C. § 4975, but the IRA provisions were never reconciled before enactment.

expressed a similar view in ERISA Opinion Letter 89-03A, stating “Mr. and Mrs. Brown are fiduciaries, and thus disqualified person[s] with respect to their IRAs because of their authority under the IRAs to direct investments.” This begs the question as to whether a trusted IRA in which the IRA owner had no investment authority would be a fiduciary to the IRA. But the answer appears to be moot as I.R.C. § 408(e)(2) clearly states that if the individual for whose benefit the IRA was established (i.e., the IRA owner, regardless of whether he is a fiduciary or not) “engages in any transaction prohibited by section 4975 with respect to such account, such account ceases to be an individual retirement account as of the first day of such taxable year.”

In the case of Greenlee v. Comm’r, Mr. Greenlee was the sole participant and plan administrator for his company profit sharing trust, and Union National Bank of Pittsburgh was the sole trustee of the plan’s trust. Mr. Greenlee requested the trustee to lend monies to Tag Land, Inc., a company in which he owned an 18% interest. The IRS held Mr. Greenlee to be a disqualified person for three reasons: under I.R.C. § 4975(e)(2)(A) (a fiduciary), under I.R.C. §4975(e)(2)(E) (an owner of 50% or more of the employer), and under I.R.C. § 4975(e)(2)(H) (an officer, director or highly compensated employee of the employer), who engaged in a prohibited transaction under I.R.C. §§ 4975(c)(1)(D), (E). The Tax Court disagreed; although Mr. Greenlee was a disqualified person, he did not use his “authority, control, or responsibility which makes [him] a ‘fiduciary’ for purposes of the lending of monies.” Since the bank as an independent trustee of the plan made the decision to make the loan, Mr. Greenlee did not “deal with the income or assets of the plan in his own interest or for his own account,” and thus did not engage in a prohibited transaction. While some practitioners cite to this case for the proposition that an IRA holder can “relinquish” his fiduciary status relative to his IRA, the IRS certainly does not bifurcate an IRA owner’s fiduciary status.

62. Id. at 396.
63. Id.
64. Id. at 397.
65. Id. at 397-98.
A fiduciary to the IRA would also include an individual or entity hired by the owner to exercise investment discretion over the IRA (e.g., a registered investment advisor) and an individual or entity hired by the owner to render non-discretionary investment advice under the DOL’s five-part definition.67 As an aside, the DOL has been attempting over the past decade, but without success, to expand the definition of persons and entities that fall within the latter category (referred to as a fiduciary by virtue of rendering investment advice for a fee or other compensation, direct or indirect, with respect to the assets of the plan).68 The intent behind such expansion is to

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67. 29 C.F.R. § 2510.3-21(c)(1) (2020); Employee Benefit Plans, 40 Fed. Reg. 50842 (Oct. 31, 1975) and 26 C.F.R. § 54.4975-9(c) (2020); Employee Benefit Plans, 40 Fed. Reg. 50840 (Oct. 31, 1975) (holding that an investment advisor would be a fiduciary investment advisor if (1) he or she rendered advice as to the value of property or securities and was involved in the recommendation as to the advisability of investing, purchasing, or selling such property or securities or (2) the person had discretionary authority or control over the investment of the assets. For those individuals not having discretionary authority or control over the investment of the assets, the individual had to satisfy a five-part test: rendered advice as to the value of the property or securities or made a recommendation as to the advisability of investing, purchasing, or selling such property or securities; provided such advice on a regular basis; pursuant to a mutual agreement between the plan and the individual; that served as the primary basis for the investment decision; and such advice was individualized based on the needs of the plan). The intent of the five-part rule was to narrow the number of nondiscretionary investment advisors to reduce the fees otherwise associated with the costs of providing fiduciary service. The DOL has been working on revising this definition of a fiduciary investment advisor for over a decade in order to expand the number of individuals covered by the definition. See 29 C.F.R. § 2510-3-21(a) (2016) 29 C.F.R. § 2510.3-21(g)(6)(ii) (2020); Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946 (Apr. 8, 2016). The U.S. Court of Appeals for the Fifth Circuit, in U.S. Chamber of Commerce vs. DOL, 885 F.3d 360, 363 (8th Cir. 2018), vacated the regulations by holding that the DOL exceeded its authority under ERISA.

68. ERISA § 3(21)(A) defines a fiduciary to the plan as someone who (1) exercises any discretionary authority or discretionary control with respect to the management of the plan or exercises any authority or control respecting the management or disposition of its assets, (2) renders investment advice for a fee or other compensation, direct or indirect, with respect to the plan assets, or (3) has any discretionary authority or responsibility in the administration of the plan. With respect to the second definition of who is a fiduciary, the DOL attempted as early as 2010 to expand the universe of individuals who would satisfy this definition. See Prop. 29 C.F.R. § 2510.3-21(c), 75 Fed. Reg. 65263 (proposed Oct. 22, 2010). Generally, that proposal sought to capture anyone (1) rendering “covered advice” (including three groups of advice) (2) involving four different “covered relationships” and (3) receiving a fee for such services. As a result, broker-deals could have become fiduciaries if they rendered investment advice individualized for the plan or the plan participant. Due to the backlash, the DOL withdrew the proposal in 2011 and reissued it in 2015. See Prop. 29 C.F.R. § 2510.3-21, 80 Fed Reg. 21928 (proposed Apr. 20, 2015). The regulations were finalized
impose fiduciary duties and provide for remedies for individuals offering investment advice to participants under qualified retirement plans (as well as IRA owners), including advice as to whether to roll monies from an employer-provided plan to an IRA. However, the U.S. Court of Appeals for the Fifth Circuit vacated these rules “in toto” (i.e., invalidating the rules nationwide unless they were appealed).

The DOL allowed its right to appeal lapse and the Fifth Circuit declined to permit other parties to join the case. Thus, the Fifth Circuit’s decision became final on June 21, 2018, reverting to the original 1975 regulations that defined who was a fiduciary for purposes of rendering investment advice.

Would the IRA owner be considered both the employer and the employer’s employee with respect to the IRA, and thus be considered a disqualified person by virtue of I.R.C. § 4975(e)(2)(C)? The IRS has answered this question in the negative in PLR 8717079. There, an IRA owner (Individual N) was employed by Company M and a member of its board of directors. Individual N owned directly or indirectly less than 1% of the total outstanding stock of Company M and wished to have the IRA custodian purchase additional shares, such that after the purchase, Individual N would own less than 1% of Company M shares. The IRS noted that there was no definition of the term “employer” for purposes of I.R.C. § 4975 but referred to ERISA’s term under section 3(5) as “any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan.”

Using that definition for purposes of I.R.C. § 4975, an employer is acting as such, in relation to an IRA, in 2016, with an effective date of June 9, 2017. See 29 C.F.R. §§ 2510.3-21(a), 2510.3-21(g)(6)(ii) (2020). But the U.S. Court of Appeals for the Fifth Circuit, in U.S. Chamber of Commerce v. Dep’t of Labor, 885 F.3d 360, 363 (8th Cir. 2018), vacated the DOL’s new fiduciary rule “in toto,” meaning that the entire rule became invalidated nationwide. The Court’s reasoning was that the DOL exceeds its authority under ERISA, resulting in an interpretation that was reasonable. As a result, the original 1975 DOL regulations which set forth who is an investment advice fiduciary continue to apply. The DOL issued a technical amendment to 29 C.F.R. §2510-3.21, removing the language that was added in 2016 and to reinsert the text of the 1975 regulation. See 85 Fed. Reg. 40589 (July. 7, 2020).


70. See U.S. Chamber of Commerce v. DOL, supra note 65.

71. Id.

only when it was involved in the establishment, maintenance, or sponsorship of the IRA. Hence, it concluded Company M was not an employer in relation to Individual N’s IRA and hence, the purchase of Company M stock by the IRA was not a prohibited transaction within the meaning of I.R.C. § 4975(c)(1)(A) (i.e., sale or exchange).\textsuperscript{73}

Hence, this would allow a former employee of IBM to invest his IRA in IBM stock without peril.

**IRA as a Disqualified Person**

The IRS regards the IRA itself as a disqualified person.\textsuperscript{74} In PLR 200324018, the IRS reasoned that under the terms of the IRA, the IRA owner had the authority to make investments (regardless of whether he did). Therefore, since the IRA owner was the sole individual for whose benefit the IRA was established, the IRS finds that the 50% or more of the beneficial interest of the IRA trust is owned directly or indirectly by the IRA owner who is a fiduciary and thus, the IRA itself is a disqualified person pursuant to I.R.C. § 4975(e)(2)(G)(iii).

In the FSA 200128011 by the IRS, a father owned a majority interest in USC Corp, while his three children owned the remaining shares equally. The father’s IRA and each of the three children’s IRAs acquired a 25% interest in FSC.\textsuperscript{75} While each of the four IRAs were disqualified persons relative to their own IRA because they were fiduciaries, the IRS concluded FSC was not a disqualified person, presumably because all of its interests were held by fiduciaries acting “only as such.”\textsuperscript{76} USC Corp was a disqualified person relative to the father’s IRA as the father owned a majority interest. Thus, if a transaction is made for the purposes of benefitting USC Corp, the IRA owners would violate I.R.C. § 4975(c)(1)(D); and if the IRA owners’ interest in the transaction because of their ownership of USC Corp affected their best judgments as fiduciaries of their IRAs, the transaction would violate I.R.C. § 4975(c)(1)(E). Thus, the IRS regards the IRA as a disqualified person.

\textsuperscript{73} I.R.S. Priv. Ltr. Rul. 8717079 (Feb. 2, 1987).
\textsuperscript{74} I.R.S. Priv. Ltr. Rul. 200324018 (June 13, 2003) (holding that the IRA was itself a disqualified person as the IRA owner was the sole person for whose benefit the IRA was established).
\textsuperscript{75} FSA 200128011 (July 13, 2001).
\textsuperscript{76} 26 U.S.C. §4975(a) (2020) (imposing excise tax on a disqualified person for engaging in a prohibited transaction except when the disqualified person is a fiduciary “acting only as such”).
Family Members as Disqualified Persons

The IRA owner’s family members (defined to include his spouse, ancestors, lineal descendants, and spouses of lineal descendants) are disqualified persons.²⁷ Bullet five of the list of disqualified persons noted above states that family members are not considered in determining whether a corporation, partnership, or trust or estate that is majority owned by plan fiduciaries (e.g., the IRA owner), but there is a caveat to that limitation. Under I.R.C. § 4975(e)(5), for purposes of determining ownership in a partnership and trust described in bullet five, the constructive ownership of stock rules under I.R.C. § 267(c) apply (but are limited by the use of the definition of family members defined in I.R.C. § 4975(e)(2)(F) as described above).²⁸ Thus, an individual is deemed to own the stock (or capital or profit interest of the partnership or beneficial interest in the trust or estate) which is owned directly or indirectly by or for his family member (i.e., his spouse, ancestor, lineal descendants, or spouses of lineal descendants). For example, if the IRA owner owned 10% of a partnership, that amount alone would normally be insufficient to make the partnership a disqualified person; however, should his children own 40% of the same partnership, the IRA owner is deemed to own 50% of the partnership due to the constructive ownership rules, making the partnership a disqualified person as it is owned 50% by the IRA owner.

ERISA’s definition of a party-in-interest for purposes of its prohibited transaction rules is comparable but not identical to the Code’s definition of a disqualified person.²⁹

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²⁷ 26 U.S.C. § 4975(e)(2)(F) (2020) (referring to I.R.C. §4975(e)(6), which defines family members to include “his spouse, ancestor, lineal descendant, and any spouse of a lineal descendant” of the plant’s fiduciary, service provider, employer, or owner of 50% or more of the voting power of stock or total stock of a corporation; capital interest or profit interest of a partnership; or beneficial interest of a trust or unincorporated enterprise, which is an employer or employee organization”).

²⁸ 26 U.S.C. § 267(c) (2020) provides: “Constructive ownership of stock. For purposes of determining, in applying subsection (b), the ownership of stock—(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionally by or for its shareholders, partners, or beneficiaries; (2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family.” I.R.C. § 267(c)(4), as modified by I.R.C. § 4975(e)(2)(F), would read “The family of an individual shall include his spouse, ancestor, lineal descendant, and any spouse of a lineal descendant.”

Prohibited Transaction Rules

The Code’s prohibited transaction rules are similar to ERISA’s, but are structured differently such that alternate interpretations of the two could exist. ERISA sets forth two different sets of prohibited transactions in ERISA §§ 406(a) and 406(b), whereas the Code’s set of prohibited transaction rules are contained in a single set in IRC § 4975(c). The legislative history indicates the intent behind the rules is to prevent taxpayers from using plans to engage in transactions for their own account, thereby jeopardizing the assets and the income before retirement.80

ERISA’s Rules

ERISA § 406(a) states, that except as otherwise provided in ERISA § 408 (the statutory exemptions), a fiduciary shall not cause the plan to engage in any direct or indirect transaction which consists of:

- A sale or exchange, leasing, of any property between a plan and a party-in-interest;81
- Lending of money or other extension of credit between a plan and a party-in-interest;82
- Furnishing of goods, services, or facilities between a plan and a party-in-interest;83 or
- Transfer to, or use by or for the benefit of, a party-in-interest, of any assets or income of the plan.84

In this article, these four transactions will be referred to as “per se prohibited transactions.” ERISA § 406(b) (which does not contain the caveat that “except as provided in section 408,” indicating that the statutory exemptions should not be applicable), the following transactions between the plan and a fiduciary are not allowed (note

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81. 29 U.S.C. § 1106(a)(1)(A) (2020). A common prohibited transaction involves the sale of property by the disqualified person to the plan followed by a lease-back of the property by the plan to the disqualified person. Note: An ordinary bling purchase or sale of property where neither the buyer or seller nor agent of either knows the identity of the other will not constitute a prohibited transaction.
no reference to a party-in-interest being on the side of the transaction):

- Dealing with the assets of the plan in his own interest or for his own account (referred to as the self-dealing prohibition);\(^{85}\)
- Acting in the fiduciary’s individual or in any other capacity in a transaction involving the plan on behalf of a party whose interests are adverse to the interests of the plan or its participants or beneficiaries (e.g., conflict of interest situations);\(^{86}\) or
- Receiving any consideration for the fiduciary’s own personal account from any party dealing with such plan in connection with a transaction involving plan assets (referred to as the kickback prohibition).\(^{87}\)

This second set of prohibited transaction rules will be referred to in this article as the “fiduciary prohibited transactions” as they are benefiting the fiduciary and do not necessarily involve a party-in-interest unless he or she is a fiduciary. Courts have long recognized that the above prohibited transactions are not mutually exclusive, and thus, a transaction could be prohibited for multiple reasons.\(^{88}\)

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85. 29 U.S.C. §1106(b)(1) (2020). ERISA’s section 406 reads: “406(a) Except as provided in section 408: (1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect—(A) sale or exchange, or leasing, … (B) lending of money or other extension of credit … (C) furnishing of goods, services, or facilities … (D) transfer to, or use by or for the benefit to … or (E) acquisition, on behalf of the plan, of any employer security or employer real property …). In contrast, the Code’s section 4975(c)(1) General rule – For purposes of this section, the term ‘prohibited transaction’ means any direct or indirect—(A) sale or exchange, or leasing, … (B) lending of money or other extension of credit … (C) furnishing of goods, services, or facilities … (D) transfer to, or use by or for the benefit to … or (E) acts by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account; or (F) receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan”), and I.R.C. section (d) reads “Except as provided in subsection (f)(6), the prohibitions provided in subsection (C) shall not apply to …”.


Code’s Rules

In contrast, Code § 4975(c) sets forth a single set of prohibited transaction rules (that presumably are all exempt under the provisions of Code § 4975(d)), whether direct or indirect:

- A sale or exchange, leasing, of any property between a plan and a disqualified person,\(^8^9\)
- Lending of money or other extension of credit between a plan and a disqualified person,\(^9^0\)
- Furnishing of goods, services, or facilities between a plan and a disqualified person,\(^9^1\)
- Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan,\(^9^2\)
- An act by a disqualified person who is a fiduciary whereby he deals with the income or assets of the plan in his or her own interest or for his or her own account,\(^9^3\) or
- The receipt of any consideration by a disqualified person who is a fiduciary for his or her own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.\(^9^4\)

In comparing ERISA’s prohibited transaction rules with the Code’s prohibited transaction rules, two statutory differences appear:

- The Code’s fiduciary prohibited transactions do not include ERISA’s second fiduciary prohibited transaction rule involving conflicts of interest, which makes sense as the Code does not impose a fiduciary standard of acting in the best interest of the plan participant or beneficiaries. The legislative history indicates that the second fiduciary

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89. 26 U.S.C. § 4975(c)(a)(A) (2020). The prohibited transaction rules include a sale of property subject to a mortgage or lien, where the plan assumes the mortgage otherwise owed by the disqualified person.
prohibited transaction was excluded from the Code due to the difficulty in ascertaining the “appropriate measure” for an excise tax. The IRS, however, in guidance, has read into the transactions prohibited under I.R.C. §§ 4975(c)(1)(E) and (F) to include a fiduciary’s conflict of interest involving the income or assets of the plan.

According to the terms of the statute, the Code’s fiduciary prohibited transactions are not written to exclude the application of its statutory exemptions set forth in I.R.C. § 4975(d), whereas ERISA’s prohibited transactions are. However, the IRS in its regulations takes the position that the statutory exemptions do not contain an exemption for acts described in I.R.C. §§ 4975(c)(1)(E) or (F), as the latter involves separate transactions that are not described in the statutory exemptions. The DOL also takes a similar position that ERISA’s fiduciary prohibited transactions are not exempt under any of the statutory exemptions. As will be discussed under the statutory exemption for reasonable compensation for services rendered, the majority of courts affirm the DOL’s interpretation, but the

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95. H.R. Rep. No. 93-1280, 4576 (1974) (Conf. Rep), reprinted in 1974 U.S.C.C.A.N. 5038 (stating “[T]he labor provisions (but not the tax provisions) prohibit a fiduciary from acting in any transaction involving the plan on behalf of a person (or representing a party) whose interests are adverse to the interest of the plan or of its participants or beneficiaries. This prevents a fiduciary from being put in a position where he has dual loyalties, and, therefore, he cannot act exclusively for the benefit of a plan’s participants and beneficiaries. (This prohibition is not included in the tax provisions, because of the difficulty in determining an appropriate measure for an excise tax.”).

96. Treas. Reg. § 4.4975-6(a)(5)(i) (2020) (“The prohibitions of sections 4975(c)(1)(E) and (F) supplement the other provisions … by imposing on disqualified persons who are fiduciaries a duty of undivided loyalty to the plans for which they act. These prohibitions are imposed upon fiduciaries to deter them from exercising the authority, control, or responsibility which makes such persons fiduciaries when they have interests which may conflict with the interests of the plans for which they act.”).

97. Treas. Reg. § 54.4975-6(a) (2020) (stating that the statutory exemption for office space or services and certain transactions involving financial institutions does not contain an exemption for acts described in section 4975(c)(1)(E) or (F) as such acts are separate transactions not described in the statutory exemption).

98. Fiduciary Responsibility Under the Employee Retirement Income Security Act of 1974, 29 C.F.R. § 2550.408b-2(a) (1998) (stating that section 408(b)(2) “exempts from the prohibitions of section 406(a) of the Act . . .” but “does not contain an exemption from acts described in section 406(b)(1) . . ., section 406(b)(2) or section 406(b)(3)”).

Eighth Circuit rejects it, stating it “conflicts with an unambiguous statute.”

**Indirect Prohibited Transactions**

Under plan assets rules that will be discussed later in the article, the DOL takes a counterintuitive approach such that there are circumstances whereby, if the plan invested in certain entities, the underlying assets of that entity are also deemed to be plan assets. If the plan asset rules were applicable, they could expand the transactions involving plan assets that are prohibited. In the aftermath of the issuance of these plan asset rules, the DOL sought to expand transactions that would otherwise have been prohibited by capturing indirect transactions, seeking to accomplish the same result. For example, even if an entity did not hold plan assets, if such investment in the entity was made by the plan with the expectation or understanding that the entity would engage in a transaction that otherwise would have been prohibited if done directly, such investment would also be prohibited. The DOL Advisory Opinion 2006-01A is illustrative of this rule. Under the facts of that opinion, taxpayer Berry proposed having an LLC be created to buy and lease property to the S Company, which was a disqualified person relative to Berry’s IRA. Due to one of the exceptions under the DOL’s plan asset rules, the underlying property of the LLC would not be a plan asset of Berry’s IRA. However, if there was an understanding that the IRA would invest in the LLC who in turn would engage in a lease transaction with a disqualified person, that amounted to an indirect prohibited transaction under I.R.C. §§ 4975(c)(1)(A) and (D), and thus not be allowed.

Other examples of indirect prohibited transactions involve transactions between the plan and an entity that was not a disqualified person (e.g., an entity that was owned less than 50% by a disqualified person), but indirectly benefitted a disqualified person. In the case of *Rollins v. Comm’r*, a plan fiduciary lent plan monies to three entities who were not disqualified persons as the plan fiduciary had only a

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99. Harley v. 3M, 284 F.3d 901 (8th Cir. 2002).
100. DOL Interpretive Bulletin 7502, 51 Fed. Reg. 41290 (Dep’t of Labor Nov. 13, 1986).
minors in each of the entities. While not held a violation of I.R.C. § 4975(c)(1)(B) (i.e., direct or indirect lending of money), the court held that the plan loans indirectly benefitted the plan fiduciary, even though none of the plan assets were transferred to him, in violation of I.R.C. § 4975(c)(1)(D) (i.e., use of the plan assets for the disqualified person’s benefit).

As the fiduciary prohibited transaction rules cover direct and indirect transactions involving the plan’s fiduciary, included in the notion of “indirect benefit” to a fiduciary would include a benefit to someone in whom that fiduciary has an interest, such that it affected his fiduciary judgement. For example, the fiduciary’s retention of his son to provide administrative services to the IRA for a fee would result in an indirect benefit to the fiduciary, which involves IRA assets.

Examples of Prohibited Transactions

From the DOL’s advisory opinions, the IRS’ guidance, and caselaw, we have a variety of examples of what constitutes a prohibited transaction, for which there is no known statutory exemption. These include:

Sales, Exchanges or Leases: Prohibited transactions that are sales, exchanges, or leases under ERISA § 406(a)(1)(A) and/or I.R.C. § 4975(c)(1)(A) include:

- In the case of Morrissey v. Comm’r, the Court examined the facts in which a sole owner of a business established a money purchase plan from which he took a number of loans from the plan, secured and unsecured by his plan’s account balance. When the owner repaid the plan loans by transferring real estate to the plan, the transfer of real estate in repayment of the owner’s debt to the plan was held to be a “sale or exchange” prohibited under I.R.C. §

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106. Morrissey v. Comm’r, 76 T.C.M. (CCH) 1006 (1998). See I.R.S. Tech. Adv. Mem. 9713002 for a similar fact pattern where the sole owner of the corporation is lent monies from the two retirement plans, evidence by promissory notes with a stated rate of interest but no fixed term or collateral, and repays those debts by transferring real estate to the plan.
4975(c)(1)(A). As this was a qualified plan, the consequence was the application of the excise tax in I.R.C. § 4975(a), (b).

- In the case of *McDougall v. Donovan*, the Court held the purchase of a jet by the plan trustees from an aircraft firm was an indirect sale prohibited by ERISA § 406(a)(1)(A), as the firm had just acquired the jet from the union conference whose members were participants under the plan.

**Lending of money or other extensions of credit:** Prohibited transactions that involve the lending of money or other extensions of credit under ERISA § 406(a)(1)(B) and/or I.R.C. § 4975(c)(1)(A) include:

- In the case of *Zacky v. Comm’r*, the Tax Court reviewed facts whereby the taxpayer was the president and sole owner of Aspects Inc., which maintained a qualified profit-sharing plan, under which the taxpayer was the plan’s sole trustee. The taxpayer borrowed funds (Loan #1) from the plan to pay Aspects Inc.’s payroll. Shortly thereafter, the plan lent funds (Loan #2) to a related corporation, Inland Empire Properties, Inc. (Inland), which was fully owned by the taxpayer, in order for the taxpayer to pay an outstanding car loan. As a result of Loan #2, the taxpayer transferred the car's title

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107. *Id.* at 6.
108. *Id.* at 7.
110. *Zacky v. Comm’r*, 87 T.C.M. (CCH) 1378 (2004). See also *D.E.W. Plumbing v. Domestic Mortgage*, No. 1:20-CV-2593-TWT, U.S. Dist. LEXIS 92136 (N.D. GA. July 3, 2012) (finding a prohibited transaction when the fiduciary to the plan signed a promissory note of $45,000 between the plan as lender, and Domestic Mortgage, as borrower, where the borrower was 100% owned by the fiduciary and his children); *In re Daniels*, 452 B.R. 335 (Bankr. D. Mass. Ct. 2011) (holding the debtor who established a profit sharing plan in which he was the sole participant, plan trustee, plan administrator, and employer engaged in a prohibited transaction by allowing the plan to make a loan to the debtor’s son); *Janpol v. Comm’r*, 101 T.C. 518, 525-27 (1993) (finding that 50% shareholders of AJVW and participants under the AJVW profit sharing engaged in prohibited transactions by lending monies to the plan as the shareholders and AJVW were disqualified persons with respect to the trust).
111. *Supra*, note 87.
112. *Id.*
to Inland.\textsuperscript{113} Subsequent to Loan #2, the plan made another loan to Inland (Loan #3) to allow Inland to pay mortgage and real estate taxes due on a building that it owned.\textsuperscript{114} Finding that each loan was either a direct or indirect act by a disqualified person who is a fiduciary (i.e., the taxpayer) with the plan, it was not only prohibited under I.R.C. § 4975(c)(1)(B) as a direct or indirect lending of money, it was also a direct or indirect transfer to, or use by or for the benefit of a disqualified person of the income or assets of a plan, prohibited under I.R.C. § 4975(c)(1)(D) and a direct or indirect act by a disqualified person who is a fiduciary dealing with the income or assets of the plan for his own interest or for his own account, prohibited under I.R.C. § 4975(c)(1)(E).\textsuperscript{115}

- In DOL Adv. Op. 2011-04A,\textsuperscript{116} the DOL opined on a proposal by an IRA owner to have his IRA purchase a note and deed of trust from a bank, that had provided a personal loan to the IRA owner and his spouse to purchase real estate. If acceptable, the IRA would be the holder of the note and the IRA owner and his spouse would make payments on the note directly to the IRA.\textsuperscript{117} It was the DOL’s opinion that such transaction would be a prohibited extension of credit, in violation of I.R.C. § 4975(c)(1)(B), between the IRA and disqualified persons (i.e., the IRA owner and spouse).\textsuperscript{118} It also noted that the continued holding of the note by the IRA would be a continuing prohibited transaction under I.R.C. § 4975(c)(1)(B) as long as payments on the note were made by the IRA owner and his spouse.\textsuperscript{119} As to whether the proposed transaction was part of an arrangement to otherwise benefit the IRA fiduciary such that it affects his best judgment as a fiduciary, the DOL declined to opine as such determination is an inherently factual question. If

\begin{footnotes}
\item[113] \textit{Id.}
\item[114] \textit{Id.} at 2
\item[115] \textit{Id.} at 7-9.
\item[117] \textit{Id.}
\item[118] \textit{Id.}
\item[119] \textit{Id.}
\end{footnotes}
so, that would give rise to an additional prohibited transaction.\(^\text{120}\)

**Furnishing of goods, services, or facilities:** Prohibited transactions that involve the furnishing of goods, services, or facilities under ERISA § 406(a)(1)(c) and/or I.R.C. § 4975(c)(1)(C) include:

- In PLR 8245075, the IRS held that a prohibited transaction under I.R.C. § 4975(c)(1)(C) would exist if the corporate trustee for an IRA were to use corporate funds to buy life insurance on behalf of the individuals who established IRAs with it.\(^\text{121}\) While there was no direct transaction between the plan (i.e., the IRA) and a disqualified person (i.e., the trustee), the IRA owner participating in the program would indirectly benefit in a prohibited transaction under I.R.C. § 4975(c)(1)(C).
- In the case of *Marshall v. Snyder*, the plan trustees for the three employee benefit plans of General Teamsters Industrial Employees Local 806 were paid monies from the employer and the plan for services rendered to the employer and to Local 806.\(^\text{122}\) The court held such payments to be prohibited transactions under ERISA § 406(a)(1)(C), and not exempt under one of the statutory exemptions of ERISA § 408(b) by reason of the provisions of ERISA § 406(b)(2).\(^\text{123}\)

**Transferring of assets:** Prohibited transactions involve the transfer to, or use by, under ERISA § 406(a)(1)(D) and/or I.R.C. § 4975(c)(1)(D) include:

- In the case of *Harris v. Comm’r*, the IRA purchased property that used as the personal residence of the IRA owner. In a brief decision, the Tax Court held that the IRA owner engaged in a prohibited transaction under I.R.C. § 4975(c)(1)(D) as a disqualified

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120. *Id.*
123. *Id.* at 900-903.
person (i.e., the IRA owner) used plan assets for his own benefit. A similar result would occur if the residence was used by a family member.

- In the case of *Reich v. Compton*, prior to ERISA, the plan lent monies to the Electrical Mechanic Association (EMA), an alter ego for Local 98 of the International Brotherhood of Electrical Workers whose members were covered under the plan. In light of the passage of ERISA, the plan accepted payment from EMA of $380,289.93 in full satisfaction of the debt, which at the time had an accounting value of $653,817.47. The Secretary of Labor filed suit alleging the transaction constituted an indirect transaction with Local 98 (an alter ego of a party in interest) in violation of ERISA § 406(a)(1)(A), (B), and (D). The court remanded the case to the district court for a finding as to whether there is proof of a subject intent to benefit a party in interest, as it is an element required under ERISA § 406(a)(1)(D) in order to support the statutory phrase “for the benefit.”

- In a Technical Advice Memorandum 9208001, the IRS reviewed the facts of a case in which a solely owned firm sponsored a qualified defined benefit plan which invested $250,000 in a mortgage loan to a limited partnership in which the owner had a 7.5% interest. Finding the owner to be a fiduciary due to his authority or control over the plan investments, the IRS held that the transaction benefitted the owner (i.e., a disqualified person), due to his ownership interest in the limited partnership, and thus violated I.R.C. § 4975(c)(1)(D).

**Fiduciary Prohibited Transactions:** Transactions that involve fiduciary prohibited transactions under ERISA §§ 406(b)(1)-(3) and/or I.R.C. § 4975(d)(1)(E) or (F)

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126. Id. at 274.
127. Id. at 281.
include:

• Generally, both the IRS and the DOL are reluctant to opine on transactions that involve fiduciary prohibited transactions as they perceive such situations to be inherently factual in nature, making a ruling more problematic.129

• In the case of Cutaiar v. Marshall, the court found that “when the trustees of two employee benefit plans whose participants and beneficiaries are not identical effect a loan between plans without an § 408 exemption, a per se violation of ERISA occurs.”130 Hence, it held that fiduciaries acting on both sides of a loan transaction could not negotiate for the best interest of either plan and thus violated ERISA § 406(b)(2).

• In the case of Lowen v. Tower Asset Mgmt., the plan and its trustees brought suit against the plans’ investment manager and its affiliates, as well as the owners of the plan’s investment manager and its affiliates (“defendants”), on the claim that the defendants’ investment of the plan assets in equities in which the individual defendants were part-owners constituted prohibited self-dealing under ERISA § 406(b).131 The three individuals owned 50%, 25% and 25%, respectively, of three corporations, Tower Asset Management, Inc., (“Tower Asset”) (who was the investment manager to the plans), Tower Capital Corporation (who was an investment banking corporation), and Tower Securities (who was a registered broker-dealer).132 Tower Asset received a fee of one-half of one percent of the market value of the plans (i.e., approximately $30 million) for investing the plans’ assets in companies in which the three individuals owned a substantial equity interest.133 The other two Tower entities entered into contract with entities to raise capital in exchange for compensation, which Tower Asset

131. Lowen v. Tower Asset Mgmt., 829 F.2d 1209, 1209, 1218, 1220 (2d Cir. 1987).
132. Id. at 1212.
133. Id.
then invested plan assets into those companies.\textsuperscript{134} Such investment of plan assets usually occurred subsequent to the individual defendants’ acquisition of such companies. The district court held that Tower Asset and its two affiliates were fiduciaries to the plan, and due to the “close and intimate relationship between the corporate and individual defendants,” the corporate veil was pierced, holding them all liable.\textsuperscript{135} The Second Circuit affirmed the district court’s finding that Tower Asset’s investment of plan assets in companies in which the individuals owned a substantial equity interest to be a violation of ERISA § 406(b)(1).\textsuperscript{136} The Second Circuit also affirmed the district court’s finding that the payment of fees was “in connection with” the investment of the plan’s assets in violation of ERISA § 406(b)(3).\textsuperscript{137} While ERISA § 408(c)(2) provides an exemption for fiduciaries receiving reasonable compensation for services rendered to the plan, the court held that it did not exempt the fees and compensation that the defendants received from companies in which the plans’ assets were invested.\textsuperscript{138}

\textit{Statutory Exemptions from the Prohibited Transaction Rules}

Both ERISA and the Code contain statutory exemptions from the prohibited transaction rules. ERISA’s statutory exemptions set forth in ERISA § 408(b) were not carefully drafted. The prohibited transaction rules set forth in ERISA § 406 state that the prohibited transaction rules of ERISA set forth in ERISA § 406(a) have an exception in ERISA § 408 (due to the language “[e]xcept as provided in section 408” which appears at the beginning of § 406(a)), whereas the fiduciary prohibited transaction rules set forth in ERISA § 406(b) do not have a similar exception clause—which appears to set up the presumption that rules of ERISA § 406(a) permit the use of statutory exemptions, but the rules of ERISA § 406(b) do not.

\textsuperscript{134} Id.
\textsuperscript{135} Id. at 1213.
\textsuperscript{136} Id. at 1214.
\textsuperscript{137} Id.
\textsuperscript{138} Id. at 1216.
ERISA § 406(a) reads as follows (emphasis added):

ERISA § 406(a) Transactions Between Plan and Party In Interest. – Except as provided in section 408: (1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should have known that such transaction constitutes a direct or indirect – (A) sale or exchange, or leasing, …. (B) lending or money or other extension of credit … (C) furnishing of goods, services, or facilities … (D) transfer to, or use by or for the benefit of …

ERISA § 406(b) reads as follows:

ERISA § 406(b) Transactions Between Plan and Fiduciary – A fiduciary with respect to a plan shall not – (1) deal with the assets of the plan for his own interest or for his own account, (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or (3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

However, the statutory language of the statutory exemptions set forth in ERISA § 408 does not make this interpretation explicit as it does not refer solely to ERISA § 406(a).

ERISA § 408(b) reads as follows:

ERISA § 408(b) Enumeration of Transactions Exempted From Section 406 Prohibitions. – The prohibitions provided in section 406 shall not apply to any of the following transactions …

In reviewing the language of ERISA § 408:

- ERISA § 408(a) sets forth the exemption procedure for the DOL to use to grants administrative exemptions to the prohibited transaction rules and
contemplates that the DOL could grant exemptions for both the prohibited transaction rules of ERISA § 406(a), as well as for the fiduciary prohibited transaction rules of ERISA § 406(b).

- ERISA § 408(b) sets forth the statutory exemptions but states that “[t]he prohibitions provided in section 406 shall not apply to any of the following transactions”—not explicitly stating whether they apply to ERISA § 406(a) and/or ERISA § 406(b) prohibited transaction rules. The language should have been tighter – to mimic the language in ERISA § 406(a)—if such statutory exemptions were to apply only to the ERISA § 406(a) prohibited transaction rules, which is the DOL’s interpretation of the statute.\(^\text{139}\)

- ERISA § 408(c) acts as a modification to ERISA § 406—again not limited to ERISA § 406(a), and thus, presumably could apply to ERISA § 406(b) transactions, such that (1) a party-in-interest person or fiduciary may receive a benefit to which he is otherwise entitled to as a participant or beneficiary (provided it is computed and paid on a basis consistent with the terms of the plan as applied to all other participants and beneficiaries); (2) a disqualified person or fiduciary may receive reasonable compensation for services rendered, or reimbursement of expenses properly incurred in connection with the performance of duties with the plan (provided a person otherwise receiving full-time pay from an employer or employee organization does not receive compensation from the plan other than for reimbursement of expense properly incurred); and (3) a person may serve as a fiduciary in addition to being an officer, employee, agent, or other representative of a party in interest.

In contrast, the Code’s statutory exemptions in I.R.C. § 4975(d) are clearer – I.R.C. § 4975(c)(1) sets forth a single set of prohibited transaction rules, which include the fiduciary prohibited transaction rules (with the exception of the conflict of interest situation) and I.R.C. § 4975(c)(2) grants the Secretary the ability to establish an exemption procedure, not differentiating between exemptions for the

\(^{139}\) See 29 C.F.R. § 2550.408b-2(a) (2019).
first four prohibited transactions as opposed to exemptions from the fiduciary prohibited transactions (other than requiring a hearing and determination of certain findings, applicable to the latter ones, but not the former ones). The statutory exemptions in I.R.C. § 4975(d) state that the prohibitions contained in I.R.C. § 4975(c) do not apply – not differentiating between the first four prohibited transactions and the latter two, which are fiduciary prohibited transactions. Yet the IRS’ regulatory interpretation is that the statutory exemptions do not apply to the fiduciary prohibited transactions set forth in I.R.C. § 4975(c)(1)(E) and (F). While the IRS’ interpretation is not supported by the literal reading of the statute, practitioners should be aware that taking a position that is contrary to published regulation must be disclosed on the tax return; otherwise the taxpayer could be faced with an accuracy related understatement penalty.

A reading of I.R.C. § 4975(d) is further complicated as it is caveated with the phrase “[E]xcept as provided in subsection (f)(6)).” I.R.C. § 4975(f)(6) states that the statutory exemptions in I.R.C. §4975(d) (with the exception of exemptions contained in I.R.C. § 4975(d)(9) and (12)) do not apply to certain transactions involving a “trust described in section 401(a) which is part of a plan providing contributions or benefits for employees some or all of whom are owner-employees.” The statute then defines owner-employees to include “[a] participant or beneficiary of an individual retirement plan (as defined in section 7701(a)(37)),” which in turn refers to an IRA described in I.R.C. § 408(a) or individual retirement annuity described in I.R.C. § 408(b). While the reference to I.R.C. § 408(a) and (c) seems to be misplaced as the typical IRA is not subject to a trust described in I.R.C. § 401(a), the statute may be referring to non-typical IRAs in which the employer is sponsoring a payroll-deduction IRA through a plan which is funded by a trust. For example, an IRA established pursuant to I.R.C. § 408(c), entitled “Accounts established by employers and certain association of employees” and I.R.C § 408(k) (established Simplified Employee Pensions) could fit such a description as trusts that are created by the employer for the exclusive benefit of its employees or their beneficiaries (which is not the typical IRA situation). But the reference to IRAs in I.R.C. § 4975(f)(6) would appear not to be relevant in the typical IRA context as an IRA is not a qualified plan, with a trust described in § 401(a).

140. Treas. Reg. § 54.4975-6(a)(1).
141. I.R.C. § 6662 (2020) imposing a 20% accuracy-related penalty for underpayments in the context where the underpayment was made due to disregard and non-disclosure of the regulations.
The IRS 2010 Training Manual simply repeats the statute, not shedding much light on whether the typical IRA would be subject to I.R.C. § 4975(f)(6), and thus the statutory exemptions (other than I.R.C. § 4975(d)(9), (d)(12)) would not be applicable.\textsuperscript{142} But a brief 2009 Chief Counsel Opinion appears to contradict the view that IRAs could not be subject to the statutory exemptions, indicating that the I.R.C. § 4075(d)(10) exemption for reasonable compensation is applicable to IRAs (thus, indicating I.R.C. § 4975(f)(6) did not apply). However, the exemption for reasonable compensation did not apply in the context of payment of salary to an IRA owner (presumably for his work performed in an IRA owned LLC) as there was an inherent conflict of interest with the IRA owner being in a position to determine the amount of compensation.\textsuperscript{143} Hence, the Service concluded that the payment of compensation of salary to an IRA owner would be an act described in I.R.C. § 4075(c)(1)(E) or (F) due to the conflict of interest inherent in the situation, referencing the Treas. Reg. § 54.4975-6(a). Interestingly, the IRS 2017 Training Manual is silent on the issue, suggesting the IRS may be rethinking its approach.\textsuperscript{144}

ERISA § 408(b) sets forth 20 statutory exemptions, as well as the grant of authority to the DOL to issue class and individual administrative exemptions.\textsuperscript{145} In contrast, the Code sets forth 23 statutory exemptions under its prohibited transaction rules, set forth in IRC § 4975(d). As noted earlier, the IRS’ view is that the Code’s fiduciary prohibited transactions are not exempt under any of the statutory exemptions, and thus, if they are to be permitted, would have to be set forth in a DOL class or individual administrative exemptions.

**Relevant statutory and class exemptions**

In the context of self-directed IRAs, the relevant statutory and class exemptions are as follows:

*Loans or other extension of credits between the IRA and a*

\textsuperscript{142} IRS Prohibited Transaction, Section 11, 4.72.11.2 (last revised Nov. 1, 2010).

\textsuperscript{143} Re: Salary as PT, CCA 2009112409523350 (Dec. 24, 2009)

\textsuperscript{144} IRS Prohibited Transactions, 4.72.11.3 (Sep. 21, 2017).

\textsuperscript{145} 29 U.S.C. § 1108(a)-(b) (2020).
disqualified person: PTE 80-26

Normally, both ERISA and the Code’s prohibited transaction rules prohibit the lending of money or other extension of credit between an IRA and a disqualified person involving IRA assets. This would also include the use of an IRA assets for the benefit of the IRA owner.\(^{146}\) Under the class exemption PTE 80-26, certain loans and other extension of credits are permitted for (1) the payment of “ordinary operating expenses of the plan” or (2) payment of other expenses “incidental to the ordinary operation of the plan.”\(^{147}\) Two DOL advisory opinions add insight as to the meaning of this exemption.

In DOL Adv. Op. 2009-03A, Mr. Berry requested an advisory opinion as to whether a prohibited transaction would occur if an IRA owner granted to a brokerage firm a security interest in the assets of his non-IRA accounts (known as cross-collateral arrangements) held by the broker to cover indebtedness that the self-directed IRA may incur. The DOL concluded that such grant of a security interest in his non-IRA accounts to cover indebtedness of his IRA would constitute a prohibited transaction under I.R.C. § 4975(c)(1)(B) (i.e., lending or other extension of credit), quoting from ERISA’s legislative history.\(^{148}\) This is an extension of credit by the IRA to the IRA owner (a fiduciary, as the account is self-directed) and the broker (a disqualified person, as either custodian or trustee). But it also noted that the situation described would likely result in other prohibited transaction violations of the prohibited transactions as the IRA owner would be transferring or using the IRA’s assets for his own benefit in violation of I.R.C. § 4975(c)(1)(D) and using the IRA assets “in his own interest or for his own account” in violation of I.R.C. § 4975(c)(1)(E).

In DOL Adv. Op. 2011-09A, the same Mr. Berry requested an advisory opinion in connection with an IRA owner directing a trust company to open a futures trading account for purposes of self-directing the investment of such account.\(^{149}\) With the establishment of


\(^{148}\) DOL Adv. Op. 2009-03A (Oct. 27, 2009) (quoting from ERISA’s Conference Report that “… a prohibited transaction generally will occur if a loan to a plan is guaranteed by a party-in-interest [disqualified person], unless it comes within the special exemption for employee stock ownership plans,” H.R. Rep. No. 1280, 93d Cong., 2d Sess., at 308 (1974)).

such account, the broker wanted an indemnification agreement effectuated by the IRA owner to secure the broker against losses or taxes attributable to the IRA account that would exceed the amount of assets held in the IRA (referred to as excess loss). While such indemnification agreement would otherwise be an impermissible extension of credit by the IRA owner to his IRA, the request inquired whether the class exemption PTE 80-26 provided relief from the prohibited transaction rules. Under that exemption, the proceeds of loans or extensions of credit to such plan are possible only if (1) they are used for the payment of ordinary operating expenses of the plan (e.g., payment of benefits, premiums under an insurance or annuity contract, or administrative expenses) or (2) they are used for a purpose “incidental to the ordinary operation of the plan.”150 Such a class exemption permits loans to be made interest-free to the plan for purposes of ordinary operating expenses. In the advisory opinion, the DOL stated that losses that arise in connection with the investment performance of a futures contract entered into by an IRA is not an “ordinary operating expense” for purpose of PTE 80-26, nor are they “incidental” costs associated with the ordinary operation of the plan.

These two advisory opinions caused confusion within the financial community as plan sponsors, the self-employed, and IRA owners routinely indemnify their plans so as to engage in short sales, margin transaction, and options and future trading – all which involve the use of cross-collateralization agreements. To the extent such agreements are prohibited, service providers’ fees need to be increased due to the additional risk that must be borne. The IRS issued Announcement 2011-81 granting temporary relief to IRS owners who sign certain indemnification agreements “[p]ending further action by the [Department] and until issuance of further guidance form the IRS superseding [the Announcement].”151 The DOL responded with a proposed amendment to PTE 80-26, giving retroactive (from January 1975) and temporary relief, and requesting comments.152 The Securities Industry and Financial Market Association (“SIFMA”) responded with comments that the DOL amend PTE 80-26 to permit indemnification agreements and cross-collateralization clauses used in brokerage agreements with self-directed IRAs.153 It

152. DOL request for a proposed amendment to PTE 80-26, 78 Fed. Reg. 31584 (May 24, 2013).
requested retroactive relief and a permanent prospective exemptions. The financial community continues to await guidance from the agencies.

Service Providers: Exemptions under ERISA §§ 408(b)(2), (c)(2), and I.R.C. § 4975(d)(2), (d)(10):

These statutory exemptions become relevant in the context of an IRA paying compensation to the IRA owner or other disqualified person for services rendered to the IRA. This is particularly relevant in the self-directed IRA context, where the IRA owner forms a business (usually an LLC) and acts as the LLC’s general manager and wishes to be paid for his services as general manager. Some observers point to the second of these statutory exemptions – ERISA § 408(c) and I.R.C. § 4975(d)(10) – to permit the fiduciary prohibited transaction, whereby a disqualified person (including a fiduciary) can receive reasonable compensation for services rendered to the plan.

As a service provider is by definition a disqualified person (and party in interest), both ERISA and the Code provide a statutory exemption under ERISA § 408(b)(2) and I.R.C. § 4975(d)(2), such that the plan can enter into a contract with a service provider for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan and pay reasonable compensation for such services.\textsuperscript{154} In the context of transactions involving fiduciaries who are service providers, the IRS regulations again take the position that furnishing of office space or a service by a fiduciary regarding acts that involve conflicts of interest under I.R.C. § 4975(c)(1)(E) or (F) are regarded as separate transactions which are not exempt under the statutory exemption.\textsuperscript{155} In its regulations, the IRS admonishes the disqualified person who is a fiduciary of their duty of undivided loyalty to the plan and to deter from “exercising the authority, control, or responsibility which makes such persons fiduciaries when they have interests which may conflict with the interests of the plans for which they act.”\textsuperscript{156} As such, the fiduciary may not cause the plan to pay additional fees to such fiduciary, or to a

\begin{footnotesize}
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\item \textsuperscript{154} I.R.C. § 4975(d)(2) read as follows: “any contract, or reasonable arrangement, made with a disqualified person for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor,” with ERISA § 408(b)(2) reading comparable, but using the term “party in interest” in lieu of “disqualified person.”
\item \textsuperscript{155} 29 C.F.R § 2550.408b-2(a) (2020).
\item \textsuperscript{156} Treas. Reg. § 54.4975-6(a)(5)(i).
\end{enumerate}
\end{footnotesize}
person in which the fiduciary has an interest which could affect his best judgment as a fiduciary. Nor can a fiduciary use his authority, control, or responsibility to cause the plan to enter into a transaction involving plan assets in which the fiduciary, or a person in which the fiduciary has an interest, will receive consideration from a third party in connection with the transaction. The DOL takes a comparable position that the statutory exemption of ERISA § 408(b)(2) does not extend to fiduciary prohibited transactions, involving self-dealing, conflicts of interest, and kickbacks. In its advisory opinions, the DOL states that situations in which the plan fiduciary increases its own compensation by means of its recommendations to use certain investment products offered by it or its affiliates results in self-dealing.

There is another exception in both ERISA § 408(c) and I.R.C. § 4975(d)(10) for the payment of reasonable compensation for fiduciaries, but they are structured and worded differently. Some practitioners point to these exceptions as permitting the payment of compensation to an IRA owner (i.e., a fiduciary) who renders services for the IRA or for a business owned by the IRA. However, one practitioner, Richard Matta, has questioned whether the DOL spent so much time working on its mammoth fiduciary proposal and corresponding “Best Interest Contract” (BIC) Exemption, if these exceptions provided such relief. Under the Code, there is a second statutory exemption found in I.R.C. § 4975(d)(10) which permits receipt by a disqualified person reasonable compensation for services rendered (or reimbursement of expenses incurred) in the performance of his duties with the plan. Since this second statutory exemption appears to duplicate I.R.C. § 4975(d)(2), the IRS in its regulations take

157.  Id.
158.  Id.
159.  26 C.F.R. § 2550.408b-2(a) (2018) (stating similar language in the IRS regulations that such fiduciary prohibited transactions are separate transactions not described in ERISA § 408(b)(2)).
162.  I.R.C. § 4975(d)(10), with the caveat that in the context of a person already receiving full-time pay from an employer, association of employers, or employee organization, compensation for services rendered to the plan will not be paid except for reimbursement of expenses properly incurred.
the position that it merely clarifies the first exemption, without providing a separate, second exemption.\textsuperscript{163} In the context of paying a plan fiduciary for services rendered to the plan, the regulations do not prohibit such payment unless the fiduciary is already receiving full-time pay from an employer, association of employers, or employee organization whose employees or members are covered under the plan.\textsuperscript{164}

Similarly, under ERISA § 408(c)(2), it says that nothing in ERISA § 406 shall prohibit a fiduciary from receiving reasonable compensation for services rendered (or reimbursement of expenses property incurred).\textsuperscript{165} If one reads ERISA § 408(c) in conjunction with ERISA § 406, one possible interpretation is that only the per se prohibited transactions are covered under ERISA § 408 (including ERISA § 408(c)(2)), and that the fiduciary prohibited transactions of ERISA § 406(b) (which have no exception for ERISA § 408) are not exempt under ERISA § 408(c). Alternatively, one could read ERISA § 408(c) to provide an exception for all of ERISA § 406 (including the fiduciary prohibited transactions) as it is not written to say as “nothing in section 406(a).”

The language of ERISA § 408(c) is as follows:

ERISA § 408(c) Fiduciary Benefits and Compensation Not Prohibited by Section 406 – Nothing in section 406 shall be construed to prohibit any fiduciary from … (2) receiving any reasonable compensation for services rendered …

The DOL have adopted in its regulations the first interpretation, as was discussed above.\textsuperscript{166} As to the meaning of ERISA § 408(c)(2), the DOL interprets it, similarly to the IRS’ interpretation of I.R.C. §

\begin{itemize}
  \item \textsuperscript{163} Treas. Reg. § 54.4975-6(e) (“Section 4975(d)(2) refers to the payment of reasonable compensation by a plan to a disqualified person for services rendered to the plan. Section 4975(d)(10) and §§ 54.4975-6(e)(2) through 54.4975-6(e)(5) clarify what constitutes reasonable compensation for such services.”).
  \item \textsuperscript{164} Treas. Reg. § 54.4975-6(e)(3). The regulations also state that excess compensation as defined in Treas. Reg. § 1.162-7 (relating to compensation for personal services which constitutes an ordinary and necessary trade or business expense) will not be considered “reasonable compensation.”
  \item \textsuperscript{165} 29 U.S. § 1108(c) (2018), with the same exception seen in I.R.C. § 4975(d)(10) (2018), for persons already receiving full-time pay from an employer, association of employers, or employee organization whose employees or members are participants in the plan (except for reimbursement of expenses properly incurred).
  \item \textsuperscript{166} 29 C.F.R. § 2550.408b-2(a) (2020).
\end{itemize}
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4975(d)(10), to say it merely clarifies what is reasonable compensation for purposes of the first statutory exemption in ERISA § 408(b)(2). In the context of compensation of a fiduciary, the DOL takes a similar position as the IRS, that reasonable compensation does not include any compensation to a fiduciary who is already full-time pay from an employer, association of employers, or employee organization whose employees or members are participants in the plan (except for the reimbursement of direct expenses property incurred and not otherwise reimbursed).

The majority of courts affirm the DOL’s regulatory position that ERISA § 408(c)(2) does not permit fiduciary prohibited transactions by a plan fiduciary regarding plan assets. But the lone Eighth Circuit takes a contrary view. In the case of Harley v. Minn. Mining and Mfg. Co., the court concludes that ERISA § 408(c) provides that nothing in ERISA § 406 shall be interpreted to prohibit any fiduciary from receiving reasonable compensation for services rendered in the performance of his duties with the plan, including its self-dealing prohibitions. Under the facts of the case, 3M’s plan assets were invested in the Granite Corporation (“Granite”), a hedge fund that invested in primarily collateralized mortgage obligations, under a performance-based compensation agreement with Granite’s investment advisor, Askin Capital Management (“ACM”). A class of

167. 29 C.F.R. § 2550.408c-2(a) (2020) (Section 408(b)(2) . . . refers to the payment of reasonable compensation by a plan to a party in interest for services rendered to the plan. Section 408(c)(2) of the Act and §§ 2550.408c-2(b)(1) through 2550.408c-2(b)(4) clarify what constitutes reasonable compensation for such services).


169. See Nat’l Sec. Sys. v. Iola, 700 F.3d 65, 90-91 (3rd Cir. 2012) (agreeing with the DOL that ERISA § 408(c)(2) does not provide fiduciaries with a defense from an ERISA § 406(b)(3) whenever reasonable compensation was paid); Patelco Credit Union v. Sahni, 262 F.3d 897, 911 (9th Cir. 2001) (reviewing cases that discuss the interplay between ERISA §§ 408(c) and 406 and concluding that ERISA § 408(c) exemption does not apply if self-dealing is involving in the transaction securing the payment); LaScala v. Scrufari, 96 F. Supp. 2d 233, 238-39 (W.D.N.Y. 2001); Daniels v. Nat’l Employee Benefit Servs., Inc., 858 F. Supp. 684, 693 (N.D. Ohio 1994); Whitfield v. Tomasso, 682 F. Supp. 1287, 1304 (E.D.N.Y. 1988); Gilliam v. Edwards, 492 F. Supp. 1255, 1264 (D.N.J. 1980) (stating that the DOL regulations would steal §1108(c)(2) of its “independent exemptive power”); Marshall v. Kelly, 465 F. Supp. 341, 353-54 (W.D. Okla. 1978). But see Harley v. Minn. Mining and Mfg. Co., 284 F.3d 901, 909 (8th Cir. 2002), cert. denied 123 S. Ct. 872 (2003) (interpreting ERISA § 408(c)(2) to unambiguously and “sensibly insulated […] the fiduciary from liability [for a § 408(b) violation] if … compensation [is] … reasonable”); Lowden v. Tower Asset Mgmt., Inc., 829 F.2d 1209, 1216 (2d Cir. 1987) (“Section 1108(c)(2) provides that [… 1106] shall not be construed to prohibit any fiduciary from ‘receiving any reasonable compensation for services rendered …’.”).

participants and beneficiaries of 3M sued, alleging that the ACM’s fee arrangement violated the prohibition against a fiduciary dealing with plan assets for its own account under ERISA § 406(b)(1), as ACM was a fiduciary.\textsuperscript{171} The plaintiffs relied on the DOL regulations for the proposition that ERISA § 408(c)(2) did not apply to the fiduciary prohibited transactions under ERISA § 406(b), but merely clarifies the statutory exemption under ERISA § 408(b)(2).\textsuperscript{172} But the court rejects this interpretation as “it conflicts with an unambiguous statute.”\textsuperscript{173} Thus, ERISA § 408(c) permits a fiduciary to receive compensation as long as it is reasonable.\textsuperscript{174} As 3M had introduced uncontradicted expert testimony that the compensation paid to ACM was reasonable, the claim that the fee arrangement violated the prohibition against self-dealing was dismissed.\textsuperscript{175}

On the tax side, there was virtually no case law examining I.R.C. § 4975(d)(10) until the recent \textit{Ellis v. Comm’r} \textsuperscript{176} case in 2015. In that case, the tax court case addressed the payment of compensation to an IRA owner for his role as general manager of limited liability company which was owned by the IRA.\textsuperscript{177} Under the facts of that case, Mr. Ellis rolled monies from his employer’s I.R.C. § 401(k) plan to an IRA and formed an LLC known as CST, in order to conduct the business of used vehicle sales.\textsuperscript{178} Mr. Ellis served as general manager of CST.\textsuperscript{179} He then caused his IRA to acquire membership units of CST in exchange for cash. CST paid Mr. Ellis compensation for his role as general manager of CST, from CST’s corporate checking account, and not from the custodial account of the IRA.\textsuperscript{180} The court noted that Mr. Ellis was a fiduciary due to his discretionary authority over the IRA assets and due to the fact that he exercised control over the disposition of its assets.\textsuperscript{181} The IRS argued that Mr. Ellis engaged in a

\begin{footnotesize}
\begin{enumerate}
\item \textit{Id.} at 908.
\item \textit{Id.} at 908-09 (citing the DOL regulations set forth in 29 C.F.R. § 2550.408c-2(a)).
\item \textit{Id.} at 908-09.
\item \textit{Ellis v. Comm’r}, 787 F.3d 123 (8th Cir. 2015).
\item \textit{Id.} at 4-6.
\item \textit{Id.} at 5.
\item \textit{Id.} at 6-7.
\item \textit{Id.} at 16.
\end{enumerate}
\end{footnotesize}
prohibited transaction at the time his IRA invested in CST, as the investment was part of an arrangement whereby it was expected that later prohibited transactions would occur under I.R.C. § 4975(c)(1)(D) or (E).\textsuperscript{182} Citing to the Swanson case (to be discussed later in this article), the court held that there was no prohibited transaction when Mr. Ellis’ IRA invested in CST, as CST had no outstanding owners or ownership interest before such investment, and thus was not a disqualified person at the time of the initial investment.\textsuperscript{183} After the initial investment, CST would become a disqualified person as Mr. Ellis was a shareholder of 50% or more of the outstanding ownership interest in CST.\textsuperscript{184} While Mr. Ellis argued that payment of compensation by CST was not a prohibited transaction as such payments did not consist of plan income or assets of his IRA, but instead from a company in which his IRA initially invested, the court dismissed the claim as “in reality CST and Mr. Ellis’ IRA were substantially the same entity.”\textsuperscript{185} The IRS argued that the payment of compensation by CST to Mr. Ellis was a transfer of plan income or assets for his own benefit in violation of I.R.C. § 4975(c)(1)(D) and caused Mr. Ellis to deal with the income or assets of his IRA for his own interest or for his own account in violation of I.R.C. § 4975(c)(1)(E).\textsuperscript{186} Mr. Ellis then pointed to the statute the exemption in I.R.C. § 4975(d)(10), thereby permitting the payment of compensation by CST to him. The court rejected this as the amounts paid by CST were not for services provided in the administration of the plan in managing its investments, but instead were for his role as general manager of CST.\textsuperscript{187}

Mr. Ellis appealed to the Eighth Circuit, who affirmed the Tax Court’s decision.\textsuperscript{188} The record established that Mr. Ellis caused his IRA to invest a substantial majority of its value in CST with the expectation that he would receive compensation for his services as general manager. According to the Eight Circuit, Mr. Ellis’ direction to CST to pay him wages from funds that were received almost exclusively from his IRA was an indirect transfer of the income and assets of the IRA for his own benefit and an indirect dealing with such income and assets for his own interest or his own account, in violation

\textsuperscript{182} Id. at 19, 21.
\textsuperscript{183} Id. at 17-19 (quoting from the case of Swanson v. Comr., 106 T.C. 76, 88 (1996)).
\textsuperscript{184} Id. at 20. (finding that CST satisfied the definition of a disqualified person under I.R.C. § 4975(e)(2)(G)).
\textsuperscript{185} Id. at 21.
\textsuperscript{186} Id.
\textsuperscript{187} Id. at 21-22.
\textsuperscript{188} Ellis v. Comm’r, 787 F.3d 1213, 1217 (8th Cir. 2015).
of both I.R.C. § 4975(c)(1)(D) and (E).\textsuperscript{189} The Court did not address whether the exemption under I.R.C. § 4975(d)(10) was applicable as that exemption applies only to compensation for services rendered in the performance of \textit{plan duties}, not for his services as general manager of CST.\textsuperscript{190} But we see from the IRS’ appellee brief that it continues to maintain even if the payments for compensation for services to the plan met the requirements of I.R.C. § 4975(d)(2) and (10), they could be exempt from the violations of the \textit{per se} prohibited transactions, but not the fiduciary prohibited transactions.\textsuperscript{191} Interestingly, given the Eighth Circuit’s position in \textit{Harley} decision, had the compensation in the \textit{Ellis} decision been for the compensation of services rendered to the plan, and not for running a business, the court may not have agreed with the IRS’ interpretation.

\textit{Bank Deposits: ERISA § 408(b)(4) and I.R.C. § 4975(d)(4)}

These statutory exemptions are relied upon by banks when advising its clients on IRA investments and on IRA rollovers, provided the IRA is designed to invest exclusively in the one or more bank’s deposit products (e.g., a certificate of deposit).\textsuperscript{192} The exemption for Deposit IRAs requires the following: (1) the product must be offered by a bank and subject to the supervision and examination of a federal or state banking authority; (2) it must act similarly as any other IRA; the product is available through the bank and the bank’s branches, which serve as the IRA trustee or custodian; (3) the initial documentation establishing the Deposit IRA states that the IRA owner intents to restrict the IRA assets exclusively to the deposits offered by the bank; (4) the deposits must bear a reasonable interest rate, but the bank may charge services fees; and (5) the Deposit IRA may or may not be subject to trust or custodian fees to cover such services.\textsuperscript{193} Such statutory exemption permits the IRA’s investment in the bank deposit accounts, which otherwise would have been an impermissible lending of money or extension of credit between the IRA and the bank (i.e., a trustee or custodian), violating I.R.C. § 4975(c)(1)(B), and the use of IRA assets by or for the benefit of a disqualified person.

\textsuperscript{189} Id. at 1216-1217.
\textsuperscript{190} Id. at 1217.
\textsuperscript{191} Brief for the Appellee, Terry L. Ellis; Sheila K. Ellis v. Comm’r, No. 14-1310 (8th Cir. 2014) (referring to the DOL regulations which do not exempt a fiduciary’s use of plan assets in his own interest or for his own account under I.R.C. § 4975(c)(1)(E), under 29 C.F.R. §§ 2550.408b-2(b), 2550.408c-2(a)).
\textsuperscript{193} 29 C.F.R. § 2550.408b-4 (2020), Treas. Reg. § 54.4975-6(b).
(i.e., the bank), violating I.R.C. § 4975(c)(1)(D), as well as the fiduciary self-dealing prohibition of I.R.C. § 4975(c)(1)(E).

This exemption is also relied upon by banks for other necessary services permitted under ERISA § 408(b)(2). In DOL Adv. Op. 88-2A, the DOL affirmed that a bank could assess a fee for sweeping uninvested plan assets into unaffiliated money market funds (referred to as “sweep services”) in order for the uninvested funds to accrue interest.194

Benefit Distributions: I.R.C. § 4975(d)(9)

This statutory exemption permits the fiduciary to distribute benefits owed to a participant or beneficiary, provided they are determined and paid on a basis consistent with the terms of the plan as applied to all other plan participants and beneficiaries.195 The literal language of the statute in I.R.C. § 4975(c)(1)(D) would have prevented the transfer of funds from the plan to a plan participant or beneficiary who could be a disqualified person.196 The IRA rules require contributions to ordinarily be in the form of cash, but there is no prohibition with respect to “in kind” distributions of property; the issue for the IRS would be the proper valuation of such property for purposes of the income tax rules. However, a separate issue arises where the IRA asset is a house that the IRA owner intends to use as a personal residence after distribution from the IRA.

Investment Advice:

The Pension Protection Act of 2006 added another statutory exemption under ERISA § 408(g) and I.R.C. § 4975(f)(8).197 A qualified fiduciary adviser may rely upon this exemption so as to provide investment advice that is well suited to a participant or beneficiary of a self-directed defined contribution plan (including an IRA), as long as the advice is given through an eligible investment advice arrangement. The exemptions extend not only to the investment advice provided, but any transactions entered into as a result of the advice and the payment of fees or other compensation related to the advice or

the investment transaction. The parameters of the exemption are as follows:

A qualified fiduciary advisor is someone who is regulated by applicable banking, insurance, or securities laws. An eligible investment advice arrangement exists for a qualified fiduciary advisor to provide advice to an employer-sponsored plan, IRAs, Archer MSAs, health savings accounts (HSAs), and Coverdell education savings accounts; the arrangement either provides that adviser fees do not vary as a result of the investment option selected (referred to as fee-leveling plans) or the advice is generated from a computer model satisfying certain conditions.198

Investment advice under the fee-leveling model must satisfy the following criteria: (1) be consistent with generally accepted investment theories; (2) take into account management fees and other fees considered in the recommended investments; and (3) information that the advisor has to take into account due to the participant’s risk tolerance, other investments, other income sources, investment preferences, current age and expected retirement age.199

For advice provided by the adviser using the computer-driven model, the model must: (1) be consistent with generally accepted investment theories; (2) take into account management fees and other fees included in the recommended investment; (3) adequately consider the factors used in estimating future returns of investment options: (4) take into consideration a plan participant’s risk tolerance, other investments, other sources of income, investment preferences, current age, and expected retirement age; (5) use objective criteria for available investment options; and (6) not lien on investment options or the adviser or his affiliates that generate greater income for such individuals.200

Transactions with Service Providers:

In connection with the sale of property, loans or other extension of credits, or transfer or use of IRA assets with a disqualified person (who is one solely because it provides services or has certain relationships with the service provider to the plan), payment of compensation may be made for services rendered by the plan or IRA as long as adequate consideration (meaning not less nor more) is paid.201

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199. 29 C.F.R. § 2550.408g-1(b)(3) (2020).
This statutory exemption for service providers is found in I.R.C. § 4975(d)(20) and ERISA § 408(b)(17), as added in 2006, and is applicable in many arms-length transactions with third parties. The exemption is not applicable to a fiduciary (or its affiliate) who has or exercises any discretionary authority or control involving the investment of plan assets involved in the transaction or who provides investment advice regarding the plan assets.

**Correction of a Prohibited Transaction:**

Correction of a prohibited transaction is permitted with respect to the purchase, holding, or sale of a security or commodity if it is done within 14 days after the date the party in interest discovers or reasonably discovers that the transaction was prohibited. Such rule is not applicable to sales or purchases of employer security or employer real property, nor if the fiduciary knew or should have known at the time of the transaction, that is was a prohibited transaction. When applicable, the correction requires undoing the transaction, if possible, and making whole the plan or restoring any losses. Excise taxes can be abated after assessment or refunded or credited after they have been collected.

**Other Types of Exemptions:**

ERISA § 408(a) and I.R.C. § 4975(c)(2) envision that other exemptions can be granted, other than the statutory ones listed. ERISA and the Code authorize the Secretary of Labor and the Secretary of the Treasury to grant a conditional or unconditional exemption of any class of transactions from all or part of the restrictions set forth in ERISA §§ 406 and 407(a) and from taxes imposed by I.R.C. § 4975(a) and (b). Under section 102 of the Reorganization Plan No. 4, of 1978, the DOL has been given jurisdiction over the issuance of administrative exemptions. The DOL’s Office of Exemption Determination, which is part of the Employee Benefits Security Administration (EBSA), handles the processing of prohibited transaction exemption

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204. See the reference to the Presidential Reorganization Plan No. 4, of 1978, supra footnote 44.
applications. The statute permits the issuance of an administrative exemption provided it is: “(1) administratively feasible, (2) in the interests of the plan and of its participants and beneficiaries, and (3) protective of the rights of participants and beneficiaries of such plan.” Generally, exemptions are granted for per se prohibited transactions; exemptions from the fiduciary prohibited transactions require an administrative hearing and a determination that the three elements above have been satisfied. Administrative exemptions can be issued individually (for the identified party) or for a class of disqualified persons (referred as class prohibited transaction exemptions or PTEs). Before the DOL issues a class exemption, it must publish the proposed exemption in the Federal Register to solicit public comments.

Class Exemptions Relevant to IRAs:

The following class exemptions provide relief from the prohibited transaction rules for a fiduciary or party in interest/disqualified person provided the conditions have been satisfied and may be relevant to IRAs:

(1) PTE 75-1: This exemption allows routine buys and sales of securities between an IRA and a broker-dealer if the following elements are met: the broker-dealer normally buys and sells securities on its own account as part of its ordinary course of business; for a reporting dealer or bank, it ordinarily buys and sells government securities for its own account, and the buy or sell between the plan and the reporting dealer or bank is for the buy or sale of government securities; the transactions is an arm’s length transaction with an unrelated buyer or seller; the broker-dealer or reporting dealer or bank is not a fiduciary with respect to the plan; and records are maintained.

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205. See 29 C.F.R. § 2570-30 through § 2570.52 for the process for filing and processing prohibited transaction exemption applications (which explains who may apply; what information should be included; when a conference with the DOL may be requested; when a request for reconsideration of a DOL decision may be made; and how the DOL and the applicant will notify interested persons if the DOL warrants a tentative approval). See also a booklet published by the DOL explaining its regulations and applicable laws in this regard, at DOL, Exception Procedures under Federal Pension Law, Regulations 76 Fed Reg 208 (2011), https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/exemption-procedures-under-federal-pension-law.pdf


207. 29 C.F.R. § 1108(a) (2020); see also I.R.C. § 4975(c)(2) (2018).

208. See 29 C.F.R. §§ 2570.30 (2020) et seq. for the procedures to be followed to requesting an exemption.
for a minimum of six years to ascertain whether the elements of the exemption were met.\(^\text{209}\)

(2) PTE 77-4: This exemption allows IRAs to buy open-end investment company shares (e.g., mutual fund shares) in the context where the mutual fund investment adviser is a fiduciary to the plan (or an affiliate of such fiduciary).\(^\text{210}\) The following elements must be satisfied: no sales commission is assessed or paid relative to the buy or sale; no redemption fee is remitted to the investment company relative to the sale unless it is paid only to the investment company and the existence of such fee is disclosed in the securities prospectus at the time of the buy or sale; no investment management, investment advisory, or similar fee may be paid for the entire duration of the investment; and a second independent fiduciary receives disclosures and reviews it to determine the purchase is suitable for the plan.\(^\text{211}\)

(3) PTE 80-26: This exemption allows IRA owners or other disqualified persons to lend money to the IRA for a very short time to cover ordinary operating expenses, or for a purpose incidental to the ordinary operation of the plan.\(^\text{212}\) This exemption is relevant if the IRA’s assets are illiquid and insufficient to meet short-term needs (e.g., payment of required minimum distributions). To comply with the exemption, the following elements must be met: no interest may be charged to the plan; the proceeds are used solely to cover ordinary operating expenses or for other purposes incidental to the ordinary operation of the plan; the loan must be unsecured; the loan is not being made directly or indirectly by another plan; if the term of the loan is 60 days or longer, it must be made pursuant to a written loan agreement describing all material terms.\(^\text{213}\)

(4) PTE 84-14: This exemption was granted for certain financial institutions (e.g., banks, federally insured savings and loan associations, insurance companies, and registered investment advisers) who acknowledge their fiduciary status relative to the plan in writing.\(^\text{214}\) The exemption permits transactions with counterparties who may be


\(^{211}\) Id. The DOL disclosed to SunTrust Banks that PTE 77-4 is available to IRAs. See DOL Adv. Op. 1993-26A (Sept. 9, 1993).


disqualified service providers (or their affiliates) if the plan assets are managed by a qualified professional asset manager (QPAM) that is independent of the parties in interest. Such QPAMs must have met certain minimum capital and asset requirements.\textsuperscript{215} This exemption eliminates the necessity for plan investment managers to track all parties in interest that may also be investing in the investment funds under their management. In the self-directed IRA context, this exemption would be relevant in the case of an IRA investing in a partnership or another entity that holds plan assets, permitting the manager of the entity to rely on the exemption so as to allow the entity to engage in portfolio investment transactions.

(4) PTE 86-128: This exemption allows certain fiduciaries (and affiliates) to receive fees (e.g., 12b-1 fees, commissions) for “effecting or executing” securities transactions as an agent for a plan (including an IRA) or a pooled investment fund. The trading may not be excessive in amount or frequency (referred to as “churning”).\textsuperscript{216} Disclosures must be made. Normally, ERISA’s self-dealing rules would prohibit a fiduciary from using his authority or control to affect or increase his own compensation. The fiduciary is allowed to act as an agent in an agency cross transaction (e.g., agent to both the plan and one or more other parties), and to receive reasonable compensation for effecting or executing the agency cross transaction from one or more of the other parties to the transaction. The exemption requires disclosure and approval by an independent fiduciary; such elements are not applicable to IRAs.\textsuperscript{217}

(5) PTE 91-55: IRC § 408(m) states that investment by the IRA in collectibles (which includes coins) will be treated as a distribution for purposes of IRC § 402.\textsuperscript{218} This exemption states that collectibles do not include gold and silver American Eagle coins and other IRS-allowed gold, silver, and platinum coins and bullion.\textsuperscript{219} PTE 91-55 allows the IRA to buy and sell American Eagle bullion coins in principal transactions to and from broker dealers, who are authorized

\begin{footnotes}
\item[215] PTE 84014, 49 Fed. Reg. 9494 (Mar. 13, 1984) (requiring banks and savings and loan associations to have equity capital or net worth in excess of $1 million; requiring insurance companies to have net worth in excess of $1 million; and requiring registered investment advisers to have total client assets under management in excess of $85 million and either shareholders’ or partners’ equity in excess of $1 million).
\item[217] Id. at 41696.
\item[218] I.R.C. § 408(m)(1)-(3) (2018).
\item[219] Id.
\end{footnotes}
buyers of such coins and serve as non-bank custodians for the IRA.\textsuperscript{220} Under the exemption, the IRA may engage in principal transactions from and to the broker-dealer (including interest-free extension of credit), provided the broker-dealer is not a fiduciary to the IRA; the transaction is arms’ length; and the transaction is settled in 10 days (mandatory).

(6) PTE 93-1: This exemption allows nominal “gifts” (e.g., something no more than $20 in value) to be given by financial institutions to IRA owners for establishing an account.\textsuperscript{221} This is the proverbial toaster exemption.

(7) PTE 93-33: This exemption allows banks to offer reduced or free services (e.g., free checking account with no fees) for the IRA owner or a family member for establishing an account, if certain conditions are met.\textsuperscript{222} It extends protection to other individuals with a beneficial interest in the IRA. Note that PTE 97-11 offers a similar exemption for IRAs established with a brokerage firm.\textsuperscript{223}

(8) PTE 97-11: This exemption allows broker-dealers registered under the Securities Exchange Act to offer reduced or free services for the individual or a family member for establishing an IRA, SEP, Keogh or SIMPLE plan. This exemption allows the broker-dealer to consider the value of certain retirement accounts and personal accounts of the owner (referred to as “householding of brokerage accounts”) in determining its fee for its brokerage services. One type of plan excluded from the list of plans to aggregate is a participant’s account in an ERISA plan (e.g., I.R.C. § 401(k) plan). The following conditions apply to meet the exemption:

- The plan being considered in determining eligibility to receive no or low-cost services must be established and maintained for the exclusive benefit of the participants covered under the plan and beneficiaries;
- The brokerage services must be of the type that the broker-dealer can provide in adherence with all applicable federal and state laws;
- The brokerage services to the plan are the same as provided in the ordinary course of the broker-

\textsuperscript{220} Id.
\textsuperscript{221} PTE 93-1, 58 Fed. Reg. 3567 (Jan. 11, 1993).
\textsuperscript{222} PTE 93-33, 58 Fed. 31053 (May 19, 1993), amended by, 64 Fed. Reg. 11044 (Mar. 8, 1999). This exemption is applicable to IRAs and Keogh plans that are Title I employee benefit plans.
dealer’s business to other customers who qualify for reduced or no cost services, but who have not established a plan with the broker-dealer;

- The combined total of all fees for the services to the plan cannot exceed reasonable compensation;

- The investment performance for the plan is no less favorable than that of an identical investment that could have been made at the same by a customer of the broker-dealer who was not eligible for discounted or free services; and

- The brokerage services to the plan customer must be the same as are offered to non-plan customers with account values of the same amount or the same amount of fees generated.\textsuperscript{224}

PTE 97-11 defines “account value” as investments in cash and securities under the plan for which market quotes are readily available.\textsuperscript{225} The exemption defines “fees” as “commissions and other fees received by the broker-dealer … for the provision of services, including, but not limited to, brokerage commissions, investment management fees, custodial fees, and administrative fees.”\textsuperscript{226}

\textbf{Important Questions to Ask in the Self-Directed IRA Context}

The following sets forth the guidance presently available through caselaw or agency guidance that is particularly relevant in the self-directed IRA context, discussing IRAs in transactions with family members; IRAs involved in impermissible loans or other extension of credit; the IRA’s investment in a family business or an entity related to the IRA owner or a family member; IRAs involved with real estate investments; and IRAs in the context of estate planning needs.

\textbf{IRA Transactions involving Family Members:}

The case of \textit{Harris v. Comm’r}, as discussed earlier, taught that the IRA’s investment in the owner’s personal residence was a prohibited transaction under I.R.C. § 4975(c)(1)(D) (as an impermissible “use by or for the benefit … of the income or assets of a plan” by the owner

\textsuperscript{224} \textit{Id.} at 5856-57.
\textsuperscript{225} \textit{Id.} at 5857.
\textsuperscript{226} \textit{Id.}
The Tax Court rejected all three of the IRA owners’ arguments: (1) the investment in the home was made by the IRA account and not by the IRA owners personally; (2) the home was not collectible within the meaning of I.R.C. § 408(m), and thus was a permissible IRA investment; and (3) as a consequence of the foregoing, there was no distribution of IRA funds to the IRA owners. A similar result occurs when a family member of the IRA owner uses the residence. Sometimes forgotten with the purchase of real estate by the IRA is the fact that many mortgagees require a personal guarantee by the IRA owner for the mortgage; such extension of credit would involve a prohibited transaction as it is unlikely the requirements for PTE 80-26 could be met (as discussed earlier).

The DOL Adv. Op. 82-08A involved a company’s request as to whether loans from three IRAs would be a prohibited transaction, where the three IRA owners and their brother owned 100% of the corporation. Although the DOL did not address the question of whether the company was a disqualified person, it clearly would not have been as the siblings were not family members for purposes of each of the three IRAs per I.R.C. § 4975(e)(2)(F). Thus, their ownership in the corporation could not be considered in determining whether the company was a disqualified person per I.R.C. § 4975(e)(2)(G); nor could the constructive receipt rules of I.R.C. § 267(c) apply as siblings are not family members for purposes of combining their ownership in a common corporation, as I.R.C. § 267(c)(4) is modified by I.R.C. § 4975(e)(2)(F). Note, had the company been a disqualified person relative to the three IRAs, any loans from the IRAs would have been a per se prohibited transaction under I.R.C. § 4975(c)(1)(B) (a loan or other extension of credit).

However, the DOL stated that the three brothers were disqualified persons with respect to their own IRAs as it regarded them as fiduciaries relative to their IRA due to their power to direct their investments. As such, they are prohibited from dealing with the income or assets of a plan “in his or her own interest or for his or her own account,” per I.R.C. § 4975(c)(1)(E). Similarly, the IRS regulations admonish fiduciaries not to enter into transactions when those fiduciaries have interest which may affect their exercise of judgment. As the company is a party in whom the brothers have an

228. Id. at 1984-85.
229. DOL Op. Ltr. 82-08A (Feb. 1, 1982).
230. Id. (quoting from Treas. Reg. § 54.4975-6(a)(5)).
interest that might affect their best judgment as fiduciaries, a loan from their IRAs to the company would likely be a prohibited act of self-dealing under I.R.C. § 4975(e)(1)(E) or an indirect transfer of plan assets to, or a use of plan assets for the benefit of, a disqualified person under I.R.C. § 4975(c)(1)(D).

The DOL Adv. Op. 93-33A involved an IRA owner requesting guidance on his IRA’s purchase and then subsequent lease-back of a tax-exempt school’s land and high school, which was founded by his daughter and son-in-law (who were the sole directors and officers of the school).231 The purchase was to be at fair market value, but the lease-back would be at the fair-market rent or below market rent depending on the school’s ability to pay. The IRA owner was held to be a fiduciary due to his investment discretion over the IRA assets, and his daughter and son-in-law were found to be disqualified persons to the IRA as they were family members per I.R.C. § 4975(e)(2)(F). Thus, the DOL found the sale and lease-back arrangement between the IRA and the school to be a use of plan assets for the benefit of disqualified persons, in violation of I.R.C. § 4975(c)(1)(D). If the transaction were also part of an agreement in which the fiduciary caused the plan assets to be used in a manner designed to benefit any person in whom such fiduciary had an interest, there would be violations of I.R.C. § 4975(c)(1)(D) and (E). The DOL then referred the IRA owner to the IRS regulations for an illustration of the latter violations. Under the regulations, if a plan fiduciary retained his son to provide necessary services to the plan regarding its operations for a fee, the fiduciary would be engaging in an I.R.C. § 4975(c)(1)(E) violation because his son is a person in whom the fiduciary had an interest that may affect the exercise of his best judgment.232 Thus, the IRA owner’s purchase of real estate subject to an arrangement to lease it back to the school at a rent that was dependent on the school’s ability to pay benefited the IRA’s family member, violating I.R.C. § 4975(c)(1)(D) and (E).

The DOL Adv. Op. 2000-10A involved an IRA owner directing his IRA to invest in a limited partnership, in which relatives and the IRA owner (in his individual capacity) were partners. Mr. Alder and his family members had a minority interest in family partnership (which meant the family partnership was not a disqualified person), for which Mr. Alder was general partner.233 Then, Mr. Alder directed his IRA to invest in the partnership, which would then become a

232. Id. (quoting from Treas. Reg. § 54.4975-6(a)(6), Example (6)).
limited partnership; the IRA’s interest will be 39.38%, a minority interest in the limited partnership, and Mr. Alder was to be its general partner. As the partnership was not a disqualified person at the time of the purchase, there should have been no prohibited transaction by virtue of the IRA purchasing the partnership per the Swanson case. Mr. Alder represents that he does not and will not receive any compensation from the partnership; nor will he have an investment management functions with respect to the assets of the partnership.

In determining whether any prohibited transactions occurred or will occur, the DOL notes that Mr. Alder is a fiduciary due to his investment discretion over his IRA assets, and thus a disqualified person; he is also a disqualified person in his capacity as general partner of the partnership, to the extent he exercises discretionary authority over the administration or management of the IRA assets invested in the partnership. Although Mr. Alder, his son and his daughter are also disqualified persons, the transaction is between the IRA and the partnership, and not with Mr. Adler and his family (except as fellow investors in the partnership). Since Mr. Alder only owns 6.52% of the partnership after the IRA purchases its share of the partnership, the DOL states that the partnership is not a qualified person per I.R.C. § 4975(e)(2)(G). That seems surprising since after the purchase, the following related parties’ ownership interest in the limited partnership is as follows: Alder’s IRA 39.38%, Alder’s 6.52%, son’s 3.07%, and daughter’s 1.35%, totally 50.32%. Hence, it would appear the limited partnership is a disqualified person after the IRA’s purchase. But as the DOL concludes that the partnership is not a disinterested person, it holds that the IRA’s purchase of an interest in the partnership does not constitute a per se prohibited transaction.

This opinion begs the question of whether the IRA could own an entity that becomes a disqualified person as a result of the IRA’s purchase of a portion of the entity, or whether that would be a per se prohibited transaction because of its power to vote or otherwise participate in the management of the entity and to receive dividends or other profits from the entity. Since Mr. Alder is a general partner of the limited partnership after the IRA’s purchase, it does not appear that his exercise of management powers as a general partner (who is a disqualified person) is a per se prohibited transaction.

The DOL Adv. Op. 2006-09A involved the IRA owner directing his IRA to invest in notes being offered by a corporation, in which

234. Id.
the IRA owner’s son-in-law had an 87.5% ownership interest. The DOL concluded the IRA owner was a fiduciary due to his ability to direct investments, and that his son-in-law was also a disqualified person under I.R.C. § 4975(e)(6). Due to the son-in-law’s majority interest in the corporation, the corporation was also a disqualified person per I.R.C. § 4975(e)(2)(G)(i). Hence, the IRA’s purchase of the notes from the corporation would be both a sale or exchange of property in violation of I.R.C. § 4975(c)(1)(A) and lending of money or other extension of credit in violation of I.R.C. § 4975(c)(1)(B). The opinion letter was silent on the appropriate penalty for engaging in the prohibited transaction – a 15% excise tax assessed against the corporation or disqualification of the IRA. Arguably the IRA owner did not “engage” in the transaction as it was between the IRA and the corporation, which would save the IRA from disqualification.

In the case of In re Daniels, the bankruptcy court found multiple prohibited transactions thereby granting the trustee’s motion for summary judgment. The debtor was the sole participant, trustee, administrator, and employer of a profit sharing plan. Over the life of the plan, the debtor engaged in a number of transactions with family members, many of these done through the Walker Realty Trust (Realty Trust), for which he was sole trustee and his spouse was the sole beneficiary. The debtor’s wife assigned her beneficial interest in the Realty Trust to the plan. The debtor deposited the rent and sales proceeds from property held by the Realty Trust directly into the profit sharing plan and used plan assets to pay real estate taxes and other management costs associated with the properties held by the trust. The debtor’s son and daughter-in-law paid rent on real property owned by the Realty Trust, which the debtor deposited into the plan as rental checks. The debtor testified that some or all of these rental checks were in connection with a “lease and sale agreement” with his son, such that he could later buy the property. After ten years of payments, a given amount of the lease payments were credited against the purchase price and there was a “gift of equity” from the debtor to his son. The IRS held that the loan made by the plan to the debtor’s son was a prohibited transaction. In another

237. Id. at 339.
238. Id. at 340.
239. Id. at 341.
240. Id. at 341.
241. Id. at 341.
242. Id.
transaction, the debtor made payments from the plan to Mr. Florence for services he rendered for the properties held by the Realty Trust and made a sale of real estate and a loan to Mr. Florence’s daughter from the plan.\textsuperscript{243}

The bankruptcy court found the debtor, his son, daughter-in-law, and wife to be disqualified persons, and thus all real estate sales and leases between the plan and them were prohibited transactions.\textsuperscript{244} It found the sale of real estate and extension of a loan to Mr. Florence’s daughter (a disqualified person) to be prohibited.\textsuperscript{245} The wife’s assignment of her interest in Realty Trust to the plan effectively merged the interests of the plan and trust, causing it to be a fiduciary prohibited transaction, in accordance with I.R.C. § 4975(c)(1)(E) and (F), as the debtor dealt with the plan assets for his own interest by investing them in a business venture in which the debtor had individually invested.\textsuperscript{246}

In the case of \textit{In re Kellerman}, Mr. Kellerman and his wife each owned a 50\% interest in Panther Mountain Land Development, LLC (Panther Mountain).\textsuperscript{247} Mr. Kellerman created an IRA, which formed a partnership (Entrust Partnership) with Panther Mountain (each being a 50\% partner) in order to buy and develop real estate.\textsuperscript{248} The partnership agreement called upon the IRA to deliver the real property as a noncash contribution and to make a cash contribution, whereas Panther Mountain made only a cash contribution.\textsuperscript{249} One day later, Mr. Kellerman directed the IRA to liquidate some of the assets and purchase a four-acre tract of land, to “complement and assist” in the development two nearby tracts of land, owned by Panther Mountain.\textsuperscript{250} At issue in the bankruptcy case was the debtors’ exemption of the IRA.\textsuperscript{251}

The debtors conceded that they were disqualified persons pursuant to I.R.C. § 4975(e)(2) (Mr. Kellerman as fiduciary to the IRA due to his discretionary authority and his spouse as a family member); that Panther Mountain was a disqualified person under I.R.C. § 4975(e)(2)(G) due to Mr. Kellerman’s 50\% interest; and that the Entrust Partnership was a disqualified person under I.R.C. §

\begin{thebibliography}{1}
\bibitem{243} Id. at 341-42.
\bibitem{244} Id. at 349.
\bibitem{245} Id. at 349.
\bibitem{246} Id. at 350.
\bibitem{247} \textit{In re Kellerman}, 531 B.R. 219, 221 (Bankr. E.D. Ark. 2015).
\bibitem{248} Id. at 220-21.
\bibitem{249} Id. at 221.
\bibitem{250} Id. at 222.
\bibitem{251} Id. at 223.
\end{thebibliography}
4975(e)(2)(G) due to Mr. Kellerman’s ownership in Panther Mountain.\textsuperscript{252} The court cites the \textit{In re Cherwenka} case and a DOL opinion letter mentioned in that case for the proposition that the IRA may invest in a partnership and a violation of I.R.C. § 4975(c)(1)(D) or (E) does not necessarily occur “merely because the fiduciary derives some incidental benefit from the transaction involving IRA assets.”\textsuperscript{253} Thus, the court finds that Mr. Kellerman engaged the IRA in transactions involving the purchase and conveyance of real property between the IRA and Panther Mountain and the cash contribution made by the IRA to the Entrust Partnership, violating I.R.C. § 4975(c)(1)(B), (D), and (E), rendering the IRA non-exempt.\textsuperscript{254} The facts also indicate that Panther Mountain used the IRA as a lending source for the purchase price and development of the land, without any commensurate input from Panther Mountain, violating I.R.C. § 4975(c)(1)(B).\textsuperscript{255} The court then cited the \textit{Rollins} case in holding that the Kellerman used the IRA to indirectly secure additional financing on behalf of Panther Mountain “without having to deal with independent lenders,” in violation of I.R.C. § 4975(c)(1)(D).\textsuperscript{256}

All of the above advisory opinions and cases illustrate that a self-directed IRA engaging in transactions with corporations or other entities that are effectively controlled by the IRA owner and/or his family members face the likelihood of the DOL and IRS finding \textit{per se} prohibited transactions, as well as fiduciary prohibited transactions due to the fact that the IRA owner’s best judgment would be affected because of his or the family’s involvement with the corporation or entity. As noted in ERISA Op. Ltr. 82-02A, there was no \textit{per se} prohibited transaction as the corporation who would be receiving a loan from the IRA was not a disqualified person.\textsuperscript{257} However, the DOL had no problem characterizing the IRA’s loan to the corporation as self-dealing by the IRA owner, as fiduciary, or an indirect transfer of IRA assets to, or a use of them, for the benefit of the IRA owner.

\textbf{IRA Transactions involving Impermissible Loans or Other}

\textsuperscript{252} \textit{Id.} at 224-25.  
\textsuperscript{253} \textit{Id.} at 226 (quoting from \textit{Cherwenka}, 508 B.R. at 239 and DOL Op. Ltr. 2000-10A (July 27, 2000)).  
\textsuperscript{254} \textit{Id.} at 227.  
\textsuperscript{255} \textit{Id.}  
\textsuperscript{256} \textit{Id.} at 227-28.  
\textsuperscript{257} DOL Op. Ltr. 82-02A (Jan. 6, 1982).
Extensions of Credit

In the case of Janpol v. Comm’r, Janpol and Berlin were 50% shareholder of AJVW, which established a profit sharing plan for which they were trustees.\textsuperscript{258} The DOL sent them a letter stating that the plan’s purchase of customer notes from AJVW, the leasing of real property to AJVW, and receipt of loans from Berlin and Janpol to the plan constituted prohibited transactions.\textsuperscript{259} Janpol and Berlin took the position that only loans \textit{from} a plan to a disqualified person were prohibited, not loans \textit{to} the plan from a disqualified person.\textsuperscript{260} The Tax Court disagreed and affirmed that any loan between the plan and a disqualified person is prohibited under I.R.C. § 4975(c)(1)(B), with parallel requirements under ERISA § 406(a)(1)(B).\textsuperscript{261}

In the consolidated case of Peek v. Comm’r and Fleck v. Comm’r,\textsuperscript{262} the Court examined facts whereby two taxpayers established traditional IRAs and used the plan assets to each purchase 50% of FP Corporation’s (FP) stock. At the formation of FP, the taxpayers had intended that FP would purchase most of the assets of another corporation (AFS) to engage in a business.\textsuperscript{263} In FP’s purchase of AFS’s assets, it gave a promissory note to the sellers of AFS, secured by the personal guaranties of the IRA owners.\textsuperscript{264} The Court held that the taxpayer’s personal guarantees of the FP’s loans to be an indirect extension of credit to the IRA, thereby prohibited under I.R.C. § 4975(c)(1)(B).\textsuperscript{265} The court reasoned that the intent of the prohibited transaction rules was to prohibit the IRA owner’s loan guarantees, whether made directly to their IRAs or indirectly to their IRAs by way of a corporation owned by the IRAs; to interpret otherwise would allow an IRA to create a shell subsidiary to whom the disqualified person could then make a loan in order to circumvent the rule.\textsuperscript{266}

In TAM 8849001, the taxpayer was a one-sixth shareholder in his employer and participated in the employer’s profit sharing and

\textsuperscript{258} Janpol v. Comm’r, 101 T.C. 518, 520 (1993), which was consolidated with the case of Berlin v. Comm’r.
\textsuperscript{259} Id. at 520-21.
\textsuperscript{260} Id. at 525.
\textsuperscript{261} Id.
\textsuperscript{262} 140 T.C. 216, 224 (2013).
\textsuperscript{263} Id. at 220. (with both Mr. Peek and Mr. Fleck intending to serve as corporate officers and directors of the FP Company).
\textsuperscript{264} Id.
\textsuperscript{265} Id. at 225.
\textsuperscript{266} Id.
money purchase plan, borrowing $50,000 from the profit sharing plan. Upon plan termination, the taxpayer received cash distributions of $472,865 from the plans, including a minority partnership interest. As a result, the taxpayer established an IRA, transferring the $431,680 in cash, a note with a balance of $41,184, and the partnership interest. The IRS held that the transfer of the taxpayer’s note to the IRA and the holding of the note by the IRA constituted a prohibited transaction as a direct or indirect lending or money or other extension of credit between the plan and a disqualified person under I.R.C. § 4975(c)(1)(B).

In the case of Flahertys Arden Bowl, Inc. v. Commissioner,267 the Tax Court examined facts in which the taxpayer owned 57% of the common stock of Flahertys Arden Bowl, Inc. (Flahertys) and was a participant under his employer’s qualified profit sharing plan and qualified pension plan. U.S. Bank, National Association, was the successor trustee of both plans, which permitted the participant to self-direct the investments of its accounts.268 The taxpayer directed the trustee to lend $200,100 to Flahertys from his profit sharing account and to lend $25,900 to Flahertys from his pension account.269 As the taxpayer was a fiduciary by virtue of his ability to direct the management of plans’ assets and Flahertys was a disqualified person as it is owned 50% or more by a plan fiduciary, the loans from the plans to a disqualified person were prohibited transactions under I.R.C. § 4975(c)(1)(B).270

The case of In re Hughes involved a debtor borrowing monies for his IRA and lending it to a corporation in which the debtor was the principal, sole stockholder, and officer, but repaying it to the IRA two months later.271 The corporation was clearly a disqualified person as it was 50% or more owned by the IRA owner in accordance with I.R.C. § 4975(e)(2)(G)(i). The fact that the monies were repaid to the IRA two months later “had no legal effect of ‘restating’ the IRA,” and thus was irrelevant.272 Thus, the bankruptcy court granted the trustee’s objection of the debtor’s claim of exemption of his IRA.273 In a similar fact pattern, the DOL examined facts in Adv. Op. 2011-04A, in which Mr. Warfield proposed to have his IRA purchase a note and deed of trust from his bank (for which he had a mortgage), for real

268. Id. at 270-71.
269. Id. at 271.
270. Id. at 273-279.
272. Id. at 530.
273. Id.
estate titled by the owner’s family trust, such that the IRA would become holder of the note and he could make payments on the note directly to the IRA.\footnote{274} While the IRA would acquire the note and deed of trust from the bank, an unrelated party, the IRA would then hold the note and receive payments from the IRA owner and his spouse, disqualified persons to the IRA. In the DOL’s view, such arrangement is a prohibited extension of credit under I.R.C. § 4975(c)(1)(B) as the holding of the note by the IRA will result in payments made by disqualified persons (the Warfields). The DOL went on to opine that if the acquisition and holding of the note by the IRS was part of an agreement which caused the plan assets to be used in a manner designed to benefit the fiduciary (Mr. Warfield) or persons in which such fiduciary had an interest that would affect his best judgment as fiduciary, there would be violations of the fiduciary prohibited transactions of I.R.C. § 4975(c)(1)(D) and (E).

These above cases and regulatory guidance had no problem finding \textit{per se} prohibited transactions between the IRA and an entity (e.g., corporation, family trust, affiliated corporation) when the IRA or the entity lent monies to one another. In the \textit{Peek/Fleck} case, the Tax Court had no tolerance for an IRA owner making guarantees on loans made to an entity other than the IRA, but instead an entity owned by the IRA, finding such guarantees to be an indirect loan.\footnote{275}

\textbf{IRA Transactions with Family Businesses or Entities Related to the IRA Owner}

The leading case involving an IRA forming a business is \textit{Swanson v. Comm’r}.\footnote{276} Mr. Swanson was the sole shareholder of H & S Swansons’ Tool Company and formed a new corporation (known as Swansons’ Worldwide (the “DISC” or “Worldwide”)) in which he was named the initial director.\footnote{277} Mr. Swanson established an IRA in 1985, retaining the power to direct its investments, and directed the custodian to execute a subscription agreement for 2,500 shares of Worldwide original issue stock, such that the IRA would be the sole shareholder of Worldwide.\footnote{278} From 1985 to 1988, Swansons Tool paid commissions to Worldwide with respect to the sale by Swansons’ Tool of export property, and in turn, Mr. Swanson, as president of

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\footnote{274} U.S. Dep’t of Labor No. 2011-04A (Feb. 3, 2011).  
\footnote{276} Swanson v. Comm’r, 106 T.C. 76 (1996).  
\footnote{277} Id. at 77-78.  
\footnote{278} Id. at 78.
Worldwide, directed it to pay dividends to the IRA.\textsuperscript{279} Mr. Swanson set up a similar arrangement with another corporation, involving a second IRA.\textsuperscript{280}

The IRS’ position was that Mr. Swanson was a disqualified person as he was a fiduciary to the IRA, due to his express authority to control the investments of the IRA.\textsuperscript{281} As he was also an officer and director of Worldwide, there had been a direct or indirect transaction between Worldwide and the first IRA which was prohibited under I.R.C. § 4975(c)(1)(A), and that the payment of dividends from Worldwide to the IRA was an act of self-dealing which was prohibited under I.R.C. § 4975(c)(1)(E).\textsuperscript{282} The Tax Court disagreed.\textsuperscript{283} The stock acquired by the IRA in the transaction was newly issued and thus, Worldwide, without shares or shareholders, did not meet the definition of a disqualified person under I.R.C. § 4975(e)(2)(G).\textsuperscript{284} Only after Worldwide issued the stock to the IRA did Mr. Swanson have a beneficial interest in Worldwide’s stock, causing Worldwide then to become a disqualified person under I.R.C. § 4975(e)(2)(G).\textsuperscript{285}

As to the payment of dividends by Worldwide to the IRA, the court held there was no support for the proposition that they constituted acts of self-dealing, as the dividends paid did not become income of the IRA until “unqualifiedly made subject to the demand of . . .” the IRA.\textsuperscript{286} The only direct or indirect benefit that Mr. Swanson received from the payment of dividends was related solely to his status as a participant of the IRA, which I.R.C. § 4975(d)(9) affirms he can receive as a plan participant.\textsuperscript{287} The court concluded by finding the IRS’ litigation position not “substantially justified” and awarded litigation costs to the Mr. Swanson.\textsuperscript{288}

Thus, the Swanson case stands for the proposition that an IRA can initially invest in a newly created entity (e.g., corporation, LLC, etc.) without engaging in a prohibited transaction as the newly created entity is not yet a disqualified person. Thereafter, the newly created entity may be a disqualified person depending on the IRA’s ownership interests. Shortly after the Swanson case, the DOL issued
regulations stating that a transaction between a party in interest (or disqualified person) and a corporation or partnership in which the plan has invested (e.g., the LLC) will generally not give rise to a prohibited transaction. But the regulations go on to say, due to the prohibitions in ERISA §§ 406(a)(1)(D) and 406(b)(1), that a prohibited transaction will occur if the plan invests in a corporation as part of an arrangement or expectation that the corporation will engage in a transaction with a party in interest (or disqualified person).

DOL Adv. Op. 2006-01A is illustrative of the DOL’s position with respect to IRA’s investments in newly created LLCs which will then transact business with entities owned by the IRA owner. Under the facts of the opinion, the Salon Services and Supplies, Inc. (“S Company”) was owned by Berry (68%) and Learned (“G”) (32%), with Payne (“R”) as its officer. Berry proposed to create an LLC that will purchase land, build a warehouse, and lease property to S Company, whereby its investors will be Berry’s IRA (49%), R’s IRA (31%), and G (20%). R and G would manage the LLC. The DOL finds Berry to be a fiduciary to his IRA due to his discretionary authority or control over its assets and management. Berry represents that S is a disqualified person (as he owns 68% of S). The DOL finds R to be a disqualified person with respect to Berry’s IRA as he is an officer of S Company, per I.R.C. § 4975(e)(2)(H). While the initial investment of Berry’s IRA in the LLC would not be a prohibited transaction, any subsequent lease of property between the LLC and S Company would be a prohibited transaction relative to Berry’s IRA, as the investment was made part of an arrangement whereby the LLC would engage in a transaction with a disqualified person (S Company). The DOL continued to state that if the proposed lease were consummated, Berry as fiduciary may violate the fiduciary prohibited transactions.

The IRS Field Service Advisory 200128011 is a comparable example of an IRA’s investment in an LLC. Under the facts, Father

289. 29 C.F.R. § 2509.75-2(a) (2019).
290. 29 C.F.R. § 2509.75-2(c) (2019).
292. Id.
293. Id.
294. Id.
295. Id.
296. Id.
297. Id. (thereby violating I.R.C. § 4975(c)(1)(A) and (D)).
298. Id. (violating I.R.C. § 4975(c)(1)(D) and (E)).
owned a majority share of USCorp, with his three minor children owning equal remaining shares.\textsuperscript{300} Father and each child own separate IRAs, which acquired a 25% interest in FSC A (a corporation).\textsuperscript{301} USCorp agreed to pay commissions to FSC A, acting as its agent in connection with export sales, as well as performing services on behalf of FSC A for which FSC A would reimburse it for actual costs.\textsuperscript{302} During year 1, FSC A paid dividends to its IRA shareholders.\textsuperscript{303} The IRS conceded, in light of \textit{Swanson}, that the IRAs investment in FSC A did not result in a prohibited transaction, nor did the payment of dividends by FSC A to the IRAs.\textsuperscript{304} While FSC A was not a disqualified person, as it was owned only by 25\% of each IRA, each IRA owner were disqualified persons as fiduciaries with respect to their IRAs and USCorp was a disqualified person with respect to Father’s IRA, due Father’s majority owned interest in USCorp.\textsuperscript{305} Thus, the IRS went on to say that if the transaction between USCorp and FSC A was made for the purpose of benefitting USCorp, the IRA owners would violate I.R.C. § 4975(c)(1)(D), and if facts were presented to demonstrate that the IRA owners’ interest in the transaction because of their ownership of USCorp affected their best judgments as fiduciaries, the transaction would violate I.R.C. § 4975(c)(1)(E).\textsuperscript{306} Thus, the IRS shows its broad interpretation of the fiduciary prohibited transactions to extend to transactions that do not involve disqualified persons.

Other examples where the IRS finds actual or potential fiduciary prohibited transactions include the following. PLR 8009091 is another example where the IRS finds no \textit{per se} prohibited transactions but cautions against possible fiduciary prohibited transactions.\textsuperscript{307} Under the facts, an individual, who is a director (but not an employee) of Corp. A and president of Corp. B (which owns 35\% of Corp. A), proposes to have his IRA purchase 5\% of the total shares of Corp. A, at fair market value.\textsuperscript{308} The individual represents that Corp. A is not a disqualified person relative to his IRA. The IRS agrees that the IRA’s purchase of stock is not a \textit{per se} prohibited transaction, but cautions the IRA owner as plan fiduciary that should he

\textsuperscript{300} Id.
\textsuperscript{301} Id.
\textsuperscript{302} Id.
\textsuperscript{303} Id.
\textsuperscript{304} Id.
\textsuperscript{305} Id.
\textsuperscript{306} Id.
\textsuperscript{308} Id.
benefit, directly or indirectly, from the purchase of stock (e.g., the IRA’s purchase assures his reelection as director of Corp. A or benefits him in his position as president of Corp. B), then the purchase would constitute a prohibited transaction under I.R.C. § 4975(c)(1)(D), (E), (F). Given the inherently factual determination, the Service would not issue a ruling on that question. In PLR 9119002, Individual A was a co-trustee of Trust B, which is a trust underlying the plan adopted by Company B, and owned 39% interest in Partnership Y. Monies were transferred from Trust B to Partnership Y, in exchanged for an unsecured promissory note. While the IRS does not comment, Partnership Y was not a disqualified person as it was not owned at least 50% by Individual A, a fiduciary to Trust B as co-trustee. The IRS held that Individual A, as partner with a substantial ownership interest in Partnership Y, would benefit from the plan loan and thus participated in a prohibited transaction under I.R.C. § 4975(c). In TAM 9208001, Individual M & Co. is a solely owned firm by Individual M, which sponsors a qualified plan. Individual M also serves as an officer of his firm and the plan’s investment adviser. Individual M is also a general partner and 7.5% owner of the partnership, T Ltd. At question was a loan between T Ltd. and Individual M & Co., in which the plan was also an investor. The IRS ruled that Individual M was a fiduciary as he was an investment adviser under the plan. Due to his ownership interest in T Ltd., there was a conflict of interest between the plan and the partnership, resulting in Individual M having divided loyalties with a plan for which he was a fiduciary. Thus, his recommendation to loan monies to T Ltd. by Individual M through Individual M & Co. violated I.R.C. § 4975(c)(1)(E). The case of Rollins v. Comm’r illustrates that plan assets may be used for the benefit of a disqualified person, violating I.R.C. §

309. Id.
310. Id.
312. Id.
313. Id.
314. Id.
316. Id.
317. Id.
318. Id.
319. Id.
320. Id.
321. Id.
4975(c)(1)(D), even if none of the plan assets were transferred to the disqualified person. In the case, Mr. Rollins caused his wholly owned company’s I.R.C. § 401(k) plan to lend monies to three entities in which he had minority interests. The court noted that “[t]ransactions were uses by petitioner or for petitioner’s benefit, of assets of the [p]lan.” Here, the petitioner derived a benefit (as he was a significant part owner of each of the borrowers) “from the [b]orrower’s securing financing without having to deal with independent lenders.”

In the case of Rutland v. Comm’r, the plan in turn leased the property to the employer, MMR. The Tax Court affirmed the IRS’ findings that (1) the sale of property by the officers who were disqualified persons by virtue of I.R.C. § 4975(e)(2)(H) constituted a prohibited transaction under I.R.C. § 4975(c)(1)(A), and (2) the subsequent lease of such property by the plan to the employer, MMR, who was a disqualified person by virtue of I.R.C. § 4975(e)(2)(C) constituted a prohibited transaction under I.R.C. § 4975(c)(1)(B). The court remarked that the prohibited transaction rules were designed “to guard against particular instances of over-reaching by a person able to exert influence over the affairs of such a plan” by charging an excessive price for the property or charging an excessive interest rate under the terms of a loan.

In the case of D.E.W. Plumbing Inc., v. Domestic Mortgage, Inc., Fishman, as trustee and plan administrator to the plan, with the power to invest the plan assets, lent plan assets to Domestic Mortgage, a company owned and controlled by Fishman and his two children. The court held Fishman to be a fiduciary due to his positions as trustee and plan administrator, and due to his discretionary authority or control over the plan assets. Domestic Mortgage was held to be a party in interest as it was 50% or more owned by Fishman and his lineal descendants, pursuant to the rules of ERISA § 3(14)(G). Thus, the plan engaged in a prohibited transaction with

323. Id. at 2-4.
324. Id. at 10.
326. Id. at 1147.
327. Id.
329. Id.
330. Id.
Domestic Mortgage as an impermissible loan or transfer.\textsuperscript{331}

The case of \textit{Etter v. J. Pease Construction Company, Inc.} demonstrates problems that can arise when the plan engages in a joint investment with someone associated with the plan.\textsuperscript{332} Etter, a plan participant of a company-sponsored pension plan, sued the company’s president Jack Pease, the plan, and the plan trustees for engaging in prohibited transactions.\textsuperscript{335} The plan loaned monies to a business acquaintance of Pease, who partnered with him in three property developments.\textsuperscript{334} The plan then purchased a 37\% interest in a real estate venture, along with Pease and Miller (trustees to the plan) purchasing 56\% and 7\% respectively, for a total ownership interest of 100\%.\textsuperscript{335} The plan realized a profit of 97\% on its investment over an 18-month period.\textsuperscript{336} Etter argued the plan’s investment in the venture on two grounds: (1) that is was a prohibited transaction, and (2) that the trustees breached their fiduciary duty to diversify.\textsuperscript{337} The court responded by saying that “prohibited transactions do not per se mandate a remedy,” and since the plan made a profit, there were no damages.\textsuperscript{338} Etter then claimed the plan’s investment in the venture constituted a use of the plan’s assets for the benefit of a party in interest, thereby violating 29 U.S.C. § 1106(a)(1)(D), as Pease and Miller were both plan trustees and personal investors in the venture.\textsuperscript{339} Etter notes that Pease had sufficient personal assets to purchase the land and that both Peace and Miller benefitted from the plan’s investment as it secured for them tax advantages while not risking their personal assets; conversely, the defendants argued that by contributing less than 100\% of the purchase price, the trustees enabled the plan to take advantage of a “valuable opportunity.”\textsuperscript{340} The appellate court found the two views permissible, thereby affirming the district court’s account as “plausible,” and thus, not reversing it.\textsuperscript{341}
IRA Investments in Real Estate

In the case of In re Cherwenka, the debtor was in the business of “flipping” houses through a company named Goldmine Properties Inc. (GPI) and operated at a profit until the real estate crash of 2008. He established a self-directed IRA with Pensco, whose assets included real property. The debtor identified property suitable for the IRA and reviewed the closing statements and related documents. After the property was purchased, the debtor engaged with contractors to improve the property, and inspected and confirmed the completion of the work before the property was sold, with the profits retained by the IRA. The debtor was not compensated for any of the work done in connection with the rehab of the property. A creditor of GPI alleged that the debtor engaged in prohibited transactions involving his IRA and thus, the IRA lost its exemption status.

The bankruptcy court rejected the creditor’s claim that the debtor’s activities regarding the IRA’s real estate assets constituted as direct or indirect services between the IRA and the debtor under I.R.C. § 4975(c)(1)(C), finding that the debtor had not engaged in any “transactions.” The court said the term “transaction” required an exchange of goods or services and that the debtor did not receive anything (e.g., in the form of money, discount, or other personal benefit) for his services other than the asset appreciation of the properties. Finding no evidence to demonstrate that the debtor’s activities regarding the IRA properties resulted in “any benefit to Debtor outside of the plan,” there was no basis for finding prohibited transactions. The court also rejected the creditor’s reliance on the case of In re Williams, which involved similar facts because the debtor engaged in work on the properties held by the IRA, but there the IRA owner’s services were compensated by payment to his wholly-

343. Id.
344. Id. at 232.
345. Id.
346. Id.
347. Id.
348. Id.
349. Id.
350. Id. at 237.
THE PERILS OF SELF-DIRECTED IRAs

owned entity.\textsuperscript{352} The facts in this case showed no form of payment to the debtor or to any of his wholly-owned entities in exchange for the alleged work or services on the properties held by the IRA.\textsuperscript{353}

The bankruptcy court also rejected the creditor’s argument that there was a prohibited transaction due to the purported co-ownership of the prepetition property by the debtor (or a wholly-owned LLC) (55\%) and his IRA (45\%), as debtor is alleged to have used or benefited from the plan’s interest in the property.\textsuperscript{354} As each party to the property had a defined, apportioned piece of the property, the court found no evidence or viable theory to show that the debtor benefited from the IRA’s property.\textsuperscript{355} The court found the DOL’s Opinion No. 2000-10A instructive, in which the DOL did not find a \textit{per se} prohibited transaction where an IRA purchased a 39.85\% interest in a limited partnership, in which the IRA owner’s general partnership interest was 6.5\%.\textsuperscript{356} The partnership was not a disqualified person under I.R.C. \textsection{} 4975(e)(2)(G) because the IRA owner only owned 6.5\% of the partnership.\textsuperscript{357} Thus, the IRA’s purchase of the interest in the partnership was not a sale or exchange prohibited under I.R.C. \textsection{} 4975(c)(1)(A).\textsuperscript{358} In that opinion, the DOL remarked that it does not generally opine on the whether the transaction violates the fiduciary prohibited transactions due to its factual nature.\textsuperscript{359} However, the DOL noted that the facts of the request indicated that the IRA owner does not and will not receive any compensation from the partnership, nor any compensation by virtual of the IRA’s investment in the partnership, indicating that it may answer the question differently if he did receive compensation.\textsuperscript{360} The bankruptcy court then concludes that the IRA owner’s and IRA’s apportioned ownership in real property is not a \textit{per se} prohibited transaction.\textsuperscript{361}

**IRA Transactions in the Context of Estate Planning**

In DOL Adv. Op. 2009-02A, Mr. Goldberg requested a ruling from the DOL regarding whether his estate planning arrangement in

\textsuperscript{352} In re Cherwenka, 508 B.R. at 237.
\textsuperscript{353} Id.
\textsuperscript{354} Id.
\textsuperscript{355} Id.
\textsuperscript{356} Id. at 239.
\textsuperscript{357} Id.
\textsuperscript{358} Id.
\textsuperscript{359} Id.
\textsuperscript{360} Id.
\textsuperscript{361} In re Cherwenka, 508 B.R. at 239.
handling benefit distributions would trigger a prohibited transaction. Mr. Goldberg established a revocable trust for the sole benefit of his grandson, which would by its terms become irrevocable upon his death. Mr. Goldberg was trustee of the trust, with his son as successor trustee. Under Mr. Goldberg’s IRA, the beneficiary was designated to be the trust, with the grandson as the identifiable trust beneficiary. Individual trustee statutory commissions would be paid to the trustee or successor trustee pursuant to state law. Mr. Goldberg queried of the DOL whether the IRA distributions to the trust and payment of the statutory commissions associated with those distributions constituted prohibited transactions.

In reviewing the facts, the DOL opined that both Mr. Goldberg, his son, and his grandson were disqualified persons as Mr. Goldberg had discretionary authority to control and direct the IRA’s investments; the son upon becoming a trustee would also be fiduciary due to such discretionary authority; and the son and grandson were family members of a fiduciary.

As the attribution rules would attribute the grandson’s 100% beneficial ownership to his grandfather who is a fiduciary, the trust is also a disqualified person, as at least 50% of the beneficial ownership of the trust is owned directly or indirectly by a fiduciary. Despite the trust being a disqualified person, the DOL held that neither the benefit distribution from the IRA in accordance with its terms, nor the trust’s receipt of the benefit distribution, would be prohibited transactions due to the statutory exemption contained in I.R.C. § 4975(d)(9), which permits participants or beneficiaries to receive benefits under the terms of the plan. And although the IRA owner was a fiduciary to the IRA, not all decisions made by the IRA owner would necessarily be fiduciary decisions, including the decision as to whether to make a permissible benefit distribution.

As to the payment of the statutory trustee commissions, the

363. Id.
364. Id.
365. Id.
366. Id.
367. Id.
368. Id.
369. Id.
370. Id. (relying on the Supreme Court’s decision in Lockheed Corp. v. Sprink, 517 U.S. 882 (1996), that the payment of benefits was not a “transaction” for purposes of ERISA § 406).
371. Id.
DOL’s view was that a decision by the IRA owner to adopt an estate planning arrangement that contemplates permissible IRA distributions being made to a separate non-IRA trust, was not a fiduciary act by the IRA owner, involving the use of the plan’s income or assets for purposes of the fiduciary prohibited transactions. 372 A similar result would occur when his son became a successor trustee, provided the IRA distributions were determined and paid on a basis consistent with the Code and the terms of the IRA. 373 However, if the son were to act as the IRA’s fiduciary (e.g., rendering investment advice to the IRA owner), he could be held as engaging in fiduciary prohibited transactions if he made an IRA distribution and transferred the proceeds to a vehicle that would benefit the fiduciary. 374

**Plan Assets Rules**

The term “plan assets” is not defined in ERISA nor the Code even though its definition is central to who is a fiduciary to the plan and who is an investment manager. What constitutes plan assets is also critical in the prohibited transaction context – the issue is whether such term includes the underlying assets held by entities in which a plan invests. For example, if an IRA were to purchase a share of stock issued by a corporation, the plan asset could constitute solely of the share of stock it purchased or it could include an undivided interest in the assets owned by the corporation. The DOL has answered this question generally in favor of the first interpretation, but not in all situations.

In Interpretive Bulletin 75-2 (“I.B. 75-2”), the DOL first addressed the issue as to what constitutes plan assets. 375 It set forth the general view in subsection of (a) of I.B. 75-2 that investment by the plan in securities of a corporation or partnership would not, solely by reason of the investment, be considered an investment of the underlying assets of the corporation or partnership for purposes of making them “plan assets” of the investing plan. 376 The concern was that a plan, while appearing to invest its assets in a separate entity, was actually attempting to retain the person who manage the separate entity to provide investment management services to the plan. If that was the case, the assets of the separate entity would be deemed to be plan assets (i.e., the look-through rule), and if the person

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372. *Id.*
373. *Id.*
374. *Id.*
375. 29 C.F.R. § 2509.75-2(c) (2020).
376. 29 C.F.R. § 2509.75-2(a) (2020).
exercised authority or control with respect to the management or disposition of those assets, he would be a fiduciary of the investing plan.

Subsection (c) of I.B. 75-2, which is still good law, describes two circumstances in which a prohibited transaction could occur between a corporation or partnership in which the plan has invested and a party in interest to the plan, even though the corporation or partnership would not be considered to hold plan assets: (1) if the plan invested in the corporation or partnership as part of an arrangement that the corporation or partnership would engage in a prohibited transaction (e.g., lending of money to a party in interest), the purchase would be a prohibited transaction regardless of whether the corporation’s or partnership’s assets were deemed to be plan assets; and (2) if the transaction between a party in interest and the plan would have been prohibited, then a transaction between the party in interest and the corporation or partnership would be prohibited if the party in interest (and its affiliates), with the aid of the plan but no other party, could require the entity to enter into the transaction. Thus, the transaction is prohibited if the plan itself is involved or if the party in interest is involved (with the aid of the plan but no other party) requiring the entity to enter into the transaction.

In 1986, the DOL published its final plan asset regulations, revising and superseding most of the rules of I.B. 75-2. The purpose of the regulations was to set forth rules to be used to determine when an arrangement was an indirect provision of investment management services, and if it is, then bring such arrangement within the purview of ERISA’s fiduciary provisions. The regulations begin with the caveat that if a plan invests in debt instruments, the underlying assets of those instruments are not plan assets. Thus, it is only equity instruments that could be subject to the look-through rule.

The regulations state the presumption that when a plan invests in another entity, the plan’s assets include such investment, but do not solely because of the investment, include any of the underlying

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377. 29 C.F.R. § 2509.75-2(c) (2020).
379. Id. at 41270. (noting that the exception to the look-through rule for plan investments in operating companies was to distinguish between entities that carried on an active trade or business, and thus not likely entities designed to provide investment management services).
380. Id. 29 § C.F.R. 2510.3-101(b), defined “debt instrument” as an “instrument that is treated as indebtedness under applicable local law and which has no substantial equity features.” Id. at § C.F.R. 2510.3-101(b)(1). A profits interest in a partnership, an undivided ownership interest in property, and a beneficial interest in a trust are equity interests.
assets of the entity. But the regulations then negate such a statement by saying that the underlying assets of the entity in which a plan makes an equity investment will be plan assets unless: (1) the entity is an operating company or (2) equity participation in the entity by benefit plan investors is not significant. Hence, if the underlying assets of the entity become plan assets because the entity is not an operating company or equity participation in the entity is not significant, this not only expands the potential for prohibited transactions involving such plan assets, but any person who exercises authority or control over the management or disposition of such assets, and any person providing investment advice with respect to such assets for a fee, becomes a fiduciary of the investing plan, expanding the cast of characters who could be held to be engaging in prohibited transactions.

There are three exceptions under the plan regulations when the assets of a separate entity will not be deemed to be plan assets: (1) publicly offered securities exception; (2) operating companies exception; and (3) the significant participation exception (referred as the 25% test). A publicly offered security is a security that is freely transferrable, part of a class of securities that is widely held, and registered under specified section of the federal securities law. The term “widely held” is defined to include securities that must be held by at least 100 investors who are independent of the issuer and one another. The intent of the exception for publicly offered securities was to guarantee that fund managers would not become “inadvertent ERISA fiduciaries” with respect to a given plan investment.

Under the operating company exception, the DOL defines an operating company as either (1) an entity primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital; a venture capital operating company ("VCOC"); or a real
estate operating company (“REOC”). A traditional operating company is defined as one that primarily is engaged in the production or sale of a product or service (other than the investment of capital), something that the DOL says is inherently factual in nature.\(^{388}\) While such a determination may be easy to ascertain in most situations, it becomes more difficult when the entity is engaged in both traditional business activities and investment fund activities. Under the regulations, two components of a VCOC include: (1) an asset test, such that it must invest at least 50% of its assets, valued at cost, in operating companies (other than other VCOCs) in which it has contractual rights to participate in management and (2) a management test, such that it exercises its management rights with respect to one or more of the operating companies in which it invests.\(^{389}\) Under the regulations, two components of a REOC include: (1) an asset test, such that it must invest at least 50% of its assets, value at cost, in real estate that is actively managed or developed, and in which it has the right to substantially participate directly in the management or development activities and (2) a management test, such that it actually engages directly in real estate management or development activities.\(^{390}\)

Under the 25% exception, if equity participation in a given entity by “benefit plan investors” is less than 25%, the underlying assets of the entity will not be deemed to be plan assets.\(^{391}\) The DOL’s rationale was that if benefit plan investors have less than a 25% equity interest in a given entity, it is unlikely that the entity actually solicited plan investors or that the plan investors believed that the entity would be managed to further a particular investment objective.\(^{392}\) The definition of “benefit plan investors” includes an employee benefit plan within the meaning of ERISA § 3(3) whether or not it is subject to Title I of ERISA; any plan described in I.R.C. § 4975(e)(1); and any entity whose underlying assets include plan assets by virtue of the plan’s investment in the entity.\(^{393}\) For purposes of determining the 25% test, the following persons are not considered: persons (other

\(^{388}\) Plan Asset Regulations, pmbl., 51 Fed. Reg. at 41,263, 41,271 (whether an entity is an operating company is a “factual question to be resolved taking into account the particular characteristics of the entity under consideration”).

\(^{389}\) 29 C.F.R. § 2510.3-101(d) (2019).

\(^{390}\) 29 C.F.R. § 2510.3-101(e) (2019).


\(^{392}\) Plan Asset Regulations, pmbl. 51 Fed. Reg. at 41,269 (“The exception should only apply where plan investment is not so substantial that any special solicitation of plan investments is likely to have occurred and where there is no reasonable expectation that the investment policies of the entity will be affected by the special objectives of the plan investors.”)

than benefit plan investors) who have discretionary authority or control with respect to the assets of the entity; who provide investment advice for a fee with respect to such assets; or who is an affiliate of such persons. 394 In the Preamble, the DOL explains that it excluded the equity interests held by an entity’s managers and their affiliates because “the [significant participation] test could be easily manipulated so as to avoid a determination that plan investment is significant, even where plans provide a substantial degree of the entity’s capital and constitute most of the outside investors in the entity.” 395

There are special rules under the regulations such that certain specialized entities are always deemed to hold plan assets. These entities include group trusts; a common or collective trust fund of a bank; certain insurance company separate accounts; and any entity in which a plan or related group of plans own all of the entity’s equity interests. 396

For an investment fund sponsor seeking to raise monies from pension funds, it will seek to qualify for the operating company exception or restrict investment by benefit plan investors to satisfy the 25% test. If those exceptions are unavailable, the fund’s assets will be held to include plan assets of each ERISA plan that invests in the fund, resulting in the fund manager becoming a fiduciary with respect to each investor. The fund manager would then become a party in interest (and disqualified person) with respect to the plans, due to being a fiduciary and a service provider, as well as its employees, officers, directors, majority-owned subsidiaries and other affiliates.

A recently discussed DOL Adv. Op. 2000-10A shows the application of the plan asset regulations. In that opinion, an IRA owner directed his IRA to invest in a limited partnership in which he and his relatives were invested. 397 After the IRA’s investment, the IRA’s interest in the family partnership would be 39.38%; the IRA’s owner’s interest is 6.52%; his son’s interest is 3.07%; and his daughter’s interest is 1.35%. 398 Due to the IRA’s investment in the family partnership (i.e., 39.38%), there was a significant investment (25% or more) in the partnership by benefit plan investors (i.e., the IRA, as a plan described in I.R.C. § 4975(e)(1)), and thus the partnership is deemed to hold plan assets. 399 This results in any person who exercises

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396. 29 C.F.R. § 2510.3-101(h) (2019).
398. Id.
399. Id.
discretionary authority or control with respect to the assets of the partnership to be a fiduciary of the IRA and thus, subject to the prohibited transaction rules.

**Valuation Issues**

Since our phrase “alternative assets” generally includes non-marketable securities, debt instruments, partnerships, LLC, privately held corporations, real estate, etc., these assets will be inherently difficult to value. The Code, regulations, and tax forms address who is responsible for reporting the annual fair market values of IRA assets. I.R.C. § 408(i) requires the trustee or issuer of the IRA to report certain information both to the individuals for whom the accounts are maintained and to the IRS. The information to be reported is determined by the IRS and must be satisfied no later than January 31 of the calendar year following the calendar year to which the report relates. Such reported information includes the fair market value of the assets held in the account at the end of the calendar year and is reported on the annual Form 5498, which is filed with the IRS by May 31 of the following year.

Under the regulations that oversee approval for non-bank custodians, they state “[t]he applicant will determine the value of the assets held by it at least once in each calendar year and no more than 18 months after the preceding valuation. The assets will be valued at their fair market value, except that the assets of an employee pension benefit plan to which section 103(b)(3)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. § 1023(b)(3)(A)) applies will be considered to have the value in the most recent annual report of the plan.” Thus, it puts the responsibility of valuation on the non-bank custodian. The Instructions to Forms 5498 and 1099-R confirm that “[t]rustees and custodians are responsible for ensuring that all IRA assets (including those not traded on established markets or with otherwise readily determinable market value) are valued annually at their fair market value.”

This begs the question as to whether the trustee or custodian can rely on the IRA owner’s valuation of the assets. The Retirement

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400. I.R.C. § 408(i).
403. See 2020 Instructions to Forms 1099-R and 5498, https://www.irs.gov/pub/irs-pdf/i1099r.pdf. Failure to comply with the requirements for Form 5498 is $50 per failure per I.R.C. § 6693; failure to comply with the requirements for Form 1099-R is $100 per failure per I.R.C. §§ 6721, 6722.
Industry Trust Association ("RITA") is a non-profit national trade group comprising of federally- and state- regulated banks and trust companies that engage in the custody or administration of more than 400,000 retirement accounts holding more than $55 billion in assets.\textsuperscript{404} In its letter to the DOL regarding its proposed regulations re-defining a fiduciary, RITA urged the DOL to clarify that directed custodians and non-discretionary trustees of self-directed IRAs should not be treated as fiduciaries by reason of the valuation reports custodians provide to IRA owners.\textsuperscript{405} While custodians of IRAs are required to provide annual valuations under the Code, including assets for which there is no generally recognized markets, they generally rely on the values provided by third parties, such as investment providers and investment managers. To strengthen its argument, RITA attached a 1993 letter from Tom Brisendine, then Chief of Branch 1 (Employee Benefits and Exempt Organizations) of the IRS.\textsuperscript{406} In that letter, Tom Brisendine stated "so long as the trustee reports the information that it receives from the partners [as to what the FMV of the assets is] it is under no obligation to appraise the investment independently. However, if this information is unreasonable on its face, a trustee may want to re-evaluate whether to continue in a fiduciary relationship with the partnership . . . . Even if the general partners are not forthcoming with the fair market value information, the trustees who are obligated to report FMV do not have to determine value independently to fulfill their obligation under the Code ... trustees who call the IRS seeking information on how to get a reasonable FMV from uncooperative general partners are told not to deal with these people on a fiduciary basis in the future unless the partnership agrees to re-appraise its assets periodically, under written contract."\textsuperscript{407} Thus, informal IRS guidance appears to suggest that the custodian can rely upon the IRA owner’s valuation unless it is unreasonable on its face.

One court affirmed this position, by finding that the custodian only had to "provide" the IRA owner with the fair market value, but that the IRA owner had a duty, in the self-directed IRA context, to


\textsuperscript{405} Id.

\textsuperscript{406} Letter from Tom Brisendine, then Chief of Branch 1 (Employee Benefits and Exempt Organizations) of the IRS, to the Retirement Industry Trust Association (Aug. 6, 1993).

\textsuperscript{407} Id.
find an independent third-party to perform the fair market valuation.\textsuperscript{408} There are also two recent Tax Court decisions in which the IRA custodian distributed and issued 1099-Rs at cost when the IRA owner failed to provide valuation information. In Berks v. Comm’r, the IRA owners invested in five different partnerships in exchange for promissory notes, upon the advice of their financial adviser, Mr. Blazer.\textsuperscript{409} The partnerships all failed for various reasons and the promissory notes held in the IRA accounts became worthless.\textsuperscript{410} Based on Mr. Blazer’s statements that the investments were worthless, the IRA owner informed the custodian to terminate the accounts.\textsuperscript{411} The custodian refused to terminate the accounts based on Mr. Blazer’s statements.\textsuperscript{412} The IRS clearly regards the closing of an IRA account and the writing down its investments’ value as a “red flag” such that the owners could avoid taking taxable distributions from the account.\textsuperscript{413} As the IRA custodian requested documentation regard the investments’ value and when it received none, it resigned and distributed the account based on the original investment amounts, not the owners’ declared “worthless” value, with Forms 1099-R.\textsuperscript{414} The Tax Court affirmed the IRS’ determination of a tax deficiency and an accuracy-related penalty under I.R.C. 6662(a) for underpayment.\textsuperscript{415} The Tax Court stated, “… [the IRA owner] simply took Mr. Blazer at his word, and they apparently never saw the need to request any documentation that would substantiate that the partnerships had failed or that the promissory notes in the IRA accounts had become worthless.”\textsuperscript{416} Thus, without sufficient documentation, the IRA owners failed to meet their burden of producing credible evidence or reasonable dispute with respect to the Forms 1099-R that the custodian issued.\textsuperscript{417} A similar result is found in Gist v. Comm’r.\textsuperscript{418} These cases highlight the importance of properly documenting any loss to the IRA assets for the IRA custodian.

\begin{thebibliography}{10}
\bibitem{410} Id. at 3.
\bibitem{411} Id.
\bibitem{412} Id.
\bibitem{413} Id. at 4.
\bibitem{414} Id. at 3-4.
\bibitem{415} Id. at 6.
\bibitem{416} Id. at 5.
\bibitem{417} Id.
\end{thebibliography}
TITLING ISSUES AND CUSTODY OF ASSETS

Undoubtedly the IRA is “owned” by the person who established it and contributed property to it. But title of the IRA is in the name of the trustee or custodian. If the IRA is a trust, which it should be based on the language of I.R.C. § 408(a) which states it is a “trust created or organized in the United States.” When an IRA invests in an alternative asset, it can invest in the asset directly or indirectly through an entity. If it invests directly, the investment is titled “[Name of Custodian], Custodian FBO John Smith IRA Account No. 12345.” Alternatively, the IRA can invest in an entity (e.g., LLC), which then in turn does the direct investing. The advantages of using an entity as the investment purchaser includes speed, privacy, and convenience as other parties may be more willing to engage in a transaction with an LLC rather than an IRA. A question not yet resolved is whether the IRA can own an entity that is managed by someone not eligible to act as an IRA sponsor (e.g., bank or custodian) and not violate I.R.C. § 408(a)(2) (requiring the IRA to be a trust where the trustee is a bank). “Checkbook control” refers to the LLC establishing a checking account by its general manager in the name of the LLC with a tax ID number (EIN). The IRA owner then controls the checkbook so as to purchase assets through the LLC, in lieu of using the trustee or custodian to purchase the investments. Presumably, this gives the IRA owner more control over the investments of the IRA, with reduced administrative and transaction fees, and faster processing of transactions. This appears to be a popular approach when the IRA owner wishes to invest in real assets.

The IRS has yet to opine on the checkbook LLC approach. The question is who holds the IRA assets – as the regulations state that the custodial account will be treated as a trust for purposes of I.R.C. § 408(a)(2) “if the assets of such account are held by a bank … or [approved non-bank custodian].” Advocates of the checkbook LLC approach take the position that the IRA assets are the shares of the LLC, which are held by the bank, and that the checkbook is that of the LLC, not the IRA. This question also arises in the context of investing in certain gold, silver, or platinum coins, and for certain gold, silver or platinum bullion. The statute is clear that in the context of bullion, it must be “in the physical possession of a trustee described

419. I.R.C § 408(a).
420. Treas. Reg. § 1.408-2(d) (2020) (in the case of a custodial account being treated as a trust because it satisfies the requirements of I.R.C. § 408(a) and the assets are held by the trustee, the custodian of the account will be treated as trustee).
under subsection (a) of this section,” but silent as to whether the trustee must be in physical possession in the context of coins.\textsuperscript{421} Given that there is no statutory or regulatory authority for a trustee or custodian to be able to delegate its authority for someone else (including the IRA owner), it would be problematic for someone else to hold coins owned by the IRA in the hands of someone other than the trustee or custodian. Should the IRA owner himself have physical possession of the coins, this may violate the rule against commingling personal and IRA assets set forth in I.R.C. § 408(a)(5). Custody of digital currencies is even more problematic for IRA owners.

**Unrelated Business Taxable Income (UBTI) Tax**

In the context of self-directed IRAs in alternative investments, two other considerations must be addressed: unrelated business taxable income tax (UBTI) and unrelated debt financed income (UDFI). Under I.R.C. § 408(e)(1), IRAs are normally exempt from taxation unless the account ceases to be an IRA.\textsuperscript{422} However, the IRA will be subject to tax imposed under I.R.C. § 511 on net business income generated from a trade or business regularly carried on by the IRA.\textsuperscript{423} The rationale is to prohibit the IRA from a tax shelter for business activities not substantially related to the performance of its exempt purposes (i.e., which is to provide a vehicle for retirement savings). Under I.R.C. § 511, the tax imposed on an IRA’s net business income is at the trust income tax rates.\textsuperscript{424} I.R.C. § 512(a) provides that “except as otherwise provided in this subsection, the term ‘unrelated business taxable income’ means the gross income derived by any organization from any unrelated trade or business … regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business . . . .”\textsuperscript{425} Under the modifications of I.R.C. § 512(b), many types of income are excluded: dividends, interest, annuities, royalties, most recent from real property, and gains from the sale, exchange or other disposition of property other than inventory or property held for sale in the ordinary course of a trade or business.\textsuperscript{426} For example, if the IRA were to invest in a partnership which deals in the purchase and sale of real estate which generates income in the ordinary course of business,

\textsuperscript{421} I.R.C. § 408(m)(3)(B).
\textsuperscript{422} I.R.C. § 408(e)(1).
\textsuperscript{423} Id.
\textsuperscript{424} I.R.C. § 511(b)(1) (subjecting the tax to the rates in I.R.C. § 1(e)).
\textsuperscript{425} I.R.C. § 512(a).
\textsuperscript{426} I.R.C. § 512(b)(1)-(5).
such income would be taxable to the IRA. As a result, the IRA would need a checking account to process and pay such taxes. The tax is reported by the IRA owner on Form 990-T; see IRS Publication 598 regarding UBTI. While many IRA trust and custodial arrangements state that the responsibility for filing Form 990-T is with the IRA owner, the instructions to the form indicate that the fiduciary to the trust is the one responsible for the filing.

I.R.C. § 512(b)(4) provides that UBTI includes any income on debt-financed property (as defined in I.R.C. § 514). "Debt-financed property" is defined as property which is held to produce income and which is subject to borrowing (either for the original purchase or for improvements). Debt that is acquired for short-term liquidity needs (i.e., less than 12 months) is exempt. Income on debt-financed property is subject to taxation but only with respect to the financed portion of the property. For example, an IRA purchases real estate worth $1,000,000, which is debt financed with a $500,000 mortgage (e.g., the real estate is a leveraged asset held by the IRA to produce income); only 50% of the rental income from the property is subject to UBTI. In addition, any proportionate share of the gains on the profit from the sale of a leverage asset are also subject to tax, unless the debt was paid off more than 12 months prior to the sale. Such tax is owed by the IRA, not the IRA owner, and thus must be paid by the IRA. Should the IRA owner pay the taxes instead, the payment would likely be treated as an excess contribution, subject to excise taxes.

The potential for UBTI taxes raises concerns that the IRA remain relatively liquid in order to pay such taxes. Once the IRA owner reaches age 70-1/2 and becomes subject to the annual required minimum distribution requirements, the IRA will need sufficient liquidity to disburse such payments.

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431. I.R.C. § 514(b)(1).
432. I.R.C. § 514(b).
433. I.R.C. §514(b)(1).
434. I.R.C § 514(b).
435. I.R.C. §4973 imposes a 6% excise tax on “excess contributions” to an IRA.
CONCLUSION

The recent GAO reports highlight the significance of self-directed IRAs investing in alternative assets, as such IRAs are subject to a host of legal impediments that could jeopardize the tax-exempt status of the IRA. The prohibited transaction rules appear to impose significant limitations on self-directed IRAs investing in transactions involving other family members; impermissible loans or other extensions of credit to entities having a relationship with the IRA owner or his family members; transactions with family businesses or other entities related to the IRA owner; and investments in real estate. Given both the DOL’s and IRS’ reluctance to opine on whether a given transaction runs afoul of the fiduciary prohibited transaction rules due to the inherently factual nature of such transactions, the 2019 GAO report highlighted the importance of the DOL and IRS in communicating with one another to provide greater education to IRA owners. Other legal impediments facing self-directed IRAs investing in alternative assets consist of the DOL’s plan assets regulations; the valuation of such alternative assets for purposes of IRS annual reporting; whether delegation of the custody of IRA assets can be made by the IRA trustee or custodian; and other related federal taxes applicable to an IRA that engages in a trade or business unrelated to the original purposes of the IRA. What should be apparent by the end of this article to any sophisticated IRA owner is that investing in alternative assets requires the expertise of an employee benefits attorney conversant with the rules applicable to IRAs. As running afoul of the prohibited transaction rules can subject the IRA to immediate disqualification, the consequences are severe and permanent.