

LEGAL ALERT

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IRAS: THE INVESTMENT MISCONCEPTIONS

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During this economic “melt down” we are frequently reminded that many investment opportunities exist to be exploited while prices are low. Individuals may be tempted to tap into their IRA in order to take advantage of these current “bargain basement” prices. Before accessing your IRA assets to seize these investment opportunities, it is important to remember that not all assets can be purchased and held in an IRA. Even assets that carry with them bargain prices may not be eligible to be held in an IRA without exposing the IRA owner to immediate income taxation.

One asset that is statutorily prohibited as an IRA investment is life insurance, whether it is a whole life, “variable” life, or “universal” life policy. *Life insurance* is expressly defined by the tax Code. But what may look like a different kind of investment, such as an annuity contract, may in actuality be viewed by the IRS as a life insurance contract.

The tax Code also clearly provides that the purchase of other unique investments by an IRA will be treated as a “distribution” to the IRA owner, which means immediate income taxation and possible excise tax penalties if the IRA owner is under the age of 59 ½ years. Prohibited investments include “collectibles,” which are defined as artwork, rugs, antiques,

metals, gems, stamps, coins, alcoholic beverages, musical instruments, and historical objects, e.g., documents or clothing. Excluded from the definition of “collectibles” are U.S. gold, silver and platinum coins, along with gold, silver, platinum, and bullion but only if these precious metals are physically held by a U.S. based trustee or custodian.

Many real estate developers propose that IRAs invest in closely-held businesses and real estate. While these assets are technically eligible IRA investments, they carry their own set of dangers. Business deals that use IRA assets might fall under the broad umbrella of a *prohibited transaction*, a term that prohibits “self-dealing” between the IRA owner and members of the IRA owner’s family or entities that the IRA owner controls. If a *prohibited transaction* occurs, the penalty is very clear: **all** IRA assets are deemed to be distributed to the owner and thus immediately taxable and subject to the 10 percent excise tax if the owner is under the age of 59 ½ years. The U.S. Department of Labor has provided examples that identify what constitutes a *prohibited transaction*. Examples of potential *prohibited transactions* that use IRA assets include the following:

- A business owner uses his IRA assets to

purchase a vacant lot next to his business plant. While the lot in the industrial park appears to be a sound long-term investment, it also permits the business owner's company to expand its plant in future years. Is this a prohibited transaction, since his business benefits from his control of the adjacent lot?

- The IRA owner purchases a lot adjacent to his home and he uses his IRA's assets to pay for the lot. The lot appears to be a long-term investment. But the adjacent lot preserves the view from and thus enhances the value of the IRA owner's home. Will this be viewed as a prohibited transaction?
- The IRA owner purchases either the lot adjacent to his business plant, or the lot adjacent to his home as a long term investment. He pays his wife a realtor's commission since she facilitated the sale. Since part of the IRA money paid her commission, is this a prohibited transaction?
- The IRA owner invests in a closely-held business as a long-term investment. Coincidentally, the business just hired the IRA owner's adult child as an officer. Another prohibited transaction?

All of these innocent investments could easily be viewed by the IRS as a *prohibited transaction*. The devil is always in the details.

Another note of caution is with regard to the income tax consequences that arise from real estate or businesses held in an IRA. IRAs are generally income tax deferred investments, designed to accumulate income until the IRA owner attains retirement age. It is possible, however, for an IRA to recognize unrelated

business taxable income well before the owner's retirement. If the IRA owner's investments are debt financed, e.g., real estate that is subject to a mortgage, the IRA holder may have to report income and file an income tax return for the IRA for its *unrelated business taxable income* that exceeds \$1,000 in a year.

Also, while the IRA owner can invest in an unincorporated active business as its sole owner or as a partner, that business held "inside" the IRA will also cause *unrelated business income* to be recognized and reported. Holding a business "inside" an IRA obviously will also cause additional expenses associated with tax filings and administrative expenses associated with reporting and paying the income tax.

If the smart decision is to not use IRA assets to make investments for fear of encountering the *prohibited transaction* rules, or there exists a genuine concern that some of the investments to be purchased will not qualify as permissible investments, e.g., collectibles, the temptation will be to use the IRA assets as collateral security to obtain a loan (assuming you can even borrow money these days!) to purchase the investment with borrowed funds.

The bad news is, if the IRA is pledged as collateral security for a loan, the IRA will be treated as having made a taxable distribution to the IRA owner of the pledged portion of the IRA account. The IRS' rule is very clear: IRAs cannot act as security for a loan without causing immediate income taxation to the IRA owner.

This rule can indirectly be violated, too, if the IRA owner engages in margin borrowing with his or her broker using his or her investment account as collateral and who also maintains the IRA account with the same broker. If the margin loan is "called" due to the drop in value

of the investments pledged to the broker as collateral security, that drop in value might also implicate the IRA account held with the same broker, and inadvertently cause the owner's IRA to be treated as collateral security.

A couple of other practical issues arise with regard to unusual assets held in an IRA. Those issues deal with *value*. Some assets, like a closely-held business, are hard to value. While that may not be much of an issue before the IRA owner retires, at some point the value of the IRA account becomes critical, such as to compute the IRA owner's requirement minimum distributions when he or she attains the age of 70 ½ years.

For example, if the IRA owner invests all of his or her IRA account in a vacant lot and the IRA owner attains the age of 70 ½ years and must begin to take his required minimum distributions, how will that required distribution be made to the IRA owner? Will the IRA owner have to take a fractional tenant-in-common interest in the lot titled in the IRA's name to satisfy the IRS' required minimum distribution? What if the IRA owner uses the wrong value for the vacant lot, meaning that he did not take the required minimum distribution with the fractional tenant-in-common distribution? If that is the case, the IRS will assess a 50 percent penalty for the failure to follow the IRS' required minimum distribution rule.

Along the same lines, if the decision is made to liquidate that single held asset in the IRA account, can the asset be quickly sold to convert it to cash which can then be used to make the required minimum distribution?

Another consideration is with regard to the distribution of assets upon the IRA owner's death. If the IRA owner has three children and there is a single vacant lot held in the IRA, arguably each of the children as designated beneficiaries will receive a one-third interest as his or her share of the IRA upon the IRA owner's death. Can the children coordinate and negotiate the sale of the lot and their respective fractional interest in the lot? Moreover, how do the children begin to take their required minimum distributions over their life expectancies after their parent's death if the asset held in the IRA is a fractional interest in a single piece of real property?

In short, real drawbacks exist to holding illiquid assets in an IRA that need to be considered before they are added to an IRA investment portfolio.

While the current turbulent economic times can create investment opportunities for those who have the cash and the courage to take advantage of them, tremendous caution needs to be exercised if IRA assets are the source of funds used to exploit those opportunities.

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