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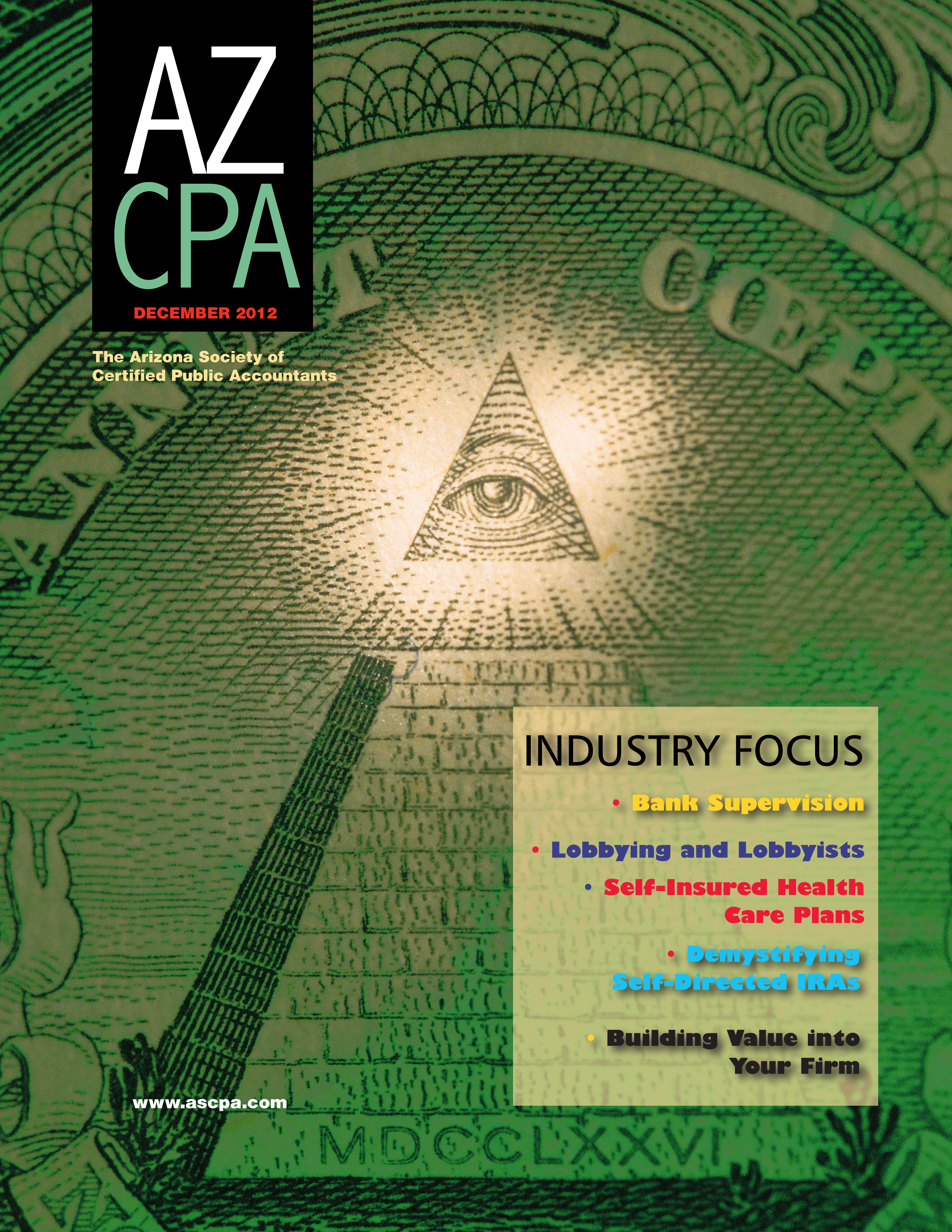

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Demystifying Self-Directed IRAs and 401 (k) Plans

by Richard E. Bingaman, CPA

In 1974, Congress passed the Employee Retirement Income Security Act (ERISA) making IRA, 401(k) and other retirement plans possible. The regulations created by the Act did not specify a list of allowable assets for investments, rather it specified a very short list of exclusions: collectibles and life insurance (IRS Code Sec. 401 IRC 408(a)(3).

Therefore, stocks, bonds and mutual funds are not the only assets a retirement plan is allowed to invest in which may be contrary to what most investment and retirement advisors may be telling you. Other allowable investments include, but are not limited to, real estate, loans and notes, private company stock and precious metals.

A New Alternative for Investing

To move outside the stock market for the allowable investments, special types of retirement plans are required. That is where the Self-Directed Individual Retirement Account (IRA) and Self-Administered Solo 401(k) plan come in. There are retirement plan professionals that specialize in setting up these plans in accordance with applicable laws, rules and regulations as established by the Congress of the United States, the Department of Labor and the Internal Revenue Service.

A Self-Directed IRA with a special purpose LLC (also known as a Checkbook Control IRA) is available to everyone and the Solo 401(k) plan is designed for self-employed, small business owners who have no full-time employees (other than a spouse). Traditional 401(k) plans may offer self-direction also but the Self-Administered Solo 401(k) plan offers the greatest flexibility and control for self-employed business owners. Both plans offer checkbook control and give the accountholder greater flexibility and control over investing their retirement funds.

The rules for retirement fund rollovers from your current IRA or 401(k) plan to a Self-Directed IRA custodian account or Self-Administered Solo 401(k) plan account are no different than the rules governing the rollovers we have been doing for many years. While the rollover rules are the same as we've been used to, these rules must be followed to avoid inadvertent tax consequences or penalties.

How Do They Work?

Self-Directed IRAs grant direct checkbook control for the IRA accountholder with the use of a special purpose limited liability company (LLC) owned by the IRA (work with an IRA custodian that allows such an investment). Every IRA requires a custodian, a company specifically approved by the IRS per IRC section 408, who is the Trustee of the plan. The Trustee role is simply that of investing the plan as directed by the accountholder.

The Self-Administered Solo 401(k) retirement plan grants direct checkbook control without the use of a LLC or custodian although a LLC may be owned by the 401(k) plan to make investments while afforded the legal liability protection of the LLC. All 401(k) plans are qualified plans, and qualified plans do not have any special restrictions on who can serve as trustee.

The main difference then is that with a Solo 401(k) plan, the participant can actually be the trustee and handle the investment transactions themselves. This simplifies the operation of the plan because there are no third parties involved. Such simplification can also minimize third-party fees such as IRA custodian fees.

Ownership of Investment Assets

When you have the responsibility of directing your investments, it is important to understand how assets must be titled. Lack of familiarity with this protocol could result in a "prohibited transaction" as described in IRC Section 4975.

IRA Example:

If Mary Johnson had an IRA with Lonesome Trust, her IRA assets are titled as follows:

Lonesome Trust F/B/O
Mary Johnson IRA

"F/B/O" means "for the benefit of."

To realize the benefits of checkbook control with a self-directed IRA, accountholders create a special purpose LLC owned by the IRA but managed by the accountholder. Ownership of the LLC is titled as follows:

Lonesome Trust F/B/O
Mary Johnson IRA

Mary (as the manager of the LLC) would direct investments on behalf of the LLC. Assets owned by the LLC are titled as follows:

Mary Johnson IRA Holdings, LLC

The Self-Directed IRA allows her to contribute up to $5,000 per year ($5,500 in 2013) to her account (or $6,000 if she's over age 50, $6,500 in 2013).

Solo 401(k) Example:

Owning and controlling retirement plan investments in a Self-Administered Solo 401(k) plan is even simpler. Mary is named the trustee of her Self-Administered Solo 401(k) plan. She directs the plan to purchase assets titled as follows:

Mary Johnson 401(k) Plan

In this case, there is no need to set up an LLC for the purpose of gaining checkbook control.

To utilize an LLC for checkbook control and an additional layer of legal liability protection, an LLC is organized and owned solely by the 401(k) plan. Mary (as the manager of the LLC) directs investments on behalf of the LLC. The assets are titled as follows:

Mary Johnson 401(k)
Holdings, LLC

Solo 401(k) plans are easier and less expensive to operate. The contribution limits are also much greater compared to the IRA. Mary serves in the roles of employer, employee, plan participant, plan administrator, and plan trustee. Serving in the roles of employer and employee allows her to contribute up to $50,000 per year ($50,500 in 2013) to her account (or $55,500 if she's over age 50, $56,000 in 2013). If Mary's spouse works in the business, they can participate and contribute up to another $55,500 per year ($56,000 in 2013) if the spouse is over age 50.

Checkbook Control or Out-of-Control?

You may have heard of potential problems with checkbook control, such as recordkeeping and legal compliance. Individuals should educate themselves on a few things when planning to utilize these plans. The Self-Directed IRA custodian will ask you to complete an annual Fair Market Valuation to determine amounts to be reported to the IRS. The Self-Administered Solo 401(k) plan has an annual filing requirement with Form 5500-EZ which is only required once the plan assets exceed $250,000 in value. There are plenty of retirement specialists and Certified Public Accountants who would be willing to assist with preparing this filing. Of course in order to provide sufficient information to the IRA custodian or to your preparer of the Form 5500-EZ, you must have an accurate accounting of your "self-directed" investment activity including bookkeeping for the LLC. This is a bookkeeping requirement that those who venture into ownership of these types of plans haven't given much thought to.

The issue of checkbook control legal compliance is simple. All self-directed accountholders and participants must avoid "prohibited transactions" as described in IRC Section 4975. Engaging in prohibited transactions may result in the plan losing its tax-exempt status with all plan assets being distributed in a taxable transaction or the amount of the prohibited transaction being voided and considered a taxable distribution. This requirement and responsibility rests solely on the accountholder/participant regardless of whether they have checkbook control and regardless of whether they have a Self-Directed IRA or Self-Administered Solo 401(k) plan.

The facts are that when using a Self-Directed IRA or Self-Administered Solo 401(k) plan:

• Meeting the annual reporting requirements is simple, and it's inexpensive to have the Fair Market Valuation prepared for your IRA or Form 5500-EZ prepared for your 401(k) plan.

•Keeping an accurate accounting of

your self-directed investment activity is as easy as maintaining a set of books, hiring someone to teach you how to maintain this bookkeeping or hiring someone to do it

• Learn what financial transactions are prohibited and seek guidance from a retirement plan specialist or Certified Public Accountant to avoid them in your interactions with the plan.

How to Assist Your Clients

Here are some ways to assist clients in utilizing self-directed plans optimally in their retirement investment portfolio:

• Counsel clients on how self-directed retirement plans operate to take away the mystery of these plans giving them a higher comfort with these valuable retirement investment plans.

• Counsel clients on the importance of prohibited transactions relating to these qualified retirement plans to avoid the risk of the IRS disqualifying the plan and creating a premature taxable event.

• Counsel clients on maximizing retirement contributions by advising which plans to set up based upon their individual retirement situation.

• Assist clients with structuring the investments and business entities properly to maximize investment returns, minimize administration, avoid prohibited transactions and minimize taxes.

Self-Directed IRAs and Self-Administered Solo 401(k) plans provide the most effective and direct way for a retirement plan participant to self-direct investments in their retirement plans. They open the door to the most flexible investing options possible. Of course with ***greater control*** over your retirement plan investment options comes *greater responsibility* for the owner/participant of these plans to engage in sensible investing practices and follow the rules in order to maintain your plan's tax-exempt status. AZ CPA

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