

MEMORANDUM

“You Have an IRA, but have you consider an LLC?”

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One wealth management strategy that has gained popularity in past years with many individual retirement account customers involves creating a limited liability company wherein the IRA account-holder is named the manager of the LLC.

The accountholder retains control of all the assets held by the LLC. This includes having signature control over all accounts under the LLC on a day-to-day basis. Here’s a quick rundown of some important facts.

History

The foundation of this strategy is based upon a Supreme Court case (Swanson v. Commissioner, 106 T.C. 76 (1996)) wherein the court rejected the Internal Revenue Service position that the structure constituted a prohibited transaction.

Many attorneys who assist clients in setting up such arrangements may also refer to various advisory opinions issued by the Department of Labor that have addressed similar issues, such as DOL Advisory Opinion 97-23A and 2000-10A. These opinions tend to focus on a specific set of facts and circumstances relating to an individual transaction and are normally quoted by attorneys as a general guide as to how the government views such activity.

Authorizing initial investments

Overall, the structuring of this arrangement is fairly easy. Accountholders need to work with a competent attorney and advisor who are familiar and experienced with the concept. These professionals will form the limited liability company and generate and file all the necessary documents.

Next, accountholders should contact the IRS and obtain a separate tax identification number for the LLC. Accountholders will then need to establish a bank or brokerage account under the name of the LLC. Finally, the accountholder instructs the IRA custodian to deposit IRA assets into the newly formed LLC. This accomplished by the completing the applicable investment authorization form provided by the custodian.

The accountholder will also need to provide the IRA custodian with the operating agreement for the LLC, properly executed subscription documents, and an opinion letter from an attorney indicating that the initial structure does not constitute a prohibited transaction. Upon receipt of these items, the IRA custodian releases funds to the LLC.

This arrangement does not remove the IRA custodian from the account. Assets are consolidated under the LLC, which now becomes the sole assets of the accountholder’s self-directed IRA. When all is said and done, the IRA statement from the custodian will simply reflect one asset, i.e., the LLC.

Accountholders will need to provide an annual market value for the LLC to the IRA custodian once a year for tax reporting purposes (some custodians may require a valuation form a third party). The custodian will use this information to file Form 5498 with the IRS at the end of each year.

Daily operations

The limited liability company operating agreement outlines the various powers of the manager of the LLC. Operating agreements should be drafted by an attorney and usually contain disclosures

regarding day-to-day operations. It is very important that the IRA accountholder understand these restrictions.

The most notable concern is focused on operating the LLC in such a way as to not cause a prohibited transaction. For example, many attorneys recommend that the IRA accountholder not to take any management fee from the LLC, as this may result in a violation of the prohibited transaction rules.

Note that merely acting as the manager of a limited liability company does not, in and of itself, create a prohibited transaction. It is the actions of the manager on a day-to-day basis that will determine if a prohibited transaction has occurred. IRA accountholders wishing to utilize an LLC strategy need to exercise great care in the management of the LLC and need to have a deep understanding of the prohibited transaction rules in order to ensure compliance.

Generating taxable income

If you IRA or LLC invests in things that produce unrelated business income, and the net income from these investments exceed \$1,000 in any given year, your IRA/LLC could be subject to the unrelated business income tax.

The definition of UBI is pretty broad. Basically, if a tax-exempt entity is involved in a business that is unrelated to its primary purpose, any income derived from such business will be subject to UBIT.

For example, if an IRA forms an LLC to buy and operate a fast food franchise or a car wash, businesses unrelated to the primary purpose of an IRA, the net income will be taxed as UBIT at the trust tax rate. In addition, whenever debt is used by an IRA or LLC, tax is applied to that portion of the gain that is debt-financed. Taxes on both calculated and reported on IRS Form 990-T.

As a result, IRA accountholders should review each transaction inside the LLC closely before investing. Transactions under an LLC that create UBIT would also apply if the investments were made directly inside the IRA.

Distributions

Once an accountholder decides to begin taking withdrawals from the IRA, the distribution amount will have to be returned from the LLC to the IRA custodian, who will then distribute the funds directly to the accountholder. This will ensure that the custodian is able to report the distribution to the IRS on Form 1099-R.

Accountholders should not use the LLC's checkbook to write themselves a distribution check, inasmuch as it might result in a prohibited transaction.

Prohibited transactions

IRC Section 4975 outlines activity that is considered to be prohibited within a retirement account. Generally, a prohibited transaction is any improper use of the IRA by the accountholder, their beneficiary or any disqualified person. A disqualified person includes the IRA accountholder, members of their family or related persons. (Note that in all examples, the terms "family" or "related persons" do not include siblings of the IRA owner.)

Activities that would be considered prohibited would include borrowing money from the IRA, the selling o property between the individual IRA accountholder and the IRA, receiving unreasonable compensation for managing the account, having access to or use of any asset of the IRA, or using the assets of the IRA as collateral for a personal loan. These rules also apply to the LLC, since it is an asset of the IRA. For more information regarding prohibited transactions, go to the IRS Web site at www.irs.gov and download Publication 590.

If the IRA accountholder engages in a prohibited transaction in connection with their retirement account at any time during the year, the account stops being an IRA as of the first day of the year. In such "You have an IRA"

cases, the IRA custodian would issue a 1099-R and report the activity to the IRS. The IRA accountholder would lose the ability to shelter the assets inside the IRA and would be subject to taxes and penalties.

Asset protection

So where does the asset-protection side of the equation come from? Apparently, if the IRA accountholder is sued and the court awards the plaintiff some or all of the defendant's IRA assets, the accountholder would be compelled to assign the interest in the LLC to the plaintiff. This would require the plaintiff (in the year the assignment was executed) to declare the value of said units as taxable income.

However, the accountholder could continue to manage the assets of the LLC and could not be forced to make any distributions to the plaintiff. Simply stated, the plaintiff would have to pay the tax on assets that they never receive.

Conclusion

An IRA accountholder should fully assess the opportunities and risks associated with this concept. We highly recommend that IRA accountholders work closely with their legal or financial advisor during the creation phase of the LLC, and on an ongoing basis regarding matters pertaining to the daily operations of the LLC.