CHAPTER 3

YES!

YOU CAN INVEST IN REAL ESTATE WITH YOUR IRA!

THE OFFICIAL SELF-DIRECTED IRA INVESTORS GUIDE

IRAR TRUST COMPANY

IRA RESOURCES, INC.

CHAPTER 3

AVOIDING PROHIBITED TRANSACTIONS

WITH YOUR REAL ESTATE IRA

You *need* to keep your Self-Directed IRA in check and avoid prohibited transactions— or else there can be serious consequences for your retirement account. Keep your savings safe from the start by investing as the IRS says you should. Here's what you need to keep in mind:

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Introduction

You've got a lot of freedom with a self-directed IRA, but you do have a few rules you need to follow. Investing in real estate with your self-directed IRA is a lot like investing in real estate outside of your IRA— except the IRS prohibits a few things (per IRC Section 4975). These forbidden investment types and transactions are really the biggest differences between IRA investing and the traditional real estate purchase (aside from the tax benefits)— except you really, *really* need to follow the rules. Otherwise you can put your account and your tax status at risk.

Prohibited Transactions

Specifically, there are a few types of investments, transactions, and situations prohibited by the IRS, known as **prohibited transactions**.

They exist to prevent you and your IRA from having an unfair advantage over other investors and keep you (or you through your family) from benefiting directly from the IRA— at least until you've retired.

Prohibited Investment Types

The IRS doesn't have a list of "approved investments" for self-directed IRAs, but what the IRS does have is a list of prohibited investment types, transactions, and situations it does not want your IRA to engage in.

Self-directed IRAs can't invest in:

- **Collectables** - like art, antiques, gems, coins, alcoholic beverages, and certain precious metals (See IRC Section 590)
- **S-Corporations** – defines allowable shareholders in Subchapter S corporations, which does not include IRAs (see 26 USC 1361)
- **Life Insurance** - (See IRC Section 408(a)(3))

Disqualified Persons

There are specific individuals (known as **disqualified persons**) that the IRS forbids your IRA from engaging in transactions with specific individuals. Any transaction with these individuals is a prohibited transaction (with one exception— when partnering on a new transaction. More details in our chapter on partnering.)

Disqualified Persons:

- You
- Your spouse
- Any of your lineal ascendants or descendants (parents, children, grandchildren, and the spouses of children, grandchildren, etc.—including legally adopted children)
- Any investment providers or fiduciaries of the IRA
- Any entity (like a corporation, LLC, or trust) where a disqualified person owns more than 50%
- Any entity (like previously listed) where the IRA account-holder is an officer, director, a 10% or more shareholder, or a highly compensated employee

Your IRA can't engage in any transactions with these individuals (with a few exceptions, like when your IRA partners on a new transaction) or you can lose the tax-status of your account.

Otherwise, if you don't follow these rules, you're putting your account at risk.

Self-Dealing

One of the most common prohibited transactions is known as self-dealing, which is when investors attempt to do business with themselves. This isn't allowed. You can't buy or sell property to yourself, you can't lend money to you from the IRA, and you can't pay any IRA expenses or take any IRA income personally. You can't use any IRA asset for personal benefit in any way— this is a prohibited transaction.

Sweat Equity

You can't do any work at all on the property— this is not something allowed with a self-directed IRA. No matter your expertise, no matter the size of the job.

Any work you perform on or for the asset is prohibited. Often called sweat equity, it refers to any work you personally do on a property (the "sweat" referring to effort spent to improve the investment, instead of paying an outside provider). So if you're a contractor, you can't fix a clogged toilet or leaky sink— that's prohibited.

With a self-directed IRA, you (or a disqualified person) are not allowed to personally do any work on the property, no matter how big or small. Any repair, improvement, or maintenance must be performed by a paid, non-disqualified person to avoid any unfair advantage to your IRA investments. The IRS sees this money you saved by doing the work yourself as an indirect benefit, so you need to steer clear.

Examples of Prohibited Transactions in a Real Estate IRA

BUYING OR SELLING A PROPERTY TO OR FROM YOURSELF

You currently own a property and want to buy with your IRA.

- This is a prohibited transaction because you're a disqualified person to your IRA.

You own property for investment purposes and want your IRA to buy it.

- Even if it's just for investment purposes, this is still a prohibited transaction. You already own the property and you are a disqualified person.

You're a business owner and you want to use your IRA to buy a property that your company owns.

- If you own over 50% of the business, you're a disqualified person, which means this is a prohibited transaction.

You're a real estate agent. You're selling a property for your IRA and want to receive commission for listing a property.

- If you receive commission, this is a prohibited transaction. You can be the agent for your IRA, but you can't receive any commission since you're a disqualified person.

Why are these prohibited transactions?

The IRS forbids "self-dealing"— any transaction between you and your IRA. If you already own the property, you won't be able to buy the property with your IRA— and same in reverse, you can't buy property from your IRA. Those are considered prohibited transactions.

COMBINING IRA AND PERSONAL FUNDS OR PROPERTY

Using funds from your IRA LLC (that you'll pay back) to pay a non-IRA expense.

- As mentioned above, you're considered a disqualified person to your IRA, so this is prohibited. This isn't allowed— personal and IRA funds must stay strictly separate.

You want to deposit your IRA's rental check into your personal bank account so you can pay a contractor ASAP.

- It doesn't matter if the funds are on their way or if you need them ASAP, combining personal and IRA funds is not allowed. This would be considered a prohibited transaction.

You want to use your IRA-owned property as collateral on a personal loan.

- This isn't allowed. Your IRA is a distinct, separate entity from your personal assets and investments. This would be prohibited transaction.

Your loan provider wants a personal guarantee a loan for your IRA.

- This isn't allowed. The only available loan type for self-directed IRAs is non-recourse, with no added liabilities or carve outs.

Why are these prohibited transactions?

You're a disqualified person, so any transaction between you and your IRA is prohibited. Your IRA is treated as a separate entity, distinct and different from (though obviously related to) you and your personal financials.

PERSONALLY LIVING, USING, OR WORKING ON THE PROPERTY

Your IRA is buying some commercial real estate to rent the building but want to use one office yourself.

- You can't use property held in your IRA. If you're planning on using the property even once, that's prohibited.

You want to buy a vacation property with your IRA for you and your family to use.

- If your IRA owns the property, you can't stay in it (not even for one night). Until the property is out of your IRA, you can't use the property.

You're a contractor, so you want to renovate property your IRA owns yourself.

- Unfortunately, this is prohibited. You're saving money by doing this work yourself instead of paying someone, so it isn't allowed.

You live nearby and are handy, so you want to be the on-call handyman for your IRA-owned rental property.

- This is prohibited. You're benefiting from your personal labor by saving money on upkeep, so this Isn't allowed (no matter how big or small the job).

You want your IRA to buy vacant land and build on it yourself?

- You can't do the work personally on land owned by your IRA. You'll have to hire a construction company or else this would be a prohibited transaction.

You want your IRA to buy vacant land to personally farm or work?

- Unfortunately, you can't do this. Like mentioned above, you can't do any work on your IRA-owned property, no matter the type. You may hire non-disqualified persons to do this work for you.

Why are these prohibited transactions?

The IRS prohibits the IRA-owner from putting "sweat equity" into their investments, (except in certain circumstances). Sweat equity means any work done on or for the property that your IRA would have had to pay someone to do, if not done by you. The IRS sees the money you saved as an indirect benefit and is this is prohibited within your self-directed IRA.

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BUYING OR SELLING A PROPERTY TO OR FROM A DISQUALIFIED PERSON

Your parents want to downsize, and you want to buy their house with your IRA.

- Unfortunately, your parents are disqualified persons, the IRS doesn't allow this.

If you want to sell a property you own in your IRA to your daughter.

- Your daughter is a disqualified person, so this is a prohibited transaction.

If you want your IRA to buy a property owned by your wife's IRA.

- Unfortunately, your wife's IRA is also a disqualified person, so this isn't allowed.

If you want your IRA to buy property owned by your father's company.

- This is prohibited— unless your father is not a controlling owner (meaning he owns less than 50% of the company), then it may be permitted.

Why are these prohibited transactions?

The IRS is looking to prevent any personal benefit, tangible or intangible, that could arise from a transaction with your IRA. This is related to the "arm's length" requirement for self-directed IRAs, where all transactions must be completed at arm's length from the account holder to assure no personal benefit from the investments.

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DISQUALIFIED PERSONS LIVING, USING, OR WORKING ON THE PROPERTY

You want your IRA to buy a house for your daughter to live in during college, and then later rent out.

- This isn't allowed, since your daughter is a disqualified person. You could buy a property and rent it out, but your daughter can't live there, not even for a few years.

You want to let your parent's/children/financial advisor stay in your IRA-owned property for just one night.

- Any disqualified persons (including you) can't stay in the property at all—not to live, not to vacation, and not even for one night.

Your IRA-owned property needs some repairs and you want to use your son's construction company to do the work.

- Your son is a disqualified person, so any company he has a controlling ownership in would be considered disqualified.

Why are these prohibited transactions?

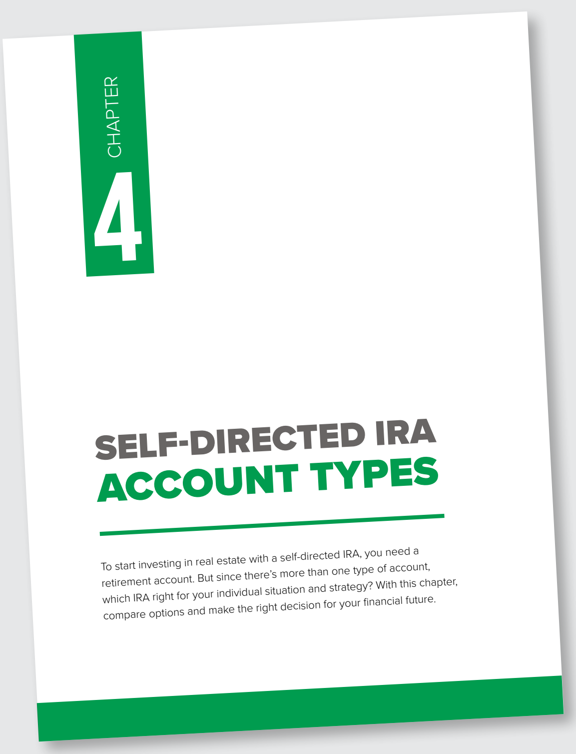
The IRS doesn't allow any benefit given to a disqualified person, either directly or indirectly. Disqualified persons cannot use or perform work on the property, even if they are being paid for it. The goal is to avoid benefits gained through avoidance of taxes, an unwritten quid-pro-quo agreement, or any other possible arrangement.

In a Nutshell

Prohibited transactions are the most important things to keep in mind when investing with a self-directed IRA— make the wrong move and you can put your retirement account in jeopardy. But with this guide, you've got what you need to avoid the major pitfalls.

Do you have any more questions? Specific concerns?

If you need help, give us a call or email.



READY FOR THE NEXT CHAPTER?

CHAPTER 4:

Self-Directed IRA Account Types