Do NOT Guarantee Loans for Your IRA…

Or Any Entity Owned by You're your IRA

By CPA & Seasoned IRA Tax Attorney

John Hyre

The basic lesson:

Do not guarantee loans for your IRA, or for any entity owned by your IRA. A corollary would be: Do not use IRA property to secure a personal loan. Get qualified, objective help when entering into IRA transactions – and keep that help in the loop throughout the entire process.[1] Watch out for "promotors" of various IRA/tax schemes.

The facts:

Thiessen wanted to acquire a metal fabrication company. A broker who had listed such a company told Thiessen that he could use his IRA to acquire the company.[2] Thiessen was referred to CPA Blees.[3] Thiessens used their IRA to purchase the company, partly on owner-financing. A separate attorney was retained to structure the agreement and the owner-financing. Blees was not included in that process.[3] The specific structure involved the Thiessen's IRA's purchasing shares in a C-Corporation, funding that C-Corporation, and then using those funds along with owner-financing to acquire the target's assets. Importantly, the owner-financing was personally guaranteed by the Thiessens.

Discussion:

Prohibited transactions kill IRA's, Roth IRA's, SEP's, HSA's and CESA's deader than chivalry.[4] The size of the prohibited transaction does not matter. Nor does the fact that the prohibited transaction was completely unintentional, or that it benefited the IRA. When an IRA dies, its assets are distributed to the owner and such a distribution is often taxable at very high rates. Further, an array of penalties often apply. We routinely advise clients that if they have a prohibited transaction in a large IRA ($250k +), they should expect to lose 50% to 60% of the IRA to the government in the form of taxes and penalties. Such harsh results, combined with the fact that prohibited transaction law is complex and murky, means that clients should be very conservative and exercise the utmost caution to avoid destroying their IRA's. Indeed,

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[1] I do a lot of work with SDIRA's and advise clients across the nation how to properly use their SDIRA's, 401k's, HSA's and Coverdale Educational Savings Accounts (CESA's). I can be reached at iralawyer.com.

[2] The broker had something to sell. Perhaps he is not the best person from whom to take tax advice. The broker also recommended getting some owner financing as part of the sale of the business to the IRA. <sigh> *[3] Bleek had previously created an IRA structure that resulted in a massive loss in Tax Court, see the Peek case. Looks like the IRS is going after more of Bleek's clients. I hope he has good malpractice insurance. He seems to be doing fine: http://www.biggskofford.com/our-team/bios/christian-blees.*

*[3] Your tax guy and your attorney should be in **constant** contact **throughout** a transaction. We shall see the consequences of failing to take that step. Perhaps if Bleek had known of the subsequent loan guarantee, he could have kept his clients from entering into a prohibited transaction.*

[4] 401k's (including self-directed "Solo" 401k's) are penalized less harshly if they enter into a prohibited transaction. Instead of being destroyed, they normally pay an annual penalty of 15% of the prohibited transaction.

we prefer to advise a *paranoid* approach. Prohibited transactions, or anything that could *possibly* be a prohibited transaction, should be avoided at *all* costs. This is not an area of tax law that rewards an "aggressive" approach.[5]

One type of prohibited transaction is "the extension of credit" by the IRA owner to the IRA, or by the IRA to the IRA owner. The term "extension of credit" is very broad, and encompasses much more than "making a loan to or from your IRA". For example, using IRA property as collateral in a loan that involves the IRA owner is a prohibited transaction. Likewise, the use of the IRA owner's property as collateral for a loan made to the IRA is an "extension of credit". Another example: Personally guaranteeing a loan made to your IRA is an "extension of credit" and therefore a clear prohibited transaction.

As part of its asset acquisition, Thiessen's IRA-owned corporation borrowed from the sellers in addition to making a large cash down payment. Such loans are common, and if properly structured, not a problem for an IRA. The problem occurred when the Thiessens personally guaranteed that loan. Such a guarantee on a corporate loan was theoretically distinct from guaranteeing a loan made directly to the IRA itself. The court disagreed and ruled that a guarantee to a corporation 100% owned by IRA's is tantamount to a guarantee to the IRA's themselves. In other words, an **indirect** loan guarantee (to an IRA-owned corporation instead of to the IRA itself) was still a guarantee and therefore a prohibited "extension of credit". This circumstance is often present with IRA law – things that cannot be *directly* done also cannot be *indirectly* done.

The amount distributed from the IRA as a result of the prohibited transaction was $432,076.41. The Thiessens owed a penalty of 10% of the distributed amount because they were under the "retirement" age of 59.5 when the prohibited transaction caused the distribution. That penalty amounted to $43,208. The total tax liability was $180,129[7] or 42% of the amount of the IRA. This liability was lower than normal because certain other penalties (e.g. – "accuracy" or "substantial understatement" penalty) were not applied in this case. Also, the Thiessens would be required to amend personal returns from 2003 forward to include income earned by the now-dissolved IRA's on their personal returns.[6]

In the closely related case of *Peek v. Commissioner*, 140 T.C. 216 (same CPA, very similar scheme, same sort of loan guarantee that resulted in a prohibited transaction), negligence penalties (which would have increased the taxes above by $27,384 (not including interest on the penalty) to a total of $207,513 (48% of the IRA) were applied because Peek knew "enough" about prohibited transactions, was heavily involved in the deal, and never received advice contradicting the idea that loan guarantees were an "extension of credit". Peek was not entitled to rely on CPA Bleek's opinion because Bleek was not a "disinterested professional". Rather, he was a "promotor" of the structure that Peek ultimately bought into for his IRA. The Court defined a promotor as "an adviser who participated in structuring the transaction or is otherwise related to, has an interest in, or profits from the transaction." Thus, for example, most companies that apply a business model of selling "check-book LLC's" would likely be considered promotors of such LLC's. As promotors, their advice cannot be relied upon to avoid IRS penalties in the event their structure does not function as advertised. The court also implied that Bleek did not advise the taxpayer as to personal guarantees – in other words, he may not have known that the taxpayers entered into the personal guarantees in either the *Thiessen* case or in the *Peek* case. Keep your tax advisor in the loop until throughout the transaction!

Summary:

- Prohibited transactions – or anything that could *possibly* be a prohibited transaction - must be avoided at all costs. This area of the law is grey and the cost of being wrong is massive.
- Get a qualified tax advisor (few CPA's or tax lawyers understand IRA's) who is not a "promotor".

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[5] *Taking an aggressive approach to grey non-IRA tax law is generally well-rewarded, mathematically speaking. In contrast, taking an aggressive approach with black & white tax law is an invitation to penalties & scrutiny. And taking an aggressive approach with prohibited transactions strikes me as a very risky and very high-cost approach.* [7] *This was the federal income tax liability. The IRS would likely have shared data with the relevant state income tax authorities (if Thiessen's state of residence has an income tax), which would likely have increased the tax bill by another 5% to 12% of the IRA balance, plus penalties & interest.*

[6] *Subject to the 3 or 6 year statute of limitations on filing 1040's, that's a conversation for another day.*

- If someone is selling you a specific structure – they are probably a promotor.
- Keep that qualified professional in the loop. Here, if CPA Bleek had known about the loan guarantee, he may have advised the Thiessens to avoid it.
- Anything that you cannot do directly in an IRA context is probably also forbidden if done indirectly.

John Hyre is an attorney, accountant and real estate investor based out of Columbus, Ohio. He advises clients nationwide on to avoid tax trouble when structuring their self-directed IRA's, 401(k)'s, HSA's and CESA's. John has also successfully defended SDIRA's from IRS attack in audits and in Tax Court. John Hyre will speak at UpstateCREIA on April 17 and come back for a full 2 day workshop on May 20 & 21, 2017. UpstateCREIA.com for details.