Prohibited Transactions Do Not Disqualify an IRA ...Always

April 2012
www.JagenLLC.com

Competitive Edge Through Knowledge

JAGEN™

Prohibited Transactions Do Not Disqualify an IRA…Always

The title of this piece probably goes against everything you've ever been told or read about prohibited transactions and IRAs. That's because (almost) everything you've ever been told or read about these transactions is incorrect. Calm down, control your breathing, it's going to be OK. We'll get through this together. I used to believe that all prohibited transactions disqualified an IRA also because that's what I had always heard or read. That was before a very knowledgeable ERISA attorney corrected me and caused me to review the rules again in an attempt to prove him wrong. Instead, the rules proved him right.

Almost all practitioners (CPAs, attorneys, financial advisors, etc.) parrot the same statement as established fact: any prohibited transaction (PT) involving an IRA automatically disqualifies said IRA as of January 1st of the year of the PT and the entire account is deemed distributed as of that date and subject to any applicable tax and penalty. Sounds familiar, right? But what do the tax code and Treasury Regulations actually say about these events?

IRC §4975 outlines the prohibited transaction provisions and their consequences. IRC §4975(c)(3) provides a "Special rule for individual retirement accounts." It states that an *IRA owner and his beneficiaries* are exempt from the PT excise tax described in paragraphs (a) and (b) of section 4975, **IF** IRC §408(e)(2)(a) or 408(e)(4) apply resulting in the account ceasing to be an individual retirement account. These are the first red flags that perhaps not all PTs involving IRAs result in the account ceasing to be an IRA. We should begin to ask what if those two sections referenced do not apply to a particular PT? And why does it state that specifically the IRA owner and his beneficiaries are exempt under those conditions but doesn't mention anything about other disqualified persons?

Let's turn first to IRC §408(e)(2)(a) which states in part: "If, during any taxable year of the individual for whose benefit any individual retirement account is established, that individual or his beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such account ceases to be an individual retirement account as of the first day of such taxable year." This section very clearly states that the IRA ceases to be an IRA *if the IRA owner or his beneficiary* engages in a PT. It does not mention anything about a PT involving someone other than those two specified parties.

Next, we look at IRC §408(e)(4) which states: "If, during any taxable year of the individual for whose benefit an individual retirement account is established, that individual uses the account or any portion thereof as security for a loan, *the portion so used* is treated as distributed to that individual." [Emphasis added.] This section is the "smoking gun" of evidence against the argument that all PTs disqualify the entire IRA. It clearly states that only the portion of the IRA used to secure a loan is treated as distributed in this type of PT.

And finally, let's turn to Treasury Regulation §1.408-1(c)(3) which states in full: "*Prohibited transaction by person other than owner or beneficiary of account*. If any person other than the individual on whose behalf an individual retirement account is established or the individual's beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such person shall be subject to the taxes imposed by section 4975." [Italics in the original.] To put this in perspective, Treas. Reg. §1.408-1(c)(2) is titled "*Prohibited transactions by owner or beneficiary of individual retirement account*." [Italics in the original.]

Thus, even the regulations differentiate between PTs involving an IRA owner or their beneficiary and PTs involving any other disqualified person. PTs involving a disqualified person, other than the IRA owner or beneficiary, fall under IRC §4975 which imposes an excise tax on the disqualified person *but does not disqualify the IRA*. The taxes imposed by section 4975 equate to either 15% or 100% of the amount involved in the PT depending on circumstances.[1]

The real question comes down to who engaged in the PT with the IRA. If it's the IRA owner or beneficiary, then the account is disqualified (subject to the limitations described in IRC §408(e)(4) mentioned above). If it's any other disqualified person, then the account is unharmed and the disqualified person is subject to excise taxes. So the next time you hear or read that a PT involving an IRA automatically disqualifies the IRA, you'll know better.

For additional reading on this topic, please see IRS Publication 590 which includes a more "plain English" outline of the same information minus the various code citations.

[1]Note that IRC §4975(a) imposes the 15 percent tax "for each year (or part there of) in the taxable period." Thus, the actual amount due under this section may be greater than 15 percent.