



Your IRA is Not a Piggy Bank

by Thomas H. Bergh, Varnum LLP

Grand Rapids, Michigan

Bridgewater Place
333 Bridge Street, N.W.
P.O. Box 352
Grand Rapids, MI 49501

Phone: 616/336-6000
Fax: 616/336-7000

Novi, Michigan

39500 High Pointe Boulevard
Suite 350
Novi, MI 48375

Phone: 248/567-7400
Fax: 248/567-7440

Kalamazoo, Michigan

251 North Rose Street
4th Floor
Kalamazoo, MI 49007

Phone: 269/382-2300
Fax: 269/382-2382

Grand Haven, Michigan

The Chemical Bank Building
1600 South Beacon
Suite 240
Grand Haven, MI 49417

Phone: 616/846-7100
Fax: 616/846-7101

Lansing, Michigan

The Victor Center
201 N. Washington Square
Suite 810
Lansing, MI 48933

Phone: 517/482-6237
Fax: 517/482-6937

This advisory has been prepared by Varnum LLP for informational purposes only and does not constitute legal advice.

Copyright © 2011, Varnum LLP. All rights reserved.



Most of us treat our IRA accounts consistent with their formal name - as "Individual Retirement Accounts". Since one's IRA is an "individual" account, there is a tendency is to consider it as an alter ego to the personal economic life of the owner. A recent Department of Labor Advisory Opinion, however, is a reminder about the significant restrictions placed on IRA accounts that can result in punitive tax consequences being imposed on transactions that would be perfectly acceptable if carried out personally.

In DOL Advisory Opinion 2011-04A, the IRA owner, Mr. Warfield, proposed that a mortgage held against an apartment building that he owned be refinanced through his IRA. This was to be done by using IRA assets to pay off the third party bank that held the current mortgage and having the IRA then be the continuing mortgage holder. In this way, Mr. Warfield hoped to use his IRA account balance to stabilize his financial situation without being forced into taking a taxable distribution from the IRA and then using the after-tax net proceeds to pay off the mortgage.

Prohibited Transactions

The difficulty arises from the concept of "prohibited transactions", commonly referred to as PTs, as defined in the Internal Revenue Code and ERISA. These rules were implemented when ERISA was enacted in 1974, and generally prohibit transactions involving loans, sales, extensions of credit, and other types of financial transactions between ERISA plans and certain "disqualified persons", including, among others, the plan sponsor, fiduciaries, and parties related to them. Because of the way that ERISA was drafted, an IRA owner, who by definition has discretion to direct the investments made by the IRA, is a "fiduciary", and therefore the PT rules apply. This analysis is somewhat counter-intuitive, as the PT rules were generally intended

to protect plan participants from "insider transactions" by third parties from harming participant's benefits. This rationale is generally not present in an IRA situation where the "fiduciary" and beneficiary are the same person. Nevertheless, there is no general exception under the law for IRA accounts in this context.

As a result, the DOL in its Advisory Opinion determined that the proposed transaction would constitute a PT by involving an "extension of credit" as represented in the refinancing, because at its conclusion the IRA would in effect have lent money to Mr. Warfield. This transaction would be a continuing PT as long as any obligation or payment on the mortgage continued. In addition, the original refinancing would be considered a separate prohibited transaction, considered as being a "sale" of the mortgage from the third party bank to Mr. Warfield's IRA. As a result, if carried out, the transaction would result in multiple negative outcomes, including significant excise taxes based on the total value of the consideration involved, additional penalties until the transaction was "unwound" under DOL correction principles, and the disqualification of the IRA, resulting in immediate income taxation to Mr. Warfield of the entire IRA balance. In sum, the consequence would be a massive tax bill resulting from the transaction that could be in excess of the total balance in the IRA account before the transaction was entered into.

The Lesson: Check for Consequences

The lesson of this DOL Advisory Opinion is that any transaction between an IRA and the account owner, or any business or party related to the account owner, should be carefully checked for possible PT consequences before the transaction is consummated. Certain promoters in the marketplace have touted IRA accounts as good vehicles for owning businesses or purchasing

Varnum Advisory

other assets from the IRA account owner. This Advisory Opinion is a lesson that any such transaction that is considered must be carefully reviewed in light of the PT rules.

Please contact any number of the Varnum Employee Benefits Group if you have any concerns about your IRA investments or

operation, or if you are contemplating any transaction that involves a sale, extension of credit, or other relationship between your IRA and any related party.