REI Mastery U

GETTING STARTED

SELF-DIRECTION

A GUIDE TO SELF-DIRECTING RETIREMENT ACCOUNTS

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in

SELF-DIRECTION

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INTRODUCTION

This “Getting Started” into Self-Direction eBook will give you a greater understanding of self-directing retirement accounts. It’s a great took in real estate investment. It will cover how to get started in self-direction and then discuss the IRA, LLC (what some call “checkbook” control), and the Solo 401K Trust plan.

While a great tool, it is a more advanced REI topic as there are some issues to understand, such as prohibited transaction and the UBIT tax. This Getting Started eBook does NOT fully cover those details! And there are some pretty serious ramifications for violations (which a lot of educators gloss over). You can get more information in our Professional Investor Online Program, and in our Self-Direction Mastery Live Course.

You should keep this eBook readily available for future reference. It’s a great reference guide.

If you need additional information, please see our Professional Investor online program and our Self-Direction Mastery Course. Check out our website for more information.

This eBook is designed to be read in its entirety! Self-direction is like a puzzle with pieces that all fit together to form a whole. You can’t rely on one or two pieces alone to understand self-direction. It is critically important information. Please read the entire eBook.

Further, this Getting Started eBook is for informational and educational purposes only! It is not meant as legal, financial, tax, or investment advice. Please consult your own professional advisors before entering into any type of investment strategy.

Happy Investing!

Jeff

INTRODUCTION

Self-direction is a means by which you can take your retirement money, like an IRA or 401K, and use those funds in a wider range of investments, most notably in real estate. That's why you're reading this!

All retirement accounts have some form of special tax benefits. Thus, the IRS keeps a pretty close eye on them. You just can't take that money, put it into a bank account and start spending it on stuff you want. Typically, retirement accounts are deposited with an IRS-authorized "custodian." That custodian is usually a bank or brokerage with a list of products—like stocks, bonds & mutual funds—to invest your money in. And you are limited to those products.

Many people, especially real estate investors, want to invest their money in products that are not offered by their current broker, like real estate. Self-direction, then, is a way to get that money working in other ways.

!**This eBook will walk you through using your retirement account in alternative ways. Please be advised that this eBook and the information it contains is NOT meant as tax, financial or legal advice. It is designed as general information for educational purposes only. Please consult your own tax planner, financial consultant or attorney before making any investment decisions**.

RETRIREMENT ACCOUNT BASICS

1. What is self-direction?

Self-direction is when a person uses their retirement account money in investments outside of typical brokerage investment products. It is often used by real estate investors looking to use their retirement money to invest in real estate, which is not offered by their broker. In other words, they have greater ability to “direct” their money into different investments. Self-direction, then, requires more work and education on the part of the investor.

2. What retirement accounts can I self-direct?

Really, any kind: IRAs, 401Ks, SEPs, SIMPLEs, 403(b)s and the like. Because most Americans have IRAs and 401Ks, those are the two that will be the focus of this Getting Started eBook.

3. Can you define some basic words that are used a lot” in self-direction?

Sure thing! Some of these words do get confusing.

a) Account Holder: This is the human being that “owns” the retirement account. This is you. You are the account holder regardless of what kind of retirement account it is.

b) Retirement Account: This is any kind of retirement (IRA, 401K) account that is set up on behalf of the account holder, typically with special tax breaks and rules on making contributions and taking distributions.

c) Custodian: All retirement accounts must be on deposit with an IRS-approved custodian. Typically, they are banks and stock brokerages. But in the self-direction world, there are “self-directed custodians” and “401K Trusts” that act as the custodian. Your current broker holding your retirement account money is most likely not a self-directed custodian.

d) Custodial Account: This is the “account” that you create with a custodian and then deposit or roll over your retirement account funds into that will then be held in the custodian’s bank account. All retirement money must first be deposited (contribution) into this account BEFORE it can be invested into other things. And taking money out of your retirement account (distribution) must also come out of this account.

e) Contribution/Distribution: This is the process of putting *your* money in or taking *your* money out of a retirement account. This does not mean making investments or receiving income or profits from investments that your retirement account makes.

f) Investment: This is something that your retirement account invests in like stocks, bonds, insurance, real estate, etc.

g) Investment Income: This is the money you make off of the investments your retirement account makes. This income MUST go to the custodial account, or to an IRA, LLC's account if the LLC held that investment. This income cannot go directly to you! See, definition of Custodian and Custodial Account.

4. What is the difference between Roth and Traditional accounts?

The terms "Roth" and "Traditional" are applied to many types of retirement accounts. Both IRAs and 401Ks can be Roth or Traditional accounts. You will need to know what type of account you have! You can look at the account paperwork and it should tell you. If it says, "Roth IRA" then you know you have a Roth account. If it doesn't mention "Roth" then most likely it's a Traditional. However, you should verify this with your current custodian!

A Traditional account is "pre" tax. This means you can contribute your income to the retirement account prior to paying tax on it. This saves you taxes in the year you make a contribution to the account. The money in the account then grows tax free. When you "retire" and go to take a distribution, it will then count as income and be taxed at that point. So you save taxes now, pay taxes later.

A Roth Account is "post" tax. This means you contribute your income after paying tax on the money. Thus, you won't get the tax break in the year you contribute. Like a Traditional account, the money grows tax free. But unlike the Traditional account, the money comes out tax free! So when you retire and take distributions, that money is not taxed. This account is pay taxes now, save later.

5. Which type of account is better?

That is a question you'll need to decide with your own tax and financial planners. All things (like taxes) being equal, it doesn't make a difference. That's because with a pre-tax investment, you'll have more money to invest *now* and therefore have more money to take *later*, compensating for the tax you'll pay when you take it out. But, life changes. And so do taxes. So, it really depends on your current income and tax rates, and what your income and tax rates will be when you retire. This should be discussed with your personal advisors.

6. What is the difference between an IRA and 401K?

While they are both retirement vehicles that benefit individuals, there are a number of differences. And as far as contribution limits, those can change year-to-year. So, you should discuss these options with your tax and financial advisors.

Individual Retirement Accounts (IRAs) are accounts that are set up by the individual tax payer. That means you! Anyone can set up an IRA, at any age. Most people go to a bank or broker to do this. You can set up either a Traditional or Roth, or both! They have much lower contribution limits than a 401K, so you can't fund them as fast. You can open an IRA and make a contribution for a given tax year before you the April tax deadline for that previous tax year. So, you get a few extra months to make that happen and still get any tax break. You can start taking money out, without a penalty, when you turn 59 ½. After you turn 70, you will need to start taking mandatory distributions.

401K Retirement Accounts (401Ks) are accounts that are set up by an employer on behalf of its employees. So, only a business entity can set it up. For many people, their employer offers a 401K to their employees. The employee's contribution limits are higher than for an IRA, and the employer can match funds as well. So, it's possible to fund a 401K much faster. All 401K contributions for a given year must be made by December 31 of that year. Thus, earlier than the deadline for an IRA contribution. A 401K has the same distribution guidelines as an IRA.

7. What are contributions and distributions?

A contribution is the official way to put your money into a retirement account. A distribution is the official way to take money out. These do NOT refer to making an investment (like buying a rental property) with that money, or the return on that investment (like receiving rental income from that property).

!There are strict rules about making contributions and distributions. You should always consult a financial advisor prior to doing either one to make sure you are complying with IRS guidelines and staying within the contribution limits.

8. Can I self-direct my IRA?

Yes. Whether you currently have an IRA or you want to set a new one up, you can self-direct it. You can even have multiple IRA accounts. You can leave some with your broker and invest in stocks. And you can have another one that is self-directed. But, please note, that regardless of the number of "accounts" you have set up, you are still restricted to the same contribution limits. You can't double up on that! And yes, you can self-direct both Roth and Traditional IRAs.

9. Can I self-direct my 401K?

This depends on two things. First, if you have a 401K with your current employer, it's quite possible that the employer will not allow you to roll over that money to another custodian while you are still employed with them. This is an internal policy decision by the employer. You'll have to check with them. If you can roll it over, then yes, you can self-direct it. You can even have multiple 401K accounts sitting at different places. But there are similar rules about not

doubling up on contributions. Always check with an advisor when making contributions to any retirement account.

But the second thing is that you must have a self-employment business entity that you own to keep those funds as a 401K money. Remember that 401Ks, unlike IRAs, are employer-sponsored plans. That means an "employer" has to establish it. But if you have an entity that you own (like a self-employment business entity), then that entity can sponsor a plan for you! You are your own employer. You do NOT need to be an employee for someone else. Most real estate investors have a business entity already (for their flips or rentals or wholesaling business), so it's usually not an issue.

If you don't have a business entity that you own and do not want to set one up, then your only option to self-direct existing 401K money is to rollover those funds to an IRA. For that, you go through the same process as self-directing an IRA.

We recommend keeping it a 401K if possible. It's not hard to set up a business entity that you own.

10. Can I rollover my IRA to a 401K or vice versa?

Maybe. To see all the options of rolling over one type of retirement account to another, you can do a web search for "IRS Rollover Chart" for a great summary. But between IRAs and 401Ks, here are couple of tips. Traditional IRAs and 401Ks can be rolled over between each other. A Roth IRA cannot be rolled over to a Roth 401K. But a Roth 401K can be rolled over to a Roth IRA.

!If you're thinking about rolling it over or switching the kind of account (Traditional—Roth), this can be a taxable event and there are rules. Bottom line: check with your CPA or financial advisor to confirm the legality and tax implications of any rollover or account type change!

11. Is an IRA or 401K a better vehicle to self-direct my retirement funds?

This will mostly be a personal decision and depend on your personal factors. However, for a variety of reason you'll learn in this eBook, the 401K is our preferred vehicle for self-direction. The main reasons are 1) you can contribute more each year, 2) it doesn't require a custodian, 3) investment transactions are easier and faster, 4) you can avoid many fees, 5) there are some additional tax benefits, and 6) the penalties for a prohibited transaction are not as bad. You'll learn more about all of these below.

12. Are there risks with self-directing my retirement accounts?

!Yes. And you must understand that. We want to make it clear here that there are risks. There are great benefits, but those come with risks. Many of our clients hear about self-direction at seminars where someone is looking to make money by selling a self-direction product or service. They explain all the wonderful benefits, but rarely explain the risks or explain them fully. We want you to be educated and make informed decisions. There are two risks that you should be aware of. And the more educated you are, the less likely you'll make mistakes. Both of these will be discuss in more detail below.

a) UBIT Tax. While there are many tax advantages to using your retirement account, it can be possible your retirement account could pay taxes on the income from your investments. This is typically not the case when investing in stocks and bonds. We'll explain more on this below. But, this is a tax like any other tax. It is just something you should be aware of and pay if required.

b) Prohibited Transactions. While this is an issue for all retirement accounts, it's more unique to self-direction because you are more in control. There are rules concerning "with what" and "with whom" your retirement account invests. There are certain people and entities that you cannot invest with or conduct a transaction with. While we will explain more below, this is a serious issue because if you engage in a prohibited transaction, you could lose your entire retirement account. The good news is that you can easily avoid these kinds of transactions if you know how to spot them.

SELF-DIRECTION BASICS

13. How do I get started in self-directing my IRA?

First, if you self-direct (we'll call it "SD" from here on) an IRA, that account MUST sit at (be deposited with) an IRS-approved SD custodian. There is no way around this. The SD custodian is like a bank or broker, but almost always it NOT a bank or broker. Banks and brokerages make their money, in some way, by getting you to invest in their products. Real estate, for example, is not one of those products so they won't make any money off you by investing in real estate. There are, however, dozens of approved SD custodians. You can do a web search and find a long list.

So, your first step is to set up an account at a SD custodian. This is pretty easy, or even done online. You then either make a contribution and/or move (see above on rollovers) your current IRA money. This means you will write a check to your SD custodian, and/or instruct your current custodian to send your IRA money to the new SD custodian. While you can set up the account at the SD custodian very quickly, transferring the money from your current custodian to a SD custodian can weeks to a month. Your current custodian will have forms for you to fill out to make that happen, then they'll process it, and finally send the money.

14. How do I choose a SD custodian?

We do not make any recommendation about SD custodians. You should conduct your own due diligence in determining the best fit for you. There have been rare cases of custodians misappropriating their clients' funds. So it can happen. Here are some questions you should ask:

- How long have you been in business?
- Are you a custodian or an administrator? Have them explain their services. A custodian is authorized by the IRS to hold your retirement money. An administrator usually just manages the money and paperwork for a custodian, like a bank. There is often more risk with a custodian than an administrator because there is no separation of management and holding funds.
- What education do you provide?
- How do you make your money?
- What is your fee schedule? And really understand how they assess fees! Most charge fees by the number of assets your IRA is invested in, or the total value of the account, or both!
- When and where do your audits come from? Internal, Bank, Gov't.?
- Are your trust accounts and operating accounts at separate banks? What are the names of those banks? What states are they in? Having separate accounts usually means more separation of your money from theirs and less risk.
- What insurance do you have?
- How best can I protect my assets?
- What else can you tell me to have confidence in your company?

15. OK, I have my SD custodian. What's next?

You've set up an account at a SD custodian and funded it (deposited or moved over your money). You can now "self-direct" that money into other types of investments. Since most of our students are interested real estate, we're sticking with that. You can now invest in real estate. You have two options:

a) You can "direct" your custodian to make an investment. They will have "direction" forms for you to fill out. You can direct them to make a loan or to buy a house or about anything else. We'll discuss more about how you invest below. One thing to know here is that when you instruct your SD custodian, they will charge a transaction fee to process that. This covers the work of them making the investment happen. Because they are assisting with the transaction, they will usually provide some help in doing it correctly, that means helping you avoid a prohibited transaction (see below). Be aware, they probably will NOT confirm to you that it's prohibited or not (they aren't lawyers), but you might get some help or oversight or indication of what might be a potential problem.

b) You can use an IRA, LLC. We'll discuss more below on the IRA, LLC. But here's how it works. You create a specially designed LLC that can be owned by our IRA. You set up a bank account for this LLC. You then "direct" your SD custodian to "invest" in the LLC. This means that your IRA is buying the membership in the LLC (just like buying stock in IBM) that the LLC is selling to the IRA. In this transaction, your IRA money sitting at your SD custodian gets transferred over to the LLC's bank account. After this transaction, you have what is termed "checkbook control" over those funds. You can use that LLC to make investments without having to instruct your SD custodian. Once this LLC is funded, it functions like any other LLC (but with rules on prohibited transactions).

   !NOTE: your SD custodian is still the holder of your IRA account! So they are still involved. It's just that your IRA has made an investment in the LLC. The LLC is one "asset" of your IRA account. You will still have some kind of yearly custodial fee and possibly provide reports to them. See below for more on the IRA.

16. How do I get started in self-directing my 401K?

Remember our discussion above about 401K retirement accounts—it requires a business to set up! Most real estate investors have an LLC or other entity that they use for investing. And if that entity is owned by you and/or your spouse (or partners, see below), then that entity can set up a 401K plan for its owners and their spouses. In other words, your investing company establishes a plan for the owners (who are also the employees) of the company, that means you.

a) First, your self-employed business entity needs to set up a Solo 401K Trust plan. This does NOT require a custodian. The Solo 401K (also called an Owner's 401K) is a trust document that acts like a 401K "custodial" entity by itself. You really are the custodian for your own account. Your business is the sponsor of the trust and that trust can then go get a bank account (just like the IRA, LLC). Then, you can rollover (see above) your current 401K funds or make a contribution to it (confirm with your CPA or financial advisor as to how much you can contribute) by simply depositing funds in the bank account set up for the trust. You can now use this money to make investments.

b) **Note**: The trust can establish both Traditional and Roth types of 401K accounts, as well as these accounts for you and your spouse. And you only have to set up one trust!

c) **Note**: What about partners in my LLC? The Solo 401K trust is also called an Owner's 401K Trust because it is established for the owners of the company and their spouses. So, yes, you can set up this trust and include all partners and spouses.

d) **Note**: What about other employees of my business entity? Do they get to self-direct as well? Our standard recommendation is that the entity that you use to establish a Solo 401K plan should be one owned just by you and/or a spouse or true partners in the company. While you can set up a Solo 401K plan that covers employees, you are responsible to oversee and manage their funds as well! This is difficult in the self-direction world. You don't want that extra work and liability.

e) **Note**: How do I keep all these different accounts separate? Because the single trust can create a bunch of separate accounts for different people and both Roth and Traditional, we recommend getting SEPARATE BANK ACCOUNTS for each kind. While you can put all those different funds into one escrow type bank account, that will get very confusing very fast. Keep them separate! So, if you and your spouse each have a Roth and Traditional 401K account, then you'll get FOUR bank accounts at the bank. With online banking these days, that's easy to manage.

17. Don't I need a "custodian" with my 401K?

Remember how we said ALL retirement accounts need a custodian to first take the money? Well, that's true even with 401K money. The Solo 401K Trust is "IRS-approved" to be a custodian. This is very important. These are NOT trusts you can create yourself or that any lawyer can create. The trust documents must be approved by the IRS! So, you do have a custodian—the trust. And the custodial account is a bank account you set up in the name of that trust.

ADVANCED SELF-DIRECTION TOPICS

18. What is this IRA or 401K, LLC you keep talking about?

Very simply it is a specially designed limited liability company, or LLC, designed to be owned by at least one retirement account. It is NOT your standard LLC that you may already have. It must be a newly created LLC and the original member(s) must be the retirement account(s). There is special language the describes the retirement account members (your IRA or 401K), custodians (your SD custodian) and account holders (this is you personally) and their relationships. This kind of LLC must be created by someone who understands self-direction and these specialized entities.

If a member of the LLC is an IRA, it's called an IRA, LLC. If the member is a 401K, it's called a 401K, LLC. But really, it's just a specially created LLC, whose member(s) is(are) retirement accounts. When you go to name the LLC, you can name it anything you want, just like any other LLC. From here on, we'll just refer to any kind of retirement account-based LLC as the "IRA, LLC."

19. Can more than one retirement account be a member of this LLC?

Yes. You can have your IRA, LLC owned by your Traditional IRA and your Roth IRA. It can be owned by your IRA(s) and/or your spouse's IRA(s). It can be owned by IRAs and 401Ks, or other kinds of retirement accounts. It can be owned by other family members' or friends' retirement accounts as well. Really, it can be owned in any combination of multiple accounts.

!There is a catch, however. And it's an important one IF the different account holders are prohibited people. See below for more info, but this means if you use two or more of your own retirement accounts or accounts with a spouse or other prohibited persons, there are extra rules and hurdles. Please see our Professional Investor Program and Self-Direction Mastery Course for more information about this!

20. How is this LLC managed?

These are always manager-managed LLCs because the members are retirement accounts held by the SD custodian. And the SD custodian is not going to be available to manage the LLC. So, you must appoint a manager to run the company. The manager will be responsible for acting on behalf of the LLC, signing documents and doing all other tasks.

21. Can my spouse or I be the manager of my IRA, LLC?

!Technically, yes. You can manage an LLC that is owned by your retirement account, or spouse's. But remember you are disqualified (see below) to your IRA, so there are limitations on

what you can do. Providing too much or the wrong kind of work could create a prohibited transaction. You must be careful if a disqualified person is the manager. We recommend appointing someone who is NOT disqualified to the retirement accounts to act as manager, like a friend or other investor. Then you have no risk. See below for more information on disqualified people and prohibited transactions.

22. Can this kind of LLC be a Series, LLC?

Yes, you can create IRA Series, LLC (if you have that as an option in your state). Creating an IRA Series, LLC is great tool for self-direction if possible.

23. What if I need to make a contribution or distribution to my IRA or 401K?

The most important thing you need to know here is that ALL future contributions or distributions MUST be done through the CUSTODIAN of your retirement account.

Remember that for IRAs, your custodian will always be the SD custodian where you set up the account.

If you have a Solo 401K Trust, the bank account that the trust set up is the "custodian."

All contributions and distributions go in and out of these accounts.

!You CANNOT make contributions directly to or take distributions directly from any IRA or 401K, LLC! This LLC is an ASSET owned by the retirement account, it is NOT the retirement account itself. For a distribution, for example, the LLC must be liquidated and money transferred back to the custodial account before it goes to you.

To repeat: There will ALWAYS be a custodial bank account (your SD custodian's or your Solo 401K Trust's) where contributions and distributions are made. If you have an IRA, LLC, then there will be another bank account for that. Keep them straight—and separate—in your head and transactions.

24. So, can I put more into my IRA, LLC?

OK. You have an IRA, LLC set up, it has already been purchased by your retirement account, and the money has been transferred to the LLC's bank account where you've been investing it. A year later, you've made another retirement contribution to your custodian's account (see above). Now, you want to get that new money into the IRA, LLC. This is called a "second funding" of the LLC.

!The honest answer is we don't know for sure if you can do this because the IRS has not explicitly said you can. But they haven't said you cannot either. You can make the first funding for sure, that we know. Most attorneys and custodians believe you can do a second funding as well, but there will certainly be rules! So, we recommend discussing this with your attorney and your custodian before doing a second funding. Yet another reason why doing a lot of advance planning can really benefit you down the road.

25. Tell me more about the Solo 401K Trust?

Great question. We recommend the Solo 401K Trust plan because it avoids needing a custodian, and you get all the other benefits of using a 401K. But, without the custodian, you are on your own. You may not get the advice on prohibited transactions or UBIT taxes. You will need to know these things on your own.

The Solo 401K trust plan is a "trust" (similar to other kinds of trusts but really technical and approved by the IRS) that your self-employed business entity (your flipping LLC) establishes to hold 401K money for its owners and their spouses. Once the trust is created, it can go out and get a bank account to receive your 401K funds, both Roth and Traditional. So at that point, you just make a contribution or rollover funds from another account.

Note: Not all banks understand or accept these kinds of checking accounts. They get confused because they think you want *them* to be the custodian of your 401K money and they'll invest it for you. These bank accounts are nothing more than business checking accounts, and the business that sets it up is a trust. But you may need some referrals from local investors who have these kinds of accounts and where they bank.

26. Does the trust have a manager?

No. It has a trustee. The trustee acts in the same role as a manager of an IRA, LLC, that is, it signs paperwork and conducts business. So, you do have to be careful about who you choose to be the trustee. All the same warnings we gave above about managers doing too much or the wrong kind of work apply here.

27. So, what can a trustee or manager do?

First, we must clearly state that there is not a lot of guidance from the IRS on this point. The key is that a disqualified person (more below on that) cannot contribute or take a distribution outside the proper and legal ways of making a contribution or distribution to a retirement account.

This means that if you, as a manager or trustee, are doing work that "adds value" to the retirement account, or if you "receive some benefit" by doing the work, then you are technically

making a contribution (or taking a distribution) outside of your allowed yearly contribution limits.

For example: If my retirement account owns a property to rehab and sell (a flip property), and I, as the manager of the IRA, LLC or the trustee of the 401K trust acts as the electrician on the project, that is prohibited. Why? Because normally you'd have to pay someone to do that work. You doing it for free is "adding value" (electrical services) to the IRA. Alternatively, if you get paid by the IRA to do that work, then you are receiving money from your IRA. These things are prohibited because technically you are either "contributing something of value to" or "taking something of value from" your retirement account. This is a no, no!

There is no clear line between what you can and can't do. So, if you understand the example above, that will help. Another way to say it is this: Be the brains, not the brawns! You can always make decisions about the kinds of investments you make. You would do that even if you were investing in stocks. You can certainly process the paperwork, pay bills, sign stuff, open accounts, hire professionals (like CPAs and lawyers) and things that are truly "management" related to the retirement account. But you might cross the line if it goes beyond that and you're doing something that normally someone else would do.

<u>This is really the best advice we can offer</u>: Have someone who is not disqualified be your manager or trustee. Then all you do is make a decision about the kinds of investment, and then they do the rest. And finding someone who is not prohibited is not that hard.

RISKS IN SELF-DIRECTION

Here, we are going to generally discuss three big topics: 1) Asset Protection, 2) the UBIT Tax, and 3) Prohibited Transactions. These are the most important issues once you decide to start self-directing your retirement accounts and have chosen a vehicle. These are the areas you should also discuss with your CPA, financial advisor or attorney if you need help understanding them or you have questions. The rewards of self-direction are great. And if you learn how to protect yourself, then the sky's the limit. But you must understand these risks!

Asset Protection

This is really no different than any other discussion of asset protection. We have numerous eBooks, classes, courses, videos and webinars on asset protection.

You should always consult with an asset protection attorney before making any asset protection plan, especially when it involves a retirement account.

Let's start with an example. You decide to self-direct your IRA and you open an account with a SD custodian. You direct them to buy a rental property (you do not use an IRA, LLC). In that case, your IRA itself owns the property in the IRA's name. If there is a slip and fall and a tenant wants to sue, they will sue the "owner" of the property—that's your IRA! Any other funds in your IRA account or assets owned by your IRA are at risk in that lawsuit.

Therefore, if your IRA owns any asset with risk, you will definitely still want an LLC to own that asset for its asset protection value. That means, you're going to need an IRA, LLC pretty much anyway.

If your IRA is doing low- to no-risk investments, like private lending where it's strictly a lender on a property, then you probably don't need to worry about protecting the rest of the funds in the IRA account. However, there are times when even a lender might get involved in a lawsuit.

If your IRA is sued (or your IRA, LLC for that matter), then the IRA (or IRA, LLC) will need to spend money to defend itself. That's why we suggest leaving some money in that account (or LLC). This will also help if your IRA owes taxes. If you need more money, then you need to either make a contribution (if you can) or the IRA will need to borrow the money. While an IRA can borrow money, it tends to be expensive because it must be a non-recourse loan.

This analysis is also true with a Solo 401K Trust. The trust has a bank account where all your 401K money is sitting. You can make investments directly from there. But again, if you're investing in something risky, you want an LLC in between. This LLC will be a 401K, LLC because it's owned by a 401K.

The long and short of it is, you will use LLCs in the same way to protect your retirement account money as you use them for protecting your personal money.

Once you have an IRA or 401K, LLC, you may need Sub-LLCs for additional layers or separation of liability. At that point, all you need is a regular LLC (not the specialized IRA, LLC). That's because this Sub-LLC is owned by another LLC, not a retirement account directly.

The UBIT Tax

This is a similar discussion of ordinary v. passive income tax. Please see our Professional Investor Program for more on real estate taxes. This is because the UBIT tax is kind of like "ordinary" income tax. And retirements accounts have to pay a tax if it looks like it's earning ordinary income.

!You must discuss this further with your CPA and financial advisor to get solid understanding of the possible taxation of retirement accounts.

There are two kinds of UBIT taxes: 1) UBI and 2) DFI.

Let's start with UBI, or the Unrelated Business Income tax.

If your IRA or 401K engages in a "business" that would otherwise be taxed, the IRS applies the UBI tax to keep the playing field equal with other companies doing the same thing. So when you are considered a "business" earning "ordinary" income, then it's possible there might be a tax. The IRS considered you to be "in the business of" something if you "regularly and consistently" engage in that business. There's not much more guidance than that. You just need to know (at this point) that it's possible for your IRA to be subject to a tax.

First, why isn't this a problem with retirement accounts invested in stocks? When you invest in stocks, you are a silent investor, you're not engaged in that business (you don't run or manage that business, you are just a stock holder), and the income is considered passive. When you self-direct in real estate, you might be actively engaged in running that real estate business where others compete.

And, as always, talk to a qualified CPA!

Now let's discuss the other kind of UBIT tax, the DFI, or Debt-Financed Income tax.

There are types of investments that are not subject to the UBI tax that we just discussed. Holding rental properties is one of them. Flipping a house is probably going to be considered ordinary if you do it regularly and consistently. But holding rental property is considered a long-term, passive investment (like owning a stock).

So, does that mean it's tax free? Well, not quite.

For rental properties, it all depends on "debt finance." A rental is debt-financed when there is any kind of financing on the property, like buying a rental with seller-financing or using a non-recourse loan to help purchase the rental. Thus, any time your retirement account needs more money to buy the rental (or any other kind of asset), it's debt-financed. And if it's debt-financed, the DFI tax may apply.

The DFI tax only applies to IRA accounts. It does not apply to 401K accounts. This is one of the reasons we prefer 401Ks over IRAs for self-direction.

We go over this in far more detail in our Professional Investors Program.

Remember, this is just a tax. And you would pay taxes if you used your own money for the same investment. You just need to include this in your financial calculations! And if you don't pay the tax, you're not going to be arrested. You'll just owe the tax and any interest and penalties. So, it's not something to stress about. Plan ahead and talk to your CPA!

Prohibited Transactions

Remember our discussion about the rules and limits of contributions and distributions? Well, these prohibited transactions are designed to keep you from violating those rules and limits. The IRS doesn't want you putting money in or taking money out of your retirement account in improper ways. And that can happen easier than you think. We mentioned above that if you provide services to your IRA, that's like you're contributing value, or money, to that account outside of the rules. If your IRA pays you for that service, it's like taking a distribution outside of the rules. That's why we have prohibited transactions.

BECAUSE THIS CAN BE A BIG DEAL, WE TRY TO EXPLAIN IT EVERYWHERE WE CAN. BUT YOU SHOULD REALLY BE EDUCATED ON PROHIBITED TRANSACTIONS BEFORE ENGAGING IN SELF-DIRECTION. OUR MASTERY COURSE IS THE BEST PLACE TO REALLY LEARN THIS MATERIAL!

Simply, a prohibited transaction is any deal, exchange or "transaction" between your retirement account plan (we'll call it your "plan") and a disqualified person or entity.

In other words, there are people/businesses that your plan can't do business with.

You certainly know what your retirement plan is—your IRA or 401K money. So, if you know who and what not to do business with, then you don't have anything to worry about. Just avoid those people and businesses.

Thus, don't do business with the following people:

-Yourself
-Your spouse
-Your children, grandchildren, great grandchildren, and so on.
-Your parents, grandparents, great grandparents, and so on.
-Financial fiduciaries, like your CPA, investment advisor, attorney

And not any of these businesses:

-Any entity that is majority owned or controlled by one of the people above.

However, we recommend not doing business with any entity that has any involvement with any of the above people. But it can be done, just confirm with your attorney.

NOTE: Be advised of who is NOT on that list: brothers & sisters, aunts & uncles, nieces, nephews, cousins, friends, neighbors, other investors, and so on. There are a lot of people you CAN do business with. Focus on them!

But, as you're probably aware, it's a bit more complicated than just not doing business with the above. We've already mentioned you can be the manager of an IRA, LLC or the trustee of the Solo 401K Trust. So, you can do some things for your plan.

The IRS doesn't fully explain things you can and can't do. But here are some things that we know are prohibited between your plan on any of the above people or businesses.

1. Buy, sell, or exchange property. This mean you cannot sell a rental to your IRA. And your 401K cannot sell a rental to you. So don't do any transaction like that with your plan. This includes "indirect" transactions. Don't try and get around this by transferring the property to someone else and then your IRA, for example. The rules on prohibited transactions include indirect transactions as well as direct ones.

2. Lend money to or borrow from. You can't loan your IRA or 401K money. And, you cannot borrow from your IRA. However, it is legal to borrow from your 401K (that's one of the benefits). This loan must be arms-length and market terms (meaning your 401K must charge an interest rate and you must pay it). There are other rules about how much and how long you can do this. Check with your financial advisor to comply with the rules if you want to legally borrow money from your 401K.

3. Furnish goods or services. You can't donate or buy materials or supplies for a flip project that your plan owns, for example. That should be clear. And you can't install the electrical on the house. That should also be clear. But, there are a few services you can provide. Remember the difference between "brain" and "brawn"? Rather than try and

describe the services you can provide, just be the brain, not the brawn. Or even better, hire your brother! He's not disqualified.

4. Use or benefit from your plan. If your plan owns a rental property in a beachfront town, you CANNOT stay there! That's receiving a benefit, a value, from your retirement account.

5. Receive commissions. This can be a big one. If you are a real estate agent, you CANNOT get a commission for selling a property owned by your retirement account. This is an indirect benefit.

In the examples above, we always said "you" and "your IRA." That's because you are disqualified to your plan and it makes the examples easy to understand. But the rules are the same with all the other people as well. So, your "spouse" cannot receive a commission on the sale of a property that "your" IRA owns. Your dad cannot provide contractor services to a flip project your IRA owns.

Hopefully, those examples will help you avoid prohibited transactions. Again, we don't have a lot of answers or other specifics. So the easiest is to stay as far away from transactions.

Now, we're going to throw a wrench into the above. You can "partner" with your retirement plan. "Partnering with" is different than "transacting between" you and your plan. Remember when we said your IRA and your spouse's IRA can both be members of an IRA, LLC? In that case, the two IRAs are both buying the asset (the LLC) at the same time, each buying a percentage ownership. That's a transaction between the two IRAs and the LLC. It's not a transaction between the two IRAs! Likewise, you can partner with your plan in a similar fashion. It's about how the partnership is structured and the timing and the reason why you are partnering. You should always consult an attorney or advisor when partnering with your retirement plan prior to doing it!

OK. What happens if I do a prohibited transaction?

If it's an IRA plan, the IRS considers your IRA fully distributed. That means they will consider all the money distributed to you. If you're under 60, then there will be early withdrawal penalties. If it's a traditional IRA, then it will be taxable income. Further, and here's the bad part, the IRS can assess a penalty up to the value of your IRA. That means they can fine you in an amount that would wipe out your IRA. These are pretty serious ramifications.

If it's a 401K plan, the penalties aren't as bad. The penalty is 15% of the amount involved in the prohibited transaction. And you have one year to fix the problem. If you don't fix it in that year, the fine can be 100%.

Remember, there is help out there. Your CPA, financial advisor, attorney and our online and live resources are available to help with self-directing your retirement accounts. It can be a great opportunity to get better returns on your retirement. But being educated is the key.

Happy investing!

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