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- [Awards](#)
- [Clients](#)
- [Events](#)
- [Media Coverage](#)
- [Publications](#)
- [Results](#)



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- [Attorneys](#)
- [Practice Areas](#)
- [Contact](#)

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## [IRA LLC: How to Use an LLC for a Self-Directed IRA](#)

[Home](#) » [Business](#) » [Business Formation](#) » [LLC Formation](#) » IRA LLC: How to Use an LLC for a Self-Directed IRA

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**A Word of Caution:** Before you begin reading about how to use an LLC for a self-directed IRA, please read the paragraph at the end where we explain why we do not recommend using a self-directed IRA. In short, the IRS has not expressly approved this practice and legal authorities have concluded this practice likely violates United States tax law.

The companies making money from using an LLC for a self-directed IRA are promoting the idea online and attempting to justify it under the law with pseudo legal research. However, our legal conclusion from our own legal research is using an LLC for a self-directed IRA is likely illegal.

## Background Information

Workers must pay an annual tax on ordinary income. Because it can be advantageous to delay these tax liabilities, workers look for ways to defer their income. This usually means giving up control of the money until a later date, however. The Self Directed IRA is a partial solution to this problem: it puts the income into a trust controlled by a third party “custodian”, but allows the owner to tell the custodian how to invest. The IRA LLC goes one step further by allowing the owner to make investments without going through the custodian.

**Here is how a Self-Directed IRA might work.** You form an LLC, naming you as the manager and the IRA as the sole owner. Once the LLC is formed, you direct the custodian of your IRA to invest in the LLC. This will result in the IRA being the owner (the sole member) of the LLC, which is being managed by you. The money from the IRA can be used by the LLC, giving you “checkbook control” of the IRA. With this set-up, you make all investment decisions and carries them out at the LLC level.

This is beneficial for three main reasons. First, you avoid the transactional fees involved with running every investment decision through the custodian. Also, you waste no time waiting on the custodian to carry out investment instructions. More importantly, you are able to invest in less traditional areas than you could have through a custodian, such as real estate. The [IRS website](#) explains why this is true:

“IRA [custodians] are permitted to impose additional restrictions on investments. For example, because of administrative burdens, many IRA trustees do not permit IRA owners to invest IRA funds in real estate. IRA law does not prohibit investing in real estate but trustees are not required to offer real estate as an option.”

This benefit carries with it a risk. Because owners can now make investments on their own with little or no supervision, they are more likely to make a “prohibited transaction” and lose the IRA’s tax exemption. Investors should be savvy, and should consult with an attorney or a CPA before making a transaction if there is any uncertainty as to whether it is prohibited.

The last benefit is limited liability. Suppose your IRA invests half its money in the LLC and half in mutual funds. If some sort of liability arises in connection with an LLC investment, only the money put towards the LLC would be at risk—the mutual funds would be safe. If the same investment was made by the IRA directly without an LLC shield, the entire IRA would be available to satisfy liabilities.

Using an IRA LLC to control retirement funds appears to be a growing trend in the financial community, and thus preparing “special” control agreements is a growing trend among law firms. Prices can be as high as \$5,000-\$10,000, and even the less expensive firms charge around \$1,000.

## Legal Issues

Three main issues come up regarding IRA LLCs.

First, the LLC must avoid prohibited transactions—certain types of transactions with related parties. This is the most serious issue, because engaging in prohibited transactions causes the entire IRA to be disbursed, leaving you with a huge tax liability. There are certain exemptions, though.

Second, the LLC must avoid specific acts like using the IRA as security for a loan, or investing in life insurance or statutorily defined “collectibles”. Breaking these rules results only in income tax liability for the amount used.

Third, the LLC should avoid creating unrelated business taxable income (UBTI). If such income is created, it would be double taxed—the IRA would have to pay tax on it immediately, and you would have to pay tax on it when the IRA is eventually disbursed.

Ideally, the language of the control agreement can guard against these issues. It should be noted, however, that [some legal sites](#) don’t believe special language is necessary for avoiding tax liability and penalties. As long as individual transactions do not violate the prohibited transactions rule, the IRA LLC will retain its tax benefits. They do, however, recommend including special language to make things look better in the case of an IRS audit.

## Prohibited Transactions

Prohibited transactions are governed by [IRC § 408\(e\)\(2\)](#), which disallows most transactions between the IRA (here, the LLC) and disqualified persons. “Prohibited transactions” and “disqualified persons” are defined in [§ 4975\(c\)\(1\)](#) and [§ 4975\(e\)\(2\)](#):

1. General rule: For purposes of this section, the term “prohibited transaction” means any direct or indirect—
  - sale or exchange, or leasing, of any property between a plan and a disqualified person;

- lending of money or other extension of credit between a plan and a disqualified person;
- furnishing of goods, services, or facilities between a plan and a disqualified person;
- transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;
- act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interests or for his own account; or
- receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

## Definitions

1. Disqualified person: For purposes of this section, the term “disqualified person” means a person who is—

- a fiduciary;
- a person providing services to the plan;
- an employer any of whose employees are covered by the plan;
- an employee organization any of whose members are covered by the plan;
- an owner, direct or indirect, of 50 percent or more of—
  - the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation,
  - the capital interest or the profits interest of a partnership, or
  - the beneficial interest of a trust or unincorporated enterprise, which is an employer or an employee organization described in subparagraph (C) or (D);
- a member of the family (*limited to one's spouse, ancestor, lineal descendant, and any spouse of a lineal descendant*) of any individual described in subparagraph (A), (B), (C), or (E);
- a corporation, partnership, or trust or estate of which (or in which) 50 percent or more of—
  - the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,
  - the capital interest or profits interest of such partnership, or
  - the beneficial interest of such trust or estate, is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);
- an officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10 percent or more shareholder, or a highly compensated employee (earning 10 percent or more of the yearly wages of an employer) of a person described in subparagraph (C), (D), (E), or (G); or
- a 10 percent or more (in capital or profits) partner or joint venturer of a person described in subparagraph (C), (D), (E), or (G).

There “disqualified persons” are further defined by § 4975 (e)(3)-(8).

Prohibited transactions are the most serious transgression that must be avoided. If the LLC carries out one of the listed transactions with a disqualified person, the whole IRA will be considered to be disbursed as of the first day of the current fiscal year, and you would have a huge tax liability towards this large chunk of income. Further, a 15% penalty tax may be levied against the disqualified person, and if the transaction is not corrected within the taxable period, the disqualified person could face a penalty under of the full amount of the transaction ([IRC 4975\(a\)-\(b\)](#)).

Clearly, you cannot gain personal income from the IRA; if he takes a salary for managing the LLC, this would

be a prohibited transaction. The LLC must not transact with any disqualified persons either, including entities that are more than 50% owned by disqualified persons. In addition to transactions involving the LLC, a fiduciary can trigger a prohibited transaction by himself if he “deals with the income or assets of the [IRA] in his own interests or for his own account.” Here are a few common transactions that are prohibited:

- Borrowing money from the IRA
- Selling personal assets to the self-directed IRA
- Buying property in the self-directed IRA for personal use
- Purchasing property from a disqualified relative i.e. Spouse, Children, Parents of the self-directed IRA holder.

## Exemptions

A lengthy list of exemptions (transactions with disqualified parties that are NOT prohibited) is contained in [§ 4975\(d\)](#). There is also a short list of exemptions to these exemptions (transactions that ARE prohibited) pertaining to owner-employees. This overlap is a good example of the complexity of the statute, and shows why all transactions involving disqualified parties should be reviewed by an attorney or CPA.

## Borrowing

Under [IRC 408\(e\)\(1\) and \(3\)](#), when “the owner of an individual retirement annuity borrows any money under or by use of such contract, the contract ceases to be an individual retirement annuity as of the first day of such taxable year.” So, borrowing is treated as a prohibited transaction—it doesn’t matter if the taxpayer has plans to (or does) pay back the borrowed funds.

## Other Prohibited Actions

Though it punishes these infractions less severely, IRC 408 also prohibits the taxpayer from using the IRA as security for a loan and precludes certain investments.

## Pledging Account as Security

IRC [408\(e\)\(4\)](#) describes the effect of pledging the IRA as security: “If . . . 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.” So, such use does not necessarily disburse the entirety of the IRA. It would do so, however, if the entire IRA is used as security.

## Investing in Life Insurance Contracts

[IRC § 408\(a\)\(3\)](#) states that “No part of the trust funds will be invested in life insurance contracts.” Again, the amount invested would be subject to tax, while the remainder of the IRA would not.

## Collectibles

[IRC 408\(m\)](#) precludes an IRA from investing in “collectibles”. The statute lists many examples: any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage, or any other tangible personal property specified by the Secretary for purposes of this subsection. Like the other actions in this section, investing in “collectibles” exposes the amount of the investment to tax liability.

## Unrelated Business Taxable Income (“UBTI”)

Most income from an IRA LLC will be tax free, at least until a later date. However, certain investments create taxable income called unrelated business taxable income (“UBTI”). UBTI is income from a trade or business regularly carried on by the IRA LLC which is not substantially related to the exercise by the IRA of the IRA’s tax-exempt purpose. Interestingly, the tax code defines *any* active trade or business to be unrelated to the IRA’s purpose. However, there are statutory “modifications” (set out in [IRC § 512\(b\)](#)) that specifically exclude certain types of income out of UBTI. These include, but are not limited to:

- dividends (e.g. paid to the IRA as a result of the IRA owning C Corporation stock);
- interest (includes “points”);
- royalties;
- rent from real property;
- sales proceeds from real property (assuming the property is not held as inventory or held in the ordinary course of the IRA’s business, e.g. flipping or development activity).

The ideology behind the UBTI rules is that Congress did not intend for IRAs to compete with active businesses. Rather, an IRA is designed to be a passive investor. The tax is meant to put IRA LLCs on an equal playing field with other active businesses.

The LLC is not prohibited from creating UBTI. It must, however, pay taxes on any such income by filing IRS form 990.

## Unrelated Debt Financed Income

A related topic is “Unrelated Debt Financed Income”, or UDFI. [IRC § 514](#) is the governing section of the tax code for UDFI. Basically, the IRS does not allow tax-free treatment of debt financed investments. An example would be if the IRA LLC buys a home for \$100,000 using \$20,000 of its own funds and borrowing \$80,000. Although the transaction is perfectly fine to do in an IRA, the IRS will not let the taxpayer benefit from the entire income (or gain) of the property. The taxpayer may only benefit from the income (and gain) as it relates to the equity or IRA funded part; in this case, the \$20,000. This may result in paying tax on 80% of the investment income and gain (if any) and receiving the tax-free or deferred benefit from the IRA on 20%. The debt financed portion is referred to as Unrelated Debt Financed Income.

## Language Requirements

I found a couple leads online suggesting what might have to be altered to create “special” articles of organization or operating agreement for an IRA LLC. The first two sections below are quotes from an IRC/LLC website (pertinent language in red), with my analysis underneath. Also, Josh suggested that we would need to include special manager control provisions, but it looks to me like our standard LLC operating agreement already does this. The point is discussed in the third section.

## LIMITS ON TRANSACTIONS

- “What are the steps that I take in order to invest in real property through an LLC?”

First, you must establish an LLC (or LP). The Operating Agreement and/or Subscription Agreement must show your IRA’s membership/partnership interest as *Polycomp Trust Company Custodian FBO IRA Holder’s*

Name IRA *or* Roth IRA # \_\_\_\_\_. **In addition the Operating Agreement and/or Subscription Agreement must require that the managing member either appoint a qualified professional such as an attorney or CPA to either conduct a review of each transaction before execution, or to take over as managing member.** These documents are reviewed and approved by you; however, Polycomp Trust Company must sign as the subscribing member/limited partner. Once you have reviewed the documents you complete our Direction Letter (which directs Polycomp Trust Company to sign the documents and purchase the LLC interest) and forward the Direction Letter and the Agreement(s) to us. As long as cash is available in your IRA, your LLC interest will be funded within 48 hours of receipt of the required documents.”

## Analysis

This website suggests that the ‘special language’ of an IRA LLC control agreement comes from including provisions that require third party review before transactions are completed. This is close to what my earlier memo proposed. Again, this would seem to take away the freedom of investment that an IRA LLC affords, but maybe running decisions by a CPA or attorney is still easier than going through a custodian.

It should be noted that this language appears to be aimed at meeting the requirements of the trust company (acting as the custodian), rather than satisfying any legal requirements.

## Purpose of LLC

- “After opening a self-directed IRA account, you must then register your business entity as a limited liability company (LLC) with the Secretary of State in the state you plan on incorporating in. **After your LLC is properly registered, the next step is to prepare an operating agreement, which meets all of the requirements for a self-directed IRA LLC mandated by the Secretary of State, such as specific language relating to the fact that the LLC is set up for your IRA.**”

## Analysis

Under Minnesota law, an LLC is formed for “general business purposes” unless otherwise stated (MBCA § 322B.10). Adapting standard LLC documents to accommodate IRA LLCs might require changing this purpose to reflect how the LLC is set up for the IRA.

This change would have to be made in the articles, though, not the operating agreement. Section 322B.10 says that the LLC has general business purposes “unless otherwise provided in the articles of organization”. Also, § 322B.115, subd. 2 (1) lists “LLC has general business purposes” as a provision that can only be changed in the articles.

## SPECIAL MANAGEMENT PROVISIONS

Josh suggested that we would need to include special management provisions so that the manager would manage the LLC, not the member. Again, I think that this is already included in our standard LLC Control Agreement. I took this language, which establishes that the manager will control the LLC, from a template we have in our “forms” folder:

## ARTICLE 9. MANAGERS

9.1 **General Authority.** The business and affairs of the Company shall be managed by the Managers subject

to the direction of the Board

**9.3.1 Chief Manager/President.** Unless otherwise provided by a resolution adopted by the Board, the Chief Manager (i) shall have general active management of the business of the Company; (ii) shall, when present and in the absence of the Chair of the Board, preside at all meetings of the Member and Board; (iii) shall see that all orders and resolutions of the Board are carried into effect; (iv) shall sign and deliver in the name of the Company any deeds, mortgages, bonds, contracts, or other instruments pertaining to the business of the Company, except in cases in which the authority to sign and deliver is required by law to be exercised by another person or is expressly delegated by this Agreement or the Board to some other Manager or agent of the Company; (v) shall maintain records of and, when necessary, certify all proceedings of the Board and the Member; (vi) shall perform the duties of the Secretary if there is no Secretary; and (vii) shall perform such other duties as may from time to time be assigned to him or her by the Board.

## Other Important Legal Risks

A number of prominent legal authorities note that although it may be possible to set up the IRA LLC legally, people are highly likely to run afoul of IRS and Department of Labor regulations while operating it. The penalties could be severe: a 20% penalty and loss of tax exemption.

The general rule with a self-directed IRA is this: You can buy a bakery with your IRA, but you cannot be the baker. Based on the serious risk faced by those who form a Self Directed LLC, our law firm has concluded that **the risks of self-directed IRA LLCs outweigh the advantages.**

For a respected legal opinion on why self-directed IRA LLCs are very susceptible to legal risk, see [http://www.rita.us.org/assets/documents/IRAMythArticle5.12.09\\_000.pdf](http://www.rita.us.org/assets/documents/IRAMythArticle5.12.09_000.pdf).

## Need help?

We recommend you consult with the following:

1. **Investment Companies:** Begin by getting basic information from companies who provide these services.
2. **CPA:** Consider consulting with a CPA experienced in this area of law. You might want to provide your CPA a copy of this article.
3. **Attorney:** Consult with with an attorney experienced in this area. Expect to retain the attorney for a 3-4 hours (at usual hourly rates) to analyze your legal documents and explain your legal rights and options. This is a complex area of law, with many potential pitfalls.

## Other Resources

- [http://www.lawtalkgroup.com/my\\_weblog/2009/07/ira-funded-llcs.html](http://www.lawtalkgroup.com/my_weblog/2009/07/ira-funded-llcs.html)
- <http://www.polycomp.net/uploads/Documents/IRA/PTC-Real-Property-FAQs.pdf>

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This is a guest article from Professor Daniel Kleinberger. Prof. Kleinberger is the director of the Mitchell Fellows Program at the William Mitchell College of Law. He was the reporter for the MSBA Business Law Section Task Force that developed the Professional Firms Act and the principal drafter of the act. Rather than being a simple hybrid,... [Read More →](#)

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- [The Next Generation: The Revised Uniform Limited Liability Company Act](#)

This is an excerpt from an article discussing the The Revised Uniform Limited Liability Company Act written by Daniel S. Kleinberger. For a discussion of Minnesota's new LLC law, see the Minnesota Revised Uniform LLC Act. I. INTRODUCTION On July 13th, 2006, the National Conference of Commissioners on Uniform State Laws ("NCCUSL" or "the Conference")... [Read More →](#)

- [Minnesota's New LLC Law: Minnesota Revised Uniform LLC Act](#)

Minnesota Revised Uniform Limited Liability Company Act Nearly 200,000 LLCs formed in Minnesota since 1993 will be affected by the new Minnesota Revised Uniform Limited Liability Company Act, which became law in 2014. On April 8th, 2014, Minnesota Governor Mark Dayton signed into law the Minnesota Revised Uniform Limited Liability Company Act. This law impacts... [Read More →](#)

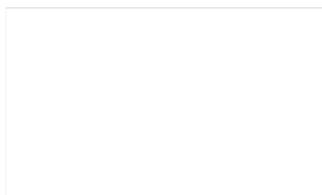
- [Minnesota Offers Interest-Free Loans to Business Startups](#)

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- Don Blevins

November 3, 2014, 5:25 pm



I have recently opened a Self Directed Real Estate IRA with Equity Trust Company as it's Custodian. Everything will be properly titled through ETC Custodian FBO "my name" IRA. I realize I cannot be paid for any work I do on these homes, but can I pay for and then be reimbursed for items bought, or services rendered by others on the houses? Can I sign contracts with contractors, utilities, tenants, etc. on behalf of the properties I will be acquiring through my self directed real estate IRA? I'm cautious and conservative. Thus far I haven't signed anything. Even the Purchase Contract, I insisted that ETC sign and initial. Also, can a house I purchase, then be sold and financed by my IRA for my Niece's family? I did not follow the advice of the seminar I attended and did not want any part of writing a check from an LLC owned by my IRA. I agree with you that this may cause a disaster and blow up the entire IRA due to engaging in Prohibited Transactions. Thank you for the information. Don

- Sarah Kaplan

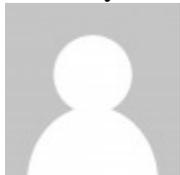
October 7, 2014, 7:11 pm



I'm researching IRA law now and found this to be a well-thought-out article. Still looking for the tax court/IRS authority for why an LLC managed by the IRA beneficiary is OK, and it would be great to cite that. I thought this was a thoughtful and good post. Thanks, Mr. Hall. Also, if you're not already talking to socially conscious investors – what do you think about this question: what's the least expensive/most accessible way to make it less risky for people to use IRA money to grow the economy they want to see, i.e. like Slow Money?

- Bill

February 8, 2014, 11:36 pm



You guys are wrong on so many levels. For example, where does the IRC or other source say that you “must open an LLC”. You even have obvious typos right on your site “...Based on the serious risk faced by those who form a Self Directed LLC, our law firm has taken concluded that the risks of self-directed IRA LLCs outweigh the advantages.”

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Our attorneys generally serve clients in Minneapolis, St. Paul, and the Twin Cities metro area, including Hennepin, Ramsey, Anoka, Washington, Carver, Scott, and Dakota counties.

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