



**AN  
EQUITY TRUST  
COMPANY**

**Understanding IRA Rules,  
Prohibited Persons, and  
Transactions**

# Inside the Guide

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**Serving Clients Nationwide**

# Disqualified Persons

**You and your IRA are separate entities. Your IRA cannot transact with certain individuals and businesses.**

Prior to executing any transaction through your IRA, you should remember there are certain people and/or entities that your IRA cannot do business with. These are known as disqualified persons and are outlined in Internal Revenue Code (IRC) Section 4975. Your IRA may not do business with any disqualified person as doing so is considered self-dealing.



**Your IRA cannot conduct business with  
any of the following:**

IRA holder	IRA holder's spouse
IRA holder's ancentors (parents, grandparents, etc.)	IRA holder's lineal descendants (children, grandchildren, etc.)
Any spouse of lineal descendants of IRA holder	Investment managers and advisors
Anyone providing services to the plan	Certain business partners: <ul style="list-style-type: none"><li>• 10% partner in the same business in which the IRA holder owns 50% or more</li><li>• 10% partner with the employer sponsoring the IRA or other pension plan</li><li>• 10% partner with a person providing services to the plan</li><li>• 10% partner with the IRA holder or any other fiduciary</li></ul>
Any entity in which any combination of specified disqualified persons has a 50% or greater interest	An officer, director, highly compensated employee, or 10% or more shareholder of the sponsoring employer of an employee organization, and a person closely associated with an entity in which the IRA holder owns 50% or more of the equity in the entity

It is also important to note that brothers and sisters, in-laws, aunts, uncles, and cousins are not defined as disqualified persons. Therefore, your IRA can conduct investment activity with relatives who are not listed as disqualified persons.



# Prohibited Transactions

A prohibited transaction is any improper use of an IRA account or annuity by the IRA owner, his or her beneficiary, or any disqualified person. In a self-directed IRA, there are a vast number of investment options. The only two things you cannot purchase in your IRA are life insurance and collectibles.

**There are specific rules regarding what you can or cannot do with the other types of assets your IRA can purchase.**

The IRA owner cannot borrow money from their IRA.	The IRA owner cannot execute a direct or indirect sale, exchange, purchase, or lease of property between the IRA and a disqualified person.
The IRA owner cannot pay unreasonable compensation for management of IRA property.	The IRA owner cannot (directly or indirectly) furnish goods, services or facilities between the IRA and a disqualified person.
The IRA owner cannot use IRA assets as collateral for a loan.	The IRA owner cannot buy property for personal use (present or future) with IRA funds.

## Assets your IRA cannot invest in:

- 1 An IRA cannot invest in collectibles such as art, stamps, coins, alcoholic beverages, precious gems, or antiques.
- 2 An IRA cannot invest in life insurance.
- 3 An IRA cannot invest in S-corporation stock.
- 4 An IRA cannot invest in any investment that constitutes a prohibited transaction, such as the purchasing of an investment asset from a disqualified person.
- 5 An IRA cannot invest in any investment that violates the exclusive benefit rule.

# Valuation Rules

The IRA account holder must provide a fair market value (FMV) annually and ensure that the IRA has enough liquidity to allow for required minimum distributions (RMDs). Part of the IRS requirement for an IRA administrator is to report FMV of every IRA account to the IRS annually. To protect the integrity of the account, our clients are required to obtain an FMV from an unrelated, independent source.

IRS form 5305 (our agreement with the account holder) requires that the valuation be obtained by the client.

## Requirements

- 1.) For annual valuations, the IRS will allow for independent valuations from parties such as realtors, tax assessors, CPAs, and attorneys. If the client has required minimum distributions, it is highly recommended that a certified appraisal be ordered. Certified appraisals are also required by the IRS if there is a taxable event (i.e. Roth conversion or in-kind Distribution).
- 2.) Failure to provide a valuation may ultimately result in the distribution of the asset to the account holder at the book value. If your IRA cannot meet the IRS requirements on filing an accurate 5498 for your account, then Midland IRA will have to ultimately resign as the administrator of the account.
- 3.) If there is a cost involved to obtain the valuation, the IRA is required to pay for the cost. Midland IRA can pay the bill from your uninvested cash balance at your request.

## FMV Supporting Documents

### Real Estate

An appraisal is acceptable but not necessary. Although an appraisal is a valuation, FMV and an appraisal are not one and

the same. A qualified real estate professional who is strictly arm's length from both you and the investment may provide a comparative market analysis to meet this requirement. The IRS specifically does not allow a tax assessor's assessed value as representative of the FMV of real estate. However, if the county property appraiser provides an estimated market value for your property, that may be representative of the FMV and be utilized in satisfying our FMV requirements.

## **Notes and Mortgages**

Generally, the fair market value of a note is equal to the outstanding principal balance of the loan. However, if the note is in default or other circumstances exist which results in the FMV of the note differing from the outstanding principal balance, you must submit the FMV form, completed by a qualified independent third party, along with supporting documentation.

## **Single Member/Closely Held LLC**

A value of each asset within the LLC is required in order to determine the value of the LLC.

## **Private Placements**

You must contact the manager of the private placement and ask how you can obtain a value for the investment. The value of an asset may be provided by a qualified third party, but enough supporting documents must be provided.

## **Precious Metals, Brokerage Accounts, Currencies, and Cash**

These do NOT need valuations, as these investment values can be easily determined by annual statements or with a set face value.

## **Bankrupt/Receivership/Zero Value Assets**

Please indicate this status on the valuation form and sign it yourself. Provide the documentation that will support the status.



## What are UBIT and UDFI?

If your IRA is purchasing an asset that has debt, this is an important topic to understand and discuss with your tax advisor. Unrelated Business Income Tax (UBIT) is levied on tax-exempt entities such as retirement accounts. UBIT income is derived from a trade or business regularly carried out by the tax-exempt entity that is not substantially related to the entity's exempt function. Unrelated Debt Financed Income (UDFI) is capital gains on the profits from the sale of real estate or other IRA assets. This tax is based on the current capital gains tax rate and filed on Form 990-T.

The four most common scenarios are:

- 1.) The IRA borrows money for an investment (non-recourse loan on real estate). A percentage of the income is subject to Unrelated Business Income Tax (UBIT) or Unrelated Debt Financed Income (UDFI).
- 2.) The underlying investment is an operating (non-passive) entity that has pass thru income features like an LLC. The IRA is responsible for paying the UBIT.
- 3.) An investment in a passive LLC that has borrowed money. The income could be taxable because of the loan.
- 4.) Rental of property.







# Glossary

## A

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### Administrator

Third party that provides the administration for IRA/401(k) plans and works along with the custodian.

### Annual Account Statement

Information on the transactions that have occurred in an IRA during a calendar year including the FMV.

## B

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### Beneficiary

The person/trust/entity that will inherit the account should the account owner die.

## C

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### Client

The IRA account owner.

### Contribution

A personal addition of funds to the specified account type. They are based on eligibility and are subject to specific limits and deadlines. Contributions are reported to the IRS on form 5498.

### Conversion

Taxable movement of assets (money or property) between a Traditional IRA, SEP IRA, or SIMPLE IRA to a Roth IRA.

### Custodian

This is an agent (such as a bank or trust company) that holds the assets for an IRA.

## D

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### Direct Rollover

The movement of funds from a qualified retirement plan to an IRA. Individual must be eligible to request the direct rollover (i.e. severed employment, over retirement age, disability).

### Disqualified Party

As outlined in IRC Section 4975, this is a person or entity an IRA holder may not engage with to avoid disqualification of the retirement plan. Includes any lineal ascendants or descendants.

### Distribution

The withdrawal of funds or assets from the IRA by the IRA owner for personal use.

### Durable Power of Attorney

A signed document that allows an IRA holder to appoint an agent to manage their financial affairs, make health care decisions, or conduct other business during incapacitation.

## F

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### Form 1099-R

Reports distributions and Roth conversions to the IRS. They are sent to the IRA owner by January 31 of each year and submitted to the IRS by March 31.

### Form 5498

Reports contributions, rollovers, recharacterizations, and value of the account as of December 31 to the IRS. They are sent to the client and the IRS by May 31.

## I

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### Indirect Rollover

The movement of funds from an IRA at one institution to an IRA at another institution when, the client takes constructive receipt of

the funds for up to 60 days. Indirect rollovers are requested by the client as a distribution from the current institution.

## **In-Kind Transfer**

The transfer of assets from the current administrator to the new IRA.

## **IRA**

An individual retirement arrangement created or organized in the U.S. for the exclusive benefit of an individual or his beneficiaries.

## **IRC Section 4975**

The section of the tax code that outlines prohibited persons and transactions with an IRA.

# **N**

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## **Net Income Attributable**

An amount in the IRC for calculating the net gain or loss generated by an excess IRA contribution or recharacterization.

# **P**

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## **Probate**

The facilitation of the transfer of title of a property held under the name of a deceased to their rightful heirs.

## **Publication 590**

IRS publication that outlines prohibited investments within an IRA.

# **Q**

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## **Qualified Trust**

The term for a trust that uses the oldest beneficiary for life expectancy calculation purposes. A qualified trust must be valid under state law, have identifiable beneficiaries, be irrevocable upon the death of the grantor, and be able to be validated.



## R

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### **Recharacterization**

The reversal of an IRA contribution or conversion.

## S

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### **Self-Directed IRA**

A type of IRA in which the owner chooses every investment without being limited to the stock market.

### **Substantial Equal Periodic Distributions**

A series of annual distributions from an IRA used to preclude the distributions from the 10 percent early distribution penalty. Also called 72-T.

## T

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### **Transfer**

A movement of funds between an IRA at one institution to an IRA at another institution. They must be requested by the receiving institution. Transfers are not reported to the IRS.

## U

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### **Unrelated Business Taxable Income**

The tax that comes from an activity engaged in by a tax-exempt entity that is not related to the tax-exempt purpose of that entity.

# About Midland



Midland, an Equity Trust Company, is focused on providing clients with as many opportunities as possible to defer or eliminate taxes through both self-directed saving plans and 1031 exchanges. Midland's services give our clients complete control over their retirement investment decisions by allowing them to self-direct in real estate and other alternative assets, while our 1031 services focus on tax-free exchanges for real estate investors.



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