



Using Individual Retirement Accounts (IRAs) to Fund Startup Companies

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Introduction

- An Individual Retirement Account (“**IRA**”) is a tax-deferred account able to use pre-tax money to purchase stocks, bonds, mutual funds, or other assets.

- IRAs comprise:
 - Traditional IRAs
 - Roth IRAs
 - SEP IRA
 - SIMPLE IRAs

The Modern IRA

- IRA funds have traditionally been used to purchase passive businesses or real property.
- In Silicon Valley, many entrepreneurs and investors use IRAs to fund startups—their own or others.

Caution

- Successfully tapping into an IRA before retirement requires adherence to specific rules.
- An IRA that conducts business with a **disqualified person** or engages in a **prohibited transaction** may trigger penalties and early tax consequences.

What is a “Prohibited Transaction”?

Any of the following, between an IRA and a **prohibited person**:

- Real Property transactions;
- Loans;
- Furnishing goods or services;
- Use of, or self-dealing in, or kick-backs for dealing in, the IRA’s income or assets.

Source: Internal Revenue Code of 1986, as amended, Section 4975(c)(1).

Who is a “Disqualified Person”?

- An IRA fiduciary or service provider;
- A direct or indirect owner of more than half of a corporation, partnership, or trust that employs an IRA fiduciary or service provider;
- An officer, director, or similarly situated person, a 10% or more shareholder, partner, or joint venturer,* or a highly compensated employee (earning 10% or more of the yearly wages of an employer) of a disqualified person;
- A family member of a disqualified person.

*. The Internal Revenue Code provides that “The Secretary, after consultation and coordination with the Secretary of Labor or his delegate, may by regulation prescribe a percentage lower than . . . 10 percent[.]” Source: Internal Revenue Code of 1986, as amended, Section 4975(e)(2). The definition of “disqualified person” is broad and includes other categories.

The Startup Context

- Conducting business with a disqualified person and conducting business with an entity with which a disqualified person is affiliated (e.g., director or officer) are legally distinct transactions. The rules allow for the latter arrangement, but formalities must be followed.
- Even if formalities are followed, an IRA's otherwise permissible conduct with a startup may be prohibitive if a disqualified person receives sufficient benefits from the investment.

The government may require an IRA account holder to explain and defend a situation in which the disqualified person:

- Is the **largest shareholder** of a business with which the IRA deals;
- Holds positions that require **direct contact with the IRA's funds**; or
- Signs, in a managerial capacity, documents approving transactions with the IRA.

Many IRA account holders in Silicon Valley use their IRAs to fund startup ventures.

Such arrangements can constitute both legal and tax-friendly investment structures. However, if the arrangements go too far in allowing an IRA account holder to enjoy the benefit of the IRA funds, tax penalties, including loss of IRA status, may result.

Royse Law Firm has advised many IRA account holders on permissible use of IRA funds, including direct interaction with trust company fund custodians.

Additional Resources



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In accordance with Section 6694 of the Internal Revenue Code of 1986, as amended (the "Code"), we hereby advise you that the positions set forth herein may lack substantial authority and, therefore, may be subject to penalty under Code section 6662(d) unless adequately disclosed on IRS Form 8275.