



## Avoiding Prohibited Transactions in Self-Directed IRAs

By  
Brett L. Davis  
Senior Vice President and Chief Trust Officer  
Exeter Trust Company



Alternative assets can be powerful investment tools inside self-directed IRAs and individual 401(k) plans. Retirement investors often use these self-directed retirement accounts to invest in private equity and debt funds, private lending (e.g., deeds of trust, mortgages, loan funds), promissory notes secured by real estate, interests in limited liability companies (LLCs), real estate and other non-traditional investment options. The diversification and flexibility for retirement investors are significant, but it also comes with strict compliance responsibilities.

The prohibited transaction (PT) rules generally do not focus on whether the asset is an alternative investment or a traditional asset such as publicly traded stocks, bonds, or mutual funds. Instead, prohibited transactions focus on who the retirement account transacts with and whether the transaction gives the account holder or another related party a direct or indirect personal benefit.

The key takeaways are straightforward. Your retirement account must invest for the exclusive benefit of the account itself. You must avoid transactions with disqualified persons, especially yourself. You must not personally benefit from plan-owned or IRA-owned assets (unless they have been distributed from the account). You are responsible for evaluating and selecting the investments whether [alternative assets](#) or traditional investments in nature, conducting due diligence, and obtaining independent legal, tax, and financial advice before proceeding.

This article provides a practical framework for understanding prohibited transactions, with special emphasis on real estate investments inside self-directed IRAs and individual 401(k) plans.

### What is a Prohibited Transaction?

A prohibited transaction is a transaction between a retirement account and certain related parties, generally referred to as disqualified parties, or a transaction that improperly benefits the account holder or another disqualified person. The rules are designed to prevent self-dealing. Congress intended retirement accounts to provide tax-advantaged savings for retirement, not a way to shift current personal or family benefits into a tax-deferred or tax-free account.

Common prohibited transactions include:

- Selling, exchanging, or leasing property between the SDIRA and a disqualified person
- Lending money or extending credit between the self-directed IRA and a disqualified person
- Furnishing goods, services, or facilities between the retirement account and a disqualified person
- Transferring retirement account income or assets to, or for the benefit of, a disqualified person
- Using self-directed IRA and individual 401(k) plan assets by or for the benefit of a disqualified person
- A fiduciary dealing with retirement account assets for their own account or benefit

In practical terms, the rule is not simply, “Can my IRA buy real estate?” In most cases, yes, a self-directed IRA can purchase and hold real estate inside the account. The better question is: Can my IRA buy this property from this seller, on these terms, with these parties involved, without creating a personal benefit or self-dealing issue? This question must be reviewed by the account holder’s legal, tax and financial advisors before the transaction is signed, funded, or closed.



## Who Is a Disqualified Person?

The prohibited transaction rules apply to transactions involving a retirement account and “disqualified persons.” This term includes the account holder and several related parties.

For a self-directed IRA or individual 401(k), disqualified persons generally include:

- The account holder or plan participant
- The account holder’s spouse
- Ancestors, such as parents, grandparents, and great grandparents
- Lineal descendants, such as children, grandchildren, and great-grandchildren
- Spouses of lineal descendants
- Fiduciaries or persons providing services to the 401(k) plan or SDIRA
- Certain entities owned or controlled by the account holder or other disqualified persons
- Officers, directors, highly compensated employees, or owners of certain disqualified entities

A helpful way to remember the family rule is this: the prohibited transaction rules generally move vertically through the family tree, not horizontally.

For example, parents, grandparents, children, and grandchildren are typically disqualified persons. Siblings, aunts, uncles, cousins, nieces, and nephews are generally not disqualified persons solely because of family status. However, they may still become disqualified persons because of ownership, control, fiduciary status, or another form of relationship.

The account holder must evaluate all relationships carefully to avoid triggering a prohibited transaction. A transaction that appears permissible at first glance may become problematic if an entity, manager, borrower, tenant, seller, or service provider is owned or controlled by a disqualified person.

## The Core Rule: No Direct or Indirect Personal Benefit

The most important prohibited transaction concept is personal benefit. Your self-directed IRA or individual 401(k) plan must invest for the benefit of the retirement account, not for your personal use, family use, business use, or financial benefit or convenience. This includes both direct and indirect benefits.

A direct benefit may include using IRA-owned real estate for personal use such as a family vacation.

An indirect benefit may include having your IRA buy property and then allowing your family member to use it, or having your business occupy it, even if rent is charged.

The rules also apply even when the retirement account receives fair market value. A prohibited transaction may occur because of the relationship between the parties, not merely because the price was unfair.

For example, an IRA buying real estate from the account holder’s parent will likely be prohibited even if the SDIRA pays full market value and receives a professional appraisal. The issue is not just the price. The issue is that the transaction is between the IRA and a disqualified person.

## Real Estate Investments Require Special Care

Real estate is one of the most common alternative assets bought and held in self-directed IRAs and individual 401(k) plans. It is also one of the most common areas where prohibited transaction problems arise.

Real estate creates practical challenges because it involves ongoing property management activity. Properties require maintenance, insurance, taxes, utilities, repairs, leasing, property management, and sometimes financing. Each activity must be reviewed and handled in a compliant manner to avoid any accidental prohibited transaction issues. Here are some examples that will help readers understand the prohibited transaction rules.



#### **Example: Buying Property From a Parent**

Assume Sarah wants her self-directed IRA to buy a rental property from her father. The property is a good investment, the price is supported by an appraisal, the closing will be handled by a title company, and Sarah will continue to hold the property for rental income after the purchase by her SDIRA.

This transaction is still problematic because Sarah's father is her ancestor and therefore a disqualified person. A sale and purchase between Sarah's IRA and her father would generally be treated as a prohibited transaction.

A compliant-style contrast would be Sarah's IRA purchasing a rental property from an unrelated third party, with the purchase price and all closing costs paid directly from Sarah's IRA, and legal title vested properly in the name of the IRA custodian for the benefit of Sarah's self-directed IRA (e.g., Exeter Trust Company as Custodian for IRA No. 123456789 FBO: Sarah).

#### **Example: Using IRA-Owned Property for Personal Use**

Assume Mark's self-directed IRA owns a vacation rental. Mark rents it to unrelated guests throughout the year. He then stays at the property for one weekend during the off-season and pays the IRA fair market rent.

This creates a serious prohibited transaction concern. Mark is the IRA owner and a disqualified person. Personal use of IRA-owned property can be treated as using IRA assets for the benefit of a disqualified person, even if rent is paid.

A compliant-style contrast would be Mark's IRA owning the property solely as a rental investment, with occupancy limited to unrelated tenants or guests, and with all rental income deposited directly into the IRA.

#### **Example: Personally Performing Repairs**

Assume Lisa's self-directed IRA owns a single-family rental. The property needs new flooring. To save money, Lisa buys materials and installs the flooring herself.

This will likely be treated as a prohibited transaction issue. Lisa is providing services to her IRA-owned property. The rules prohibit the furnishing of goods, services, or facilities between an IRA and a disqualified person. The investments held in self-directed IRAs and individual 401(k) plans must be passive in nature and not involve active management by a disqualified party.

A compliant-style contrast would be Lisa's IRA hiring an unrelated contractor, paying the contractor directly from IRA funds, and maintaining invoices and records in the IRA's name.

#### **Example: Paying Expenses with Personal Funds**

Assume David's IRA owns a rental property, but the IRA temporarily lacks enough cash to pay the property tax bill. David writes a personal check with out-of-pocket funds to pay the property taxes to the county to avoid late payment penalties.

This will create a prohibited transaction issue because David is using personal funds to benefit IRA-owned property. It may be treated as an improper extension of credit or transfer of value between a disqualified person and his IRA.

A compliant-style contrast would be David maintaining sufficient liquidity inside the IRA, having the IRA pay all expenses directly, or arranging permissible financing that is reviewed in advance by qualified advisors. David may be able to make an annual contribution to his SDIRA to help cover the expenses. In limited cases, David may be able to loan funds to his IRA.

#### **Example: Personally Guaranteeing a Loan**

Assume Maria's IRA wants to buy an apartment building with financing. The lender requires Maria to personally guarantee the loan.



A personal guarantee by the IRA owner is a significant prohibited transaction concern. The guarantee may be treated as an extension of credit between the IRA and a disqualified person. Even if the IRA is the borrower, Maria's personal guarantee supports the debt and benefits the IRA.

A compliant-style contrast would be non-recourse financing where the lender's sole remedy is against the property and not against Maria personally. Even then, tax issues such as unrelated business taxable income ("UBTI") and/or unrelated debt finance income ("UDFI") may apply and should be reviewed by tax counsel.

#### **Example: Related Business Occupying 401(k) Plan-Owned Property**

Assume James has a self-directed individual 401(k) plan that owns a small commercial office building. James also owns a consulting company. His company leases office space from the 401(k) plan at fair market rent.

This arrangement will likely trigger a prohibited transaction. James controls the company, and the company may be treated as a disqualified person. The lease may be viewed as a transaction between the plan and a related business.

A compliant-style contrast would be the plan leasing the property to an unrelated third-party tenant under arm's-length lease terms, with rent paid directly to the plan and all property expenses paid by the solo 401(k) plan.

#### **Private Lending and Private Equity Have Similar Risks**

The same principles apply to private loans, private placements, startup investments, and closely held business interests.

A self-directed IRA may be able to make a private loan to an unrelated borrower. However, the IRA should not lend money to the account holder, the account holder's spouse, parents, children, grandchildren, or an entity controlled by these parties.

Likewise, a retirement account may be able to invest in private equity. However, the account holder must carefully evaluate whether they or other disqualified persons own, manage, control, work for, or receive compensation from the company.

#### **Private Lending Example**

Assume an IRA lends money to an unrelated real estate investor. The loan is documented by a promissory note and secured by a deed of trust. Payments are made directly to the IRA. The IRA owner does not personally guarantee the borrower's obligations, provide services, or receive compensation. That structure may be more consistent with a passive retirement account investment, provided all other facts are reviewed.

Now compare that with an IRA loan to the account holder's son for a house flip. The son is a lineal descendant and a disqualified person. That loan would generally be prohibited.

#### **Private Equity Example**

Assume an IRA buys a minority interest in an unrelated private company. The IRA owner does not work for the company, does not control the company, does not receive compensation from the company, and does not cause the company to transact with related parties. This may be a permissible passive investment structure.

Now compare that with an IRA investing in a company owned by the IRA owner, the IRA owner's spouse, or the IRA owner's children. That ownership and control structure requires careful review and will likely be viewed as a prohibited transaction.

#### **Case Law Highlights: What Courts Have Focused On**

Court decisions involving self-directed retirement accounts often focus on substance over form. The documents may appear formal, but courts examine whether the account holder or related parties received an improper benefit, extended credit, or used retirement assets in a way that violated the prohibited transaction rules.



### **Peek v. Commissioner**

In *Peek v. Commissioner*, taxpayers used self-directed IRAs to acquire a business. As part of the transaction, they personally guaranteed a loan connected to the acquisition. The court found that the personal guarantees were prohibited transactions.

The important lesson is that a personal guarantee can be more than a routine financing requirement. It can be treated as an extension of credit involving a disqualified person. Retirement investors using debt financing must carefully avoid personal liability, personal pledges, personal guarantees, and other credit support from disqualified persons.

### **Rollins v. Commissioner**

*Rollins v. Commissioner* involved loans from a retirement plan to businesses in which the plan participant had an ownership interest. The court concluded that the transactions benefited the participant's businesses and violated prohibited transaction rules.

The key lesson is that loans or investments involving businesses connected to the account holder can create self-dealing problems. Even if the retirement account expects repayment or receives interest, the transaction may still improperly benefit a disqualified person or related entity.

### **Swanson v. Commissioner**

*Swanson v. Commissioner* is often discussed in the self-directed IRA context because the court respected an IRA investment in a newly formed corporation under the facts presented. The case is frequently cited by investors interested in IRA-owned entities.

However, *Swanson* should not be read too broadly. It does not mean an IRA owner can freely use IRA-owned entities for personal benefit or transact with related parties. The case turned on specific facts. Investors should have experienced legal and tax advisors review any IRA-owned LLC, corporation, or private entity structure before investing to avoid prohibited transaction issues.

### **Ellis v. Commissioner**

*Ellis v. Commissioner* involved a self-directed IRA investment connected to a business where the IRA owner received compensation and had significant involvement. The court found prohibited transaction issues.

The practical lesson is that an IRA owner should not use IRA-owned business structures as a way to create current compensation, employment benefits, or personal business opportunities. Retirement account investments must remain retirement investments, not operating platforms for the account holder's personal services or income.

### **McNulty v. Commissioner**

*McNulty v. Commissioner* involved IRA-owned precious metals that were held in physical form by the IRA owner. Although not a real estate case, it reinforces an important principle: IRA assets must be held and administered in compliance with IRA rules, not treated as personal property.

The same concept applies to real estate. If an IRA owns the asset, the account holder should not treat it like personal property, personally use it, store personal items there, pay its expenses personally, or manage it in a way that creates personal benefit.

## **The Consequences of Prohibited Transactions Can Be Severe**

Prohibited transaction violations can be costly. The consequences depend on the type of retirement account, the parties involved, and whether the transaction is corrected.

For IRAs, the most severe consequence is potential disqualification of the entire IRA. If the IRA owner or beneficiary engages in a prohibited transaction, the IRA may be treated as if it ceased to be an IRA as of the first day of the taxable year in which the prohibited transaction occurred.



That can result in a deemed distribution of the entire IRA balance. The distribution may be subject to ordinary income tax and, if applicable, early distribution penalties.

For qualified plans, including individual 401(k) plans, prohibited transaction excise taxes may apply. These taxes can include an initial excise tax and, if the transaction is not corrected, a much larger additional tax. Fiduciary breaches and plan qualification issues may also arise.

Potential consequences may include:

- Taxable deemed distribution of IRA assets
- Early distribution penalties, if applicable
- Excise taxes on prohibited transactions
- Interest and penalties
- Loss of tax-deferred or tax-free status
- Required correction of the transaction
- Additional reporting obligations
- Litigation, audit exposure, or plan compliance issues

Because the consequences can be severe, investors should evaluate prohibited transaction risks before entering into any transaction, not after a problem has occurred.

### **The Account Holder's Responsibility Cannot Be Delegated Away**

Self-directed IRA custodians and plan administrators generally do not evaluate whether an investment is suitable, prudent, profitable, or compliant with prohibited transaction rules. Their role is merely administrative and clerical in nature.

They may process investment documents, custody (hold) assets, receive income, and disburse expenses at the account holder's direction. They generally do not provide individualized legal, tax, investment, or financial advice.

This point is critical.

The account holder is solely responsible for:

- Evaluating and selecting investments
- Conducting independent due diligence
- Understanding the parties involved
- Reviewing ownership and control relationships
- Determining whether a party is a disqualified person
- Confirming that no personal benefit will occur
- Ensuring income and expenses flow properly through the account
- Consulting independent legal, tax, and financial advisors
- Maintaining records that support compliance

Before investing, the account holder should have the proposed transaction reviewed by qualified professionals who understand self-directed retirement accounts, prohibited transaction rules, real estate law, tax law, and the specific asset involved.

### **Practical Guidelines for Real Estate Investors**

Real estate investors can reduce risk by following disciplined operating procedures.



### **Keep All Income Inside the Account**

Rental income, option fees, interest income, sale proceeds, and other property income must be paid directly to the IRA custodian and credited to the self-directed IRA or individual 401(k) plan. The account holder should never receive, deposit, hold, or redirect those funds personally under any circumstances.

### **Pay All Expenses From the IRA or 401(k) Plan**

Property taxes, insurance, repairs, utilities, HOA dues, management fees, and closing costs should be paid directly from the retirement account. The account should maintain enough cash reserves to cover expected and unexpected expenses, including unexpected vacancies.

### **Use Unrelated Third Parties**

Always use unrelated sellers, tenants, contractors, lenders, property managers, and service providers whenever possible. Always avoid transactions with the account holder, spouse, parents, grandparents, children, grandchildren, and related entities. This advice is crucial to avoid potential prohibited transaction issues.

### **Avoid Personal Use**

Do not personally use IRA-owned or plan-owned property. Do not allow family members or related businesses to use it. This includes short stays, free use, discounted use, storage, office use, or temporary occupancy.

### **Do Not Provide Personal Services**

Avoid performing repairs, maintenance, leasing, construction, bookkeeping, or management services personally. Use unrelated third-party professionals paid by the account. The investment held in self-directed IRAs and individual 401(k) plans should always be passive in nature.

### **Be Careful With Financing**

If debt is used, avoid personal guarantees, personal pledges of collateral, or other personal credit support. Non-recourse financing is commonly used in retirement account real estate transactions, but it should still be reviewed for tax and compliance issues.

### **Document Everything**

Maintain clear records showing:

- The retirement account owns the asset
- The parties are unrelated
- Income and expenses flowed through the IRA or 401(k) plan
- Services were provided by unrelated third parties
- The investment was held for retirement account purposes only
- Advisors reviewed the transaction when appropriate

Good records do not cure a prohibited transaction, but they can help demonstrate compliance when the structure is proper.

### **Compliant-Style Structures Often Share the Same Features**

While every transaction requires specific review, compliant-style alternative asset investments often have several features in common.

- The retirement account is a passive investor.
- The seller, borrower, tenant, manager, and service providers are unrelated parties.
- All income is paid directly to the retirement account.
- All expenses are paid directly from the retirement account.
- The account holder receives no current personal benefit.
- The account holder does not personally guarantee debt.



- The account holder does not provide services to the asset.
- The transaction is reviewed in advance by qualified advisors.

These features do not guarantee compliance, but they reflect the type of structure retirement investors should generally seek when investing in alternative assets.

### **Best Practices Checklist for Avoiding Prohibited Transactions**

Before your self-directed IRA or individual 401(k) invests in real estate, private equity, private lending, or another alternative asset, review these best practices:

- Confirm whether any party is a disqualified person.
- Identify all direct and indirect ownership and control relationships.
- Avoid buying from, selling to, leasing to, or lending to related parties.
- Do not personally use retirement account-owned property.
- Do not allow family members or related businesses to use the asset.
- Do not personally perform repairs, management, or other services.
- Do not pay expenses personally or deposit income personally.
- Maintain enough cash inside the account to support the investment.
- Avoid personal guarantees and personal credit support.
- Use unrelated third-party professionals where appropriate.
- Keep clear records for all income, expenses, contracts, and ownership.
- Have independent legal, tax, and financial advisors review the transaction before closing.

### **Final Thoughts**

Self-directed IRAs and individual 401(k) plans can hold a broad range of alternative assets, including real estate, private loans, private equity, private debt and private offerings. The compliance challenge is not usually the asset itself. It is whether the transaction involves a disqualified person or creates a direct or indirect personal benefit.

The safest approach is to treat the retirement account as a separate stand-alone investor with separate funds, separate records, and a retirement-only purpose. Before moving forward, conduct careful due diligence and obtain guidance from your own legal, tax, and financial advisors. Prohibited transaction mistakes can be severe, and prevention is far more effective than correction.

Contact [Exeter Trust Company](#) to learn more about prohibited transactions.

### **Frequently Asked Questions About Prohibited Transactions**

#### **What is a prohibited transaction?**

A prohibited transaction is a transaction involving a retirement account and a disqualified person, or a transaction that provides a direct or indirect personal benefit to the account holder or another related party. These rules are intended to ensure that self-directed IRAs and individual 401(k) plans are used for retirement investment purposes, not for current personal, family, or business benefit.

Common examples include selling property to or from the account with a disqualified party, lending money between the account and a related party, personally using account-owned assets, or personally guaranteeing debt incurred by the account.



### **Who is considered a disqualified person?**

Disqualified persons generally include the account holder, the account holder's spouse, certain family members such as ancestors and lineal descendants, fiduciaries such as the account custodian or trustee, service providers, and entities owned or controlled by disqualified persons.

For family members, the rules generally include:

- Parents and grandparents and great grandparents
- Children, grandchildren, great grandchildren and other lineal descendants
- Spouses of lineal descendants
- Entities such as corporations, partnerships, LLCs, or trusts may also be disqualified persons if they are owned or controlled by the account holder or other disqualified persons.

### **Can I personally use real estate owned by my self-directed IRA?**

No. The account holder must not personally use real estate owned by their self-directed IRA or individual 401(k). This includes vacation use, temporary stays, office use, storage, or any other personal use.

Paying fair market rent does not necessarily solve the issue. The concern is that the account holder is a disqualified person and may be receiving a current personal benefit from a retirement account asset.

### **Can I perform repairs or maintenance on property owned by my IRA?**

Generally, the account holder should not personally perform repairs, maintenance, improvements, or management services for IRA-owned property. Providing services to the retirement account or its assets can create a prohibited transaction issue.

A more compliance-minded approach is to have the IRA or plan hire unrelated third-party contractors, property managers, or service providers, with all invoices paid directly from the retirement account.

### **Can I use personal funds to pay expenses for IRA-owned real estate?**

No. Expenses related to IRA-owned or plan-owned property should be paid directly from the retirement account. This includes property taxes, insurance, utilities, repairs, HOA dues, and other carrying costs.

Using personal funds may be treated as an improper contribution, extension of credit, or transfer of value between the account holder and the retirement account. Investors should maintain sufficient cash reserves inside the retirement account before acquiring real estate or other assets with ongoing expenses. Unexpected issues like vacancies can create cash flow challenges, so account holders should maintain reserves to cover those unplanned cash flow problems.

### **Can I personally guarantee a loan for my self-directed IRA or individual 401(k)?**

No. A personal guarantee by the account holder will create a serious prohibited transaction. The guarantee may be treated as an extension of credit between a disqualified person and the retirement account.

When retirement accounts use financing, investors often explore non-recourse lending arrangements. However, debt-financed investments may raise additional tax and compliance issues, including unrelated business taxable income ("UBTI") and unrelated debt finance income ("UDFI"). The structure should be reviewed by qualified tax and legal advisors before closing.

### **Are siblings disqualified persons?**

Siblings are generally not disqualified persons solely because they are siblings. The prohibited transaction family rules typically apply vertically through the family line, such as parents, grandparents, children, and grandchildren.

However, a sibling may still be treated as a disqualified person for another reason. For example, if the sibling is a fiduciary, service provider, business partner, or owner of an entity involved in the transaction, additional analysis may be required.



**Why should I consult my own legal, tax, and financial advisors before investing?**

Self-directed IRA custodians and plan administrators generally do not determine whether an investment is suitable, prudent, or compliant under the prohibited transaction rules. The account holder is responsible for evaluating the investment, conducting due diligence, and confirming that the transaction does not violate applicable rules.

Before proceeding, investors should have their own legal, tax, and financial advisors review:

- The proposed investment structure
- All parties involved in the transaction
- Any family, ownership, or control relationships
- Income and expense payment procedures
- Financing terms and guarantees
- Potential tax reporting or compliance obligations

Professional review before closing can help identify prohibited transaction risks and reduce the likelihood of costly tax consequences.