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MADISON TRUST COMPANY

Considerations for IRA Investment into Fund Structures

The tool to access the largest pool of liquidity in the United States.

Retirement savings accounts (IRAs and 401Ks) presently hold over 27 Trillion dollars in assets, representing the single largest pool of funds available for investment in the world. Typically, alternative asset managers cannot access IRA or 401K funds as the majority of retirement funds are held within traditional brokerage house accounts.

A different structure that allows for flexibility, diversification and investment with Alternative Asset Managers.

Standard IRAs limit the account owner's investment options to a selection of publicly traded assets offered by retail brokerage houses. Standard IRA custodians are incentivized not to allow alternative investments due to their interest in selling traditional products and are hesitant to allow them due to the added administrative burden of alternative assets. Clients are typically told that investments in non-publicly traded assets are not an option.

History and legality.

According to the IRS guidelines, an IRA can invest in LLCs, LPs, Hedge Funds, promissory notes and other private illiquid investments. Typically, a self-directed custodian equipped to handle such investments will be retained to manage the administration of such assets. (https://www.irs.gov/retirement-plans/retirement-plan-investments-faqs)

An alternative structure offering the investor discretion and choice – with opportunity for the asset manager.

While the majority of retirement funds are held by traditional brokerages with their limited options, Self-Directed IRA custodians are specifically equipped to allow investors to invest in the gamut of investment opportunities. Clients can, with very few exceptions, invest in virtually any asset class and any investment type. This presents tremendous opportunity for alternative asset managers looking to increase AUM.

Advantages for investment sponsors.

Self-directed IRAs enable investment sponsors (Hedge Funds, Private Equity, Crowdfunding, etc.) to tap into the single largest source of investment funds - with numerous advantages.

- **Tremendous upsell opportunity.** Most IRA owners are unaware of their ability to invest in "off wall street assets" and many will jump at an opportunity to allocate more funds to their current managers.
- **Retention of capital.** By their very nature, IRA investments tend to have a long term time horizon and are less sensitive to short term fluctuations in NAV. Funds invested through the self-directed model have an extremely high retention rate, allowing for predictable cash flow and stability.
- **Opening the fund to investors who could not have invested otherwise.** For many investors, including accredited investors, IRAs are their single largest liquid asset. Working with a self-directed custodian enables sponsors to reach out to investors who are otherwise illiquid, or have the bulk of their savings in IRAs/401Ks.

Onboarding process for investors with a self-directed custodian.

- Client / investment sponsor opens account with the custodian and submits a transfer authorization to transfer funds to the custodian.
- Client submits an investment form directing the custodian to invest in the fund along with a completed and signed subscription agreement.
- The custodian signs the subscription agreement, issues a check/wire to the investment sponsor and forwards the Subscription Agreement to the investment sponsor and fund admin.

What a self-directed custodian should do.

- Setup and maintain the IRA
- Facilitate the investment
- Keep clear records of the account
- Report the value of IRA to the IRS
- Provide client support and information along the way.

What an investment sponsor should do.

The responsibilities of the fund are generally limited to providing the custodian with an updated account value on an annual basis

Differences between the Brokerage Model and the Self Directed Model.

While traditional brokerage houses earn their profit from asset management and referral fees, Self Directed Custodians typically do not offer specific investments nor investment advice to their clients. Self-Directed Custodians charge annual account fees as well as transaction based fees to stay in business. On a percentage basis, most Self Directed Custodians fees total a fraction of the fees of traditional brokerage houses.

Legal considerations / Prohibited Transactions

Prohibited Transaction limitations - as outlined by the IRS- IRC § 4975 - apply to all IRAs and 401Ks, but take on special importance in the context of self-directed IRAs. There are certain people that are considered disqualified with regard to an IRA, including lineal ancestors or descendants of the IRA account holder and their spouses and in-laws, key people in a company owned 50% or more by disqualified persons and entities owned 50% or more by disqualified persons. Any transaction (purchase or sale) between an IRA and a disqualified person or disqualified entity would result in a Prohibited Transaction. IRA investments must be made for the exclusive benefit of the retirement account; therefore, any transaction that provides a benefit to the account holder personally would be prohibited. Similarly, the IRA account holder cannot provide a benefit to the IRA, including personally guaranteeing a loan on behalf of the retirement account. The IRS has shown at times to interpret these rules liberally. Consultation with one's tax counsel is strongly advised on whether a transaction could be considered prohibited.

Prohibited Transaction FAQ's for Hedge Fund Managers

Q. Can I invest my IRA in my own fund?

A. Yes, as long as your IRA investment does not provide benefit to you personally. For example, avoiding personal benefit would include that you do not charge fees for managing the funds, do not own 50% of the fund, either personally or combined with other disqualified persons, do not use your IRA to draw in other investors, or your fund is self-sustaining without your IRA investment.

Q. Can I charge fees to my family members?

A. It depends on whether or not they are disqualified persons. Typically, lineal ancestors or descendants are not allowed; certain lineal ancestors or descendants of the spouse may not be allowed and other family members (i.e. cousins, brother/sister) are likely okay. For specific questions on which family members are or are not allowed, please consult tax counsel.

Q. Is there a limit on the amount of retirement funds I can allow in my fund?

A. Depending on the circumstances, if any class of interests in an investment entity is funded by 25% or more of retirement assets, there could be a trigger of fiduciary and prohibited transaction rules. Consult with your tax counsel or other professional familiar with these rules.

Tax considerations / Unrelated Business Taxable Income (UBTI)

Generally, portfolio income (interest, dividends, capital gains, etc.) derived by alternative investment funds is not taxable income to IRAs. However, if the portfolio income or other income derived by an alternative investment fund is considered to be Unrelated Business Taxable Income ("UBTI"), such income is taxable income to an IRA under most circumstances. Alternative investment funds usually derive UBTI when the fund uses leverage/debt to purchase its portfolio assets and real estate assets or the fund invests in pass-through entities that derive income that is considered income derived in a trade or business.

Fortunately, alternative investment managers that seek IRA investors and that operate UBTI producing strategies will often, but not always, have UBTI blocking structures or vehicles available for their IRA investors, including, but not limited to, offshore blocker corporations and parallel investment vehicles. Please consult your tax counsel and the fund manager regarding potential UBTI effects before investing in any alternative investment fund.

Richey May and Madison Trust are dedicated to sharing best practices and trends in the industry to help you stay competitive in the local and national marketplace. For more information on Richey May, please contact **Stephen Vlasak** at **svlasak@richeymay.com** or visit our website at **www.richeymay.com**. For more information on Madison Trust, please contact **Phillip Klein** at **pklein@madisontrust.com** or vist our website at **www.madisontrust.com**.

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