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Considerations for IRA Investment into Fund Structures

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Accessing 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 New Way to Look at Accessing Retirement Accounts

Unknown to most investors, IRAs and 401(k) plans have always been able to invest into private alternative investments, such as hedge funds, private equity, real estate, and venture capital. However, traditional brokerages make considerably more money off mutual funds so through marketing the narrative has been you can only invest in those investments with retirement funds. Alternative investments have grown in popularity and so alternative investment custodians (also known as Self-Directed IRA companies) have developed, creating an alternative for investors to easily tap into retirement funds to invest in alternative investment fund products.

Advantages for Investment Sponsors

Alternative investment custodians can be utilized as a tool for capital raisers to tap into the single largest source of investable capital, IRAs and 401(k) money.

- **Providing value through education.** Most IRA owners are unaware of their ability to invest in alternative investments or non-mutual fund investments and many will jump at an opportunity to allocate with their IRA. Simply bringing up the topic could be an exciting education lesson for the investor.
- **Sticky money.** Retirement accounts are designed for long term horizons with penalties for taking money out early. Investors are more likely to "set it and forget it," rather than pulling their funds out on a frequent basis. This leads to capital you can count on instead of having liquidity concerns.
- **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.

Allowing Flexibility and Diversification into Private Alternative Investments

IRAs provided by name retail brokerages limit account owners to only mutual funds or publicly traded positions. These name brand retail brokerages are in business to push their product lines and disallow that of private alternative investments. However, IRS guidelines established in 1974 allow an IRA to invest in LLCs, LPs, Hedge Funds, Private Equity, promissory notes and much more.

Due to the restrictions put in place by name retail brokerages, an industry was formed by alternative investment custodians to provide better flexibility and diversification into alternative investments. These custodians are better equipped to handle and simplify the seemingly complex nature of alternative investments, making the concept attractive to new investors. For further detail on IRA rules, see link. (https://www.irs.gov/retirement-plans/retirement-plan-investments-faqs)

What's next for a hedge fund to get setup with an alternative investment custodian?

- Contact your alternative investment custodian to get your offering setup on their platform. Each company has a different process and should look to familiarize their team with your offering.

What's next for a hedge fund to get setup with an alternative investment custodian?

- Client will need to establish IRA account with custodian of choice by completing application.
- Through the application process, client will initiate a method of funding by transfer, rollover, or annual contribution.
- When funding is complete, funds will be on deposit with the custodian.
- Fund manager will work with custodian and client to execute subscription agreement.
- Client will authorize custodian to make investment via an investment direction document and funds will be dispersed via check or wire to investment fund's bank account.

What an alternative investment custodian should do:

- Setup and maintain clear records of the IRA
- Facilitate investments and disbursements authorized by IRA owner
- Provide proper tax-reporting for IRA
- Report the Fair Market Value (FMV) of the IRA to the IRS
- Handle cash flows deposits/withdrawals surrounding IRA investments
- Offer on-going support of necessary changes made to IRA

Considerations for choosing an Alternative Investment Custodian:

- Do they have experience with your type of investment fund offering?
- How is the client on-boarding process?
- How is the client's online portal experience?
- Are values provided by the fund updated in a timely manner?
- How do they charge and does it make sense for your type of client?
- Do you feel comfortable having that firm engage with your trusted client?

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 on-going basis.

How do alternative investment custodians make money?

Retail brokerages that offer mutual funds and stock trading make their money off of expense ratios and trading commissions. Alternative investment custodians charge flat annual account fees typically based on workload to facilitate investment transactions. These fees are very transparent, not dependent upon value, and minimal to typical fees charged by name brand retail brokerages. There are no surprises and they don't eat into the profits of your investment as the IRA grows in value.

Prohibited Transactions in a Self-directed IRA

Prohibited Transactions and prohibited persons - 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 with severe penalties. 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 is prohibited. Similarly, the IRA account holder cannot provide a benefit to the IRA, including personally guaranteeing a loan on behalf of the retirement account. Consultation with your tax counsel is strongly advised on whether a transaction could be considered prohibited.

FAQs 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.

Q. Can investors invest their 401(k) plan into a hedge fund?

A. Investors with 401(k) plans at a previous employer or of the age 59 ½ and older can rollover all or a portion of their assets into an IRA, which they can use to invest in a hedge fund. For investors participating in their current employer's 401(k) plan, they are limited to investment choices dictated by the employer and often not able to invest in alternative assets. There are exceptions to this rule so contact your SD IRA company of choice to consult on the matter.

Tax Considerations and Unrelated Business Income Tax (UBIT)

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 Income Tax (UBIT), such income is taxable income to an IRA under most circumstances. Alternative investment funds usually derive UBIT 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 UBIT producing strategies will often, but not always, have UBIT 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 Midland 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 & Co., please contact Stephen Vlasak or visit our website. For more information on Midland Trust, please contact Brad Janitz or visit our website.