

An Overview Of (Swanson) Checkbook IRAs

We already have regular IRAs, contributory IRAs, rollover IRAs, ROTH IRAs. Do we need another one? Actually yes. A Swanson IRA is fortunately not another type of IRA. Instead it how any of the aforementioned IRA types can be used in some new and unusual manners.

For all intents and purposes financial institutions have a lock on the \$20 plus trillion dollar IRA marketplace. All of the brokerages, banks, insurers do not care how the money arrived in your IRA; they don't care how or when you are going to spend the contents of your IRA; what they do care about is AUM — assets under management. Every one of those financial institutions wants your AUM dollars forever. They do not care what specific financial products you purchase — what they do know is every product they sell (and they all sell the same products) has a built in fee for them which averages 1% per year. So the math is easy; have \$1 trillion in AUM creates a guaranteed \$10 billion in fees¹. Make no mistake, this is a huge market place with fierce fighting between the participants, to wit: today you can open a rollover IRA account and purchase stocks, bonds, mutual funds and etf's all commission free and all online. The players all still collect their 1% per year; it's just hidden.

The menu offered by all the financial institutions is the same. What if you don't like what's on the menu? What if you would like to make investments from your IRA that no one is offering. These are not illegal or improper investments; nonetheless they are not offered for sale. For example, you might want to:

- Purchase individually titled real estate; land, homes, apartments for rent.
- Purchase private / unregistered stock or bond certificates.
- Use your IRA as a source of funds to start a business.
- Fund the creation of new intellectual property.

All of these ideas are bonafide investments but there seems to be no way to get there. These ideas all seem to be too difficult or too rare to be on the typical financial institution menu. Enter the Swanson IRA². The Swanson case ended in 1996 but started four years earlier in 1992.

¹ In the AUM sweepstakes, the 1st four horses are: Blackrock @ \$8.5mmm; Vanguard @ \$7.1mmm; Fidelity @ \$3.7mmm; State Street @ \$3.4mmm. Looks like 27 billion happy meals to me.

² Swanson v. Commissioner, 106 T.C. 76 (1996) is a landmark case confirming the ability of IRAs to create and invest in entities/businesses. Mr. Swanson caused his IRAs to form and own two corporations. He was director of each but never owned any stock himself. Mr. Swanson then directed the custodian of the IRA to purchase all the original issue stock of the entity.

The Tax Court held that initial formation of the company by the IRA is not a prohibited transaction under Internal Revenue Code Section 4975 because the sale of the company stock to the IRA was

Swanson fought the IRS for four years and won; so we all put his name on it. The essence of this arrangement is the structuring of two new entities as follows:

- (1) Swanson hired an independent qualified trustee³ and transferred his existing IRA then located at a traditional brokerage.
- (2) He then created a new corporation (and it's a real "C" corporation); let's call it CapitalCorp.
- (3) He then created a 2nd new corporation (and it is a real "S" corporation (or LLC); let's call it ServiceCorp.
- (4) He caused CapitalCorp to issue 1000 shares of stock which the corporation sold to his IRA for \$1000 per share thus causing \$1,000,000 to be transferred from the trustee to the bank account of CapitalCorp.
- (5) CapitalCorp, as a self-standing "C" corporation. now has complete control of \$1mm and is free to invest in whatever endeavors the Board of Directors of CapitalCorp deem appropriate — how about a multi-unit apartment building?
- (6) Swanson is essentially the Board of Directors of both corporations. His IRA owns CapitalCorp; he, the person owns all the shares of ServiceCorp. He instructs CapitalCorp to enter into a contract with ServiceCorp to get the daily work done like: collect the rent, paint the units, replace appliances, etc.

The structures are now built; what does an operating year look like? ServiceCorp gets all of the daily work done for CapitalCorp and prices its services so that at the end of the year CapitalCorp has close to zero net income. ServiceCorp has modest positive net income. For the year:

- (1) CapitalCorp files an 1120 federal tax return declaring close to zero net income and pays a little income tax as appropriate.
- (2) ServiceCorp files an 1120S federal tax return declaring its net income and issues a Schedule K-1 to Swanson for that net income amount. Further, it distributes cash

not a sale or exchange of property between a plan (the IRA) and a disqualified person within the meaning of Code Section 4975(c)(1)(A).

The Tax Court also held that receipt of dividends by the IRA from the company was not a prohibited transaction because the dividends did not become IRA assets until they were paid. The Tax Court also held that Mr. Swanson's performance of management functions, as director of the company, was not a prohibited transaction.

³ There are probably a dozen independent qualified trustee companies available. Search the internet and they all pop up. Their fees for trust management are usually several hundred dollars per year.

from the corporation to Swanson as a “tax free” stockholder distribution.

Ten years later the apartment building is worth \$2.5mm; how does it end?

- (1) CapitalCorp sells building to ServiceCorp for \$1.5mm. CapitalCorp, in its last year declares \$500,000 in gain and pays \$100,000 in federal income tax sending \$1.4mm back to the trustee. Swanson then instructs the trustee to send all \$1.4mm back to the regular trustee of his choosing and buys S&P 500 index funds.
- (2) ServiceCorp sells building to an outsider for \$2.5mm and declares a \$1mm capital gain. Swanson declares the gain because he received a Schedule K-1 from ServiceCorp for that amount and pays federal income tax of \$200,000. He then takes the remainderman, \$800,000 and heads for the Caribbean.
- (3) Both CapitalCorp and ServiceCorp terminate as does the independent trust and the entire project concludes.

In its simplest form, this is how a Swanson IRA functions. You might read this and ask: “Well up there is step X you had CapitalCorp do activity 123; could it instead do activity 789 instead which might result in a different financial or tax outcome?” Answer — absolutely yes!

You might further conclude that this whole structure looks like a circular charade to avoid “self-dealing” and “prohibited transaction” rules — again you are 100% correct however this time Swanson won and the IRS lost. Essentially the court ruled that the paired corporations created impenetrable shields through which the IRS was not permitted to look for the disqualifying person.

In conclusion, a Swanson IRA is not for the faint-of-heart. They cost money between creation costs and annual tax returns and trustee fees amounting to easily a thousand or two per year. So why would you do this? Most likely when all of your other capital formation strategies are less palatable because almost all of your assets are tied up in IRAs and you are age 45.

Lastly, the path here is intricate with lots of land mines. There are several mistakes that can be fatal. Further, the IRS does not like to lose⁴. As a result, if you are examined, there is a 100% chance that this process will be put under the microscope for minute examination. We would suggest that you not go it alone here — hire professional help to get it done absolutely correctly.

⁴ The IRS just attempted to legislate (through sponsored legislation) Swanson IRAs out of existence in the Fall of 2021 and Spring 2022 in the current tax bill. They just failed a 2nd time.

