

# Using IRAs and 401(k)s to Buy and/or Fund Real Estate Investments

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## **USING IRA'S & 401(k)'S TO BUY AND/OR FUND REAL ESTATE INVESTMENTS**

### **I. ASSETS THAT IRA'S & 401(k)'S CAN HOLD PURSUANT TO ERISA RULES**

#### **A. PROHIBITED ASSETS**

##### **1. Investment Limitations for IRA's/401(k)'s under ERISA (26 U.S.C. § 408(a))**

**(a) Individual retirement account.** For purposes of this section, the term “individual retirement account” means a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries, but only if the written governing instrument creating the trust meets the following requirements:

**(1)** Except in the case of a rollover contribution described in subsection (d)(3) or in section 402(c), 403(a)(4), 403(b)(8), or 457(e)(16), no contribution will be accepted unless it is in cash, and contributions will not be accepted for the taxable year on behalf of any individual in excess of the amount in effect for such taxable year under section 219(b)(1)(A).

**(2)** The trustee is a bank (as defined in subsection (n) [which includes trust companies]) or such other person who demonstrates to the satisfaction of the Secretary that the manner in which such other person will administer the trust will be consistent with the requirements of this section.

**(3)** *No part of the trust funds will be invested in life insurance contracts.*

**(4)** The interest of an individual in the balance in his account is nonforfeitable.

**(5)** The assets of the trust will not be commingled with other property except in a common trust fund or common investment fund....

##### **(m) Investment in collectibles treated as distributions.**

**(1)** In general. The acquisition by an individual retirement account, or by an individually-directed account under a Plan described in section 401(a) [e. g. – qualified plans], of any collectible shall be treated (for purposes of this section and

section 402) as a distribution from such account in an amount equal to the cost to such account of such collectible.

**(2) Collectible defined.** For purposes of this subsection, the term “collectible” means—

- (A) any work of art,**
- (B) any rug or antique,**
- (C) any metal or gem,**
- (D) any stamp or coin,**
- (E) any alcoholic beverage, or**
- (F) any other tangible personal property specified by the Secretary for purposes of this subsection.**

**(3) Exception for certain coins and bullion.** For purposes of this subsection, the term “collectible” shall not include—

- (A) any coin which is—**
  - (i) a gold coin described in paragraph (7), (8), (9), or (10) of section 5112(a) of title 31, United States Code,**
  - (ii) a silver coin described in section 5112(e) of title 31, United States Code,**
  - (iii) a platinum coin described in section 5112(k) of title 31, United States Code, or**
  - (iv) a coin issued under the laws of any State, or**
- (B) any gold, silver, platinum, or palladium bullion of a fineness equal to or exceeding the minimum fineness that a contract market (as described in section 5 of the Commodity Exchange Act, 7 U.S.C. 7) requires for metals which may be delivered in satisfaction of a regulated futures contract, if such bullion is in the physical possession of a trustee described under subsection (a) of this section.**

## **B. PERMITTED ASSETS**

1. Other than the prohibited asset categories listed above, most other investment options are available for retirement accounts. Accordingly, IRA's & 401k's are free to invest in the full spectrum of Wall Street products and Alternative Assets, including the most popular options:

- Real Estate
- Private Loans
- Private Placements
- Venture Capital
- Start-up Companies
- Precious Metals
- Off-shore Holdings
- Crypto Currency

## II. HOW TO ACCESS MONIES IN YOUR RETIREMENT ACCOUNT FOR REAL ESTATE-RELATED INVESTMENTS

### A. ESTABLISH A *FULLY* SELF-DIRECTED IRA OR 401(k)

1. You are in position to establish a *Fully* Self-Directed IRA, if...
  - You have a Standard IRA Account (Traditional, Roth, SEP, SIMPLE)
  - You have an Employer Plan when a “*Separation of Service*” occurs (e.g. 401(k), 403(b), 457(b) Plans)
  - You have an Employer Plan allowing “*In-Service*” Distributions or Withdrawals
  - You have an Employer Plan utilizing an “*Alternative Asset Administration Portal®*”

### B. TRANSFER/ROLLOVER FROM AN EXISTING IRA OR 401(k)

#### 1. DIRECT vs. INDIRECT IRA ROLLOVER/TRANSFER

- a. If an eligible rollover distribution is paid to the recipient (*indirect rollover*), rather than paid as a *direct rollover* to another plan, the distribution is still eligible to be rolled over. The rollover contribution must be made to a qualifying plan, however, no later than the 60th calendar day after the distribution was actually received by the individual (not the date on the check). Reg. §1.402(c)-2. See *Exhibit “A”*,

**Rollover Chart, to determine the types of Plans that are qualified for one to roll into.**

- b. §408(d)(3)(B) provides that an individual is permitted to make only one non-taxable 60-day rollover (indirect rollover) between IRA's in any 1-year period. This means that an individual receiving an IRA distribution on or after January 1, 2015, cannot roll over any portion of the distribution into an IRA if the individual has received a distribution from any IRA in the preceding 1-year period that was rolled over into an IRA. (IRS Announcement 2014-32)**
- c. The one-rollover-per-year limitation does not apply to a rollover to or from a qualified plan (and such a rollover is disregarded in applying the one-rollover-per-year limitation to other rollovers), nor does it apply to trustee-to-trustee transfers (direct transfer). (See Rev. Rul. 78-406, 1978-2 C.B. 157)**
- d. A direct rollover from a Qualified Plan to an IRA or a direct transfer from an existing IRA to another IRA is generally preferable because:**
  - **there is no withdrawal penalty**
  - **no withholding or tax reporting**
  - **no tax liability is triggered**
  - **multiple direct rollovers are allowed per year**

### **C. UTILIZE EXISTING EMPLOYER-SPONSORED PLAN**

**Some Employer Plans allow for “participant-directed” investments in alternative assets. Check with the HR Department.**

## **III. TAX ADVANTAGES & ASSET PROTECTION**

### **A. TAX-DEFERRED SAVINGS AND RETURNS**

- 1. IRA contributions and 401(k) salary deferrals are pre-tax, so they effectively reduce one's taxable income for the year a given contribution is made.**
- 2. A business can expense the Employer Match made on behalf of the Company's employees, thereby reducing its taxable income.**



3. The earnings realized within the retirement account are also tax-deferred, thereby enhancing the tax-advantaged benefits thereof.

## **B. TAX-FREE RETURNS AND DISTRIBUTIONS**

1. **ROTH IRA's.** It is often difficult for many Americans to first establish, then *contribute* to a Roth IRA because they make too much money. For 2019, the Roth IRA eligibility limit is \$203,000/year (AGI). However, in 2010 the income limits for *converting* to a Roth IRA were eliminated, so one is now free to convert all or part of his/her Traditional IRA or Qualified Plan to a Roth IRA or Roth 401(k). Of course, one must pay tax on the value of the amount converted, unless a tax credit or loss carry-forward is available.
2. **ROTH 401(k)'s.** There is currently no maximum income eligibility limit for *Roth 401(k)*'s, so even Bill Gates is free to establish such an account in his Employer-Sponsored Plan.
3. The greatest benefit of investing via a Roth Account is the fact that, once established, all returns are tax-deferred and subsequent distributions to the Account Holder are tax-free! To qualify for tax-free distributions the Roth Account must be in place for a minimum of five (5) years and the Account Holder must have reached retirement age to avoid penalties on premature distributions.
4. **ASSETS SUBJECT TO VALUATION DISCOUNTS** (Discussed in presentation).

## **C. PROTECTION FROM CREDITORS**

1. **State Law.** Under Washington Law "Employee Benefit Plans," and any fund created by such a Plan or Arrangement, are generally exempt from execution, attachment, garnishment, or seizure by or under any legal process whatever. (RCW 6.15.020(3))
  - a. The Employee Benefit Plan definition includes IRA's and Qualified Plans.
  - b. Most, if not all, states similarly afford protection from creditors for Employee Benefit Plans.

2. **ERISA Law.** Under 29 USC §1056(d), each Plan shall state that benefits provided under the Plan may not be assigned or alienated.
3. **Bankruptcy Law.** The 2005 Bankruptcy Code Amendments revised the exemptions under Section 522(b)(3)(C). Retirement funds in plans that are exempted from federal income tax under Code Sections 401, 403, 408, 408A, 414, 457, and 501(a) are now exempted from the bankruptcy estate. This covers qualified retirement plans (401(k)s, etc.), 403(b)'s (annuities and TIAA-CREF), IRAs, Roth IRAs, governmental plans, and tax-exempt organization plans.
  - a. As of April 1, 2019, there is an inflation-adjusted cap of \$1,362,800.00 on IRA's and Roth IRAs. This cap can be increased at the discretion of the Bankruptcy Court and it does not apply to certain rollover contributions.
  - b. The Amendments took effect in October '05. They provide greater creditor protection for retirement plan assets, but only in bankruptcy. They do not apply to judgments awarded in other courts where state creditor protection laws will apply.

#### **IV. ACQUIRING REAL ESTATE WITH A SELF-DIRECTED IRA**

- A. SD IRA Investor runs across a “Fixer Upper” real estate opportunity with great upside potential. Because he has already established and funded his Self-directed IRA Account, he is in position to capitalize on the deal.
- B. **Step-by-Step Process.**
  1. Self-Director executes a Purchase and Sale Agreement reflecting the Buyer as “Foundation Trust Company, Custodian, fbo Self-Director's IRA Account.”
  2. Self-Director completes an Asset Purchase Directive instructing RealTrust, as IRA Administrator, to process the purchase on behalf of the SD IRA.
  3. Self-Director forwards the Asset Purchase Directive and Purchase Agreement to RealTrust's Operation Center for processing.
  4. RealTrust executes the closing documents on behalf of the Custodian and wires the \$250,000 purchase price to the Closing Agent.
  5. The Warranty Deed is issued in the name of:  
“Foundation Trust Company, Custodian, fbo SD's IRA Account”.
  6. Self-Director hires a contractor to Rehab the property (on behalf of his IRA).



- a. \$50k Rehab costs are funded from the additional cash in Tex's SD IRA Account.
  - b. Invoices are submitted to and paid by RealTrust.
7. Once the renovations are completed, the property goes on the market.
8. Self-Director sells the Majestic Cottage for \$400,000.00 within 13 months (rehab and marketing time combined).
9. Self-Director sends the *Sales Contract* and "*Asset Sale Directive*" to RealTrust who coordinates closing with the escrow company.
10. Prior to closing, Self-Director reviews and approves all closing documents; RealTrust executes the Deed and the sale closes.
11. The Net Proceeds are wired back into his RealTrust SD IRA Account.

#### C. RETURN ON INVESTMENT

- Initial cash investment (\$250k + \$50k):      \$300,000
  - Gain from Sale (\$400,000 - \$300,000):      + \$100,000
  - Balance in SD IRA Account after sale:      = \$400,000
1. The IRA produced a tax-deferred return on investment of \$100,000 (33.33%) in just over a year!
  2. There is no obligation to buy like-kind replacement real estate (as with a §1031 Exchange) in order to realize the tax-advantaged benefits. SD's are free to invest in whatever makes the most sense at the time.
  3. SD pays tax as distributions are made from the IRA Account.

#### D. USING A ROTH IRA/401(k) TO MAKE THE INVESTMENT

If our Self-Director used funds from a Self-Directed Roth IRA to do the deal, he pays no tax on the returns now *or* when taking distributions from his Roth Account at retirement. He keeps it totally tax free!

1. It may be difficult for many to establish and *contribute* to a Roth IRA, because they make too much money. (2019 Roth eligibility AGI limit: \$203,000/year.)
2. However, in 2010 the income limits for *converting* to a Roth IRA were eliminated, so one is now free to convert all or part of his/her Traditional IRA or 401(k) to a Roth IRA or Roth 401(k) Account. One must pay tax on the value of the amount converted, of course, unless a tax credit or loss carry-forward is available.
3. If one converts a Traditional IRA to a Roth IRA Account (\$300k), ordinary income tax would be owed on that amount, payable at the effective tax rate (e.g.- 30% or a \$90,000 +/- tax hit)! However, one's

subsequent gain would be tax-free, so he/she would more than make up the tax hit on the sale of the fixer-upper and the Roth IRA Account would produce tax-free income going forward!

## **V. LEVERAGING THE REAL ESTATE**

### **A. NON-RECOURSE FINANCING**

1. Because of the Prohibited Transaction Rules (discussed below), the IRA loan must be non-recourse to the IRA. Accordingly, the Lender can look only to the real property asset for recovery in the event of default (and not to other assets in the IRA itself or to the personal credit or assets of the IRA Holder). Accordingly, the loan-to-value ratios are generally in the 50 – 60% range in this context.
2. There are a number of local and national IRA *Non-Recourse* Lenders that specialize in the Real Estate IRA loan market.

### **B. FIXER-UPPER EXAMPLE USING 50% DEBT-FINANCING**

1.  $\$150,000.00$  Cash from the IRA (vs.  $\$300k$  cash)  
+  $\$150,000.00$  Debt-Financed  
=  $\$300,000.00$  Total Investment

[50% of the profits will be taxable]

2. Even though the IRA deploys qualified dollars for its investment in real estate, the borrowed funds are not tax-advantaged. So, a pro rata percentage (50% in this case\*) of the ongoing revenues, if any, and profit realized on the ultimate sale, will be taxable at the effective tax rate (Debt Financed Taxable Income or DFTI).

[\*The leveraged amount of  $\$150,000 = 50\%$  of the total acquisition cost ( $\$300,000$ ).]

3. Charming Fixer Example using 50% Leverage:

- 100% of net gain =  $\$100,000$
- 50% of net gain, or  $\$50,000$ , will be taxed (DFTI)
- Estimated tax due:  $\$10,000$  +/- (based on capital gain rate)

After-tax profit of  $\$90,000.00$  represents a 60% cash-on-cash return ( $\$90k/\$150k = 60\%$ )!

[Non-IRA/401(k) Investors pay the applicable tax rate on 100% of the net gain.]

### **C. AVOIDING DEBT-FINANCED TAXABLE INCOME (DFTI)**

- 1. Qualified Plans (e.g.- Solo 401(k) Plans) are statutorily exempt from DFTI on acquisition financing! [IRC §514(9)]**
- 2. Utilize a §1031 Tax-deferred Exchange to defer the DFTI!**

## **VI. USING ENTITIES TO HOLD REAL ESTATE FOR IRA’S/401(k)’S**

### **A. CHECKBOOK IRA LLC’S**

- 1. Two Self-Directors and their spouses want to purchase an office building by partnering their IRA’s with personal funds.**
- 2. They elect to create a Limited Liability Company (LLC).**
- 3. A new LLC (B. Free, LLC) is established with 10,000 authorized shares and is capitalized with \$1,000,000.00.**

#### **LLC Members and ownership interests:**

<b>Custodian FBO Tex Free IRA:</b>	<b>2500 shares for \$250,000</b>
<b>Custodian FBO Hoss IRA:</b>	<b>2500 shares for \$250,000</b>
<b>Tex and Les Free (married):</b>	<b>2500 shares for \$250,000</b>
<b>Hoss and Boss (married):</b>	<b><u>2500</u> shares for <u>\$250,000</u></b>
	<b>10,000                      \$1,000,000</b>

- 4. Transaction Summary for IRA’s (Funding the LLC)**
  - a. Tex and Hoss have already established their Fully Self-Directed IRA accounts.**
  - b. Their Attorney creates B. Free, LLC, a “Check Book IRA” limited liability company.**
  - c. Tex and Hoss send LLC documentation, Subscription Agreement and Asset Purchase Directives to Administrator.**
  - d. Clients review and approve all LLC documents.**
  - e. LLC Member Units are issued:**
    - FTC FBO Tex Free IRA (25%)**
    - FTC FBO Hoss Cartwright IRA (25%)**
    - Tex & Les Free marital community (25%)**
    - Hoss & Boss Cartwright marital community (25%)**



- RealTrust wires the funds from the IRA Accounts to the LLC's new bank account. Personal funds are also deposited.

- LLC Managers now have "Checkbook Control."

**5. Acquisition of Office Building:**

- a. B. Free, LLC initiates a contract to purchase the office building (through its authorized Managers).
- b. The LLC Managers execute the closing documents.
- c. The office building is *titled in the name of the LLC*.

**6. The LLC now owns the office building:**

- a. LLC hires a Property Manager.
- b. Property Manager leases building.
- c. Property Manager handles income and expenses.
- d. Income and expenses are run through the LLC's operating account.

**7. Three years later, LLC sells the Building.**

- a. Proceeds are wired back into the LLC's operating account.
- b. After the building is sold, the LLC monies are distributed.
- c. The pro-rated proceeds are returned to the Owners/IRA'S.
- d. Retirement Account profits are returned tax-deferred.

**B. PRIVATE PLACEMENTS**

Private placements are generally governed by Reg D and are popular investment vehicles for self-directed retirement accounts. They come in the form of LLC's, limited partnerships and non-traded REIT's, for the most part.

The principles and processes for investing in this type of vehicle parallel those of the basic LLC framework outlined above, although the structures utilize private placement memoranda and subscription agreements in order to comport with governing law.

**VII. THE IRA/401(k) AS PRIVATE LENDER**

**A. Notes, Deeds of Trust & Private Lending**

**1. IRA/401(k) funds can be used for Private Lending.**

- a. Loan money to any non-disqualified party
- b. Hold a Deed of Trust against real property

c. Applies to many situations; not just real estate:

- Equipment Leasing
- Chattel Paper
- Business Loans
- IRA/401(k) Holder determines interest rates, LTV and payment schedule.

2. Case Study: Self-Director loans \$100,000 from the SD IRA to help a Builder complete a project.

- a. The loan is secured with a First Lien Deed of Trust against the subject real property.
- b. The Property is currently appraised at \$250,000.

- 40% LTV ratio
- 12% interest/2 points
- Interest-only payments
- Balloon payment in 2 years

- c. Tex completes an *Asset Purchase Directive* instructing RealTrust to fund \$100k in the new Loan.
- d. Escrow Company/Attorney prepares the Note, DOT and closing docs showing the IRA as the “Lender”. (Foundation Trust Company, LLC fbo Tex’s IRA)
- e. Tex reviews and approves all closing docs first; RealTrust signs-off and wires IRA funds to Settlement Agent.
- f. The Deed of Trust is recorded and held by RealTrust for safekeeping.
- g. Builder makes payments to RealTrust fbo Tex’s IRA account in the amount of \$1,000/month.
- h. RealTrust receives and posts the monthly payments; Tex tracks payments *via his online account access*.
- i. In two years, the loan is repaid:

- \$26,000 of interest/points have been earned and \$100,000 loan returned to IRA.
- 13% Annual Rate of Return
- \$126,000.00 now in SD IRA account

## VIII. NAVIGATING THE POTENTIAL PITFALLS

### A. PROHITED TRANSACTIONS - (26 CFR §4975 – See Exhibit “B”)

**1. Prohibited Transactions may arise when a Disqualified Person engages in any of the following activities with an IRA:**

- a. Buy, Sell, Lease or Exchange property**
- b. Loan, Borrow Money or Extend Credit**
- c. Furnish Goods, Services or Facilities**

**2. Three key points with IRA's and Alternative Investments**

***NO self-dealing, NO personal guarantees, NO personal use!***

**3. IRC §4975- Disqualified Persons.**

**a. Common Examples of Disqualified Persons:**

- **IRA Holder (You and Your Spouse)**
- **Ancestors**
- **Lineal descendants (and their spouses)**
- **Any Fiduciary of the IRA**
- **Anyone providing services to your IRA**
- **Corporations, partnerships, trusts, or estates in which IRA Holder owns, directly or indirectly, 50% or greater interest;**
- **The Manager, Officer or Director of a disqualified entity who owns a 10% or greater interest therein.**

## **B. UNRELATED BUSINESS TAXABLE INCOME (UBTI)**

**1. IRA's/401(k)'s are deemed Tax Exempt Organizations by law (e.g.- 501(c)(3)) and are required to file Tax Form 990T when UBTI arises.**

**2. UBTI may arise when an IRA/401(k) Account realizes income that is not exempt from taxation.**

**3. Tax Exempt Categories:**

- 1. Interest Income**
- 2. Dividend Income**
- 3. Rental Income from Real Estate**
- 4. Capital Gain**
- 5. Royalties**




**4. Examples of IRA/401(k) Investments that are exempt from UBTI:**

- a. Private Lending (Interest Income)**
- b. Private Stock in C-Corp (Dividend Income)**
- c. Apartments (Rental Income from Real Estate)**
- d. Profit from Sale of Asset (Capital Gain)**
- e. Copyrighted Materials (Royalties)**

## EXHIBIT “A”

### ROLLOVER CHART

		Roll To							
		Roth IRA	Traditional IRA	SIMPLE IRA	SEP-IRA	Governmental 457(b)	Qualified Plan <sup>1</sup> (pre-tax)	403(b) (pre-tax)	Designated Roth Account (401(k), 403(b) or 457(b))
Roll From	<a href="#">Roth IRA</a>	Yes <sup>2</sup>	No	No	No	No	No	No	No
	<a href="#">Traditional IRA</a>	Yes <sup>3</sup>	Yes <sup>2</sup>	Yes <sup>2,7</sup> , after two years	Yes <sup>2</sup>	Yes <sup>4</sup>	Yes	Yes	No
	<a href="#">SIMPLE IRA</a>	Yes <sup>3</sup> , after two years	Yes <sup>2</sup> , after two years	Yes <sup>2</sup>	Yes <sup>2</sup> , after two years	Yes <sup>4</sup> , after two years	Yes, after two years	Yes, after two years	No
	<a href="#">SEP-IRA</a>	Yes <sup>3</sup>	Yes <sup>2</sup>	Yes <sup>2,7</sup> , after two years	Yes <sup>2</sup>	Yes <sup>4</sup>	Yes	Yes	No
	Governmental <a href="#">457(b)</a>	Yes <sup>3</sup>	Yes	Yes <sup>7</sup> , after two years	Yes	Yes	Yes	Yes	Yes <sup>3,5</sup>
	<a href="#">Qualified Plan<sup>1</sup></a> (pre-tax)	Yes <sup>3</sup>	Yes	Yes <sup>7</sup> , after two years	Yes	Yes <sup>4</sup>	Yes	Yes	Yes <sup>3,5</sup>
	<a href="#">403(b)</a> (pre-tax)	Yes <sup>3</sup>	Yes	Yes <sup>7</sup> , after two years	Yes	Yes <sup>4</sup>	Yes	Yes	Yes <sup>3,5</sup>
	<a href="#">Designated Roth Account</a> (401(k), 403(b) or 457(b))	Yes	No	No	No	No	No	No	Yes <sup>6</sup>

## **EXHIBIT “B”**

### **26 U.S. Code § 4975. Prohibited Transactions**

#### **(c) Prohibited transaction**

(1) General rule. For purposes of this section, the term “[prohibited transaction](#)” means any direct or indirect—

- (A) [sale](#) or exchange, or leasing, of any [property](#) between a [plan](#) and a [disqualified person](#);
- (B) lending of money or other extension of credit between a [plan](#) and a [disqualified person](#);
- (C) furnishing of goods, services, or facilities between a [plan](#) and a [disqualified person](#);
- (D) transfer to, or use by or for the benefit of, a [disqualified person](#) of the income or assets of a [plan](#);
- (E) act by a [disqualified person](#) who is a [fiduciary](#) whereby he deals with the income or assets of a [plan](#) in his own [interest](#) or for his own account; or
- (F) receipt of any consideration for his own personal account by any [disqualified person](#) who is a [fiduciary](#) from any party dealing with the [plan](#) in connection with a [transaction](#) involving the income or assets of the [plan](#).

(2) **Disqualified person.** For purposes of this section, the term “[disqualified person](#)” means a [person](#) who is—

- (A) a [fiduciary](#);
- (B) a [person](#) providing services to the [plan](#);
- (C) an employer any of whose [employees](#) are covered by the [plan](#);
- (D) an [employee organization](#) any of whose members are covered by the [plan](#);
- (E) an [owner](#), direct or indirect, of [50 percent](#) or more of—
  - (i) the combined voting power of all classes of [stock](#) entitled to vote or the total value of shares of all classes of [stock](#) of a [corporation](#),
  - (ii) the capital [interest](#) or the profits [interest](#) of a [partnership](#), or
  - (iii) the beneficial [interest](#) of a [trust](#) or unincorporated enterprise, which is an employer or an [employee organization](#) described in subparagraph (C) or (D);
- (F) a member of the [family](#) (as defined in paragraph (6)) of any individual described in subparagraph (A), (B), (C), or (E);



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