
The Do's & Don'ts
of Promissory Note
Solo 401k Investment
Dos
Don'ts

Dos		Don'ts
Do confirm if your solo 401k can be invested in alternative investments such as promissory notes. • While the solo 401k plan document outlines the types of investments allowed under the Plan, the solo 401k provider may place restrictions.	Confirm	Don't invest if your solo 401k provider does not allow for it. • If the Note investment is made under a solo 401k plan that does not allow for alternative investments, it may result in a taxable distribution.

Dos | Don'ts

Do get the solo 401k funds in order.

- You may need to transfer additional retirement funds and/or make an annual contribution.

Liquid Funds

Don't lend funds to your solo 401k plan.

- The rules don't allow for loans to a solo 401k plan for making solo 401k Note investments.

Dos

Don'ts

Do draw up Promissory Note investment paperwork.

- The note investment is documented in writing NOT by a handshake.
- Documents include the Note instrument, payment schedule and documents securing the Note investment for secured notes.

Document Investment

Don't forget to include the terms of the Promissory Note.

- The purpose of the Note investment is to grow the solo 401k, so don't omit the interest rate, if the loan is secured or unsecured, the length of the note and the type of interest (simple vs compound).

Dos

Don'ts

Do list the solo 401k as the lender/beneficiary.

- The solo 401k is the lender, so confirm it is listed on the note in the name of the solo 401k plan.
- For Example: Jane Do, Trustee of Four Squares Trust

Proper Title

Don't list the solo 401k provider as the borrower, as it is prohibited to lend funds to your solo 401k provider.

Dos

Don'ts

Do confirm the borrower is not a disqualified party. It would prohibited to process a Note to your parents, children and their business, for example.

Borrower

Don't lend the solo 401k funds to yourself.

- A Promissory Note falls under the investment umbrella.
- However, you can borrow from your own solo 401k plan via a participant loan, provided it is done pursuant to the solo 401k participant loan rules.

Disqualified Persons

You & Certain Family Members:

- Your Spouse
- Your Natural Parents
- Your Adoptive Parents
- Your Natural Children
- Your Adopted Children
- Spouses of your natural children
- Any people providing services to your plan

Entities Controlled by You or Family Members

- Corporation
- Partnership
- Trust
- Estate
- Commercial Paper

Common Prohibited Transactions

Promissory Note:

- Loaning solo 401k funds to your parents.
- Loaning solo 401k funds to your business.
- Loaning solo 401k funds to your spouse's business.

Common Prohibited Transactions

Illustration 1

promissory note to daughter

Tina loans $50,000 from her Solo 401k to her daughter charging her 10% interest per year. This is considered a prohibited transaction because Tina's daughter is considered a disqualified person.

Illustration 2

Lending of money or other extension of credit between a plan and a disqualified person.

Sue's solo 401k plan has a balance of $100,000. Her father recently started a new business and needs a short-term loan to cover payroll. Sue offers to loan $60,000 from her solo 401k to her father in a form of a promissory note paying 8 (eight) percent interest in 12 monthly installments. This investment deemed prohibited because Sue's father falls under the disqualified party umbrella.

Family Member

Illustration 1

While helping a family member is something one should not have to think twice about, helping a family member with your solo 401k plan can result in a prohibited transaction under the Internal Revenue Code (the “Code) and the ERISA rules.

For example, a son asks his mother, who is an advisor at a broker-dealer, to manage his self-directed 401k plan, any compensation paid to the mom would be a prohibited transaction. That is, the son is causing a family member – a person in whom he presumably has an interest that could affect his fiduciary judgment – to receive compensation.

Such transaction is considered a prohibited transaction because the mother is a “member of the family” of the fiduciary (the son). The Code defines a family member as the fiduciary’s “spouse, ancestor (e.g., parent or grandparent), lineal descendant (e.g., child, grandchild), and any spouse of a lineal descendant.”

Such transaction would not run afoul with the prohibited transaction rules, however, if the advisor (the mom) did not receive compensation for the advice.

In sum, advisors (and their firms) should not provide advice to family members about transferring their IRAs or 401k plans or about investing their solo 401k or IRA assets… unless they waive compensation for the advice.

Family Member Continued

Illustration 2

Q: My brother is considering purchasing a vacation rental property from my father. Can my 401K loan my brother the funds to make the purchase?

A: While it is not prohibited to invest one’s solo 401k funds via a promissory not to the solo 401k owner’s sibling, it is prohibited for the sibling to turn around and loan/invest those funds to the solo 40k owners parents. Such transaction would be deemed a roundabout/straw-man transaction which would result in a solo 401k prohibited transaction.

Dos | Don'ts

Do wire the funds directly to the borrower.

- Make sure the Note investment funds flow directly to the borrower's bank account; otherwise, it may result in a taxable distribution from your solo 401k plan.

Funding

Solo 401k Distribution

Don't first loan your personal or business funds to the borrower and then have your solo 401k reimburse you.

Dos		Don'ts
Do make sure the Note payments are made direclty to the solo 401k plan. • Once Note payments commence, they need to be deposited directly into the solo 401k bank or brokerage account.	Note Payments	Don't first deposit the Promissory Note payments into your personal or business bank account. • The lender is the solo 401k plan; therefore, note payments and final payoff must be deposited directly into the solo 401k account.

Solo 401K: Learn More!

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