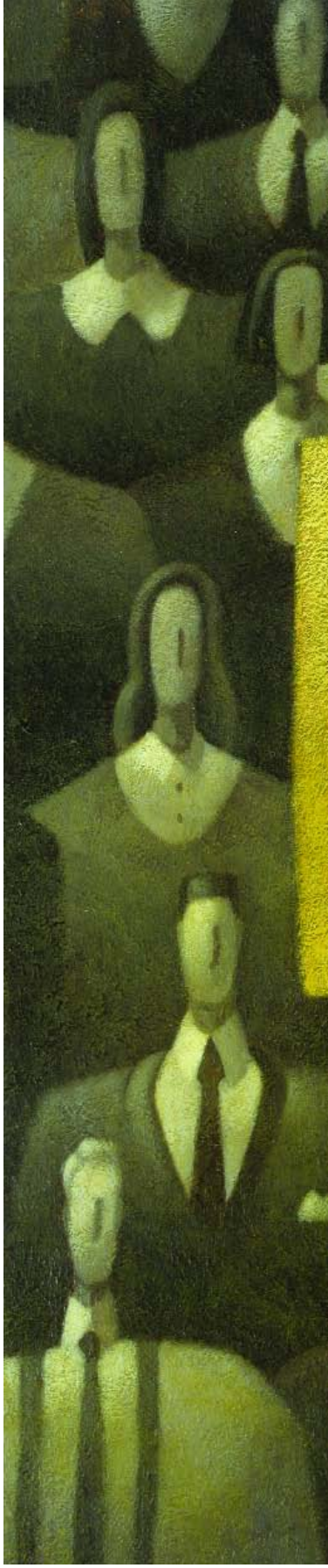
You Want to Do What



This article addresses the legal, compliance, and IRS reporting concerns associated with unique assets such as real estate and limited partnerships in IRAs.

Most trust departments and wealth management departments (referred to collectively as "trust departments") do not go out in search of clients who want to hold real estate or limited partnerships in their IRAs. They usually take this kind of business to get other, more lucrative, business from the client. Some trust department managers might think they don't have this type of asset in their IRAs, but a close look at their book of business will show that they do. This leads to significant compliance concerns that may lie dormant for years before posing compliance or legal issues for the bank. However, if knowledgeable administrators following established compliance guidelines handle these assets properly, they can greatly reduce the risk to the institution. (Of course, it's good to remember that trust departments do have the option of saying "no" to this type of asset. There are a number of IRA custodians around the country that specialize in handling unique assets, and in many cases it makes sense to refer this type of business to them.)

By John N. Singletary Jr., CISP, CRSP, CFP

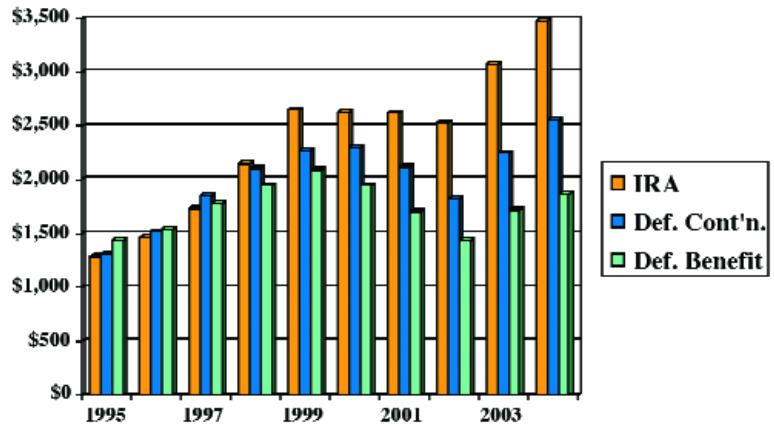
With Your IRA?

Illustration by Rob Colvin © images.com

Until recently, the issue of unique assets in IRAs was not significant because IRAs have typically made up a small percentage of the overall trust department's book of business. However, with an aging baby boomer generation, the IRA rollover business has been on a drastic upswing that will continue for nearly 20 years. Exhibit 1 (next page) shows how the total assets in IRAs have surpassed assets in defined contribution plans as well as defined benefit plans.

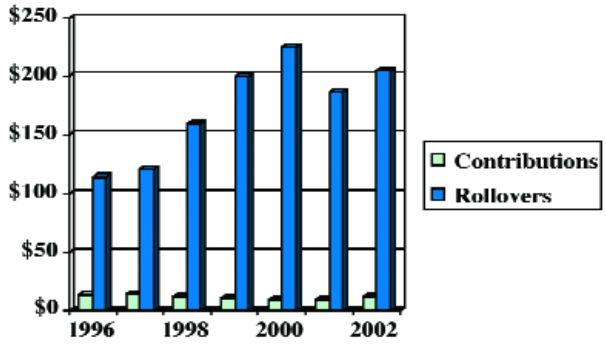
Exhibit 2 shows the rapid increase in rollovers from employer plans to IRAs over the last several years compared to regular annual IRA contributions. The point here is that total assets in IRAs are growing rapidly, becoming a much more significant piece of business for trust departments. With that growth comes the likelihood of having more unique assets in IRAs.

Exhibit 1: Growth of Private U.S. Retirement Assets



Source: Employee Benefits Research Institute, January 2006 EBRI Notes

Exhibit 2: Total Annual IRA Contributions and Rollovers



Source: Fundamentals, Vol. 14, No. 4A, copyright 2005 Investment Company Institute

This article will first address general rules that apply to unique assets in IRAs (e.g., valuation of assets, prohibited transactions, unrelated business taxable income, etc.), then provide more detail on specific types of IRA assets.

ASSET VALUATION

The IRS requires all assets in all IRAs to be valued at every year-end.[1] This requirement applies regardless of the following issues:

- The IRA provider is serving as IRA custodian or IRA trustee. (This article will use the term "trustee" to refer to trustees and custodians collectively.) The IRS considers IRA trustees and custodians subject to the same reporting and other requirements.[2]
- The trustee or the IRA client or "grantor" manages the IRA investments. Investment authority has no impact on tax reporting requirements.
- The IRA grantor has provided a written statement that the IRA trustee does not need to obtain an accurate market value on certain assets. The client does not have the authority to waive IRS requirements.
- The IRA grantor is subject to required minimum distributions.

Obtaining an accurate year-end market value is simple with assets such as bank deposits, actively traded securities, and even many publicly traded limited partnerships. However, real estate, private placement limited partnerships, closely held stocks, etc., are unique assets and generally are not actively traded. In these cases, obtaining a true market value is much more challenging and typically requires having the IRA pay for an appraisal of that asset. Because most bank branches and brokerage firms restrict their IRAs to exchange-traded securities, such valuation issues are generally not a concern for them. It's only the bank trust departments, wealth management departments, and certain IRA custo-

dians that handle unique assets and therefore must be in the business of hiring appraisers to properly value unique assets.

When the IRS says "fair market value," what exactly does it mean? In a 1993 General Information Letter,[3] the IRS points to its definition of market value for estates: "the price at which the property would change hands between a willing buyer and a willing seller, neither under any compulsion to buy or sell and both having a reasonable knowledge of the relevant factors."[4] In other words, the IRS wants trust departments to follow the same procedures for year-end IRA asset valuations as they do for estate valuations.

Many IRA trustees feel they are not responsible for obtaining valuations on unique assets. In the same IRS General Information Letter referenced above, the IRS states that IRA assets must be valued annually regardless of how hard they are to value and "the person responsible for insuring that an IRA's assets are properly valued is the IRA trustee or issuer."

PROHIBITED TRANSACTIONS

The prohibited transaction rules in the Internal Revenue Code apply to IRAs.[5] All of the following direct or indirect transactions are prohibited:

- sale, exchange, or leasing of any property between a plan and a disqualified person
- lending of money or other extension of credit between a plan and a disqualified person
- furnishing of goods, services, or facilities between a plan and a disqualified person
- transfer to, use by, or transfer for the benefit of a disqualified person of income or assets of a plan
- 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 (self-dealing)
- receipt of any consideration for his 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

All of the transactions listed above mention "disqualified persons." So, the usual challenge is to determine whether a party to the transaction is a disqualified person. Identifying "self-dealing" often becomes murky and will frequently require the guidance of legal counsel, whose fees must generally be paid by the IRA. The issue of when fees can be paid out of the IRA grantor's pocket as opposed to the IRA is discussed later, under "Fees."

Following is a simplification of how the Internal Revenue Code defines disqualified persons:

- any fiduciary to the IRA, including IRA trustee and the IRA grantor, because the owner has the ultimate power to direct the investments in the IRA
- the IRA grantor's spouse
- the IRA grantor's ancestors and lineal descendants
- spouses of the IRA grantor's lineal descendants
- anyone providing services to the IRA (e.g., investment managers/advisers and the IRA trustee or custodian)
- any corporation, partnership, trust, or estate in which the IRA grantor or family member listed above has a 50 percent or greater interest

In summary, virtually any transaction between an IRA and a disqualified person is a prohibited transaction. In addition, any self-dealing by a disqualified person who is a fiduciary to the IRA is considered a prohibited transaction. Self-dealing can include a wide array of activities, such as the IRA grantor's hunting or camping on land owned by the IRA, the IRA grantor's using a beach or mountain condominium owned by the IRA, and the IRA's purchasing land adjacent to land owned by the IRA owner in order to drive up the value of the IRA owner's land.

Through an arrangement between the IRS and the Department of Labor (DOL), it is the DOL's responsibility to determine whether a specific transaction is a prohibited transaction and to issue prohibited transaction exemptions.[6] When the IRS discovers what appears to be a prohibited transaction in an individual's IRA, it turns the matter over to the DOL to make the determination. The DOL reviews the situation and responds to the IRS, which in turn responds to the taxpayer. If the IRA grantor wants to apply for a prohibited transaction exemption, he or she must apply to the DOL.

As mentioned above, the DOL has the authority to issue prohibited transaction exemptions. Some, known as "prohibited transaction class exemptions" (PTCEs), are available for anyone's reliance, while others, called "individual prohibited transaction exemptions" (PTEs), are issued only to the applicant.

Two well-known prohibited class transaction exemptions are PTCE 93-1 and PTCE 93-33. These are often referred to as the "free toaster" exemptions, because they allow IRA trustees to provide nominal gifts to IRA customers without disqualifying their IRAs. Those offering gifts to IRA prospects must be cognizant of the limits under these PTCEs.

It should be pointed out that if a trust department manages the investments of an IRA and it uses proprietary mutual funds that pay the IRA trustee (or a subsidiary) an investment advisory fee, this is a prohibited transaction. Fortunately, PTCE 77-4 provides money managers with protection from the prohibited transaction rules if they follow certain rules. One of these basic rules prohibits "double dipping," meaning that managers cannot charge account level market value-based fees on those funds and keep the investment advisory fees of those funds—they can do one or the other but not both. This is a complex area and any institution offering proprietary mutual funds to IRA clients in its trust department must seek the guidance of legal counsel.

The penalty to the IRA grantor for a prohibited transaction in an IRA is significant: The entire IRA becomes taxable as of the first day of the year in which the prohibited transaction occurred.[7] For example, a $10,000 prohibited transaction in a $1 million IRA in December 2005 causes the entire $1 million IRA to be taxable as of January 1, 2005.

The penalty to the IRA trustee for engaging in a prohibited transaction is the same as the penalty for prohibited transactions in qualified retirement plans[8]: 15 percent for each year the prohibited transaction goes without correction. An additional 100 percent applies if the prohibited transaction is not corrected in a timely fashion. Whether and when the IRA trustee is "engaged in" a prohibited transaction can be a gray area. Frequently, the IRA trustee is unaware of the specifics of the IRA investment that would cause it to be a prohibited transaction. If the trustee is knowingly involved in the transaction (especially in multiple prohibited transactions), the trustee can be subject to IRS penalties.

The IRA trustee should also be concerned with how the IRA grantor will respond to prohibited transaction determinations. There have been many lawsuits where IRA grantors allege that the IRA trustee should have warned them that the investment was a prohibited transaction prior to allowing the investment. Although there is no guarantee that an IRA grantor will not sue the trustee under these circumstances, appropriate language in the IRA document and in an investment direction form (signed by the client) should lessen the likelihood of a successful lawsuit against the trustee.[9]

If the IRA grantor insists on proceeding with the transaction, the IRA trustee has several options:

- **Refuse to conduct the transaction.** If the transaction is an obvious prohibited transaction, refuse to conduct the transaction. Failure to stop the transaction leaves only one option available to the IRA trustee after it is conclusively proved

that a prohibited transaction has occurred—issue a 1099-R to the client and the IRS informing them of the taxability of the entire IRA. Legal guidance should be obtained as soon as it is known a potential prohibited transaction may have occurred.

- **Resign as trustee.** If the transaction is suspected of being prohibited, the IRA trustee may resign. This must be done *before* the transaction has occurred. If the grantor ignores the warnings and wants to proceed with the transaction anyway, he or she must transfer the IRA to an institution that, for whatever reason, is willing to allow the transaction. It's better to let this type of business walk out the door than to incur major compliance issues in the future.
- **Obtain a prohibited transaction exemption.** Recommend to the client that he or she apply to the DOL for a prohibited transaction exemption prior to conducting the transaction.
- **Require that the IRA owner sign a hold-harmless statement.** This should not be used for transactions that are clearly prohibited and the IRA trustee should seek legal counsel before taking this route. It is suggested that the hold-harmless language be built into the investment direction form referenced above. In this way it cannot later be alleged by the IRA grantor that the IRA trustee had prior knowledge that the investment was a prohibited transaction.
- **Open a separate account.** Require that the IRA grantor open a separate account for this questionable transaction. This allows the grantor's other IRA assets to not become taxable if the transaction is later determined to be a prohibited transaction. Again, this practice should be applied only to transactions that are not clearly prohibited transactions.

In the unfortunate case where it appears that a prohibited transaction has already occurred in an IRA, the trustee should consult its legal counsel, risk management department, or compliance department. First, it must be determined whether a prohibited transaction has in fact occurred. Second, if it has occurred, how should the matter be presented to the IRA grantor? It would generally be best to inform the client prior to his or her receiving the 1099-R reporting the taxability of the entire IRA. Generally, the greater the tax ramifications to the client, the greater the chance he or she will want to place the blame with the IRA trustee. Involving the appropriate legal or compliance personnel from the beginning will help control the situation.

Generally, the greater the tax ramifications to the client, the greater the chance he or she will want to place the blame with the IRA trustee. Involving the appropriate legal or compliance personnel from the beginning will help control the situation.

UNRELATED BUSINESS TAXABLE INCOME

This is another area that causes confusion for IRA trustees and custodians. Certain investments generate unrelated business taxable income (UBTI). If the UBTI exceeds $1,000 in a tax year, the UBTI is taxable on a current basis to the IRA at trust rates. Yes, the IRA can actually owe income taxes on an annual basis on UBTI. As with valuing securities, many IRA trustees feel they have no responsibility in reporting UBTI. This is not the case: The IRS has made it abundantly clear that the IRA trustee or custodian is responsible for filing Form 990-T and paying the taxes from the IRA.[10]

An IRA investment can generate UBTI in one of two ways:

- **Operation of a business.** Although it is rare for an IRA to actually own and operate a business, requests like this do come in from IRA grantors. An example would

The tax on UBTI amounts to a significant penalty that makes it difficult for any investment generating UBTI to be justifiable on an after-tax basis.

be where the IRA grantor wants to direct his or her IRA to purchase and operate a franchise. If that franchise generates more than $1,000 per year in income, the IRA would be required to file Form 990-T and pay taxes on that income.

- **Debt-financed income.** Probably the most common case of IRAs' generating UBTI is through the use of debt financing. If an IRA uses debt to enhance its investment returns, earnings attributable to that debt are subject to the tax on UBTI. For instance, the Department of Labor has determined that IRAs can be margined[11]; however, earnings attributable to the margin loan would be subject to the tax on UBTI. Another example is if the IRA grantor directs the IRA trustee to purchase unimproved real estate in his or her IRA and then borrow against that real estate to make improvements to the property. In such a case, the earnings attributable to that debt would be subject to the tax on UBTI. (If the IRA grantor were to use the proceeds from this leverage to benefit himself or herself outside of the IRA, it would be a prohibited transaction.)

The above examples involving UBTI are somewhat rare. However, a common IRA investment that can generate UBTI is limited partnerships, because many limited partnerships use debt to enhance their returns. Due to the legal structure of limited partnerships, UBTI on any debt financing is passed on to retirement plans that hold them. For more on this, see "Limited Partnerships" below.

The tax on UBTI is substantial because it is calculated at trust rates, which can add up very quickly. In 2005, the marginal trust tax rate was 35 percent starting at $9,750 of taxable income. Also, if the UBTI tax is expected to be in excess of $500, the IRA trustee must file quarterly estimated tax returns on Form 990-W. Finally, some states have an equivalent to the federal UBTI tax.

The last significant point to make on UBTI is that the retirement plan gets no basis in the earnings subject to unrelated business income tax. In other words, if over a number of years an investment in an IRA generates UBTI totaling $100,000, those earnings will ultimately be taxed again when they are distributed to the IRA grantor from the IRA. The tax on UBTI amounts to a significant penalty that makes it difficult for any investment generating UBTI to be justifiable on an after-tax basis.

Titling and Possession of Property

It is critical that all IRA investments be registered or titled in the name of the IRA or a nominee name for the IRA trustee. In addition, the IRA trustee must take possession of the evidence of ownership of that property (e.g., stock certificate or legal title). Frequently, the IRA grantor will be present at the closing for the purchase of the property and will have the property titled in his or her name. He or she will later tell the IRA trustee about the transaction and attempt to have the investment booked into the IRA. This creates a prohibited transaction because the IRA grantor is essentially selling the investment to his or her IRA. The proper procedure is for a representative of the IRA trustee to be present at the closing, sign the necessary documents, and present a check drawn from the IRA. Also, when assets are rolled over from a qualified plan or transferred from another IRA, those assets must be re-titled in the new IRA trustee's name. Failure to take these steps can cause problems when the IRA grantor wants the

IRA to sell the asset, only to learn that the IRA trustee never took proper title to the property.

Liquidity

Compared to the above issues, liquidity is straightforward. Most unique assets held in IRAs are illiquid, which makes it difficult to distribute required minimum distributions (RMDs) at age 70½ and to collect IRA trustee fees if there are no liquid assets in the account. With regard to RMDs, if the IRA has no liquidity, an asset can be distributed as a taxable distribution that would count toward the RMD. The unique asset must be valued at the time of distribution. Distribution of a partial interest in an asset can cause a prohibited transaction if it leaves the IRA and the IRA grantor together owning 50 percent or more of the asset (see "Prohibited Transactions" above). Sometimes a client will move an IRA's marketable assets to another institution that will not accept unique assets, leaving the IRA trustee with only the unique assets. This can easily be avoided by communicating to the client in advance that the IRA trustee will resign as trustee of the IRA and the unique asset will be distributed to the grantor as a taxable distribution if the IRA grantor does not deliver transfer instructions for a new IRA trustee or custodian within a given time frame. Nearly all IRA documents provide for the resignation of the trustee, but the terms of that resignation can vary from document to document (e.g., 30-, 60-, or 90-day notice), so the trustee must be certain to follow the resignation provisions of its IRA document. Because this issue is relatively simple, it will not be specifically addressed for each investment type described below, although it can apply to any of them.

Fees

It is appropriate to charge more for administering unique IRA assets than for administering exchange-traded securities. For example, prior to the purchase of real estate for an IRA (directed by the IRA grantor), the trustee typically must expend time and effort to properly inspect the property to ascertain environmental contamination issues, liability issues, and the like. On an ongoing basis, the trustee must pay property taxes and liability insurance premiums, hire tradesmen to make repairs, and hire appraisers for annual appraisals, among other duties. The way these fees are calculated (e.g., market value-based, based on a specific service, or based on hours) are at the discretion of the IRA trustee. However, these fees must be communicated to the IRA grantor prior to accepting the unique asset, either when the client initially signs the IRA agreement, at the time of purchase of the asset, or both.

IRA trustee's fees, such as a trust department's "account level" market value fee, may be billed to the IRA grantor, but the grantor's check must be processed outside of the IRA. If the fee is first charged to the IRA and then the IRA grantor's check is deposited to the IRA (effectively reimbursing the IRA), the IRS considers the deposit of the grantor's check to be a regular IRA contribution.[12] Administrative fees deducted from the IRA balance are not taxable distributions.[13] Brokerage commissions may not be billed to the IRA grantor.[14]

Because this issue is less complex than many others, it will not be addressed for each investment type described below.

Does This IRA Investment Make Business Sense for the Trustee?

The IRA trustee should make a business assessment of each situation and determine whether allowing the investment is in the best interest of the trustee from a business standpoint as well as from a compliance standpoint. Of course, this decision must be made in light of the overall relationship with the IRA grantor. Many times, trust officers are reluctant to say "no" to a client, even when that is the right answer for the trustee (it usually is for the IRA grantor, too, but they typically cannot see it at the time). Because this issue is not as complex as the above issues, it will not be addressed for each investment type described below.

HOW THESE ISSUES IMPACT SPECIFIC TYPES OF INVESTMENTS

Real Estate

Real estate tends to be the most labor-intensive asset to administer in an IRA. It requires two types of specialists: the IRA specialist who is familiar with the above issues, and the real estate specialist, who knows how to oversee real estate purchases and sales, ascertain the necessity of environment audits, and hire appraisers, among other tasks. An environmental audit is not always necessary, but it takes an experienced real estate professional to know when one is. The potential liability for the IRA trustee or custodian in this area is enormous. In spite of the potential headaches, IRA grantors are more interested than ever in having their IRAs purchase real estate. Newspaper and magazine articles alluding to massive potential returns without addressing the expenses and compliance issues that go along with this type of investment have fed this interest.

- **Valuations:** Real estate in an IRA must be valued at every year-end. The valuation standards described above indicate that the IRS applies the same valuation standard as it does for valuing estates. Clients frequently ask if a real estate tax assessment suffice for market value determination. The tax-assessed value of property does not meet IRS standards for valuing assets in an estate, so it does not appear to be appropriate for valuing IRAs either.[15]

- **Prohibited transactions:** Real estate purchased in an IRA risks qualifying as a prohibited transaction, which may not be evident to the IRA trustee prior to the purchase of the property. As part of its due diligence prior to the purchase of real estate, the trustee must ask several questions:

  - **Who is selling/buying the property to/from the IRA?** If it's a disqualified person, it's a prohibited transaction. For instance, if it's a corporation, partnership, or trust that is more than 50 percent owned by the IRA owner or a family member, it is a prohibited transaction. If a disqualified person gets some form of personal benefit or the use of the income from an IRA investment, that also is a prohibited transaction.
  - **Who will be providing services to the IRA to manage the unique investment?** If the IRA grantor is a real estate broker or developer, as is often the case, he or she may not charge a fee for any services he or she provides to the IRA (e.g., collecting rent, hiring repairmen, or lining up a buyer or seller for the property). To be safe, the IRA grantor should avoid providing any services to the IRA, regardless of whether a fee is charged.
  - **Who will be signing the legal documents at closing?** It has to be either the IRA trustee or its agent. No disqualified person can sign at the closing.
  - **Does any party other than the IRA stand to benefit from the transaction?** If the seller of the property is not a disqualified person, but a disqualified person owns the property surrounding the real estate in question, that disqualified person is likely to benefit from the transaction, making it probable that the Department of Labor will determine it is a case of self-dealing in the event it is caught in an IRS audit.

- Unrelated business taxable income:

  - **Operation of a business:** Real estate investments are exempt from many of the UBTI rules, so it can be somewhat complicated to determine when the UBTI rules apply for real estate investments and when they don't. For example, consider that an IRA holds rental property, such as a

Limited partnerships (LPs), including hedge funds, family limited partnerships, and limited liability corporations (LLCs), are likely the most widely held unique asset that can raise many of the compliance issues discussed above.

condominium at the beach. Management of the condominium (weekly rentals, cleaning, and repairs) requires active management of that property. Is the IRA operating a business? The best approach for the IRA trustee and the grantor is to get a letter from the client's tax advisor stating whether the activity in question constitutes UBTI.

- **Debt-financed property:** If the IRA is using debt leverage to enhance the returns on the real property, the normal rules of UBTI apply. As mentioned above, UBTI taxes amount to a significant penalty, which typically makes the investment not justifiable from an after-tax return standpoint.

Limited Partnerships

Limited partnerships (LPs), including hedge funds, family limited partnerships, and limited liability corporations (LLCs), are likely the most widely held unique asset that can raise many of the compliance issues discussed above. Most domestic hedge funds, all family limited partnerships (FLPs), and many small businesses fall into this category. They each have their own issues, which will be addressed below. It is not within the scope of this article to address the specific tax benefits (if any) and valuation risks of FLPs. The reader should at least be aware that the IRS does not look fondly on FLPs and it seems to have gained some traction in tax courts since the Strangi case.[16]

- **Valuation:** Publicly traded limited partnerships are generally exchange traded, so a year-end market value can be obtained easily (their value is typically obtained from the same daily download as exchange-traded stocks and bonds). Private placement limited partnerships are much more of a challenge to value, so a valuation service typically must be hired to provide year-end valuations. The price for this service can vary from a few hundred dollars to thousands of dollars, depending on the complexity of the partnership and its holdings. In some cases, general partners will employ a valuation service and provide the year-end value to the LP holders. If the valuation is by a reputable service, this should be acceptable to the IRS. However, if it's just the general partner's estimate of the value of the LP, this would likely not be acceptable to the IRS.
- **Prohibited Transactions:** The standard prohibited transaction rules apply to limited partnerships. The investment must be scrutinized prior to purchase to verify that the transaction is not with a disqualified person and does not constitute self-dealing. FLPs deserve special scrutiny in this area because they involve the IRA's purchasing an interest in a partnership that is entirely owned by the IRA grantor's family members. Many attorneys rely on *Swanson v. Commissioner*[17] to establish that buying an FLP is not a prohibited transaction. If the IRA trustee is inclined to allow an IRA to purchase an interest in an FLP, it is strongly recommended that the IRA grantor or the IRA trustee obtain a written opinion from the attorney stating that the transaction is not prohibited under Code Sections 4975 and 408.
- **Unrelated business taxable income:** Limited partnerships are likely the most common source of UBTI for IRAs because they are so widely held (by trust departments and brokerage firms) and because they are typically leveraged. Debt lever-

age causes problems for domestic hedge funds held in IRAs. Most domestic hedge funds are highly leveraged and are structured as limited partnerships. For this reason, IRAs (and retirement plans in general) typically must buy offshore hedge funds, which are structured as corporations, thus negating the UBTI issue. Fortunately, most hedge fund providers have both domestic and offshore versions of every fund style they offer. As mentioned earlier, if an IRA has more than $1,000 in UBTI, the IRA trustee or custodian is required to file IRS Form 990-T and pay taxes on the UBTI.

Closely Held Securities

Closely held securities present both valuation and prohibited-transaction concerns. By definition, these companies are not widely held and there is no ready market for them. It's even questionable in many instances whether a recent trade outside of the IRA might establish a fair market value for the security because the transaction may have been conducted under special circumstances between family members. Therefore, an appraisal of the security must be done at every year-end and at the time of distribution from the IRA. Prohibited transactions are of great concern because many closely held securities are held entirely by members of the same family. UBTI is not an issue here because the closely held company is structured as a corporation rather than a limited partnership.

S Corporations

S corporations may not be held by IRAs. The problem lies with the IRS requirements for S corporations and not with the IRA rules.[18] If an IRA purchases shares of an S corporation, the corporation loses its special tax status, which impacts *all* of the corporation's shareholders. Rectifying the situation after it has occurred is complicated and requires the involvement of a tax attorney or CPA who is knowledgeable in this area. Special procedures apply to rollovers from ESOP plans where the employer is an S corporation.[19] In this case, the ESOP plan administrator must be closely involved with the rollover process to make certain the corporation's tax status is not endangered.

Notes and Mortgages

The primary area of concern with notes and mortgages held in IRAs is prohibited transactions. The IRA cannot purchase the note or mortgage of any disqualified person (IRA grantor, family members, etc.) and it cannot engage in self-dealing with a disqualified person. The IRA trustee must determine in advance whether it is willing to be responsible for processing monthly payments of principal and interest, paying liability insurance premiums and real estate taxes, and informing the IRA grantor when note payments are late. The alternative would be to assign these tasks to an outside agent who would be paid from the IRA or draw fees from the payments as they are processed. Also, is the trustee willing to take possession of the collateral on the note or mortgage if it goes into default? Will an environmental audit be required prior to accepting the mortgage, or will it be required only at the time the mortgage goes into default? With regard to valuations, many institutions take the position that the principal balance on the note or mortgage should be acceptable to the IRS as fair market value. It appears this is a reasonable position as long as payments on the note or mortgage are current; however, the trustee should obtain its own guidance on this matter.

Prohibited Investments

IRAs are prohibited from investing in life insurance and certain collectibles,[20] such as artwork and collectible automobiles. Certain coins and bullion are exempt from this prohibition,[21] but they must be in the possession of the IRA trustee. Also, new loopholes are constantly being discovered in the tax law, such as Roth conversion transactions involving annuities with high short-term surrender charges that temporarily show a low value for income tax purposes at conversion. Many of these loopholes are being closed by

legislation or tax court cases shortly after they are discovered. It is up to the trustee to determine whether it will accept a questionable transaction that could become prohibited in the future.

CONCLUSION

This article has addressed the six primary areas of concern for IRAs holding unique assets:

- year-end valuation
- prohibited transactions
- unrelated business taxable income
- liquidity
- fees
- whether the investment makes business sense for the IRA trustee

If an IRA trustee is going to accept even one unique asset, it must have clearly established policies and guidelines, as well as knowledgeable specialists in this field. Although real estate is the current hot topic in this area, many trust departments hold other types of unique assets in their IRAs. For an institution to ignore any of the issues addressed here may invite legal and compliance problems. ti

[1] 2005 Instructions for IRS Form 5498, box 5; IRC 408(i) and 6047(c); Reg. 1.408-5, Prop. Reg. 1.408(c); Rev. Procs. 94-35 and 89-52.
[2] IRC Code 408(h), Treasury Reg. 1.408-2(d).
[3] General Information Letter to Brad Davidson, Partnership Valuations, Inc., February 24, 1993.
[4] Reg. 20.2031-1(b); Revenue Ruling 59-60, 1959-1 C.B.237, as modified by Revenue Ruling 65-193, 1965-2 C.B. 370.
[5] IRC 408(e)(2)(a), IRC 4975.
[6] Reorganization Plan #4 of 1976, IRS Announcement 79-6, Cumulative Bulletin 1979-1, C.B. 480.
[7] IRC 408(e)(2)(A).
[8] Treasury Regulation 1.408-1(c)(3).
[9] Metz v. Independence Trust Corp., No. 92-1653, 7th Circuit 1993.
[10] IRS Form 990-T, IRS Publication 598, "Tax on Unrelated Business Income of Exempt Organizations," and IRS General Information Letter to Pension Management Co., Inc., 3/26/01.
[11] DOL Opinion Letter 86-12A.
[12] IRS Revenue Ruling 84-146 and 86-142, IRS Private Letter Rulings 8329049, 8711095, 8747072, and 8830061.
[13] Private Letter Rulings 9845003 and 9005010.
[14] IRS Private Letter Ruling 8711095.
[15] General Information Letter to Brad Davidson, Partnership Valuations, Inc., February 24, 1993; Revenue Ruling 59-60, 1959-1 C.B.237, as modified by Revenue Ruling 65-193, 1965-2 C.B. 370.
[16] Strangi v. Commissioner, U.S. Court of Appeals, Fifth Circuit, docket #03-60992, 11/7/2005.
[17] *Swanson v. Commissioner*, Tax Court 1996.
[18] IRS Revenue Ruling 92-73, 1992-2 C.B. 224.
[19] Private Letter Ruling 00240038.
[20] 20IRC 408(m)(2); Prop. Reg. 1.408-10, Article III of IRS Forms 5305 and 5305A.
[21] IRC 408(m)(3)(A), (B) & (C).

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