

By Thomas C. Foster

## Client Considering Using His IRA For an Unconventional Investment?

Here's what you as the advisor need to know

**W**ealthy clients often ask advisors whether they should use their individual retirement accounts for unconventional investments. And now that the equity and debt markets have experienced significant volatility, clients may be even more interested in going beyond such common investments as publicly traded stocks and bonds, mutual funds and annuity contracts to venture into commercial or residential real estate, interests in closely held businesses, hedge funds, tangible personal property, etc.

But on top of the normal risk/return/diversification analysis that advisors apply to all proposed investments, unconventional investments that will be held in IRAs must be evaluated considering certain additional criteria, including:

- Are the investments statutorily proscribed for IRAs?
- Are they prohibited transactions (PTs) vis-a-vis the IRA owner?
- Are they likely to generate unrelated business taxable income (UBTI)?
- Will they be difficult/expensive to value for purposes of calculating required minimum distributions (RMDs) and/or when the investments are distributed in kind?
- Will they be difficult/expensive to divide if needed



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to facilitate RMDs and/or splitting IRAs for multiple beneficiaries?

- Might they be difficult or risky to administer within IRAs?

It's critical that advisors be able to spot situations in which these concerns may be important. Of course, once identified, a more in-depth analysis should be undertaken. That focused examination might lead to the conclusion that:

- the preliminary concern is justified and serious—the unconventional investment should not be made within the IRA;
- the preliminary concern is not justified, possibly because additional facts or a more complete legal analysis indicates an exception applies;
- there is a way to restructure the investment to eliminate the concern; or
- the concern is not that expensive to deal with (valuation or UBTI) and is outweighed by the risk/return profile of the investment.

### Proscribed Investments

Internal Revenue Code Section 408 specifically requires IRA documents to prohibit investments in life insurance contracts.<sup>1</sup> Transgressions are rare. Still, I recently encountered an IRA invested in an annuity contract that had substantial death benefits, raising the question of

whether it was really a life insurance contract.<sup>2</sup>

IRC Section 408 treats pledging IRA assets as security for a loan as a distribution of the pledged portion of the account.<sup>3</sup> Again, this is rarely a concern. Yet it should be considered if an IRA could be subject to a margin agreement or similar transaction for other accounts the IRA owner has with the IRA issuer.

IRC Section 408 also treats as distributions investments in "collectibles," defined as art work, rugs, antiques, metals or gems, stamps or coins, alcoholic beverages, musical instruments and historical objects (documents, clothes, etc.). But certain U. S. gold, silver and platinum coins are excepted from the collectibles prohibition, as is gold, silver, platinum and palladium bullion physically held by the IRA trustee.<sup>4</sup>

### Prohibited Transactions

The most important concern with many possible unconventional IRA investments is that they might be prohibited transactions described in Internal Revenue Code Section 4975 vis-a-vis the IRA owners.<sup>5</sup> (This article does not address PTs vis-à-vis IRA trustees or investment managers.)

In general, the PTs advisors need to be concerned about include many forms of self-dealing in which IRA assets are used for the benefit of IRA owners, certain of their family members and certain entities they control. The penalty for engaging in any such PT is severe: All the IRA's assets are deemed to be distributed. Of course, upon the occurrence of such a deemed distribution, the fair market value (FMV) of the IRA is includible in the IRA owner's gross income, except to the extent of after-tax contributions made by the owner, and, if the IRA owner is under 59½, is likely subject to a 10 percent additional tax. Further, the benefit of continued tax deferral within the IRA will be lost.

Advisors need to conduct both a technical and a substantive analysis of whether an unconventional investment would constitute a PT.

In the technical analysis, we apply the provisions of IRC Section 4975 as well as Internal Revenue Service and Department of Labor regulations to the proposed investment.<sup>6</sup> (PT class exemptions, generally, do not address IRA owner-related PTs.)

For a substantive analysis, advisors look at whether the IRA owners benefit from the investment other than

by the return to their IRA. If yes, then we need to examine the letter and spirit of the law to see if the investment would be a PT.

Neither type of analysis can be reduced to simple formulas. Therefore, they're best explained by examples. Here are some proposed unconventional IRA investments I've seen that raised PT concerns and deserved more careful analysis:

- An IRA would purchase, from an unrelated individual, a parcel of land adjoining the owner's residence that, theoretically, could be separately developed or sold. But the IRA owner's actual intent was to hold the parcel as open space to enhance the value of his residence.

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- An IRA would invest in an existing hedge fund for which the IRA owner's son is an investment manager compensated by a percentage of fund earnings.
- An IRA would subscribe for shares of a newly formed community bank for which the IRA owner would be the CEO.
- An IRA would lend money to a real estate investment partnership to be formed. The IRA owner's spouse would be a broker for that partnership and would earn sales commissions for finding the properties that the partnership would acquire.

### UBTI

Unrelated business taxable income<sup>7</sup> arises in IRAs in one of two ways:

- An IRA may invest in an unincorporated active business as a sole owner or as a partner; or
- the IRA may hold investments that are debt-financed (for example, real estate with acquisition financing).

If an IRA has UBTI exceeding \$1,000 in a year, it needs to file an income tax return and it incurs tax liability at

the sharply progressive trust tax rates.<sup>8</sup>

Arguably, the taxes incurred on UBTI puts IRAs in essentially the same position as if they had invested in corporate securities and/or similar assets, that is to say one level of tax is being paid. But the tax filings and payments are an additional administrative expense that may prove unwelcome.

### Valuation

There are many situations in which IRAs are required to report the value of their assets and/or use those values for important tax calculations. Annually, IRA asset values are reported on Form 5498. When account owners attain age 59½ and/or after their deaths, RMDs must be calculated by dividing account values by a life expectancy factor.<sup>9</sup> Also, when IRA assets are distributed in kind, their distribution date FMVs determine the taxable amounts of the distributions.<sup>10</sup>

Almost by definition, unconventional investments are more difficult and/or expensive to value than conventional IRA investments. In some cases, expert appraisals will be needed. Even after you have such appraisals in hand, there's no guarantee the IRS won't challenge those values.

### Distribution Hurdles

Eventually, RMDs must not only be calculated, they must also be distributed to IRA owners or their beneficiaries. In most cases, making RMDs over an extended number of years based on a life expectancy factor for the owner and/or the beneficiaries yields substantial tax deferral advantages. For IRAs holding marketable securities and similar conventional investments, periodic RMDs can readily be made, either in cash after selling a portion of the investments or in-kind.

But partial sales of certain unconventional investments may be difficult or impossible. Also, in certain cases, it may be difficult to distribute in-kind a portion of such investments, for example deeding percentage tenants-in-common interests in real estate. Similar tasks or concerns can arise when it's advantageous to split an IRA into two or more IRAs for separate beneficiaries.

### Administrative Difficulty, Risk

Certain proposed unconventional IRA investments may pose administrative hurdles or risks within

IRAs. One concern would be investments that might require expenditures that could exceed cash that can be readily raised within the IRAs. In that category falls real estate requiring expenditures for real estate taxes, insurance and/or maintenance and partnerships that could make capital calls on partners. When analyzing that concern, advisors need to take into account that any payments of such expenses by the IRA owner would be treated as contributions to the IRA subject to the limits on annual IRA contributions. Also, borrowing within the IRA to make the expenditures would likely be a hassle and cause debt-financed UBTI.

IRA custodians or trustees are likely to be wary about allowing investments that have a risk of incurring losses exceeding the value of the unconventional investment. One example of such a loss risk would be real estate that may be environmentally contaminated. While fiduciaries are likely, in the end, to be shielded from personal liability, the potential for an adverse outcome and the expense of fighting claims may be a deal stopper.

### Let Clients Know

With recent volatility in marketable securities, some individuals may want to use their IRAs for unconventional investments that seem to hold promise. That may be a good idea. But it is the job of advisors to make sure IRAs will remain safe—before clients leap. Let them know that they shouldn't make such a move with their IRA assets without consulting with you first. **IE**

### Endnotes

1. 26 U.S. Code Section 408(a)(3).
2. 26 USC Section 1035(b) and 7702.
3. 26 USC Section 408(e)(4).
4. 26 USC Section 408(m).
5. 26 USC Section 4975.
6. Under the ERISA Reorganization Act, the Department of Labor was assigned primary responsibility for defining prohibited transactions (PTs) and issuing exemptions. The Internal Revenue Service is responsible for administering the tax penalties for PTs that have been committed. There are parallel PT provisions in Employee Retirement Income Security Act Title I and the Internal Revenue Code.
7. 26 USC Sections 511-515.
8. 26 USC Sections 408(e)(1) and 511(a)(2).
9. 26 USC Sections 408(a)(6) and 401(a)(9).
10. 26 USC Section 408(d).