By **Warren L. Baker** & **Natalie B. Choate**

The Care and Feeding of Large IRAs

Perform annual checkup meetings with your clients

Every individual retirement account[1] deserves an annual checkup. The larger the account, the greater the need.[2] Recent cases and regulatory changes indicating increased Internal Revenue Service interest (and effectiveness) in enforcing valuation requirements and prosecuting prohibited transactions (PTs) add to the importance of this annual review.

The participants in the checkup meeting are the client (IRA owner)[3] and the attorney. Subject to later comments on preserving confidentiality, input will be needed from the client's investment advisor, accountant, tax preparer and IRA custodian or trustee.

The purpose of the checkup is to review tax and other compliance issues for the current and just-past year; discuss new regulatory and other developments that may impact this IRA; firm up responsibilities and compliance guidelines for the coming year, including avoidance of PTs; and discuss "what if" scenarios for the longer term future.

The annual IRA checkup can help the IRA owner and her professional team avoid problems before they occur, correct missteps that have occurred in the past before their consequences become unmanageable and assure that the owner and beneficiaries maximize the value of their IRA dollars, both currently and potentially for decades to come.

Review Applicable IRS Forms

Review of what may seem to be routine or minor tax forms is important in keeping the IRA healthy. Because these few brief forms give the IRS its only window into the IRA's operations, it's critical to correctly complete and timely file each form. Each member of the team should review and verify the information in these forms that's within such member's purview. Even with large accounts, you can't assume that "the computer," or the office clerk in charge of these forms, has completed the forms properly. Personnel (whether associated with the IRA custodian or the IRA's owner) who are inadequately trained or misinformed, or who simply misread the form and its instructions, can make a mistake. An error on a tax form could invite an audit or, worse, a penalty.

IRS Form 5498. The custodian or trustee of the IRA (the IRA provider) must file IRS Form 5498 annually. The 2015 form, for example, was required to be filed by May 31, 2016. Form 5498 looks both backward and forward. It tells the IRS who owns the account, what type of IRA it is and what contributions, if any, were made to the account during the preceding year. The form reports the prior year-end value of the account and tells the IRS whether a required minimum distribution[4] (RMD) is due for the current year.

Not every box on Form 5498 applies to every IRA. For example, in the case of an inherited IRA,[5] there would be no contributions to the account, because a beneficiary isn't allowed to make contributions to an inherited IRA. Similarly, there would be no RMD for a living participant's Roth IRA regardless of the participant's age. Also, for now, IRA providers aren't required to report regarding RMDs for inherited IRAs, only for IRAs of living participants.[6]

There's a recent significant change in Form 5498: The IRS for the first time wants to know whether the IRA holds non-publicly traded assets. Previously, the IRS had no way to tell which IRAs held non-publicly traded assets, other than by auditing every account.[7] Beginning

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in 2016 (reporting for 2015), the IRA provider must report, separately, in new Box 15a, the fair market value (FMV) of "certain specified assets," namely, assets "that are not readily tradable on an established US or foreign securities market or option exchange, or that do not have a readily available FMV."[8] In Box 15b, the IRA provider must provide specified letter codes to indicate which type(s) of non-tradable assets are held in this account (for example, real estate, debt obligation or partnership interest).

While this change will have the greatest impact on so-called "self-directed IRAs," which typically are established for the sole (or primary) purpose of holding non-traditional investments, most large IRAs own at least some of these types of assets (for example, private equity/hedge funds).

The investment manager must code every holding in the portfolio for the benefit of the IRA provider, so that when the IRA provider gets the portfolio value to be entered on Form 5498, it also knows what code(s) to put in Box 15b. The investment manager should code each investment either with a letter from the IRS table or with some other code that will indicate the asset isn't the type of "specified asset" to be so reported. The investment manager will need to review each holding's status and code annually, before sending the year-end information to the IRA provider, as investments can change their status—for example, a privately held stock goes public, a partnership spins off publicly traded stock or a directly owned real estate parcel is contributed to a limited liability company (LLC).

Reporting hard-to-value assets in Box 15b will likely create a higher chance of an IRS audit. The IRS may be interested in checking RMD calculations when there are non-publicly traded assets or may be looking for potential attack points related to prohibited transactions.

An IRA owner who holds only a small portion of his account in such assets may want to consider disposing of them. There are only two legal ways to dispose of an IRA asset: Distribute the asset in kind to the IRA owner or sell it on the open market (not to a related party). Note that the in-kind distribution of a non-publicly traded asset will trigger special reporting on Form 1099-R.

Whatever past practice may have been, IRA owners and providers should consider obtaining annual appraisals of non-publicly traded assets to correctly report the FMV of the IRA on Form 5498.[9]

IRS Form 1099-R. The IRA provider must file Form 1099-R early in each year to report any distributions made from the account in the prior year. Unlike Form 5498 (which must be filed every year for every IRA), Form 1099-R isn't filed if there was no distribution.[10]

As with Form 5498, the IRS has modified Form 1099-R to add a "distribution code" for non-publicly traded assets. If assets "not having a readily available FMV" were distributed in the prior year, the new distribution code "K" must be entered in Box 7 of Form 1099-R (mandatory for 2015 and later years).[11]

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Errors in Form 1099-R lead to a high likelihood of contact from the IRS, which can, in turn, result in RMD or prohibited transaction scrutiny. If the year's distributions are underreported, the IRS will think the participant failed to take his RMD. If the distributions are overreported, the distributee will get a notice that he failed to report all his income.

When assets are distributed in kind, the IRA provider may require an appraisal of the assets to assure correct tax reporting, and regardless, it's wise for the IRA owner to receive an appraisal to ensure tax compliance.

IRS Form 990-T. If the IRA had unrelated business taxable income (UBTI) or unrelated debt-financed income (UDFI), the IRA provider may need to file Form 990-T. Misunderstandings and mistakes regarding this subject are common among IRA owners and even among supposedly sophisticated IRA providers.

First, the IRA may owe taxes if the UBTI or UDFI is a large enough amount. That may be an unwelcome surprise to the client. If the client didn't understand

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that when he purchased the investment, there may be friction with the investment advisor who sold him the investment.

Second, the IRA provider, not the IRA owner, files this return.[12] Strangely, some IRA providers seem unaware of this duty, or for misguided reasons ("we don't provide tax advice") fail to inform the client of the filing requirement, even after receiving a K-1 that shows a large amount of UBTI/UDFI. The advisor team may need to educate the IRA provider regarding this responsibility and firmly require the IRA provider to carry out its filing responsibility. Of course, in many cases, the IRA owner and/or professional advisors have the most knowledge regarding the non-publicly traded assets within the IRA, and thus, the IRA provider must rely on information provided by them.

> While other IRA penalties are finite and often reversible, the PT penalty is draconian, irreversible and non-waivable.

Similarly, in cases in which the IRA is being issued a Schedule K-1 (as a result of an ownership stake in a partnership or LLC), the investment provider might mail the K-1 directly to the IRA owner, rather than the IRA custodian. The attorney must ask the client, "Have you or your custodian received any K-1 forms related to your IRA's investments?" and then coordinate the UBTI or UDFI tax information received from each and all sources.[13]

IRS Forms 1040, 1041, 8606 and 5329. Review how any IRA distributions will be reported on the tax return of the recipient(s). Generally, an individual reports gross IRA distributions on line 15a of Form 1040, then enters the taxable portion on line 15b. The trust income tax return form (Form 1041)[14] provides no such convenient way to distinguish between gross and taxable distributions.

Although qualified distributions from a Roth IRA aren't includible in gross income, and an individual or trust that has no gross income isn't required to file a tax return, as a practical matter, the recipient of qualified Roth IRA distributions will end up having to report them on Form 1040 or 1041 partly because the payer of the distribution reports the distribution to the IRS on Form 1099-R (hopefully, correctly coded with a "Q" in Box 7, "qualified distribution from a Roth IRA"), but also to start the statute of limitations running with respect to that year.

Form 8606 tracks the IRA owner's after-tax contributions to the account. Although the existence of after-tax money inside an IRA can be established even if the Forms 8606 weren't filed or can't be located, the easiest way to establish such "investment in the contract" is to have a history of consistent Forms 8606 filed each year documenting the increases and decreases.

The final tax form on the list isn't required but highly recommended. It's Form 5329, which is used to report IRA excise taxes (such as the 50 percent excise tax for failure to take an RMD and the 6 percent annual levy on excess IRA contributions). Every IRA owner and beneficiary should strongly consider filing Form 5329 every year with their tax returns, even when (as will typically be the case) there appears to be no such tax owed. There's no statute of limitations protection against IRS assertion of these excise taxes if no return was filed, and Form 5329 is the applicable return. The IRS has successfully extracted excise taxes from IRA owners many years after the statute of limitations had expired on regular income tax claims,[15] when the owners had never filed Form 5329 for the applicable years.

RMD Compliance

Review the calculation and payment of the RMD for the year just past and the current year. Verify that procedures are in place to assure distribution of this payment in future years. Consider whether the RMD can do double duty to accomplish other goals. For example:

- Consider which account to take the RMD out of, if the IRA owner owns multiple IRAs.[16] For example, consider whether to take the year's RMD for all accounts from the smallest account to close that account out (perhaps), thereby reducing administrative burdens. If the IRA owner holds both a rollover and a contributory IRA, consider reducing the contributory IRA first. Rollover IRAs are entitled

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to greater protection under the federal Bankruptcy Code and to lower taxes under some states' laws.

- If the qualified charitable distribution option is available, consider whether using that option would be advantageous.[17]
- Use the RMD to remove (by distribution) non-publicly traded assets if doing so eliminates the need for future reporting of such assets on Form 5498.
- Consider whether the IRA holds any assets that might be better off held outside the IRA in the future. For example, suppose the IRA holds a piece of raw land, an investment that's been dormant to date. The IRA owner is now considering purchasing (with outside assets) some adjacent land for purposes of development. Distribute the raw land now, as part of the year's RMD, to sidestep possible future prohibited transaction issues that could arise from having a real estate development owned partially inside and partially outside the IRA. Also, regardless of whether the IRA owner is involved on an individual basis, development activity within an IRA or IRA-owned entity (such as an LLC) can result in UBTI tax consequences, which may be another reason to remove the asset from the IRA.[18]

PT Avoidance

An important element of the checkup is a review of guidelines for avoiding any PT. The penalty for an IRA owner or beneficiary engaging in a PT with the IRA is disqualification of the account.[19] The account is treated as having been distributed in full on the first day of the taxable year in which the transaction occurred. Both the Department of Labor (DOL) and the IRS enforce the PT rules.

While other IRA penalties are finite[20] and often reversible,[21] the PT penalty is draconian (the entire account is apparently disqualified, even if only a tiny portion of it was involved in the PT),[22] irreversible (there's no grace period during which you can save the account by undoing the transaction) and non-waivable. Thus, it's highly desirable to steer well clear of any transaction that could trigger this punishment.

A PT avoidance plan is especially desirable for IRAs that are invested in non-publicly traded assets, such as private equity funds or real estate. Here are examples of the pitfalls that could lie in such investments:

IRA ownership of a business that pays compensation to the IRA owner has been held to give rise to a PT.[23] Thus, the IRA shouldn't invest in a business that pays compensation to the IRA owner and related parties. In addition, because the wording of Internal Revenue Code Section 4975 is very broad,[24] the rules can be read to strictly prohibit any direct or indirect benefit to the IRA owner and other "disqualified" individuals.

One Tax Court case held that an IRA owner personally guaranteeing a loan to an IRA-owned business was a PT.[25] When the IRA needs financing for its investments, the financing should be nonrecourse against the IRA owner (and all other disqualified individuals). Other types of IRA debt can also cause this personal guarantee PT problem. For example, if an IRA owns an interest in an LLC, the IRA owner might be asked to personally guarantee the LLC's debts. Even something as mundane as an IRA-owned LLC credit card can result in the IRA owner's becoming personally liable. Unfortunately, many banks and other potential lenders don't understand these IRA-specific rules.

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The first step in a PT avoidance plan is to develop a list of the people and entities who are disqualified persons (DQPs) with respect to the IRA. IRC Section 4975(e)(2) defines a DQP. Although Section 4975 doesn't specifically say so, it's wise to assume that the IRA owner is always a fiduciary of the account, and therefore is always (along with his spouse and children and certain other related parties and entities) a DQP as to the IRA.

Business entities and parties related to or associated with the IRA owner can also be DQPs. For example, if the IRA owner owns 50 percent or more of a business entity, the entity itself becomes a DQP. If the business entity is a DQP, any other 10 percent or greater owner

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in the same business (and in some cases executives, directors and highly paid employees) also becomes a DQP. This can result in a "spider web effect," in which numerous business entities and business associates of the IRA owner become DQPs and, thus, can never interact with the IRA.

If the IRA and its owner jointly invest in the same entity, a DOL Advisory Opinion suggests that there's no PT as long as neither investor has any preferential treatment, but implies that there would be a PT if the IRA's investment was used to meet a minimum investment requirement that the IRA owner couldn't have met on his own.[26] The IRS may seek to prove that the owner's and IRA's co-investment in the same entity (or piece of real estate) has resulted in a direct or indirect personal benefit to the IRA owner and is therefore a PT.

Even if the investors' rights and obligations are the same and the IRA money isn't shoring up the IRA owner's investment, a joint investment may require constant vigilance to avoid PTs in the future. For example, suppose the investment entity that both the IRA and its owner hold requires an additional infusion of capital. Must the IRA owner and the IRA itself contribute strictly pro rata? To avoid the need for such constant vigilance, some IRA owners and advisors conclude that the IRA, its owner and other related parties should never co-invest in anything.

Similarly, consider whether an IRA owner's personal involvement with a company the IRA has invested in raises a PT risk. For example, the IRA owner serving as a director of a corporation in which the IRA is an investor could raise "fiduciary conflict of interest" problems.[27] In situations in which the IRA owner has a fiduciary duty to a company as a whole (for example, because he's a director), this duty can conflict with the IRA owner's fiduciary duty to his own IRA (which owns stock in that company), because what's best for the IRA may not be what's best for the company. The DOL has ruled that even if no DQP is involved in the transaction, if the IRA owner's best judgment as a fiduciary is conflicted, a PT can still occur.[28]

One wise practice to help steer clear of PT issues is having the IRA owner pay for fees associated with the IRA (such as investment management fees) out of non-retirement funds rather than out of the IRA. For example, if an inherited IRA is payable to a trust, and the trustee is a family member of the IRA creator or the trust beneficiary, paying compensation to the trustee directly from the IRA could risk a PT. Instead, make the distribution from the IRA to the trust first and then pay the expense from the trust's taxable checking account. An IRA distribution of benefits to the beneficiary of the account is never a PT.[29]

If there comes a time when the IRA owner wants to become more personally involved in a particular IRA investment (for example, by being in a business partnership with his own IRA), there are a few ways to avoid or minimize the risk of a PT:

- Don't make that investment.
- Apply to the DOL for an Advisory Opinion to the effect that the transaction isn't prohibited.
- Apply to the DOL for an exemption so that the transaction is permitted despite being prohibited. This step is done occasionally for qualified retirement plans if the proposed transaction is a good investment deal for the plan.
- Move funds into a separate IRA, and make the investment in that separate account, so that (if a PT occurs) only that separate account (presumably) will be disqualified;[30] or
- Distribute the funds to the IRA owner, and make the investment outside the IRA.

Wait, There's More!

Review the beneficiary designation form: Is it still appropriate and up to date? Does the IRA provider have the physical original document?

Who will manage the non-publicly traded assets if the IRA owner dies? Such management may not be an easy task, particularly for beneficiaries unfamiliar with the issues discussed here. The IRA beneficiary may not realize that personally interacting with and/or benefiting from the IRA's assets will result in a PT. Post-death missteps can be difficult (or impossible) to recover from, even when they're innocent mistakes.

Consider the impact of recent cases, legislation and IRS pronouncements. For example, a current review might: evaluate the effects of the *Bobrow* case[31] and the IRS' response implementing the "once per year" IRA-to-IRA rollover rule; explore any new possibilities for Roth conversions in light of Revenue Ruling 2014-9[32] (providing guidance for IRA-to-qualified plan transfers, thereby facilitating

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tax-free Roth conversions of after-tax money in the IRA) and IRS Notice 2014-54[33] (providing altered guidance for plan-to-IRA rollovers, thereby facilitating tax-free Roth conversions of after-tax money inside a qualified plan); and consider whether it would be desirable to purchase a qualified longevity annuity in light of recent regulations[34] allowing the purchase of such annuities inside an IRA.

Consider anticipated personal changes and changes in personnel. Is the IRA owner reaching the age at which RMDs must start? In the case of an inherited IRA payable to a trust, is the trust going to terminate soon? Are there succession plans in place for all key roles in the IRA's management? Is there any reason to consider consolidating IRAs or splitting them up into multiple accounts, to consider changing to a different IRA provider or to convert any pre-tax IRA funds to Roth status if that's an option?

Finally, look at prospects for legislative change. For example, if Congress eliminates the stretch (life expectancy) IRA payout option and replaces it with a 5-year payout, how will that affect this account? Should any steps be taken to anticipate that possibility?

Preserving Confidentiality

Because part of the checkup amounts to auditing yourself, you'll be almost like a prosecutor, reviewing any potential points of tax vulnerability the IRA may have. It wouldn't be helpful if the IRS could obtain a detailed record of the checkup discussion, because such record would be a road map of the IRA's weak points, if there are any.

To prevent the IRS from reaching the notes of the checkup meeting (should litigation arise), take steps to preserve the attorney-client privilege and the confidentiality of information obtained in attorney-client communications. For example, it's recommended that the core attendees of the meeting be only the client (IRA owner) and attorney. They can seek needed information from other parties, such as the IRA provider (bank custodian or trustee), accountant and investment advisor. Such third parties can provide the information in advance or at the meeting via conference call or personal attendance, leaving the meeting (or hanging up the phone) after providing the information. Any new or changed instructions can then be delivered to such third parties after the audit part of the meeting has concluded.

Make sure the client understands the need for confidentiality regarding the checkup meeting and knows not to share the meeting record with anyone. Consider also the value (and risk) of maintaining detailed IRA records, which can be used for purposes of proving, if necessary, that the IRA hasn't committed a PT and that RMDs have been calculated correctly. Keep these records separate from the IRA owner's individual (or individually owned business) financial records; it would be unfortunate if the IRS decided to focus on the IRA (particularly non-publicly traded assets) only because records related to the IRA's assets were commingled with the IRA owner's other records.

If there's any doubt regarding the extent and application of the attorney-client confidentiality and privilege (and/or whether a PT and/or UBTI problem exists), consult a tax attorney who's expert on that topic.

Endnotes

1. Internal Revenue Code Section 408.
2. There were more than 9,000 individual retirement accounts worth in excess of $5 million as of 2011, according to a 2014 Government Accountability Office (GAO) report. *See www.gao.gov/products/gao-15-16.* How many of those accounts belong to clients of your firm? The GAO got its numbers from Internal Revenue Service records drawn from annual Form 5498 reports from IRA custodians and trustees. Because the total value of assets held by IRAs has increased from $5.8 trillion to $7.4 trillion (21.6 percent increase) between 2012 and 2016 (*see* Investment Company Institute's Quarterly Retirement Market Data, First Quarter 2016, *www.ici.org/research/stats/retirement/ret_16_q1*) the number and size of "large IRAs" have presumably both grown further since the GAO report.
3. Alternatively, the client would be the beneficiary of the IRA if the original IRA owner is deceased. The beneficiary might be one or more individuals or the trustee of the trust named as beneficiary of the IRA.
4. *See* IRC Section 401(a)(9) and regulations thereunder.
5. An IRA held by a beneficiary of the deceased original accountholder is referred to as an "inherited IRA" (or sometimes, a "beneficiary IRA").
6. *See* "IRS Instructions for Form 5498 (2016)," at p. 19.
7. However, because some IRA providers are known for being willing to hold non-traditional assets, even without the new Form 5498 information, arguably the IRS could have done a random audit of accounts held at those particular custodians.
8. Although completing lines 15a and 15b was optional for the 2014 forms (filed in 2015), this reporting has become mandatory for the 2015 forms (filed in 2016) and years going forward.
9. Although arguably it's legally sufficient to estimate fair market values as long as the value of the IRA in the particular year in question doesn't result in a specific

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tax consequence (for example, if the IRA's owner is in a required minimum distribution (RMD) year or the account is being converted to Roth status).

10. An IRA-to-IRA transfer (other than a Roth conversion) generally isn't reportable as a distribution. *See* IRS Instructions for Forms 1099-R and 5498 (2016), at p. 17.
11. *Ibid.*
12. *See* IRS Instructions for Form 990-T (2015), at p. 2 ("Who Must File ... Trustees for the following trusts that have $1,000 or more of unrelated trade or business gross income: (1) Individual retirement accounts (IRAs), including traditional IRAs described under section 408(a) ...").
13. It's also possible that the IRA is invested in an activity that's not resulting in a K-1 being issued, but nonetheless has unrelated business taxable income (UBTI) or unrelated debt-financed income (UDFI) implications. For example: the IRA holds a promissory note with a "disguised equity" feature; the IRA holds 100 percent of a limited liability company (LLC) (a disregarded entity, so no tax return prepared) and the IRA-owned LLC earns income that's not exempt from UBTI.
14. Applicable if the IRA has been inherited by a trust.
15. *See Paschall, Robert, et ux.*, 137 T.C. 8 (2011), and *Mazzei, Celia, et al.*, T.C. Memo. 2014-55 (April 1, 2014).
16. *See* Treasury Regulations Section 1.408-8, A-9.
17. *See* IRC Section 408(d)(8)(F).
18. For more detail on potential UBTI/UDFI traps, *see* Warren L. Baker, "Self-Directed IRAs: A Tax Compliance Black Hole," *Journal of Accountancy* (Oct. 1, 2013), *www.journalofaccountancy.com/issues/2013/oct/20137626.html.*
19. *See* IRC Section 408(e). For more detail, *see* Natalie B. Choate's *Special Report: Buyer Beware! Self-Directed IRAs and Prohibited Transactions, www.ataxplan.com.*
20. For example, 6 percent penalty for excess contributions, 10 percent penalty on pre-age-59½ distributions, 50 percent penalty for failure to take an RMD.
21. Excess contributions can be corrected, penalty-free, for a certain period of time; the IRS can waive the penalty for failure to take an RMD in appropriate circumstances.
22. Although in one case, the court disqualified only the portion of the account involved in the transaction. *See Gerald M. Harris*, T.C. Memo. 1994-22.
23. *See Ellis v. Commissioner*, T.C. Memo. 2013-245 (Oct. 29, 2013).
24. *See* IRC Section 4975(c)(1)(D), (E).
25. *See Lawrence F. Peek, et ux., et al., v. Comm'r*, 140 T.C. No. 12 (2013).
26. *See* DOL Advisory Opinion 2000-10a (*Adler*).
27. *See also* Treas. Regs. Section 54.4975-6(a)(5)(i).
28. *See* DOL Advisory Opinion 93-33A (*Faith*) (IRA's investment benefited the IRA owner's brother and sister, who weren't otherwise considered disqualified parties).
29. *See* DOL Advisory Opinion 2009-02A (*Goldberg*).
30. Dividing an IRA into multiple pieces after a prohibited transaction has occurred won't insulate any of the pieces from risk, because a prohibited transaction results in the retroactive disqualification and distribution of the entire account. The IRA ceases to be a tax-exempt account from Jan. 1 of the year in which the violation occurred, and this invalidation remains regardless of what occurs thereafter.
31. *Bobrow v. Comm'r*, T.C. Memo. 2014-21.
32. 2014-17 I.R.B. 975 (April 3, 2014).
33. 2014-41 I.R.B. (Sept. 18, 2014).
34. *See* Treas. Regs. Sections 1.401(a)(9)-5, A-3 and 1.401(a)(9)-6, A-17.

SPOT LIGHT

Melting Pot

"Soviet/American Array IV," by Robert Rauschenberg, sold for $15,000 at Sotheby's Prints & Multiples sale in New York City on Oct. 27-28, 2016. Rauschenberg was known for his "combines," as seen in this painting, which is a style that brings together various materials and objects, creating a hybrid of painting and sculpture.

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