COMPLIANCE February 1, 2022

Caution Clients Against IRA Asset Class Mistakes

A recent court case demonstrates why owners of self-directed IRAs should be careful about their investment strategies and asset classes—and where they store any physical assets owned via their IRAs.

By DJ Shaw

The Wagner Law Group has published a new law alert that examines in detail the increasing attention the Internal Revenue Service (IRS) is paying to what it regards as the impermissible use or operation of individual retirement accounts (IRAs).

The recent U.S. Tax Court case of *McNulty v. Commissioner* illustrates the type of IRA strategy the IRS has been challenging—in this instance successfully.

In the law alert, attorneys with the Wagner Law Group explain that, as the owner of a self-directed IRA, the individual charged in the case was generally entitled to direct how her IRA assets would be invested. She could do this without losing IRA tax benefits, unless she engaged in an investment that was deemed to be a "prohibited transaction." If a transaction was prohibited, Section 408(e) of the Internal Revenue Code (IRC) dictates that the account would lose its IRA status and then be considered distributed at the beginning of the taxable year.

An example of a permissible investment in a self-directed IRA is an investment in a single-member limited liability company (LLC), the Wagner attorneys explain. This would not be prohibited because the LLC does not have any members at the time the initial investment is made and therefore is not a disqualified person at the time.

The attorneys note that in the *McNulty* case, an LLC was used to purchase American Eagle (AE) coins, intended to be titled in the name of the LLC, although there was no evidence in the record establishing who had legal title. While IRAs are prohibited from holding collectibles, IRC Section 408(m)(3) provides an exception for certain coins, and

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she had purchased.

"In so doing, she relied on a statement on the LLC vendor's website that advertised that an LLC owned by an IRA could invest in AE coins, and IRA owners could hold the coins at their homes without tax consequences or penalties so long as the coins were titled to the LLC," the attorneys explain. "The LLC marketers believed they had found a proverbial tax loophole, but the Tax Court disagreed."

The court found that there were two problems with placing the AE coins in a safe at the taxpayer's residence, the attorneys say in the alert. First, the Tax Code provides that IRA assets may not be commingled with other property except in a common trust fund or common investment fund.

The IRS argued that that the taxpayer violated the provision when she stored the coins in her safe with non-IRA assets. Her response was that there was no commingling of assets because the AE coins were labeled as IRA assets before being placed in the safe, the law alert notes. The Tax Court was skeptical as to whether labeling an asset was sufficient to avoid the commingling of assets.

Second, the Tax Court questioned whether storage in a safe satisfies the IRA requirement that assets requiring safekeeping be kept in an adequate vault. This infrequently discussed provision of the IRS regulations will likely need to be considered in connection with IRA investments in cryptocurrencies, the attorneys say.

The law alert notes that the Tax Court did not address the commingling issue, or other issues of disagreement between the IRS and the taxpayer, because it held that her physical possession of the AE coins resulted in a taxable distribution to her.

The taxpayer argued that the AE coins were owned by the LLC, while the Tax Court questioned whether that was an issue in this case since the LLC was a disregarded entity, the attorneys explain in the alert. To make clear that this was not a basis on which this case could be distinguished by future coin holders in self-directed IRAs, it stated that resolution of the issues did not depend on the LLC's status as a disregarded entity or a separate legal entity.

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of the statutory plan under IRC Section 408. It explained that an owner of a self-directed IRA may not take actual and unfettered possession of the IRA assets.

"It is a basic axiom of tax law that taxpayers have income when they exercise complete dominion over it," the attorneys explain. "Constructive receipt occurs where funds are subject to the taxpayer's unfettered command and she is free to enjoy them as she sees fit."

Finally, the law alert says the Tax Court rejected the taxpayer's argument that the flush language of IRC Section 408(m)(3), which requires physical possession, only applies to bullion, and that AE coins are not bullion. It found no evidence of legislative intent to discontinue the fiduciary requirements generally applicable to IRAs for IRA investments in coin or bullion and referred to statements in the legislative history supporting its conclusion.

The Wagner attorneys conclude that the *McNulty* decision may not be the final word in this area—practitioners will seek ways to distinguish it—but owners of self-directed IRAs should proceed with caution in general in pursuing aggressive investment strategies.

Tagged: IRA, IRS, prohibited transactions

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