Tax Court Rejects Aggressive IRA Strategy

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In recent years, the IRS has paid increased attention to what it regards as impermissible uses or operation of individual retirement accounts (IRAs). The recent Tax Court case of *McNulty v. Commissioner*, 157 T.C. No. 10 (Nov. 18, 2021), is an illustration of the type of IRA strategy that the IRS has been challenging, in this instance successfully.

Ms. McNulty was the owner of a self-directed IRA. As such, she was entitled to direct how her IRA assets would be invested without forfeiting the tax benefits of an IRA, unless the investment constituted a "prohibited transaction". If there is a prohibited transaction, Section 408(e) of the Internal Revenue Code (the Code) provides that the account loses its IRA status and is considered distributed and taxable at the beginning of the taxable year. A permissible investment in a self-directed IRA is an investment in a single-member limited liability company (LLC). Such an investment is not regarded as a prohibited transaction, because the LLC does not have any members at the time the initial investment is made and therefore is not a disqualified person at that time.

In the *McNulty* case, the LLC owned by the IRA purchased 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, Code Section 408(m)(3) provides an exception for certain coins, and the AE coins may have satisfied the conditions of that statutory exemption, an issue the Tax Court did not need to address its holding was based on another basis. Up to this point, no issues under Code Section 408 were presented. But Ms. McNulty then took physical possession of the AE coins and placed them in a home safe with non-IRA assets—other coins that 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 LLC marketers believed they had found a proverbial tax loophole, but the Tax Court disagreed.

There were two problems with taking possession of the AE coins and placing them in a safe in the owner's residence. First, Section 408(a)(5) of the Code provides that IRA assets may not be commingled with other property except in a common trust or investment fund. The IRS's position was that the taxpayer violated this 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 labelled as IRA assets before being placed in the safe. The Tax Court was skeptical as to whether labelling 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 crypto currency. Here, however, 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, by disregarding the purported ownership of the AE coins by the LLC, the IRS was seeking to elevate substance over form, an issue on which the IRS's view had recently been rejected by four Circuit Courts in connection with investments by Roth IRAs. The Tax Court questioned whether that was an issue in this case, since the LLC was a tax entity. Nonetheless, 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.

According to the Tax Court, independent oversight by an IRA trustee or custodian to track and monitor an IRA's assets is one of the key aspects of the statutory scheme under Code 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. Constructive [tax] 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 Tax Court rejected taxpayer's argument that the flush language of Code 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. To add insult to injury to the taxpayer, in upholding IRS's assessment of the Code's accuracy-related penalty, the Tax Court questioned whether the LLC's website could constitute reasonable cause. It stated that, "Check Book's website is an advertisement of its products and services, and a reasonable person would recognize it as such and would understand the difference between professional advice and marketing materials for the sale of products or services."

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 need to proceed with caution in general in pursuing aggressive investment strategies.

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