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President's Message

Greetings! It has been a great year thus far. The Tax Section continues to grow in numbers and quality due to its esteemed members.

The Tax Section is working on several events for its members, including a Tax Court Judge reception to allow the section members to interact with a visiting United States Tax Court Judge, CLE's on current tax topics, and the well-attended annual luncheon. In addition, the Pro Bono committee (Vijay Gosalia, chair) and Young Lawyers committee (Ivan Jauregui, newly elected chair) are planning events for new members of the bar to network with other tax lawyers in the area. Please check our website for upcoming events.

'Tis the season to be thankful and there are several people I would like to thank for their generosity in giving back to the Tax Section.

Thank you to the Washington State Department of Revenue and the local Internal Revenue Service office whose continued support brings valuable information to our members. Jeff Mahan is the current year DOR liaison, and Melissa Hilty and Sandra Veliz are the Section's IRS liaisons. We appreciate your support!

I would also like to personally thank council members Jon Schorr, Bob Mahon, and Rob McCallum. They have donated several years to the Tax Section and are the rocks of the council. The Section would not be as well respected as it is today without their support. Thank you!

Finally, I want to thank all of our members for your continued support. Please feel free to contact me if you have any questions, thoughts or suggestions for our Tax Section.

Happy Holidays,
Cori Flanders

When you have finished reading this newsletter, please pass it on to someone else in your firm.

Boom! Boom! Boom! IRS Fires Three Shots Across the Bow of Self-Directed IRA Investors

by Warren L. Baker, J.D., LLM, Amicus Law Group, PC

Background

Although the idea of investing in real estate, promissory notes, non-publicly traded securities, precious metals, limited liability companies (LLCs), and partnerships using a retirement account might seem obscure (or perhaps impossible) to many people, the practice of using so-called "self-directed IRAs" has become more common in recent years. The rationale for *why* IRA account owners decide to invest some (or all) of their retirement dollars into "alternative" assets varies widely; however the most common rationales include[1]: dissatisfaction with past stock market results; perceived dangers of the current U.S. fiscal situation; personal experience and success within certain asset classes (e.g., real estate, hard-money lending, private equity, etc.); and the desire to hold something "tangible" within the retirement account. Regardless of the reason, investors with a wide variety of past experience and net worth are pursuing self-directed IRA investments. For example, a former CEO with a high net worth and a large retirement nest egg might seek an investment in a hedge fund or private equity opportunity; a retired Boeing engineer with moderate wealth and a smaller retirement account might pursue a single-family home for long-term rental income and appreciation.

As of the end of the second quarter of 2013, the total value of assets within IRAs was over $5.7 trillion.[2] This compares to $2.6 trillion at the end of 2000.[3] Another $5.3 trillion currently resides within employer-sponsored defined contribution plans (e.g., 401(k) plans) and $5.2 trillion in government-sponsored plans (e.g., 457 plans).[4] It is likely that the assets within IRAs will continue to increase as baby boomers retire and "roll over" their employer (or government) plans into IRAs, a practice that is generally encouraged by both employers and the financial planning community as a whole.[5]

The percentage of IRA assets that are currently invested into alternative assets within self-directed IRAs is difficult to measure. In late 2011, the Securities and Exchange Commission estimated that twp percent of IRA assets were held in self-directed IRAs

(continued on next page)

Boom! Boom! Boom! IRS Fires Three Shots Across the Bow of Self-Directed IRA Investors

continued from previous page

(equal to $94 billion at that time; $114 billion based on mid-2013 figures).[6] However, some sources suggest that the percentage of assets in alternative investments within all individual/retail accounts (both retirement accounts and general brokerage accounts) is much higher, and could reach 13 percent by 2015.[7] If this is the case, it would mean that self-directed IRAs would be holding around $780 billion of alternative assets within the next several years.[8] Regardless of the exact figures, overall investment dollars appear to be flowing into alternative investments at a much faster rate than other more traditional asset classes (e.g., mutual funds).[9]

The legal framework that governs self-directed IRAs is the same as any other IRA,[10] but the essential element that makes these accounts unique is that they are held by an IRA custodian that allows investments into alternative assets under the direction of the IRA owner. Generally, the most well-known brokerage firms (e.g., Fidelity, Charles Schwab, Vanguard, etc.) will not facilitate an investment from an IRA into alternative investments such as real estate (for example) but that does not mean that this type of investment is not legally permissible. In fact, IRAs are allowed to invest into *any* asset except for life insurance contracts[11] and "collectibles"[12]. The companies that hold self-directed IRAs might not be household names, but they are also not as small as many people might think.[13] Examples of these alternative IRA custodians include, but are definitely not limited to: PENSCO Trust Company, Millennium Trust Company, IRA Services Trust Company, Provident Trust Group, Equity Trust Company, and Trust Company of America. The precise manner in which these custodians execute transactions and charge fees varies widely, but they all promote themselves as being a good fit for self-directed IRA owners.

Self-directed IRAs are subject to the same "prohibited transaction" rules that apply to all IRAs, however self-directed IRAs are more likely to run afoul of these rules than traditional IRAs. Internal Revenue Code (IRC) Section (Sec) 4975 prohibits many direct and indirect transactions between the IRA and certain "disqualified persons." Because the IRA owner exercises discretionary control over a self-directed IRA, the owner is a disqualified person with respect to the self-directed IRA. In addition, attribution rules apply to make certain "related persons" (both natural persons and entities), disqualified persons with respect to the self-directed IRA. If the self-directed IRA engages in prohibited transactions with a disqualified person, the self-directed IRA ceases to qualify as an IRA as of the first day of the tax year in which the prohibited transaction occurred. For tax purposes, this is treated as a 100 percent lump sum retroactive distribution of the IRA assets to the IRA owner as of the first day of the year *in which the prohibited transaction occurred*, triggering what could be a substantial income tax bill, along with a cascade of penalties including the 10 percent early withdrawal penalty, accuracy-related penalties, and interest.

There are two fundamental methods that are commonly used by self-directed IRA owners in order to execute the particular IRA investment. The first method involves the IRA purchasing an asset *directly*. For example, the IRA holds legal title to a parcel of real property, pays ongoing expenses, and collects future rental income and sales proceeds. This method requires the IRA owner to instruct the IRA custodian to execute all transactions, whether large or small, on behalf of the IRA. An example of a clearly prohibited transaction in this context is if the IRA owner directs the custodian to purchase assets directly or indirectly owned by the IRA owner or a related person. The second method involves the IRA investing substantially all of its assets into a newly-formed LLC, thereby making the IRA the sole Member (i.e., owner) of the LLC and, under most circumstances, the IRA owner the designated Manager of the LLC (i.e., these LLCs are "manager-managed," not "member-managed"). The IRA-owned LLC (IRA/LLC) method results in the LLC executing all transactions and holding legal title to the assets, with the end result being that the IRA custodian is largely removed from day-to-day involvement.

Self-directed IRAs present challenges for the Internal Revenue Service (IRS) due to the limited federal reporting requirements for IRAs[14] and IRA/LLCs.[15] Historically, the IRS, courts, and other federal authorities have rarely provided guidance on issues specific to self-directed IRAs. However, three events in 2013 likely indicate an increased level of IRS scrutiny of self-directed IRA investors in the coming years. A casual observer might view these events as just two tax court opinions and a minor amendment to an IRA disclosure form; however, in the context of the self-directed IRA marketplace, each event is significant.

Shot #1: *Peek v. Commissioner*

On May 9, 2013, the United States Tax Court in *Peek v. Commissioner*[16] issued the first Tax Court decision to hold that the owner of a self-directed IRA is prohibited from personally guaranteeing a loan by a company owned (in part) by his or her IRA.

In 2001, two individuals ("Peek" and "Fleck") formed self-directed IRAs[17] and invested $309,000 each into a newly-formed corporation, FP Company. FP Company then purchased an operating business, Abbott Fire & Safety ("Abbott"), which specialized in the sale of fire alarms, sprinklers and other fire suppression equipment. The purchase price for Abbott consisted of $400,000 from Peek's and Fleck's IRAs, a bank loan, and a $200,000 seller-financing promissory note. The promissory note was *personally guaranteed* by Peek and Fleck and was secured by their personal residences. Abbott was later sold for a substantial gain in 2006.

The Tax Court ruled that IRC Sec. 4975(c)(1)(B), which prohibits "any direct or indirect…extension of credit between a plan and a disqualified person," applies to situations in which an IRA owner personally guarantees debt relating to the IRA's investment. IRC Sec. 4975(e)(2)(A) defines "disqualified person" as a "fiduciary," which is itself defined in IRC Sec. 4975(e)(3) as "any person who…exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets."[18] In a self-directed IRA context, the IRA owner is considered a fiduciary because the IRA owner exercises control over the IRA's investments.[19] The Tax Court rejected the idea that personally

(continued on next page)

Boom! Boom! Boom! IRS Fires Three Shots Across the Bow of Self-Directed IRA Investors

continued from previous page

guaranteeing debt relating to a legal entity in which the IRA only owned 50 percent is legally distinguishable from guaranteeing the IRA's debt directly.[20]

If a prohibited transaction occurs within an IRA, the account ceases to qualify as an IRA as of January 1 of the year in which the prohibited transaction occurs.[21] In *Peek*, the prohibited transaction occurred in tax year 2001 when Peek and Fleck personally guaranteed the promissory note, and the prohibited transaction continued to occur until the IRS audit in question (i.e., tax year 2006).[22] As a result, Peek and Fleck were required to recognize the complete retroactive distribution of their IRAs in 2001. In addition, Peek and Fleck were deemed to *personally* own FP Company (and Abbott, via FP Company) from 2001 to the time when Abbott was sold in 2006, thereby resulting in a large capital gain on Peek and Fleck's personal tax returns. In the end, the Tax Court ruled that Peek and Fleck *each* owed more than $225,000 of tax plus more than $45,000 in penalties.

Although the *Peek* case does not represent a profound creation of new law,[23] it should serve as a warning that the IRS will attempt to retroactively invalidate an IRA if the audit of a significant transaction (e.g., the sale of a business) uncovers potential problems in prior years within the IRA.

Shot #2: 2014 Form 5498

Form 5498 is a once-per-year IRS disclosure form that is used by IRA custodians to report information related to the IRAs that they hold. Example items documented on the form include: IRA contributions[24]; rollover contributions;[25] Roth IRA conversions;[26] information relating to "required minimum distributions";[27] and the current fair market value of the IRA.[28] Whether IRA owners realize it or not, the IRS maintains information regarding retirement accounts, with these reports helping the IRS identify when inaccuracies are occurring that might require further scrutiny. For example, if the owner of an IRA makes a maximum annual contribution to three different Roth IRAs (thereby exceeding the normal limit), the IRS should be able to detect that an "excess" IRA contribution was made (based on the three separate Form 5498 reports from each IRA custodian). Without the Form 5498 reporting, this error would likely go unnoticed.

Currently, the Form 5498 reporting requirements are the same for self-directed IRAs (i.e., IRAs that hold alternative assets) as they are for IRAs held at more traditional brokerage houses. However, given that many alternative assets are inherently illiquid and difficult to value, self-directed IRA custodians have struggled with how to best capture and report "fair market value."[29] For example, if an IRA's only asset is ownership in an LLC (i.e., the IRA/LLC concept discussed above) and the LLC owns multiple pieces of real estate and/or fractional ownership interests in other private-held entities, it is impossible for the IRA custodian to accurately determine the IRA's value, particularly if the IRA owner is non-responsive regarding the custodian's request for value reporting.[30] Also, the current version of Form 5498 does not distinguish between the fair market value of publicly traded assets as compared to alternative assets held within the IRA. The end result is that Form 5498 reporting from IRA custodians provides very little information that the IRS can use to determine whether legal and tax compliance (e.g., prohibited transactions, UBTI/UDFI, etc.) is occurring with regards to the underlying IRA investments.

On June 20, 2013, the IRS released draft instructions for the 2014 version of Form 5498.[31] The new version of the form includes two new reporting boxes that have not previously appeared. New box "15a" requires the IRA custodian to list the "fair market value of certain specified assets."[32] New box "15b" then requires the IRA custodian to write a "code" relating to the type of asset that is being valued in box 15a.[33] These codes correlate to basically any asset that is not publicly traded, i.e., the same types of assets that are commonly held within self-directed IRAs. Specifically, the codes listed in the instructions for the 2014 Form 5498 include the following:

A – Stock or other ownership interest in a corporation that is not readily tradable on an established U.S. or foreign securities market.

B – Short- or long-term debt obligation that is not traded on an established securities market.

C – Ownership interest in a limited company of similar entity (unless the entity is traded on an established securities market).

D – Real Estate.

E – Ownership interest in a partnership, trust, or similar entity (unless the entity is traded on an established securities market).

F – Option contract or similar product that is not offered for trade on an established U.S. option exchange or established foreign option exchange.

G – Other asset that does not have a readily available FMV.

H – More than two types of assets (listed in A through G) are held in this IRA.

The new reporting in boxes 15a and 15b is in addition to the original box 5, which requires the custodian to list the *total* fair market value of the IRA. The relationship between the fair market value numbers in box 5 and box 15a will provide the IRS with information that could theoretically lead to scrutiny of certain self-directed IRAs. Consider the following example: John Smith has an IRA at Provident Trust Group (a custodian that will allow alternative IRA investments) that holds $50,000 of mutual funds and $200,000 of real estate. On the 2014 Form 5498 for John Smith's IRA, Provident would need to list $250,000 in box 5 (i.e., total fair market value), $200,000 in box 15a (i.e., fair market value of "certain specified assets"), and code "D" in box 15b (i.e., real estate). Prior to the 2014 changes to Form 5498, Provident Trust Group would only list $250,000 in box 5, which would not provide the IRS with any insight whatsoever regarding the nature of the IRA's assets.

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Boom! Boom! Boom! IRS Fires Three Shots Across the Bow of Self-Directed IRA Investors

continued from previous page

Several questions arise from the Form 5498 changes that are important to the self-directed IRA marketplace. First, **why does the IRS want to see new information relating to alternative IRA investments?** Adding boxes 15a and 15b to the Form 5498 does not automatically tell the IRS that something is wrong with the underlying IRA investments – it also does not necessarily mean that the information reported in Boxes 15a and 15b is accurate.[34] However, it will allow the IRS to target certain IRAs in a way that was not previously possible. Said another way, the change to the Form 5498 will make it easier for the IRS to identify who might be a good candidate for an audit. For example, if the IRS believes (for whatever reason) that IRAs that invest into privately-held partnerships have a high likelihood of non-compliance, then the IRS could randomly audit taxpayers who have IRAs with Form 5498 reporting that shows code "E" in box 15b (i.e. "ownership interest in a partnership, trust, or similar entity"). Without the changes to Form 5498, it is impossible to know what IRAs own interests in these types of privately held companies. This same concept could apply to IRA/LLC structures (code "C" in box 15b – "ownership interest in a limited company or similar entity") which, as discussed above, have become very popular with self-directed IRA investors.

It is also possible that the IRS wants to discourage new self-directed IRA custodians from entering the marketplace by imposing additional reporting burdens. It seems likely that if the IRA custodians are required to report more specific information about alternative assets and these changes result in more administrative burden, some custodians will either exit the marketplace[35] and/or raise their fees on IRA owners. Either result would have a negative consequence on self-directed IRA owners.

A second question that stems from the Form 5498 changes is: **will the IRA custodians require more specific fair market value reporting of alternative assets within self-directed IRAs?** Currently, most IRA custodians require IRA owners to provide only an estimate of the value of alternative assets once per year,[36] which is done by filling out a custodian form that simply lists the value of the asset (e.g., real estate) or the total value of the IRA-owned LLC. It is possible that IRA custodians will require IRA accountholders to get a **certified/professional appraisal of IRA assets every year** because the value of these assets must be specifically listed in box 15a. The instructions for the 2014 Form 5498 do not specifically require this change in valuation technique, but it is possible that IRA custodians will feel pressure to be more stringent going forward.

Shot #3: *Ellis v. Commissioner*

On October 29, 2013, the Tax Court in *Ellis v. Commissioner*[37] held that the receipt of compensation by the taxpayer from a LLC that was 98 percent owned by the taxpayer's IRA resulted in several types of "self-dealing" prohibited transactions.

As discussed with regards to the *Peek* case above, an IRA loses its tax-advantaged status as of the first day of the tax year in which a disqualified person engages in a prohibited transaction.[38] IRC Sec. 4975(c)(1)(D) prohibits transfers to, or use by or for the benefit of, a disqualified person of the income or assets of a plan, and IRC Sec. 4975(c)(1)(E) prohibits a disqualified person who is a fiduciary from dealing with the income or assets of an IRA for his/her own interest or account. Under IRC Sec. 4975(e)(2), a disqualified person includes, but is not limited to: a IRA's fiduciary, which includes the IRA owner if he/she exercises any discretionary authority or control related to the management of the IRA; and, a corporation or partnership of which 50 percent or more is owned directly or indirectly by a disqualified person.

In 2005, Terry Ellis ("Ellis") established a self-directed IRA,[39] which was subsequently funded using two rollovers from Ellis' former employer's 401(k) plan. The IRA then purchased 98 percent of the membership units of CST Investments, LLC ("CST"), a new Missouri LLC, for around $320,000 – resulting in the IRA's only assets being CST units and less than $2,000 of cash. CST, managed by Ellis, used its capital to operate a used car business. During tax year 2005, CST paid Ellis $9,754 in compensation for his role as "General Manager" of CST. Also in 2005, Ellis' legal counsel formed CDJ, LLC ("CDJ"), an entity 100 percent owned by a combination of Ellis, his wife, and his children. In late 2005, CDJ acquired a parcel of real property and in 2006 leased the property to CST.

In its ruling, the Tax Court reinforced the principle discussed in Peek, i.e., that an IRA owner who exercises discretionary control over the IRA's investment is a fiduciary under IRC Sec. 4975(e)(3), and thus, a disqualified person under IRC Sec. 4975(e)(2)(A). Further, under the disqualified person rule in IRC Sec 4975(e)(4) and the constructive ownership rule of IRC Sec. 267(c)(1), the IRA was treated as proportionately owning the assets of CST, meaning that transactions between the CST and Ellis were no different than transactions between the IRA and Ellis. Importantly, the court held that the initial purchase of LLC units by Ellis' IRA was not a prohibited transaction.[40] However, the payment of compensation to Ellis was prohibited under IRC Sec.. 4975(c)(1)(D) and IRC Sec.. 4975(c)(1)(E), and thus, a complete taxable distribution of all IRA assets (consisting of mostly units of CST) occurred on January 1, 2005. All transactions in years after 2005 were deemed irrelevant because once a prohibited transaction occurs, the IRA is terminated from that point going forward.[41]

From Ellis' personal tax perspective, the Tax Court's ruling resulted in income tax on the $321,366 constructive IRA withdrawal (retroactive to 2005), plus a 10 percent early distribution penalty[42] and a 20 percent accuracy-related penalty.[43] In addition, because the assets of the IRA (i.e., CST units) became Ellis' personal assets on January 1, 2005, any income within CST (or, because CST was a corporation, any dividends paid from CST to the IRA) from 2005 to 2013 would be includable in Ellis' personal income. Assuming CST was profitable, Ellis would face additional retroactive taxes and penalties.[44]

Conclusion

Although it is possible that the *Peek* case, the amendments to the 2014 Form 5498, and the *Ellis* case were all completely isolated and unrelated events, it appears that the IRS is positioning itself to be a more

(continued on next page)

Boom! Boom! Boom! IRS Fires Three Shots Across the Bow of Self-Directed IRA Investors

continued from previous page

effective watchdog of self-directed IRAs in the future. In the author's opinion, this is a positive development due to the extremely large amount of non-compliance within self-directed IRAs created over the past 10 years, as well as the general lack of regulatory framework. However, it is critical for individuals (and their advisors) to be aware of the potentially disastrous tax consequences that can occur if self-directed IRA investments are not handled with the utmost level of care.

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1 These statements are based on the author's experience in providing legal and tax consulting to over 2,500 self-directed IRA investors, representing approximately $600 million of assets. However, the author does not personally believe in many of the rationales for investing in this manner and believes that many self-directed IRA investors should not be involved in this area whatsoever due to the applicable legal and tax complexities.

2 Investment Company Institute, *Quarterly Retirement Market Data, Second Quarter 2013* (*http://www.ici.org/research/stats/retirement/ret_13_q2*). As of June 30, 2013, total IRA market assets estimated to be $5.734 trillion, with $2.643 trillion of those assets being mutual funds and $3.091 trillion being other asset classes.

3 *Id.*

4 *Id.*

5 The investment flexibility within an IRA is generally more broad (regardless of whether a self-directed IRA is involved) than within "qualified retirement plans" (e.g., 401(k) accounts). The reason is that qualified plan administrators normally limit the investment options in order to streamline administration. Generally, once an employee reaches age 59 ½ or "separates from service" (i.e., is no longer employed by the company that sponsored the qualified plan), the employee is free to "rollover" the qualified plan funds to any IRA custodian that he/she chooses, thereby increasing flexibility going forward. Also, if the individual is nearing age 70 ½ and no longer working for the company that sponsored the plan, rolling the funds into an IRA increases flexibility when dealing with "required minimum distributions."

6 "Investor Alert," Securities and Exchange Commission's (SEC) Office of Investor Education and Advocacy, September 2011 (*http://www.sec.gov/investor/alerts/sdira.pdf*).

7 McKinsey & Company, *The Mainstreaming of Alternative Investments: Fueling the Next Wave of Growth in Asset Management*, July 2012.

8 *Id*. Assuming total assets within IRAs increases modestly from 2013 to 2015 (e.g., $5.734 trillion in 2013 to $6 trillion in 2015) and alternative assets within self-directed IRAs increases to 13 percent by the end of 2015, this would result in $780 billion within IRAs.

9 *Id*. McKensey's report estimates that the total value of investment dollars in alternative assets grew seven times faster between 2006 and 2011 than other asset class.

10 *See generally* Internal Revenue Code (IRC) Sections 408 and 4975.

11 An IRA's governing instrument must prohibit the investment of any part of the account in life insurance contracts. *See* IRC 408(a)(3); Regs. 1.408-2(b)(3).

12 A collectible is any work of art, rug or antique, metal (except as provided below with respect to U.S. coins), gem, stamp, coin, alcoholic beverage (e.g., vintage wines), musical instrument, historical object (such as a document or clothes), or other item of tangible personal property that the IRS determines is a collectible. *See* IRC 408(m)(2) and Prop. Regs. 1.408-10(b). An IRA that buys a collectible is treated as having distributed the cost of the collectible to the IRA owner. *See* IRC 408(m)(1).

13 For example, PENSCO Trust Company states that it has over $10 billion of assets under custody and over 50,000 client accounts (*www.pensco.com);* Millennium Trust Group has $8.5 billion of assets under custody (*www.mtrustcompany.com*); IRA Services Trust Company has $4 billion of assets under custody and over 37,000 accounts *(www.iraservices.com).*

14 Generally, IRA custodians must issue only one tax form (per IRA) to the IRS each year, i.e., Form 5498. This form lists IRA contributions and rollovers that were received by the custodian during the tax year. Also, the IRA custodian must list the IRA's fair market value, which is an issue that will be discussed in more detail later in this article. If the IRA owner has taken distributions from the IRA, the IRA custodian must also issue a Form 1099R. Finally, an IRA is not required to file a standalone tax return unless the IRA (or IRA/LLC) incurs "unrelated business taxable income" (UBTI) or "unrelated debt-financed income" (UDFI) – in which case a Form 990-T must be filed. However, if the IRA owner does not realize that the IRA's or IRA/LLC's investments are resulting in UBTI or UDFI, there will likely be no Form 990-T filed (note: IRA custodians will generally refuse to advise IRA owners on whether a Form 990-T is required and/or file a Form 990-T on the IRA owner's behalf). For more on the UBTI/UDFI problem, see my article, *Self-directed IRAs: A Tax Compliance Black Hole* (Journal of Accountancy, October 1, 2013) (*http://www.journalofaccountancy.com/Issues/2013/Oct/20137626.htm).*

15 The same Form 5498 is required in an IRA/LLC situation, but due to the fact that LLC's investments are outside the view of the IRA custodian, the fair market value reporting is even more unreliable than in non-IRA/LLC situations. Because most IRA-owned LLCs are 100 percent owned by the IRA, the LLC is automatically characterized as a "disregarded entity" for federal tax purposes, resulting in the LLC never filing a federal tax return. This causes significant tax compliance problems when UBTI/UDFI situations occur (see endnote above).

16 *Peek v. Commissioner*, 140 T.C. No. 9 (May 9, 2013).

17 At an IRA custodian named First Trust Company of Onaga.

18 *See Swanson v. Commissioner*, 106 T.C. 76, 88 n.13 (1996).

19 *Id.*

20 See *Peek*, 140 T.C. No. 9, page 7. The Tax Court reasoned that allowing the taxpayer's argument would permit taxpayers to "easily and abusively" avoid the prohibited transaction rules "simply by having the IRA create a shell subsidiary to whom the disqualified person could then make a loan."

21 IRC Section 408(e)(2)(A) provides: "If, during any taxable year of the individual for whose benefit any individual retirement account is established, that individual or his beneficiary engages in any transaction prohibited by Section 4975 with respect to such account, such account ceases to be an individual retirement account as of the first day of such taxable year." Further, IRC Section 408(e)(2)(B) provides: "In any case in which any account ceases to be an individual retirement account by reason of subparagraph (A) as of the first day of any taxable year, paragraph (1) of subsection (d) applies [i.e., "any amount paid or distributed…shall be included in gross income" of the account owner] as if there were a distribution on such first day in an amount equal to the fair market value (on such first day) of all assets in the account (on such first day)."

22 *Id*. The Tax Court rejected the taxpayer's statute-of-limitations argument because the prohibited transaction was not isolated to tax year 2001; instead, it continued to occur due to the promissory note (and the personal guarantees) being in effect until 2006.

23 More than 20 years earlier, the Department of Labor (DOL) examined an almost identical IRA investment fact pattern in DOL Advisory Opinion 90-23A (July 3, 1990) and reached the same conclusion as the Tax Court in *Peek*. Thus, the Tax Court's ruling in *Peek* should be viewed as merely affirming the long-held position of the DOL with respect to personal guarantee transactions, rather than creation of new law.

24 IRS Form 5498 (2013) (*http://www.irs.gov/pub/irs-pdf/f5498.pdf), box 1 (IRA contributions), box 8 (SEP contributions), box 9 (SIMPLE contributions), box 10 (Roth contributions).*

25 *Id*. Box 2.

26 *Id*. Box 3.

27 *Id*. Boxes 11, 12a, 12b. IRAs must comply with minimum distribution rules and incidental death benefit requirements similar to those that apply to qualified plans. See IRC 408(a)(6) and (b)(3), which reference the required distribution rules for qualified plans contained in IRC 401(a)(9).

28 *Id*. Box 5.

29 For example, determining the precise value of a parcel of real estate on December 31st of each calendar year is challenging. This problem becomes even more difficult in an IRA/LLC situation where the LLC holds all of the assets, and thus, the value of those assets are completely outside of the IRA custodian's view. Most self-directed IRA custodians deal with these problems by sending a "valuation" form to the IRA owner in December of each year. These valuation forms do not require a certified/professional appraisal unless the IRA's fair market value has a direct tax consequence (for example, if the IRA

(continued on next page)

CLE Committee Report

by Robert Boeshaar

The CLE Committee sponsored a CLE, "International Tax & Estate Planning – What to Avoid and How to Plan for Your Clients" on Tuesday, December 17, 2013, from 8:30 a.m. to 4:15 pm. at the WSBA-CLE Conference Center. It was also available by webcast.

The topics included: Basics of International Tax and Estate Planning, Global International Tax Reform & OECD Action Plan, International Tax Compliance and Enforcement, Trust and Estate Litigation: Estate Planning from a Litigator's Perspective and Current Issues, and While the Partners Are Away: Tales of Ethical Blunders in Estate and Gift Tax Planning.

If you are interested in getting involved with the CLE Committee, please contact Robert Boeshaar, CLE Committee Chair, at *boeshaar@boeshaarlaw.com*.

Legislative Committee Report

by Bob Mahon and Stephanie Gilfeather

The Legislative Committee of the WSBA Tax Section is preparing for the upcoming 2014 Legislative Session. The 2014 Legislative Session begins January 13, 2014 and ends March 13, 2014. The Legislature adopted a biennial 2013-2015 budget in the 2013 Legislative Session, and therefore only needs to pass a supplemental budget in 2014. Because passing the supplemental budget is less time consuming, the 2014 regular session is a short, 60-day session. If more time is needed, the Governor may call a Special Session.

The WSBA's Legislative Affairs Division (i.e., our lobbyists) refers all tax-related bills to the Tax Section's Legislative Committee. The Legislative Committee reviews the bills to determine whether they "relate to or affect the practice of law or the administration of justice" (a requirement of GR 12(c)(2)) and merit comment by the Tax Section. If the Legislative Committee determines that a bill likely meets the requirements of GR 12(c)(2) and merits comment, the Legislative Committee brings the bill to the attention of the Tax Council (the Tax Section's Board) to determine whether the Tax Section will support, oppose, or otherwise comment on a bill. The Tax Section may not take a position on a bill without the approval of at least 75 percent of the members of the Tax Council. If the Tax Council takes a position on a bill or legislation, the Legislative Committee works with the WSBA's lobbyists to communicate and, where appropriate, advocate for our position.

The Legislative Committee also supports legislative efforts by other Tax Section Committees. This fall the Legislative Committee supported the State and Local Tax Committee's efforts to comment on possible proposals for an independent state tax tribunal in Washington state.

In 2013, the Tax Council supported two bills that failed to pass (one requiring the publication of Department of Revenue tax determinations and another changing the standard of review in property tax valuation to "preponderance of the evidence") and opposed one bill that did pass (legislation that retroactively increased state estate taxes in response to the *Estate of Bracken* case). The Legislative Committee is looking forward to a short and productive 2014 Legislative Session.

Boom! Boom! Boom! IRS Fires Three Shots Across the Bow of Self-Directed IRA Investors

continued from previous page

owner is older than age 70 ½, the fair market value of the IRA becomes critical when determining the appropriate amount of the required minimum distribution; also, if the IRA owner elects to convert some or all of the self-directed IRA to a Roth IRA, the fair market value is important in order to determine the constructive/taxable IRA distribution to the IRA owner).

30 *Id.* It is not uncommon for a self-directed IRA custodian to report the exact same IRA value for numerous years due to the fact that the IRA owner is unwilling to provide updated asset values.

31 2014 Form 5498 Instructions (draft, June 20, 2013), *see generally* pages 18-22 (*http://www.irs.gov/pub/irs-dft/i1099r--dft.pdf*).

32 *Id.* at page 22.

33 *Id.*

34 Because the IRA owner (or his/her advisor) is reporting the fair market value of assets to the IRA custodian, there is no guarantee that this self-reporting is accurate. *See also* endnote #29 above.

35 Occasionally small banks and trust companies voluntarily withdraw from serving as self-directed IRA custodians, although the reasons for these decisions are not always known. For example, for many years, Viking Bank (acquired by American West Bank in November 2011) operating Viking Asset Retirement Custodian (VRAC), which held self-directed IRAs. In mid-2013, American West Bank voluntarily shut down VRAC and transferred all of its self-directed IRAs to Millennium Trust Group.

36 In most situations, this seems sufficient considering that the increase or decrease in the value of an IRA does not automatically trigger a tax consequence (assuming the IRA owner is not in an RMD year). In situations where the value of the IRA's assets is critical (e.g. RMD years, Roth conversion, in-kind distribution of assets), the IRA custodians will typically require a "licensed professional" to sign off on the value of the assets being reported by the IRA owner (i.e., the professional must sign the custodian's "valuation form").

37 *Ellis v. Commissioner*, T.C. Memo. 2013-245 (October 29, 2013).

38 IRC Section 4975(c)(1); IRC Section 408(e)(2)(A) and (B).

39 Perhaps ironically (or not), Ellis' IRA was also formed at First Trust Company of Onaga (the same IRA custodian that was involved in the *Peek* case).

40 As discussed in the "background" section of this article, one of the two primary methods for executing self-directed IRA investments is through a wholly-owned (or majority-owned) LLC. However, the IRA/LLC structure relies on the legal foundation that an IRA can initially purchase 100 percent of a newly formed LLC without a prohibited transaction occurring. Thus, the *Ellis* court confirming the fundamental IRA/LLC structuring issue was important.

41 Although the court did not specifically address the issue, it is almost certain that the lease agreement between CDJ and CST would have also triggered a prohibited transaction because CDJ was a disqualified person due to it being 100 percent owned by other disqualified people (i.e., Ellis and his family members).

42 IRC Section 72(t). Ellis was younger than 59 ½ on January 1, 2005 (i.e., the date of the constructive IRA distribution).

43 IRC Section 6662(a), (b)(1) and (2).

44 The Tax Court in *Ellis* did not calculate the specific tax consequences to Ellis in tax year 2005 or beyond, because, in the court's words, those issues were purely "computational."

State and Local Tax Committee Report

by Michelle DeLappe

The SALT Committee has been continuing to consider concerns and possible improvements to Washington's tax appeals system. As reported at our last meeting on October 30, we decided, in coordination with the Legislative Committee, not to move forward with a proposal for legislation on this issue in 2014 but rather to continue drafting and working with stakeholders. Independently, Senator John Braun took up the same issue at a work session in the Senate Trade and Economic Development Committee that he chairs. Thanks to the work of various SALT Committee members, the Tax Council approved a list of key attributes that we believe any proposed legislation on an independent tax tribunal should include. That document was presented at the work session and is available, along with others discussed at the session, on the legislature's website: *https://app.leg.wa.gov/CMD/document.aspx?agency=7&year=2013&cid=17550&mid=19462&hid=145621*.

The SALT Committee is continuing to hold quarterly meetings to provide a forum to discuss recent developments and common concerns in state and local tax. We welcome new participants at our meetings, which can be attended in person (in Seattle) or toll-free by phone. To receive occasional notifications of general interest to Washington's SALT community and details about upcoming meetings and events, please contact Committee Chair Michelle DeLappe at *mdelappe@gsblaw.com*.

Transactional Tax Committee Report

by Andrew Bryant

The Transactional Tax Committee held its fall quarterly meeting on October 24 at the offices of Wilson Sonsini Goodrich & Rosati. Chris Brown of Summit Law Group provided a timely and relevant discussion regarding application of the new 3.8 percent Medicare contribution tax to business transactions and Andrew Bryant discussed the partnership tax issues raised by the recent case of *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012), *cert. den.*, U.S. No. 12-901 (May 28, 2013). Our first meeting for 2014 will be held on Thursday, January 30, at noon and we will be returning to the offices of Riddell Williams, courtesy of Jim Minorchio. We welcome new committee members or guests from the WSBA Tax Section as well as any ideas for future presentations or discussions related to taxation of business transactions. Please contact Andrew Bryant at *abryant@wsgr.com* or 206-883-2512 if you have any questions or suggestions regarding the Transactional Tax Committee.

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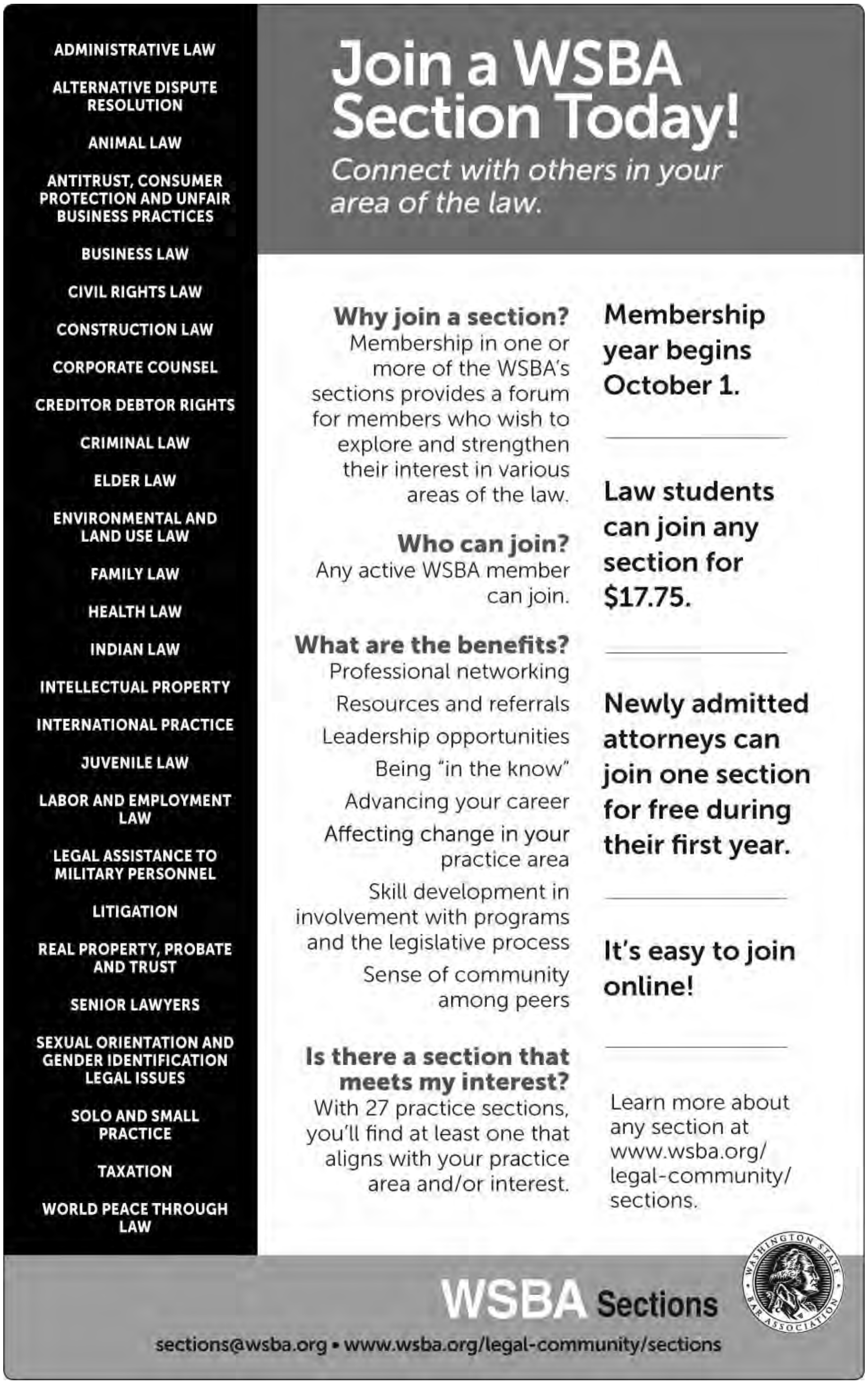
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