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Navigating the self-directed IRA waters

With IRAs being a major component of retirement plans, participants should try to maximize their returns. One way may be through a self-directed IRA. However, before considering an investment in a self-directed IRA, many questions must be asked. For example, what investments are permitted? Are there limits on who can be an investor? What are the ramifications of not complying with the applicable rules? What are the costs involved in comparison with traditional IRAs?

Permitted investments

Other than those items specifically prohibited (as described in "Prohibited investments" on Page 2), the choice of investments in a self-directed IRA is relatively wide open.

Accordingly, permitted investments include the following categories:

- Real estate
- Private equity
- Startups
- Promissory notes
- Tax lien certificates
- Foreign currencies
- Cryptocurrencies
- Precious metals (e.g., gold, silver, palladium) that meet certain purity standards

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In addition, a self-directed IRA may be established as either a traditional or Roth IRA.

Prohibited investments

Specific assets not permitted in a self-directed IRA include the following:

- Collectibles (e.g., artwork, rugs, antiques, gems, stamps, alcoholic beverages)
- Life insurance
- Coins
- S corporations

Accredited investors

One possible impediment to investing in a self-directed IRA is that certain private placement investments (specifically, Regulation D9 offerings) are restricted to accredited investors.[1] An accredited investor is one who earned over $200,000 ($300,000 joint income if married) in each of the past two years and continues to maintain that income level. Alternatively, they must have a net worth of more than $1 million (not including the value of a primary residence). A 2020 amendment to the definition includes certain people who are deemed sufficiently knowledgeable about investments by way of certifications, employment or other means.[2]

Prohibited transaction rules

Prohibited transaction rules are another major concern when investing in a self-directed IRA. Under these rules, qualified retirement plans including IRAs are not allowed to engage in prohibited transactions with a disqualified person. A 15% excise tax (100% if it remains uncorrected) applies to any disqualified person who engages in a prohibited transaction. This tax does not apply to fiduciaries acting in that capacity, nor to the IRA owner or beneficiary.[3]

> "If a disqualified person engages in a prohibited transaction with an IRA, the arrangement ceases to be exempt from tax."

Loss of exempt status. If a disqualified person engages in a prohibited transaction with an IRA, the arrangement ceases to be exempt from tax.[4] As a result, the fair market value of the IRA (or at least the portion affected by the transaction) is treated as a taxable distribution to the owner or beneficiary as of the first day of the tax year in which the prohibited transaction occurs. In addition, the 10% additional tax on early withdrawals may apply if the taxpayer is under age 59½.[5]

The definition of a disqualified person includes:[6]

1. Plan fiduciaries
2. Anyone providing services to the plan
3. Employers or employee organizations, including a direct or indirect 50% or more owner of the employer organization whose employees or members are covered by the plan
4. Certain family members of any individual disqualified person
5. Corporations, partnerships, trusts or estates 50% or more owned by those described in 1 through 3 above
6. Officers, directors, 10% (or more) shareholders or highly compensated employees (earning 10% or more of the annual compensation of an employer) of those described in 3 or 5 above
7. 10% (or more) partners or joint venturers of those described in 3 or 5 above

Family members who count as a disqualified person include spouses, the owner's lineal ancestors (parents, grandparents and great-grandparents), lineal descendants (children, grandchildren and great-grandchildren) and spouses of lineal descendants (sons- or daughters-in-law).[7]

Owner as fiduciary. A fiduciary includes any person who exercises any authority or control respecting management or disposition of the plan's assets, renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has any discretionary authority or responsibility in the administration of the plan.[8] In the context of a self-directed IRA, the owner is a fiduciary and therefore a disqualified person.[9]

Prohibited transactions between a disqualified person and a plan include:[10]

- Sales, exchanges or leases of property
- Loans or extensions of credit
- Furnishing of goods, services or facilities
- Transfers to or use by or for the benefit of the disqualified person of plan income or assets
- Use of plan income or assets by a fiduciary for his or her own benefit or account
- Receipt by a plan fiduciary of consideration for their own account from a party who is dealing with the plan in connection with plan income or assets

Fees and costs

Another potential downside to investing in a self-directed IRA concerns the related costs. Many different fees can impact an investor's bottom line. First, there is a start-up fee, which can vary depending on the type of investment. For example, fees to create an LLC for investing in real estate are usually higher.

Most custodians also charge an annual fee, which can vary according to asset type and value. In addition, there are typically fees associated with transactions, such as buying or selling assets, transferring funds or cutting checks. Additional fees can apply when buying or selling real estate, including for notary services, wire transfers and setting up earnest money accounts.

There may also be administrative fees based on the type of asset held. For example, custodians holding precious metals may require a fee simply for storage of the gold, silver or other metals. And there may be separate fees associated with using an online portal or robo-advisor system maintained by the custodian.

Choosing a self-directed IRA custodian

Following the decision to invest in a self-directed IRA, an IRA custodian must be selected. Several factors, including investment choices, experience and cost, go into this decision. Unfortunately, this is an area where fraudulent companies have attempted to lure investors.[11] It is also important to note that, although self-directed IRA custodians are responsible for administering and holding the assets chosen, they are not required to investigate or evaluate the worthiness of the investment.

Conclusion

Self-directed IRAs may provide a viable alternative to traditional IRAs for some investors. However, like any investment, self-directed IRAs require a thorough analysis before making a commitment.

1 Regulation D (17 C.F.R. §230.501)

2 https://www.sec.gov/news/press-release/2020-191

3 Code Secs. 4975(a) and 4975(e)(1)

4 Code Secs. 408(e)(2)(A) and 4975(c)(3)

5 Code Sec. 72(t)

6 Code Sec. 4975(e)(2)

7 Code Secs. 4975(e)(2)(F) and 4975(e)(6)

8 Code Sec. 4975(e)(3)

9 *G. Harris*, 67 TCM 1983, Dec. 49,624(M), TC Memo. 1994-22; DOL Advisory Opinion 93-33A

10 Code Sec. 4975(c)

11 https://www.sec.gov/investor/alerts/sdira.html ◆

Simplified procedure to request relief to make portability election

The IRS has updated its simplified procedure for estates requesting a time extension to make a portability election under Code Sec. 2010(c)(5)(A). The updated procedure replaces that provided in Rev. Proc. 2017-34 (Rev. Proc. 2022-32). If the portability election is made, the deceased spousal unused exclusion (DSUE) amount is available to a surviving spouse to apply to transfers made during life or at death. The simplified method is for use instead of the letter ruling process. No user fee is due for submissions filed in accordance with the revenue procedure.

A simplified method to obtain an extension was available for decedents dying after Dec. 31, 2010, if the estate was only required to file an estate tax return for the purpose of electing portability. However, that method was only available on or before Dec. 31, 2014. Since then, the IRS has issued numerous letter rulings under Reg. §301.9100-3 granting extensions to elect portability in situations where the estate was not required to file a return under Code Sec. 6018(a). The number of ruling requests received after Dec. 31, 2014, and the related burden imposed on the IRS prompted continued relief for estates that have no filing requirement under Code Sec. 6018(a). Rev. Proc. 2017-34 provided a simplified method to obtain an extension to elect portability, available to the estates of decedents having no filing obligation under Code Sec. 6018(a) for a period through the later of Jan. 2, 2018, or the second anniversary of the decedent's death. An estate seeking relief after the second anniversary of the decedent's death could do so by requesting a letter ruling in accordance with Reg. §301.9100-3.

Despite the relief this simplified procedure provided for the IRS, numerous estates still sought relief through letter ruling requests in which the decedent died within five years of the date of the request. The number of these requests has placed a continuing burden on the IRS.

Therefore, the updated procedure extends the period within which the estate of a decedent can make the portability election under that simplified method to on or before the fifth anniversary of the decedent's date of death.

Section 3 provides that the simplified procedure is only available if certain criteria are met. First, the taxpayer must be the executor of the estate of a decedent who was survived by a spouse, died after Dec. 31, 2010, and was a U.S. citizen or resident at the time of death. In addition, the estate must not be required to file an estate tax return under Code Sec. 6018(a) and must not have filed an estate tax return within the time prescribed by Reg. §20.2010-2(a)(1) for filing a return to elect portability. Finally, all requirements of section 4.01 of the revenue procedure must be met.

> "Section 3 provides that the simplified procedure is only available if certain criteria are met."

The revenue procedure does not apply to estates that filed an estate tax return within the time prescribed by Reg. §20.2010-2(a)(1) to elect portability. For taxpayers that do not qualify for relief because the requirements of section 4.01 are not met, the estate can request an extension to file the estate tax return to make the portability election by requesting a letter ruling.

Under Section 4.01, the requirements for relief are:

- A person permitted to make the election on behalf of a decedent must file a complete and properly-prepared Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return* (as provided in Reg. §20.2010-2(a)(7)) on or before the fifth anniversary of the decedent's date of death.
- "FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)" must be written at the top of the Form 706.

If the requirements of sections 3.01 and 4.01 are met, the estate will be deemed to meet the requirements for relief under Reg. §301.9100-3, and relief will be granted to extend the time to elect portability. If relief is granted pursuant to the revenue procedure and it is later determined that the estate was required to file a federal estate tax return, based on the value of the gross estate plus any adjusted taxable gifts, the extension of time granted to make the portability election is null and void.

If a decedent's estate is granted relief under this revenue procedure so the estate tax return is considered timely filed for the purpose of electing portability, the DSUE amount of that decedent is available to the surviving spouse or the surviving spouse's estate for application to transfers made by the surviving spouse on or after the decedent's date of death. If the increase in the surviving spouse's applicable exclusion amount attributable to the addition of the decedent's DSUE amount as of the date of the decedent's death results in an overpayment of gift or estate tax by the surviving spouse or their estate, no claim for credit or refund may be made if the limitations period for filing a claim for credit or refund with respect to that transfer has expired. A surviving spouse will be deemed to have filed a protective claim for refund or credit of tax if the claim is filed within the time prescribed in Code Sec. 6511(a) in anticipation of a Form 706 being filed to elect portability pursuant to the revenue procedure.

The revenue procedure is effective July 8, 2022. Through the fifth anniversary of a decedent's date of death, the procedure described in section 4.01 of this revenue procedure is the exclusive procedure for obtaining an extension to make portability election if the decedent and the executor meet the requirements of section 3.01 of this revenue procedure. If a letter ruling request is pending on July 8, 2022, and the estate is within the scope of the revenue procedure, the file on the ruling request will be closed and the user fee will be refunded. The estate may obtain relief as outlined in the revenue procedure by complying with section 4.01. ◆

Proposed rules related to actuarial tables and computation of estate tax

Two sets of highly anticipated proposed regulations have been issued by the IRS. First, a proposed rule under Code Sec. 2010 provides an exception to the "anti-clawback" rule, which describes what happens if a donor made gifts when the lifetime exclusion from estate and gift taxes was higher at the time of the gift and then lower on the date of death. In addition, regulatory actuarial tables used to value annuities, interests for life or terms of years, and remainder or reversionary interests in property were also released.

Exception to the special rule for post-2025 decedents

In November 2019, Reg. §20.2010-1(c) was finalized, providing a special rule in cases where the portion of the credit against the estate tax based on the basic exclusion amount (BEA) is less at the date of death than the sum of the credit amounts attributable to the BEA allowable in computing gift tax payable within the meaning of Code Sec. 2001(b)(2) with regard to a decedent's lifetime gifts (NPRM REG-118913-21). The proposed regulation would apply to the estates of decedents dying on or after April 27, 2022.

The exception to the special rule applies to the following examples:

- Transfers includible in the gross estate pursuant to Code Secs. 2035, 2036, 2037, 2038 or 2042, regardless of whether any part of the transfer was a deductible charitable or marital gift
- Transfers made by enforceable promise to the extent it remains unsatisfied as of the date of death
- Transfers described in Reg. §25.2701-5(a)(4) or §25.2702-6(a)(1)
- Transfers that would have been identified above, but for the transfer, relinquishment or elimination of an interest, power or property, effectuated within 18 months of the decedent's date of death by the decedent alone or in conjunction with any other person, or by any other person

Certain transfers still covered by the special rule

The special rule still applies to transfers includible in a decedent's gross estate when the taxable amount of the gift is 5% or less of the taxable amount of the transfer, valued as of the date of the transfer. In addition, the rule also applies to transfers, relinquishments or eliminations as described above that are effectuated by the termination of the durational period described in the original transfer instrument by either the mere passage of time or the death of any person.

Valuation regulations related to actuarial tables

These regulations affect the valuation of *inter vivos* and testamentary transfers of interests dependent on one or more measuring lives and will generally be effective for valuations occurring on or after the first day of the month following the date the Treasury Decision finalizing these rules is published in the *Federal Register* (NPRM REG-122770-18).

Pursuant to Code Sec. 7520(c)(3), the IRS must revise the tables at least once in each 10-year period. Revised Tables S (*Single Life Remainder Factors*) and U(1) (*Unitrust Single Life Remainder Factors*), effective for transfers for which the valuation date is after the effective date, are based on data compiled from the 2010 census as set forth in Life Table 2010CM.

Tables S and U(1), which are referenced in Publications 1457 and 1458, will no longer be published in the regulations. The current Tables S and U(1), effective for transfers for which the valuation date is after April 30, 2009, and before the applicability date of the Treasury Decision adopting the regulations as final, will be moved to sections containing actuarial material for historical reference. The updated actuarial tables are freely available on the IRS website at www.irs.gov/retirement-plans/actuarial-tables.

Transitional rules

To avoid any potential adverse consequences resulting from the proposed regulatory changes, the regulations provide certain transitional rules.

Estate and gift taxes. For gift tax purposes, if the date of a transfer is on or after Jan. 1, 2021, but before the applicability date of the Treasury Decision finalizing the regulations, the donor may choose to determine the value of the gift (and/or applicable charitable deduction) under tables based on either Life Table 2000CM or Table 2010CM. Similarly, for estate tax purposes, if a decedent dies on or after Jan. 1, 2021, but before the applicability date of the Treasury Decision adopting the regulations as final, the value of any interest (and/or applicable charitable deduction) may be determined

at the discretion of the decedent's executor under tables based on either Life Table 2000CM or Table 2010CM. However, the Code Sec. 7520 interest rate to use is the appropriate rate for the month in which the valuation date occurs, subject to the following special rule for certain charitable transfers.

Charitable deductions. In cases involving a charitable deduction, the transitional rule and those contained in Reg. §§1.7520-2(a)(2), 20.7520-2(a)(2) and 25.7520-2(a)(2) dictate a somewhat different choice. Specifically, if the valuation date occurs on or after Jan. 1, 2021, but before the applicability date of the Treasury Decision adopting the regulations as final, and the executor or donor elects under section Code Sec. 7520(a) to use the Code Sec. 7520 interest rate for a month that is prior to Jan. 1, 2021, then the mortality experience contained in 2000CM must be used. If the executor or donor uses the Code Sec. 7520 interest rate for on or after Jan. 1, 2021, but before the applicability date of the Treasury Decision finalizing the regulations, the tables based on either Table 2000CM or Table 2010CM may be used. However, if the valuation date occurs on or after the applicability date of the Treasury Decision adopting the regulations as final, the executor or donor must use the new mortality experience contained in Table 2010CM, even if the use of a prior month's interest rate is elected.

Mental incompetency. In addition, the proposed regulations no longer provide that the estate of a mentally incompetent decedent may elect to value the property interest included in their gross estate under the mortality table and interest rate in effect at the time the decedent became mentally incompetent or as of the decedent's date of death. Estates of decedents with a mental disability who die after the applicability date of the Treasury Decision finalizing the regulations will be required to use the mortality table and interest rate in effect on the decedent's date of death or the alternate valuation date, if elected. ◆

Proposed regulations address estate tax interest expense and guarantees

Proposed rules provide guidance on the following:

- The applicability of present-value principles in determining the amount deductible under Code Sec. 2053
- The deductibility of interest accruing on tax and penalties owed by an estate
- The deductibility of interest on certain loans incurred by an estate
- Substantiation requirements for the value of a claim against an estate that is deductible under Reg. §20.2053-4(b) or (c)
- The deductibility of amounts paid under a decedent's personal guarantee (NPRM REG-130975-08)

The proposed regulations apply to the estates of decedents dying after the date of publication in the *Federal Register* of a Treasury Decision adopting the rules as final.

Application of present-value principles to the deductible amount

Excluding unpaid mortgages and indebtedness incurred under Reg. §20.2053-7, present-value principles in determining the amount deductible would be incorporated into the rules. The proposed rule defines a reasonable grace period for administering and closing a decedent's estate as three years after the date of death. The present value of the amount of a deductible claim or expense not paid within the grace period is calculated using a formula provided in the proposed rule.

Interest expense as deductible administration expense

Interest payable under Code Sec. 6601 on unpaid estate tax in connection with an extension under Code Sec. 6161 or 6153 is necessarily incurred in the administration of the estate. Interest payable under Code Sec. 6601 or under state or local law, other than Code Sec. 6166 interest accrued on and after the date of death on unpaid tax or penalties connected to an underpayment of tax or a deficiency, is generally considered actually and necessarily incurred in the administration of the estate. The proposed rule provides an exception for circumstances in which the interest expense would not be deemed actually and necessarily incurred in estate administration, such as an interest expense attributable to the executor's negligence, disregard of the regulations or fraud with intent to evade tax. In addition, Rev. Rul. 79-252, 1979-2 CB 333, will be obsolete, and Rev. Rul. 81-154, 1981-1 CB 470, will be modified effective on the date that rules are adopted as final.

Interest accruing on certain loan obligations

Some estates obtain loans to pay estate tax and other liabilities during the administration of the estate. The proposed regulations provide guidance on when the interest expense from such a loan is deductible:

- The interest accrues pursuant to an instrument or contractual arrangement that constitutes indebtedness under applicable income tax regulations and general principles of federal law.
- Both the interest expense and the loan on which the interest expense accrues meet bona fide requirement of Reg. §20.2053-1(b)(2).
- The loan on which the interest accrues and the loan's terms are actually and necessarily incurred in the administration of the estate and are essential to the proper settlement of the estate.

The proposed rules provide a nonexclusive list of factors to consider whether an interest expense payable pursuant to a loan obligation of an estate meets the requirements of Reg. §§20.2053-1(b)(2) and 20.2053-3(a).

Substantiation requirements

New requirements to establish the valuation of claims deductible under Reg. §20.2053-4 are proposed. The requirements that the valuation of claims be supported by a qualified appraisal performed by a qualified appraiser are removed.

Amounts paid pursuant to a decedent's personal guarantee

The proposed rules provide that a claim founded on a decedent's agreement to personally guarantee a debt of another must be bona fide and in exchange for adequate and full consideration in money or money's worth. Under a bright line rule, a decedent's agreement to guarantee a bona fide debt of entity in which the decedent had control at the time of the guarantee satisfies that requirement. The requirement is also satisfied if, at the time the guarantee is given, the decedent's maximum liability under the guarantee did not exceed the fair market value of the decedent's interest in the entity. ◆

Building a team of professionals to help provide solutions for our clients

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We want to work together as a team and offer value for your practice and clients. Using complementary skills and philosophies, we can help save time, money and resources while assisting mutual clients in planning for today's financial and tax challenges.

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