Employee Benefits Corner

By Elizabeth Thomas Dold and David N. Levine

Tax Treatment on the Payment of IRA Fees Gets a New (but Familiar) Private Letter Ruling

For years, the IRA industry has sought official, comprehensive guidance on the proper tax treatment of payment of various IRA fees, through various types of fee structures. The recent guidance issued in this area—LTR 201104061[1]—reaffirms the IRS's favorable position regarding the IRA owners' payment of wrap fees with non-IRA funds, but continues to leave a number of guidance gaps. A review of the key guidance in this area is set forth below, followed by a review of the recent LTR. Until further guidance is issued, the IRA community should carefully review their fee structures to ensure that they do not inadvertently trigger a deemed taxable distribution or a deemed IRA contribution, which could result in taxable income and excise taxes to IRA owners and reporting and withholding obligations for an IRA provider (and penalties and interest related thereto). Moreover, absent general guidance in this area, consideration should be given to whether a private letter ruling should be requested on the IRA provider's fee structure arrangement.

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Official Guidance

The Internal Revenue Code of 1986, as amended ("the Code"), does not expressly provide for the tax treatment of IRA fees. However, the Code does impose an annual six-percent excise tax on excess IRA contributions under Code Sec. 4973. Moreover, distributions from an IRA are generally

included in gross income under Code Sec. 408(d)(1) and early distributions (pre–59 1/2) may be subject to an additional tax under Code Sec. 72(t). Excess contributions generally arise if contributions exceed the maximum limits set forth under Code Sec. 219(b) (*e.g.,* contributions to a traditional and Roth IRA than generally exceed $5,000 for 2011 ($6,000 for a catch-up eligible participant who has reached age 50).

In Rev. Rul. 84-146,[2] the IRS applied the principles of Reg. §1.404(a)-3(d) to an IRA, which provides that:

> [a]ny expenses incurred by the employer in connection with the plan, such as trustee's fees and actuary's fees, which are not provided for by contributions under the plan are deductible by the employer under section 162 (relating to trade or business expenses), or section 212 (relating to expenses for production of income) to the extent they are ordinary and necessary.

Following this regulation, the ruling expressly provides that trustee fees in connection with the IRA paid directly by an IRA owner with non-IRA funds are deductible under Code Sec. 212 to the extent they satisfy the requirements of that Code section and are not "deemed" IRA contributions and therefore not subject to the annual six-percent excise tax. Specifically, Code Sec. 212 provides for a miscellaneous itemized deduction (subject to the two-percent floor) for all ordinary and necessary expenses paid or incurred during the tax year (1) for the production or collection of income; (2) for the management, conservation or maintenance of property held for the production of income; or (3) in connection with the determination, collection or refund of any tax. Importantly, the deduction under Code Sec. 212 is subject to Code Sec. 265, which generally prohibits taking a deduction for expenses related to income that is exempt from taxation (which may impact a deduction taken for a Roth IRA as the earnings thereto are intended to be tax-free).

In Rev. Rul. 86-142, the IRS addressed the treatment of brokerage expenses paid under an IRA. It concluded that brokerage commissions are not "recurring administrative or overhead expenses," such as trustee or actuary fees, but rather are intrinsic to the value of the trust's assets. Under the ruling, direct payment by the IRA owner of the brokerage fees was treated as a contribution to the IRA. The IRA contributions to reimburse the IRA for brokers' commissions, or direct payments by the IRA owner to a broker, were not deductible under Code Sec. 162 or 212, but were subject to the Code limits (Code Sec. 219, referenced above) on IRA contributions.

In 1999, the Tax Court rejected the IRS's "recurring administrative or overhead expenses" approach under Rev. Rul. 86-142 and held that if an employer pays "any" ordinary and necessary plan-related expenses directly to a third party from the employer's assets, and if such expenses are not provided for by contributions under the plan, those payments will not be deemed constructive contributions to the plan subject to the plan deduction (Code Sec. 404) limitations, but rather are business expenses deductible under Code Sec. 162.[3] Although this case involved attorney fees, the case supports the view that all expenses (including brokerage expenses and similar fees) paid directly by the employer outside a qualified plan would not be considered additional plan contributions, provided that the plan document permits direct payment. However, the Internal Revenue Manual—which is used by IRS auditors in analyzing deductions for qualified plans—continues to cite the 1984 and 1986 rulings, distinguishing between separately deductible administrative fees and expenses paid directly by the employer, and "investment fees, brokers' commissions and the like."[4]

Informal IRS Guidance

Deemed Contribution

The IRS has also issued a long line of private letter rulings on the payments of IRA fees made directly by an IRA owner that are trustee's fees (and not brokerage commissions) are deductible under Code Sec. 212 and are not treated as "deemed" IRA contributions (and not reportable on Form 5498).[5]

However, these rulings (including rulings for qualified plans and IRAs) have not been consistent on the issue of whether an IRA owner/employer could reimburse an IRA/plan for fees already paid. For example, in the late 1980s, the rulings treated the direct payment and reimbursement of a plan for flat investment management fees unaffected by number or volume of securities sold in the same manner as regular trustee fees (*e.g.,* account maintenance). In that case, the payments or reimbursements were deductible

by the employer under Code Sec. 162 or 212, and were not plan contributions for purposes of Code Secs. 404 and 415.[6] The IRS reconsidered these conclusions in the early 1990s and modified the earlier rulings, stating that the treatment of reimbursements (but not direct payment) was incorrect.[7] However, more recently, the IRS has indicated that, in certain qualified plan cases at least, employer payments to reimburse a plan solely for administrative fees (and not commissions) were deductible under Code Sec. 162 in the tax year in which the plan disburses such payments to the service providers.[8]

In 2005, the IRS released a favorable private letter ruling (LTR 200507021[9]) on a broker-dealer's "wrap fee" programs. Most of the subject programs allowed unlimited trades, but focused primarily on asset allocation, advisory, custody and other research services in return for the single "wrap fee" based on a "%-of-assets." In these programs, the broker-dealer stated that brokerage/trading costs would amount to roughly 15 percent of total costs. However, one program was a nonadvisory program where the client could pay directly for trades or instead pay a flat "%-of-assets" fee like the other programs for unlimited trades.

In all cases, the 2005 LTR ruled that the IRA owner's payment of the wrap fee from non-IRA assets would not be treated as a deemed IRA contribution. Importantly, the IRS did not require any allocation of a portion of the wrap fee allocable to brokerage transactions. The apparent IRS thinking here is that it is too complex to require an allocation of a portion of a wrap fee to the trading function. This thinking apparently extended to the nonadvisory program because the fee also covered trustee and recordkeeping fees. This ruling does not cover whether payment of the fee from the IRA would be taxed as a distribution (presumably not: see below), or whether the owner can reimburse the IRA for the wrap fee and get the same favorable outcome (presumably not, as noted above). As with all private rulings, it only applies to the requestor and the facts presented to IRS.

Deemed Distribution

A line of private letter rulings[10] have also concluded that fee payments made by debiting the IRA itself does not result in deemed distributions (and not reportable on Form 1099-R) where the fees fall within the description of trustees' fees in Rev. Rul. 84-146 (described above) and the IRA does not accept a reimbursement.

New Private Letter Ruling

The IRS recently released a favorable private letter ruling (LTR 201104061[11]) on a broker-dealer's "wrap fee" program. A "wrap fee" is a fee that provides IRA account holders with investment advice, custody and trade execution services, where the fee is a percentage of assets under management and typically is not related to the number of trades executed in any account. The ruling largely mirrors the 2005 private letter ruling (LTR 200507021[12]) that first addressed "wrap fee" programs. As in the prior LTR, the programs generally allowed unlimited trades, but focused primarily on asset allocation, advisory, custody and other research services in return for the single "wrap fee" based on a "percentage of total account assets."

In all cases, the IRS ruled that the IRA owner's payment of the quarterly wrap fee from non-IRA assets (*e.g.,* the owner's "retail" account) would not be treated as an additional IRA contribution. (It appears that the IRA owner could still opt to have the fee paid directly from the account.) Although each of the three investment advisory accounts included a securities trading service, the cost of which was included in the wrap fee, the IRS determined that clients who participate in these accounts are predominantly paying for investment advisory, money management, custodial and other administrative services. Importantly, as in the 2005 LTR, the IRS did not require any allocation of a portion of the wrap fee to brokerage transactions.

Although the 2005 and 2011 rulings largely mirror each other, there are a few notable differences between them:

- **No Brokerage Cost Representation.** Unlike the 2005 ruling, the new ruling does not include a representation regarding the percentage of the wrap fee attributable to securities trading services. In the prior ruling, the broker-dealer stated that brokerage/trading costs would amount to no more than roughly 15 percent of total wrap fee costs.
- **Does Not Address Nonadvisory Programs.** Unlike the 2005 ruling, none of the account arrangements in the new ruling include a nonadvisory program. However, there is no indication that the IRS would rule differently today on such a program.

- **Other Expenses.** The new ruling lists a number of types of expenses that are treated as "other expenses" and not part of the wrap fee; therefore, the ruling does not address the proper tax treatment of the payment of these expenses. These "other expenses" include commissions charged by other brokers, interest on debit account balances, interest charges on margin loans, the entire public offering price on securities purchased from an underwriter or dealer involved in a distribution of securities, bid-ask spreads, off-lot differentials, exchange fees, transfer taxes and other fees required by law, transaction charges on the liquidation of assets not eligible for the account and short-term trading charges for purchases and redemptions of certain mutual fund shares within short periods of time. Also, under one arrangement, a $55 "active trader" fee for trades exceeding the trade caps specified in the account terms and conditions also would not be covered by the wrap fee.

Unfortunately, the ruling does not provide any much needed general guidance in this area—as with all LTRs, it technically only applies to the requestor and to the facts presented to the IRS. Moreover, it does not cover issues such as (1) whether payment of the fee from the IRA would be taxed as a distribution to the owner (presumably not), or (2) whether the owner can reimburse the IRA for the wrap fee and get the same favorable "noncontribution" outcome (presumably not, following a line of private letter rulings where the IRS reversed itself after taking a favorable position). Nevertheless, the LTR is a helpful indicator of the IRS's position on common current industry practices.

Endnotes

[1] LTR 201104061 (Nov. 4, 2010).

[2] Rev. Rul. 84-146, 1984-2 CB 61.

[3] *Sklar, Greenstein & Scheer, P.C.*, 113 TC 135, Dec. 53,505 (1999).

[4] IRM §4.72.15.3.6 (June 14, 2002).

[5] *See, e.g.,* LTR 9005010 (Nov. 2, 1989) (where annual maintenance fees and additional transaction fees could be paid separately by IRA owner and IRA owner could separately pay investment advisor and IRA does not accept reimbursements from IRA owner); LTR 8835062 (June 13, 1988) (where various fees such as annual maintenance, self-directed investment and withdrawal processing fees are ordinary and necessary fees do not reflect the number or frequency of brokerage account transactions, and are billed separately to the IRA owner); LTR 8830061 (May 4, 1988) (where various fees such as annual administration fee are billed directly to IRA owner); LTR 8711095 (Dec. 18, 1986) (where administrative fees and services fees billed directly to the IRA owner and paid separately by the IRA owner were not treated as deemed contributions and not reported on Form 5498, but the brokerage commissions so billed to the IRA owner were deemed contributions reportable on Form 5498); LTR 8704058 (Oct. 29, 1986) (where unbundled trustee's fees, which are incurred in the ordinary maintenance of the IRA, are not credited to the IRA and are paid separately by the IRA owner); LTR 8432109 (May 11, 1984) (where fees paid separately by IRA owner); LTR 8329049 (Apr. 19, 1983) (where IRA owner paid trustee's fees).

[6] *See* LTR 8940014 (June 30, 1989), LTR 8940013 (June 30, 1989), LTR 8941010 (June 30, 1989) and LTR 8941009 (June 30, 1989).

[7] *See* LTR 9124034 (Mar. 19, 1991), LTR 9124037 (Mar. 19, 1991) and LTR 8830061 (May 4, 1988): "[I]n the case at hand, the IRA may initially pay to the IRA custodian the custodian's annual maintenance fee. Thereafter, the IRA depositor (who was also liable to the IRA custodian for the payment of such fee and who, in the first instance, could have paid such fee directly to the IRA custodian) either reimburses the IRA for the amount of such fee or pays the amount of such fee to the IRA custodian and requests that the IRA custodian then refund to the IRA the fee previously paid from the IRA."

[8] *See* LTR 200127031 (Mar. 26, 2001) and LTR 199940021 (July 9, 1999).

[9] LTR 200507021 (Nov. 23, 2004).

[10] *See, e.g.,* LTR 9845003 (Aug. 3, 1998) (where asset allocation fees paid directly from an IRA annuity under Code Sec. 408(b) of the Code were an "integral part" of the contract), LTR 9005010 (Nov. 2, 1989) (where annual maintenance fees and additional transaction fees were debited from IRA if not timely paid separately by IRA owner and IRA does not accept reimbursements from IRA owner); LTR 8951010 (Sept. 18, 1989) (where IRA is solely liable for investment advice fee that is based upon gross value of IRA and IRA owner never pays fee).

[11] LTR 201104061 (Nov. 4, 2010).

[12] LTR 200507021 (Nov. 23, 2004).