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BENEFITS BRIEF

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IRS Maintains Favorable Position on IRA Owner's Direct Payment of "Wrap Fees"

The IRS recently released a favorable private letter ruling (PLR 201104061, Nov. 4, 2010) 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 (PLR 200507021, Nov. 23, 2004) that first addressed "wrap fee" programs. As in the prior PLR, 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 PLR, the IRS did not require any allocation of a portion of the wrap fee to brokerage transactions.

In Revenue Ruling 86-142, the IRS addressed the treatment of brokerage commissions paid under IRAs and qualified plans. It concluded that such expenses were not "recurring administrative or overhead expenses," such as trustee or actuary fees, but rather are intrinsic to the value of the trust's assets; as a result any direct payment by the IRA owner/employer of such fees resulted in a deemed contribution to the IRA/plan, subject to the section 404 plan deduction limits or the section 219 IRA contribution limits. This contrasts with the treatment of trustee and other annual fees, which are deductible under section 212 when paid directly by the IRA owner and not subject to the IRA contribution limits. Rev. Rul. 84-146; Rev. Rul. 68-533 (trustee fees not treated as additional contributions to a qualified plan).

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% of total wrap fee costs.

- Does Not Address Non-Advisory Programs. Unlike the 2005 ruling, none of the account arrangements in the new ruling include a non-advisory 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 PLRs, 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 "non-contribution" outcome (presumably not, following a line of private letter rulings where the Service reversed itself after taking a favorable position). Nevertheless, the PLR is a helpful indicator of the Service's position on common current industry practices.