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IRA "Checkbook Control" in the Crosshairs?

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In a recent decision, the U.S. Tax Court reached the not surprising conclusion that an individual who purchased American Eagle gold coins using her IRA received a de facto distribution of those coins when she took physical possession and stored them at home. McNulty v. Commissioner, 157 T.C. No. 10 (Nov. 18, 2021). More importantly, however, the taxpayer did not buy the coins directly through her IRA, but using a separate bank account in the name of a "checkbook LLC" created by and held by her IRA. In doing so, the court found that she had "unfettered command" over the her IRA assets, with no "independent oversight" by the custodian, resulting in a deemed distribution of those assets.

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Background

The case actually involved self-directed IRAs owned by a husband and wife. The facts suggest that the husband – who also had a checkbook LLC invested in coins and real estate – had engaged in some form of prohibited transaction and thus did not contest the assertion that he had a deemed distribution of his IRA assets, only resulting penalties.

No prohibited transactions were asserted against the wife; the sole question is whether she violated the requirement that the assets of an IRA must be held in the custody of a bank or a qualified non-bank custodian.[1] The facts indicate that she engaged a third-party servicer who advertised the purported tax loophole that allowed individuals to purchase American Eagle coins with their IRAs and store them at home. The actual custodian was a separate trust company. With the servicer's assistance, the wife directed the IRA custodian to form a single-member LLC for which she was appointed manager, and to transfer cash from the IRA to a bank account established in the name of the LLC. She then used the bank account to buy the coins and used invoices and shipping receipts to identify the LLC as the actual purchaser. The court stated that the IRA custodian "did not have any role in the management of [the LLC], the purchase of the AE coins, or the administration of [the LLC's] assets or the IRA assets." The

custodian did file annual Forms 5498 reporting the value of the IRA assets, but solely relied on the owner's reported valuation for the LLC.

The above facts appear to have been discovered on audit of the taxpayer's individual returns, though it is not clear how the details were uncovered.

Discussion

Internal Revenue Code section 408(m) generally prohibits the investment of assets of an IRA (and any self-directed qualified plan account) in certain "collectibles" including precious metals; however, there are exceptions for certain coins (AE coins meet this exception) and bullion. With respect to bullion, the exception applies "if such bullion is in the physical possession of a trustee [which is a bank or qualified non-bank custodian]." Some marketers have seized on this language as indicating that the custody requirements do not apply to coins. However, based on the plain language of the text and legislative history, the court found that no such exception exists.[2]

If the court relied solely upon the foregoing analysis, the case would be rather unremarkable. In fact, however, the court treated this as a *secondary* argument. It *first* went through a rather lengthy discussion of why the structure here violated the basic rule of Code section 408(a) that an IRA trustee must be a bank or IRS-approved non-bank custodian who will "administer" the trust[3] in accordance with the requirements of section 408. While the court acknowledged that an IRA owner always has the right to fully direct the investment of his/her IRA assets, including investing those assets into a single-member LLC, "IRA owners cannot have unfettered command over the IRA assets without tax consequences." Specifically, the court noted that an IRA custodian "is required to be responsible for the management and disposition of property held in a self-directed IRA," including maintaining custody of the assets, maintaining required records and "processing transactions" involving IRA assets. "Independent oversight by a third-party fiduciary to track and monitor investment activities is one of the key aspects of the statutory scheme…. Personal control over the IRA assets by an IRA owner is against the very nature of an IRA." This, the opinion suggests, could cause the nominal trustee or custodian to not be the trustee or custodian *in fact*.

The court acknowledged that an IRA owner may act as a "conduit or agent" of the IRA custodian for certain purposes, but only so long as that does not result in constructive receipt of IRA assets. Exactly where that line is drawn is unclear.

Observations

We have for many years counseled clients to beware of arrangements that give IRA owners complete "checkbook control" over their IRA assets. While the IRS has done little to regulate these structures to date, we know that they have been aware of them and suspect that they consider some such arrangements to be abusive. The recent Congressional focus on "self-directed" IRAs as part of the Build Back Better legislation, and that legislation's emphasis on IRS enforcement, likely will spur further activity from the regulators. This case may be just one of many.

Does this mean the end of the "checkbook LLC" or similar arrangements? Perhaps not; however, custodians and IRA owners may wish to consider additional oversight to ensure that ultimate control remains with the custodian. We would be pleased to provide suggestions for appropriate oversight depending on the circumstances.