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IN PRACTICE

TAXATION

IRS Proposes Significant Revision to Form 5498

Make sure your IRA is properly invested; the penalties can be severe

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Establishing an individual retirement account (IRA) provides many tax advantages. The contributions may be deductible from income and generally the earnings and gains will not be taxed until distributed. However, in order to obtain these tax advantages, the account holder must ensure that: (i) the accounts are properly invested and not maintained in the type of investments prohibited by the Internal Revenue Code, such as collectibles (including art, antiques and gems) or life insurance; and (ii) the IRA does not engage in a prohibited transaction. The Internal Revenue Service (IRS) has proposed a significant change from the current reporting requirements in an effort to monitor IRAs, to ensure that they are being invested properly and that the IRA has not engaged in a prohibited transaction.

The custodian of an IRA must file Form 5498 with the IRS (with a copy to the IRA owner) for each person for whom it maintained any IRA. The form must be filed by May 31 of each year. Currently, Form 5498 does not require the custodian to report how the assets of the IRA are being invested. However, according to an announcement by the IRS and the draft instructions for the 2014 Form 5498 (the actual draft form having yet to be released), commencing in 2014, two new boxes (15a and 15b) will be added to Form 5498. It will be optional in 2014 and mandatory thereafter for the custodian to report in such boxes the fair market value of certain investments in the IRA in specific categories listed using a code as follows:

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 or 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 fair market value.

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

Most IRAs are invested in publicly held stocks and bonds with financial institutions, but IRAs are not required to be so invested. According to the newly released draft instructions, "IRAs that include or consist of, nonmarketable securities and/or closely held investments, in which the IRA owner effectively controls the underlying assets, have a greater potential for resulting in a prohibited transaction."

A prohibited transaction is an improper use or investment of an IRA by the account holder, beneficiary or other disqualified person. Prohibited transactions include, but are not limited to, the following transactions, directly or indirectly: (i) a disqualified person borrowing money from the IRA; (ii) the sale, exchange or leasing of property between an IRA and a disqualified person; (iii) a disqualified person using the assets to secure a personal loan; (iv) the receipt of consideration by a disqualified person; and (v) the furnishing of goods or services or facilities between an IRA and a disqualified person. A disqualified person includes the account holder as

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well as the spouse and descendants of the account holder.

To further illustrate, if the IRA invests in a limited liability company that owns real estate or a business, the ownership in and of itself is not a prohibited transaction. However, if the limited liability company now pays the account holder or a member of the account holder's family compensation for services rendered in connection with the business, a prohibited transaction has occurred. If the IRA invests in a two-family rental unit, the ownership itself is not a prohibited transaction, but if the account holder lives in the property and regardless of whether the account holder pays rent, a prohibited transaction has occurred. If the IRA purchases real estate, the purchase itself is not a prohibited transaction, but if the account holder lends money to the IRA for the purchase or personally guarantees a loan obtained by the IRA for the purchase, a prohibited transaction has occurred.

If a prohibited transaction occurs, the assets of the IRA are treated as distributed on the first day of the tax year in which the prohibited transaction occurs. In other words, the IRA account is no longer an IRA and the owner must recognize income as if the IRA assets were distributed outright. In the case of a traditional IRA, the entire account is taxable. Moreover, if the account holder has not yet reached the age of 59-and-a-half, a 10 percent premature withdrawal penalty may also be assessed in addition to the tax.

Taxpayers who have already invested a portion of their IRAs in a nontraditional manner and who cannot now easily re-invest or convert to traditional investments should consider splitting their IRA accounts to reduce the potential penalties. For example, if one IRA account contains investments in both publicly held stock and rental property, the account should be split so that the rental property is in a separate IRA account. If then the IRS determines a prohibited transaction has occurred in connection with the real estate, only the IRA holding the real estate will immediately be treated as distributed on the first day of the tax year in which the prohibited transaction occurs. The separate IRA holding the publicly held stock will continue to be maintained and taxed only on withdrawal.

In addition to traditional IRAs, both Roth IRAs as well as other qualified plans are subject to the restrictions regarding prohibited transactions. However, with respect to these plans, the consequences are slightly less severe. Taxes have already been paid on the contributions made to the Roth IRAs. Thus, if a prohibited transaction occurs in a Roth IRA, the consequence of the Roth IRA account being treated as distributed on the first day of the year means all earnings, but not the contributions, are taxed in such year, and there will be no future deferrals. If a prohibited transaction occurs in a qualified plan, an excise tax is imposed. The initial tax is 15 percent of the amount involved in the prohibited transaction for each year or part thereof. The tax imposed is paid by any disqualified person who participates in the prohibited transaction other than the fiduciary. If the transaction is not corrected in the tax year, an additional tax of 100 percent of the amount involved in the transaction is assessed. Correcting a prohibited transaction with respect to a qualified plan generally means undoing the prohibited act and making the plan whole.

The proposed reporting requirements for IRA custodians will allow the IRS to be notified and thus focus on the types of IRA investments that more likely result in prohibited transactions. Consequently, taxpayers with nontraditional IRA holdings may anticipate greater scrutiny and audits by the IRS. Taxpayers with nontraditional IRA investments should immediately seek advice from tax counsel and not just the IRA custodian to ensure compliance with investment rules, as the penalties for engaging in a prohibited transaction are financially severe. ■