MATSORENSEN ATTORNEY • AUTHOR • SDIRA EXPERT

DRAFT
Retirement Improvements and Savings Enhancements Act of 2016 ("Rise Act")

Legislation Analysis as Applied to IRA Savers and Investors

By: Mat Sorensen, Attorney at Law
mat@kkoslawyers.com
www.matsorensen.com

BRIEF ANALYSIS

Summary of Negative Effects from the Mandatory Valuation Requirement and a New 10% Rule

- **Harmful to Job Creation**. Investment in job creating enterprises will decrease and this will have a negative effect on job growth.

- **Significantly Increases Retirement Account Costs for Hundreds of Thousands of Americans**. Self-directed retirement account investors will be forced to pay fees for unwanted and unnecessary valuation services. Mandating gift tax valuations on transactions between IRA buyers and sellers will cause millions of dollars annually in unwanted retirement account fees.

- **Negatively Impacts Real Estate Market and in Particular Distressed Real Estate Markets**. One of the most common investments of self-directed IRA investors is distressed real estate and small-market investment properties. These properties are key to the revitalization of neighborhoods and in the rehabilitation of small commercial and residential rental real estate.

Explanatory Summary: Self-directed retirement accounts are primarily invested into two different assets types; distressed or investment real estate and small business/private company. These investments are vital to creating jobs and to funding real estate projects that would otherwise go unfunded. Self-directed investors have invested billions of dollars into these investments and have been responsible for creating tens of thousands of jobs and in revitalizing thousands of distressed real estate properties. The result of these new regulations will divert these funds from these vital investment classes to public market investments that already receive plenty of capital investment.

The legislative provisions were critiqued under the following premises.

1. Americans Need to Save More for Retirement. Does the provision result in Americans having more money in their IRA for retirement?
2. Americans Need Easier Tools and More Options to Save and Invest for Retirement. Does the provision make it easier for Americans to save and invest in their IRA for retirement?
3. Costs and Fees Associated with Retirement Account Investments Are Harming Account Growth. Does the provision reduce costs and fees for Americans saving and investing their IRA for retirement?
4. Americans Need More Incentives and Encouragement to Save for Retirement. Does the provision increase incentives and encourage Americans to save and invest in their IRA for retirement?

TITLE III – Anti-Abuse Rules Relating to IRAs	Against	**Mandatory Valuation Requirement** – Provision subjects retirement accounts to gifting valuations rules. IRA account owners will be required to obtain a third party valuation for all private investment transactions showing fair market value is being exchanged (public markets excluded).

RATIONALE

The proposal to use gifting valuation rules for actual IRA transactions should be removed from the bill for the reasons outlined below. Alternatively, an exception should be added to transactions negotiated at arm's-length between an unrelated buyer and seller.

1. **Gifting Rules that Lack an Actual Transaction Should Not be Applied to IRA Transactions.** IRA transactions occur between a willing buyer and a willing seller negotiating at arms-length in the market. Because there is an arms-length transaction, there has never been a need or requirement for a valuation to support the willing buyer or the willing seller. Gifting donations, on the other hand, do not involve a willing buyer and a willing seller. The tax code requires at third party to determine the value of property donated to a charity so that the donor can properly take a charitable deduction for tax purposes. This valuation is necessary since there is no buyer and seller exchanging and setting the value of the asset being exchanged. Instead, one party is gifting the property to another who receives the property for free. As a result of this dynamic, it is necessary for a third-party to determine what value the property holds as there is no transaction between a buyer and seller setting such value. Retirement account transactions, on the other hand, occur between a willing buyer and willing seller and as a result the value of the property being exchanged is determined between the buyer and seller in the private market.

2. **Fair Market Value is Already Well Established in Tax Law**. Fair market value does not require an appraisal when two parties are transacting in their own best interest. Fair market value has a long history in the tax law and has been understood to be the, "price at which property would change hands between a…willing…buyer and …seller, neither being under compulsion to buy or sell, and both having reasonable knowledge of the facts." U.S. v. Cartwright, 411 US 546 (1973). This standard has been used for IRAs and every

other taxpayer for decades and there has been no explanation why retirement account investments would be different.

3. **Gift Law Valuation Rules Won’t Work with Real Transactions**. Requiring a third-party valuation for an actual arm’s-length negotiated transaction creates significant problems. First, what should occur if the valuation is above or below the actual agreed upon price between the IRA and the other party to the transaction? Must the parties, who have negotiated and agreed to value, adjust their agreement to meet what a third-party thinks the value of the asset is? It will be chaotic for actual transactions to be allowed only when a third-party valuation expert believes fair market value has been reached. The most routine self-directed IRA investments are real estate purchases, private loans arrangements, and small private company stock/unit investments. These investment terms are set by negotiation of the parties and a third-party’s determination of their value would only be an opinion as to what the actual fair market is as opposed to what the actual parties transacting in the market have agreed upon for this specific asset and for the terms in question.

   Additionally, what a third party appraiser says an asset is worth (based on different valuation models; market, income, asset) and what it is in fact worth to someone buying the investment can be entirely different. The effect of this requirement is that all transactions must occur at what some third party would dictate as opposed to two un-related parties who negotiate price at arms-length and for their best interest. Forcing gifting valuation rules on real transaction in an actual marketplace would be extremely disruptive.

4. **Increase in Costs Will Hurt Retirement Accounts**. Mandating a third-party appraisal on all non-public transactions will add unnecessary costs and fees to transactions that will harm an IRA owner’s ability to invest and grow their account. This requirement will force hundreds of thousands of unwanted and unnecessary appraisals.

5. **There is No Evidence of Systematic Abuse to Mandate Valuations for All Private Investment Transactions**. The appraisal requirements appear to be aimed at preventing investments in certain start-up or venture capital investments where there has been a significant value increase following a Roth IRA’s investment. The Government Accountability Office’s 2014 Report on “Mega IRAs” has referenced certain tech company founder investments that have resulted in million dollar returns for account holders and this bill summary explains that this provision is aimed to prevent those accounts from unfairly acquiring ownership at an unfairly low value. Unfortunately, these “unicorn” investments are quite rare and there is likely less than 100 of these per year. Meanwhile, there are hundreds of thousands of retirement investment transactions that will unintentionally be subjected to unwanted and unnecessary valuation requirements.

6. **Alternative Provision**. There are instances where an asset may have increased or decreased in value since purchase and where it is necessary to have a professional third-party valuation of the asset to determine its current fair market value. This would certain taxable events where the value of the IRA’s assets would result in tax being paid and would include in-kind distributions of the asset and Roth conversions. However, it would not include standard purchase and sale transactions involving an IRA where there is a negotiated arm’s-length transaction setting the value.

DRAFT

TITLE III – Anti-Abuse Rules Relating to IRAs	Against	**Change 50% Rule to 10%.** An IRA cannot invest into a company owned 10% or more by disqualified persons. The current rule sets the restriction at 50%.

RATIONALE

Existing law restricts an IRA in all instances from investing into a company where the owner of the account (or people disqualified to him/her, e.g. spouse, kids, parents) personally owns 50% or more of a company. IRC § 4975 (e)(2)(G). The 50% rule was set to restrict an IRA from investing into a company controlled by the IRA owner or disqualified parties and to prevent abusive transactions between IRAs and companies an IRA owner controls. The new proposal is to adjust the control percent from 50% to 10%.

1. **Current Law Restricts Self-Dealing**. Rationale from proponents of the bill is that certain tech investors have been able to invest their IRAs into companies they own 1/3 of. While this may be the case, there is no explanation of why this is a bad thing. Current law already restricts transactions where the IRA owner is determined to be self-dealing with his own IRA into a company or investment he or other disqualified persons (e.g. certain family) are personally involved in. IRC § 4975 (c)(1)(D),(E), (F). This situation arises under the self-dealing prohibited transaction rules and can already be broadly applied by the IRS in instances of abusive transactions where the IRA owner is unfairly benefitting from the transaction.

2. **All Transactions are Restricted at 50% or More of IRA or other DQP Ownership as Are Transactions Where a DQP Personally Benefits at Any Ownership Percent**. Existing law presently prohibits all investment from an IRA into a company 50% or more owned by disqualified persons. IRC § 4975 (e)(2)(G). Current law also restricts investments from an IRA into a company where the IRA or other disqualified persons owns less than 50% when the IRA owner or disqualified person would benefit from the IRAs transaction. IRC § 4975 (c)(1)(D),(E), (F). In all instances, an IRA cannot invest into a company where an IRA owner or other disqualified person is an owner (at any percent) and where said IRA owner or disqualified person will benefit from the IRAs transaction. This restriction is known as a self-dealing prohibited transaction and is already well developed in case law in situations under 50%. *See* Rollins v. Commissioner, T.C. Memo, 2004-260, DOL Advisory Opinion 2011-04A, DOL Opinion Letter 99-018A, DOL Advisory Opinion 82-08A, DOL Advisory Opinion 89-03A, DOL Advisory Opinion 2000-10A.

   The current state of the law is preferable to the proposed rule as the current law will allow an IRA investment into a company majority controlled by un-related persons to the IRA owner. These investments are only allowed when the IRA owner or other disqualified person owns less than 50% of the company and when there is no self-dealing or benefit occurring to the IRA owner or disqualified persons as a result of the IRA's investment. The current state of the law is compromise as it allows for IRA investment into companies where the IRA owner may personally be involved but it restricts such investment if that IRAs investment is made to unfairly benefit the IRA owner or other disqualified persons.

DRAFT

TITLE III – Anti-Abuse Rules Relating to IRAs		**Rationale**
Expand Statute of Limitations on IRA Non-Compliance – Provision will extend IRA Compliance from 3 years to 6 years in all instances. Current law allows for 3 years and an additional 3 for a total of 6 years if the non-compliance results in a change of gross-income of 25% or greater.	Neutral	The current provision will create a unique rule and requirement for IRAs in the tax code that is different from the standard tax procedure. While non-compliance with the rules should not occur, creating a special rule and time frame for IRAs is unwarranted where there is no evidence of abuse.
IRA Owner is a Disqualified Person. Include IRA Owner as a Disqualified Person under IRC 4975.	For	This provision will include the IRA owner in the list of disqualified persons under IRC 4975. This restriction is already well established in case law and should be codified. *See Harris v. Commissioner*, 76 T.C.M. 748 (USTC 1994), DOL Advisory Opinion 93-33A.
TITLE II – Roth IRAs		**Rationale**
Prohibit New Contributions to Roth IRAs that Exceed $5M	Neutral	Most Roth IRA owners with accounts $5M or more are not seeking to make new Roth IRA contributions and are more concerned with growing the account through investments. This change will have little or no effect.
$5M Cap on Roth IRAs. Provisions would require the distribution of amounts held in a Roth IRA that exceed $5M.	Against	Many Roth IRA investors with accounts in excess of $5M are investing their accounts into start-ups or venture capital investments that are creating some of the economy's best jobs. Other common investments by these investors are distressed real estate and non-performing assets. Requiring the distribution of amounts over $5M will reduce these investor's incentives into some of the most important and critical investments in our economy.
Elimination of Roth Conversions. Accounts cannot be converted to Roth.	Against	Many Americans have chosen to save and invest for retirement using a Roth account. These savers and investors have chosen to convert their funds and to pay taxes on their

DRAFT

		balances now so that they can have a tax-free stream of income at retirement. Restricting the ability to convert to Roth will greatly reduce incentives for hundreds of thousands of investors who have determined that a Roth account is a superior method of savings and investing for retirement.
Require RMD for Roth IRAs. Required minimum distributions would be required for Roth IRAs in the same manner as traditional IRAs.	Against	Traditional IRAs have been accumulated and grown based on tax deferral and all distributions are subject to tax on the amount distributed. Requiring distribution of said traditional accounts forces the taxpayer to begin taking distributions and to start paying taxes on said distributions at age 70 ½. These taxpayers received a tax deduction when they contributed to their traditional account. This distribution requirement has not applied to Roth IRA owners, as distributions from Roth IRAs are not subject to tax. Roth IRA contributions do not receive a tax deduction but grow and are distributed at retirement age tax-free. Because the government has no financial benefit in Roth IRA distributions, there is no reason to force distribution of Roth IRA accounts from account owners.
Increase RMD Age to 71, Then 72, and 73. Required minimum distributions are currently set to occur for traditional IRAs at age 70 ½. Provision would increase the age to 71, and then over time to 72 and then 73.	For	Americans are living and working longer. Increasing the RMD age will help Americans saving and investing for retirement to choose to delay distributions and reliance on their retirement account until later in life.
No Required Minimum Distributions for Combined Retirement Accounts under $150K.	For	Americans are living and working longer. Requiring distribution on smaller accounts has forced certain retirees to take distributions when they would otherwise choose to keep their funds saved and invested for distribution later in life.
Eliminate Stretch IRAs for Non-Spouses. Provision would remove the ability of children or grandchildren to inherit an IRA	Against	Many Americans have been incentivized to save as much for retirement as they can afford and have done so hoping to live comfortably through retirement. Inherited retirement accounts have become more common as these

DRAFT

and to take distributions of said account over their own lifetime.		savers and investors have passed away with funds still remaining in their account. Allowing these funds to pass to children or grandchildren and to be distributed over that person's lifetime has been an incentive for many Americans to save and invest smartly as any amounts they don't use can be used by their heirs over their lifetime. Removing the ability of a child or grandchild to stretch the account of their deceased parent or grandparent will reduce incentives to save and invest for retirement.
TITLE I – Encourage Retirement Savings		**Rationale**
Repeal Maximum Age of 70 ½ for Traditional IRA Contributions	For	Americans are living and working longer. The new provision will allow traditional IRA owners the ability to contribute to a traditional IRA while they still have earned income and a desire to save and invest for retirement.
Allow 60-Day Rollovers for All Inherited Plans and IRAs. Allows 60-day rollovers for inherited IRAs of non-spouse beneficiaries. Current rules only allow for 60-day rollovers for spouse beneficiaries.	For	This provision will make the 60-day rollover rules congruent among all persons who are inheriting a retirement account. It will help avoid mistaken distributions that have occurred as a result of different rules and treatment for spouse and non-spouse beneficiaries.

DRAFT