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KEY SERVICE INSIGHTS

INDIVIDUAL TAX NEWSLETTER

ROLLOVER OF HEDGE FUND INTEREST FAILS IRA RULES:

ESTATE OF CAAN OFFERS A WARNING ON NONTRADITIONAL ASSETS

Case Overview

Issues

(1) Was there a proper rollover of the hedge fund interest where the rollover occurred more than 60 days after distribution of the hedge fund interest to the Taxpayer?

(2) Was there a proper rollover when after the distribution of the hedge fund interest out of IRA Custodian 1 and prior to the hedge fund interest being rolled over to the new IRA, the hedge fund interest was liquidated to cash and the cash was then rolled over to the new IRA in three separate contributions?

Held

There was not a proper rollover into the new IRA of the hedge interest as:

(1) The Taxpayer changed the character of the rolled over property by liquidating the hedge fund interest;

(2) the contribution of cash to the new IRA occurred well after the 60-day rollover period had passed; and

(3) the hedge fund's three transfers of cash to the new IRA constituted three separate contributions and the rollover rules only allow one rollover per year.

Key Insight

When an IRA holds a nontraditional asset such as an interest in a private hedge fund, the Taxpayer must be extremely careful to provide the annual value for that interest to the custodian and to follow the rules in rolling that nontraditional asset to a new IRA. Failing to do so can result in significant tax implications.

Brief Overview

The Taxpayer held two IRAs with Custodian 1. One of the IRAs held a nontraditional asset which was an interest in a hedge fund. Custodian 1 is required to report the fair market value ("**FMV**") of the hedge fund interest each year. Since the interest in the hedge fund is not publicly traded, the IRA custodial agreement required the Taxpayer to provide the FMV of the hedge fund interest each year. In 2015, the Taxpayer failed to provide Custodian 1 with the FMV of the hedge fund interest at the end of 2014. In this event, the custodial agreement provides that Custodian 1 will distribute the hedge fund interest to the Taxpayer and issue an IRS Form 1099-R for the last available value of the investment.

In December 2015, Custodian 1 informed the Taxpayer of its resignation as IRA custodian and the corresponding distribution of the hedge fund interest was effective as of November 25, 2015. Custodian 1's resignation letter informed the Taxpayer he had sixty days from November 25, 2015 to rollover the hedge fund interest into another IRA held at Custodian 2 and that the Taxpayer was to contact the hedge fund to re-register the interest into Taxpayer's name or have it registered in another IRA held at Custodian 2. Thereafter, Custodian 1 issued the Taxpayer a 2015 Form 1099-R reflecting an IRA distribution of $1,910,903 as of November 25, 2015.

Disputed Rollover and IRS Challenge

The Taxpayer and Custodian 2 did not realize the hedge fund interest had not been transferred to the new IRA at Custodian 2 until October 2016. The Taxpayer and Custodian 2 instructed the hedge fund to liquidate the Taxpayer's interest into cash and transfer cash to the new IRA held at Custodian 2.

In 2017, the hedge fund made three separate cash transfers to the Taxpayer's new IRA totaling $1,532,605.46. The Taxpayer took the position the hedge fund interest was properly rolled over to the new IRA at Custodian 2 in 2015. The IRS disagreed with the Taxpayer's position and issued a notice of deficiency. The Taxpayer then filed a timely Tax Court petition.

The Taxpayer took the position that despite Custodian 1's resignation in 2015, Custodian 1 never actually distributed the hedge fund interest to the Taxpayer. The Tax Court disagreed with this position, pointing to Custodian 1's December 2015 letter specifically advising the Taxpayer to contact the hedge fund for purposes of re-registering the interest into Taxpayer's name or having the interest registered in the name of another IRA custodian.

Tax Court's Findings

The Tax Court further elaborated:

There are three problems with the way the [hedge fund interest] was handled. First, and most importantly, in liquidating the [hedge fund interest] Taxpayer changed the character of the property; yet section 408(d)(3)(A)(i) required him to contribute the [hedge fund interest] itself, not cash, to another IRA in order to preserve its tax deferred status. See Lemishow, 110 T.C. at 113; Treas. Reg. §1.408-4(b)(1). Second, the contribution of the cash proceeds from the liquidation occurred long after January 25, 2016, deadline. And finally, the [hedge fund's] three transfers [of cash] to Custodian 2 constituted three separate contributions, yet section 408(d)(3)(B) allows for only one rollover contribution in any one-year period, making only the first transfer potentially eligible for a tax-free rollover.

Conclusion

This case is a good example of the care that must be taken when an IRA holds nontraditional assets, which is more and more common these days.

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