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## Retirement Security: Improved Guidance Could Help Account Owners Understand the Risks of Investing in Unconventional Assets

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## Retirement Security: Improved Guidance Could Help Account Owners Understand the Risks of Investing in Unconventional Assets

### Abstract

[Excerpt] Federal law places few restrictions on the types of investments allowable in tax-favored retirement accounts, such as IRAs or employer-sponsored 401(k) plans. Recent federal and state investigations and litigation have raised questions as to whether investing in unconventional assets may jeopardize the accounts' tax-favored status, placing account owners' retirement security at risk. GAO was asked to examine issues related to the potential risks and responsibilities associated with investments in unconventional assets.

GAO examined: (1) what is known about the prevalence of accounts that invest in unconventional assets; (2) how these accounts are managed; and (3) what challenges are associated with administering these retirement accounts. GAO reviewed relevant federal laws, regulations, and guidance; analyzed data collected from the retirement industry; analyzed available industry documents; and reviewed 334 related consumer complaints collected from three federal agencies and two independent entities.

### Keywords

retirement security, investment, unconventional assets

### Comments

#### Suggested Citation

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December 2016

# RETIREMENT SECURITY

Improved Guidance  
Could Help Account  
Owners Understand  
the Risks of Investing  
in Unconventional  
Assets

# GAO Highlights

Highlights of [GAO-17-102](#), a report to the Ranking Member, Committee on Finance, U.S. Senate

## Why GAO Did This Study

Federal law places few restrictions on the types of investments allowable in tax-favored retirement accounts, such as IRAs or employer-sponsored 401(k) plans. Recent federal and state investigations and litigation have raised questions as to whether investing in unconventional assets may jeopardize the accounts' tax-favored status, placing account owners' retirement security at risk. GAO was asked to examine issues related to the potential risks and responsibilities associated with investments in unconventional assets.

GAO examined: (1) what is known about the prevalence of accounts that invest in unconventional assets; (2) how these accounts are managed; and (3) what challenges are associated with administering these retirement accounts. GAO reviewed relevant federal laws, regulations, and guidance; analyzed data collected from the retirement industry; analyzed available industry documents; and reviewed 334 related consumer complaints collected from three federal agencies and two independent entities.

## What GAO Recommends

GAO is making three recommendations to the Commissioner of Internal Revenue to, among other things, improve guidance for account owners with unconventional assets on monitoring for ongoing federal tax liability and to clarify how to determine the fair market value of hard-to-value unconventional assets. IRS generally agreed with these recommendations.

View [GAO-17-102](#). For more information, contact Charles Jeszeck at (202) 512-7215 or [jeszeck@gao.gov](mailto:jeszeck@gao.gov), or James R. McTigue, Jr. at (202) 512-9110 or [mctiguej@gao.gov](mailto:mctiguej@gao.gov).

December 2016

## RETIREMENT SECURITY

# Improved Guidance Could Help Account Owners Understand the Risks of Investing in Unconventional Assets

## What GAO Found

Federal data collection efforts to date have captured little information on retirement accounts holding unconventional assets—such as real estate, precious metals, private equity, and virtual currency—making the prevalence of such accounts unknown. In tax year 2015, the Internal Revenue Service (IRS) began requiring that custodians or trustees of individual retirement accounts (IRA)—including banks or other institutions approved to hold account assets—report selected information on unconventional assets in their clients' accounts to IRS. As of November 2016, IRS plans to begin compiling the new IRA asset data in 2017, but has not specified when the new IRA asset data will be available for analysis. Seventeen of the 26 custodians, who GAO identified as allowing retirement accounts with unconventional assets and who participated in GAO's data collection effort, reported having nearly half a million of these accounts in their custody at the end of calendar year 2015. IRAs made up the vast majority of accounts and assets reported.

An IRA owner's decision to invest in unconventional assets can expand their role and responsibilities substantially. GAO's review of industry documents found that individuals wanting to invest in unconventional assets through their IRA generally agree to be responsible for overseeing the selection, management, and monitoring of account investments and shoulder the consequences of most decisions affecting their accounts. For example, owners of such accounts assume a fiduciary role, which makes them assume greater responsibility for overseeing the selection, management, and monitoring of account investments, and shoulder the consequences of most decisions affecting their accounts.

Current IRS guidance provides little information to help IRA owners understand their expanded responsibilities and potential challenges associated with investing in unconventional assets. Targeted IRS guidance for these IRA owners may help them navigate the potential compliance challenges associated with certain types of unconventional assets. For example, GAO found that some IRA owners can experience challenges in the following areas:

- **Monitoring for ongoing federal tax liability:** IRA owners are not always aware of the need to monitor the gross income from certain unconventional assets in their accounts for ongoing federal tax liability. For example, IRA owners who invest in active businesses or debt-financed properties need to monitor their accounts for ongoing tax liability that must be paid from the IRA. Failure to do so can result in underpayment penalties.
- **Obtaining annual fair market valuations for nonpublicly traded assets:** IRA owners investing in hard-to-value unconventional assets can face challenges meeting their responsibilities to provide updated fair market value information to their custodian to meet IRS's annual reporting requirement. Failure to provide an updated fair market value in a timely manner can result in a custodian prematurely distributing account assets to the owner at a fair market value that is not current, potentially incorrect, and which could lead to a loss of tax-favored status for their retirement savings.

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### Abbreviations

DOL	Department of Labor
EBSA	Employee Benefits Security Administration
ERISA	Employee Retirement Income Security Act of 1974
FDIC	Federal Deposit Insurance Corporation
FINRA	Financial Industry Regulatory Authority
FMV	fair market value
IRA	individual retirement account
IRC	Internal Revenue Code
IRS	Internal Revenue Service
LLC	Limited Liability Company
NASAA	North American Security Administrators Association
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
RMD	required minimum distribution
SEC	Securities and Exchange Commission
UBTI	Unrelated Business Taxable Income
UDFI	Unrelated Debt-Financed Income

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December 8, 2016

The Honorable Ron Wyden  
Ranking Member  
Committee on Finance  
United States Senate

Dear Senator Wyden:

Each year individuals saving for retirement in tax-favored retirement accounts defer an estimated \$100 billion in federal tax revenue.<sup>1</sup> Federal law places few restrictions on the types of investments allowable in these tax-favored retirement accounts. Aside from a general prohibition on investing retirement funds in life insurance or collectibles, individuals can generally invest in a broad spectrum of assets.<sup>2</sup> Many owners of individual retirement accounts (IRA) and participants in 401(k) plans invest in mutual funds comprising stocks, bonds, and cash (in part because their IRA custodian or employer may limit their investment options).<sup>3</sup> Other individuals choose to invest a portion of their savings in less conventional nonpublicly traded assets not commonly held in retirement accounts, such as real estate, precious metals, and private equity. To facilitate such “unconventional” investments, these account owners often roll over, or transfer, their accumulated retirement savings into a similar retirement account for which a custodian or employer allows

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<sup>1</sup>U.S. Department of the Treasury, Office of Tax Analysis, Tax Expenditures (FY2018), (Washington, D.C.: Sept. 28, 2016), <https://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Expenditures.aspx>. This estimate, which is based on provisions of federal tax law enacted through July 1, 2016, is measured as the tax revenue that the government does not currently collect on contributions and earnings amounts, offset by the taxes paid by those who are currently receiving retirement benefits. Revenue loss estimates do not represent the amount of revenue that would be gained from repealing a tax expenditure because repeal would probably change taxpayer behavior in some way that would affect revenue.

<sup>2</sup>26 U.S.C. § 408(a)(3), (m). “Collectibles” can include works of art, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, or certain other tangible personal property specified by the Secretary of the Treasury. Some exceptions exist for certain coins and bullion.

<sup>3</sup>In this report, we use the general term “account owner” to refer to (1) IRA owners and (2) sponsors of 401(k) plans who are either self-employed or owners of small businesses with no employees



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investment in such assets.<sup>4</sup> Regardless of the types of investments held, IRAs and 401(k) plans must adhere to specific rules governing tax-favored accounts, including limits on contributions and distributions, and comply with various federal disclosure and reporting requirements.

Recent federal and state investigations and litigation have raised questions as to whether the investment in unconventional assets in retirement accounts may jeopardize these accounts' tax-favored status and place account owners' retirement savings at risk. You asked us to examine the potential compliance risks and responsibilities account owners may assume when choosing to invest in unconventional assets. This report examines:

1. what is known about the prevalence of retirement accounts that invest in unconventional assets,
2. how these accounts are managed, and
3. what challenges, if any, are associated with the administration of these types of retirement accounts.

We employed several diverse methodologies in developing our findings. For all objectives, we interviewed a range of federal and state regulators, industry stakeholders, and participant advocates; reviewed relevant federal laws, regulations, and guidance; and consulted available literature. To examine the prevalence of retirement accounts that invest in unconventional assets, we compiled data from industry stakeholders, web searches, and the literature to help us identify 26 custodians and 48 other service providers with experience working with account owners in establishing and managing such accounts.<sup>5</sup> Next, to learn about the number, type, and value of retirement accounts held under custody at the end of calendar year 2015, we conducted a survey data collection effort and obtained responses from 17 of the 26 custodians that we identified

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<sup>4</sup>A custodian is either a bank or other institution that demonstrates that the manner in which assets will be held are consistent with the Internal Revenue Code. 26 U.S.C. § 401; 26 C.F.R. § 1.401(f)-1(b)(1)(ii). An IRA custodian generally serves as an asset holder for an IRA. It tracks all IRA activities, such as contributions, 401(k) rollovers, transfers, distributions and any investments made through an IRA. The custodian also reports transactions to the Internal Revenue Service. An IRA custodian can either be an IRS-approved financial institution or a nonfinancial institution that has been given specific IRS approval.

<sup>5</sup>The types of service providers that we identified included account recordkeepers, facilitators of special transactions, attorneys, and accountants.

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from available sources. We focused our effort on custodians as they are responsible for reporting annually the fair market value of each IRA under custody to the Internal Revenue Service (IRS). The custodians who provided information varied in terms of the number and value of accounts they held, and the types of unconventional assets they allowed. To examine how these retirement accounts are managed and any associated challenges, we developed a follow-up set of questions for the same 17 custodians and received responses from 10 of them. We also developed a similar set of questions for the 48 service providers we identified who provide administrative support for IRAs and solo 401(k) plans, collecting information from 21 of them. To augment our understanding of challenges associated with managing retirement accounts invested in unconventional assets, we analyzed 334 complaints filed with three federal agencies—the Department of Labor (DOL), the Department of the Treasury’s Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC)—and two independent organizations—the Financial Industry Regulatory Authority (FINRA) and the Better Business Bureau.<sup>6</sup> Our list of custodians and service providers was used to query databases and identify complaints. We analyzed the complaints, developed general categories of challenges account owners faced, and conducted a two-step review process to ensure proper categorization of each complaint. We did not confirm the authenticity of these complaints or independently investigate any of the allegations made, or collect information on the extent to which each complaint was resolved. As part of developing challenge categories, we also reviewed federal and state enforcement actions against entities involved with these types of retirement accounts. Finally, we examined industry websites, and collected and reviewed publicly available documents, including application forms, fee disclosures, and custodial trust account agreements used to establish an IRA. We determined that the data obtained from these sources was sufficiently reliable for the purposes of this report. For more information on the development of the methodology used in this report, see appendix I.

We conducted this performance audit from August 2015 through December 2016 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable

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<sup>6</sup>IRS officials told us that the IRS systems would not allow them to locate complaints on a specific topic.

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basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

In passing the Employee Retirement Income Security Act of 1974 (ERISA), Congress sought to encourage individuals to save for retirement in tax-favored retirement arrangements.<sup>7</sup> Traditionally, account owners participating in these arrangements defer taxes on contributions to these accounts up to certain statutory limits, and in general, contributions and investment earnings on those contributions are not taxed as income until the account owner withdraws them from the account.<sup>8</sup> In addition, account owners typically direct their investments and make decisions regarding the purchase, sale, reinvestment, and withdrawal of investments. Individuals saving for retirement in the United States typically save through IRAs or an employer-sponsored plan, like a 401(k) plan.<sup>9</sup>

- IRAs have become a key retirement savings vehicle for many individuals, including small business owners, independent contractors, and other workers who are not covered by an employer-sponsored retirement plan. ERISA established IRAs to (1) provide a way for individuals not covered by a pension plan to save for retirement and (2) give retiring workers or individuals changing jobs a way to preserve assets in employer-sponsored retirement plans by allowing them to roll over, or transfer, plan balances into IRAs. IRA owners generally make tax-favored contributions to their accounts to purchase assets from investment options offered through their

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<sup>7</sup>Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-1461). Under ERISA, employers may sponsor two broad types of retirement plans, referred to in ERISA as pension plans: (1) defined benefit plans, which generally promise to provide benefits based on an employee's years of service and frequently are based on salary, regardless of the performance of the plans' investments, and (2) defined contribution plans, including 401(k) plans, in which benefits are based on contributions and the performance of the investments in participants' individual accounts.

<sup>8</sup>The annual contribution limit for traditional and Roth IRAs in 2017 is \$5,500 (\$6,500 if age 50 or older). The annual elective deferral limit for 401(k) plans in 2017 is \$18,000 (\$24,000 if age 50 or older). The total annual additions to a 401(k) plan participant's account for 2017 is \$54,000 (\$60,000 if age 50 or older).

<sup>9</sup>This report focuses on IRAs and solo 401(k) plans, as they are the retirement vehicles account owners use most often to invest in unconventional assets.

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custodians. IRS has the primary enforcement responsibility to ensure that IRAs meet Internal Revenue Code (IRC) requirements necessary

#### What Is a Solo 401(k) Plan?

While employer-sponsored plans generally have multiple employees participating in their plans, a solo 401(k) plan—also called an individual 401(k), a one-participant plan, self-employed 401(k), or self-directed 401(k) plan—are qualified retirement plans designed for the self-employed or a small business owner with no employees (beyond themselves and their spouse). The Economic Growth and Tax Relief Reconciliation Act of 2001 included reforms that generally provided small business owners with no employees and the self-employed the same advantages of a conventional 401(k) plan, such as employee deferrals, loan features, and Roth contributions. Solo 401(k) sponsors select plan investment options and may contribute to the plan both as plan sponsor and plan participant up to a combined \$54,000 per account (or \$60,000 if age 50 or older) in tax year 2017. In addition, plan sponsors may elect to maintain exclusive authority and discretion to manage and control plan assets without involving a third-party.

Source: GAO analysis of IRS and industry information. | GAO-17-102

to qualify for preferential tax treatment. The most common IRA types are: (1) traditional IRAs (which allow eligible individuals to make tax-deductible contributions and accumulate tax-deferred investment earnings); and (2) Roth IRAs, (which allow eligible individuals to make after-tax contributions and accumulate investment earnings tax-free).<sup>10</sup>

- 401(k) plans have become the most common employer-sponsored retirement savings vehicle in the United States. Created by the Revenue Act of 1978, 401(k) plans typically allow participants to specify the size of their contributions and direct those contributions, as well as any made by their employer, to one or more investments among the options that the employer has preselected as offering effective diversification across broad asset classes. Investment options generally include mutual funds, company stock, and money market funds. DOL's Employee Benefits Security Administration (EBSA) is responsible for, among other things, administering and enforcing the fiduciary, reporting, and disclosure provisions of Title I of ERISA. Self-employed individuals or owners of small businesses with no employees may sponsor a 401(k) plan, known as a solo 401(k) plan. To set up a solo 401(k) plan, individuals must adopt a written plan document, arrange a trust for the plan's assets, develop a recordkeeping system, and provide plan information to employees eligible to participate. Solo 401(k) plan account owners can select the plan's investment options as plan sponsor and invest in these options as the plan participant. (See sidebar for further description of solo 401(k) plans, the 401(k) plans we focus on in this report.)

The owner of a tax-deferred account cannot keep retirement funds in their accounts indefinitely. When IRA owners or 401(k) plan participants reach age 70½, they generally have to start taking annual payments—known as required minimum distributions (RMD)—from their plan savings based on their account balance and life expectancy.<sup>11</sup> The distribution for the year in which a participant turns 70½ must be made no later than April 1 of the

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<sup>10</sup>Less common are employer-sponsored plans that use IRAs, such as Saving Incentive Match Plans for Employees or a Simplified Employee Pension, which may also allow account owners to invest in unconventional assets.

<sup>11</sup>Failure to take the RMD subjects the account owner to an excise tax equal to 50 percent of the amount by which the RMD exceeds the actual amount distributed during the taxable year. 26 U.S.C. § 4974. Roth IRAs, which are funded by after-tax contributions, do not require withdrawals until after the death of the owner.

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following calendar year and no later than December 31 for any other subsequent year.<sup>12</sup>

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## Investments

Account owners have wide latitude in the types of assets in which they can invest and custodians can choose to limit which type of assets they will allow. While some custodians generally limit investments to publicly traded assets, other custodians allow investments in a range of unconventional assets.<sup>13</sup> (See table 1.)

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**Table 1: Examples of Unconventional Assets in Tax-Favored Retirement Accounts**

Asset type	Asset description
Energy investments	Investments may include oil and gas interests, solar energy, biofuels, water power, wind energy, eco-friendly stocks and bonds, or energy-efficient housing.
Equipment leasing	Equipment leased to a business at a flat monthly rate for a specified time period.
Foreign-based assets	Investment options include foreign exchange currency and property located overseas.
Farming interests	Interest in a farm or other property that sells agricultural products, such as lumber, or milk and wool from animals.
Precious metals	Approved gold, silver, platinum, and palladium bullion and certain coins.
Private equity	Investments in privately held enterprises, such as private company stock or interests in limited liability companies or limited partnerships.
Promissory notes (secured)	A form of debt backed by collateral, such a mortgage or deed of trust, in which a borrower promises to return the lender's funds and make fixed-interest payments to the lender in exchange for borrowing the money.
Promissory notes (unsecured)	A form of debt not backed by collateral in which a borrower promises to return the lender's funds and make fixed-interest payments to the lender in exchange for borrowing the money.

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<sup>12</sup>RMDs generally apply to participants who have retired and remain in the plan (or another qualified tax-deferred account) after age 70½. 26 U.S.C. §§ 401(a)(9) and 408(a)(6). RMDs generally do not apply to plan participants older than 70½ continuing to work and not yet retired. 26 U.S.C. § 401(a)(9)(C)(ii). Typically, participants age 70½ or older who have not self-initiated withdrawals will automatically receive payments administered by their recordkeeper or third-party administrator pursuant to RMD calculations.

<sup>13</sup>A custodian is not precluded from holding both conventional and unconventional assets.

<b>Asset type</b>	<b>Asset description</b>
Real estate	Investment in real property options, such as rental housing, commercial buildings, and undeveloped land.
Tax liens	Investment in liens imposed on tax-delinquent real property or personal property that if unpaid can result in the assumption of the property deed.
Virtual currency	A type of digital money existing only in cyberspace (e.g., Bitcoin) that is used and accepted among the members of a specific virtual community.

Source: GAO analysis of IRS and industry information. | GAO-17-102

## Roles and Responsibilities

Under Title I of ERISA, fiduciaries of ERISA-covered plans, such as conventional 401(k) plans, must carry out their responsibilities prudently and solely in the interest of the account participants and beneficiaries.<sup>14</sup> For ERISA-covered plans, a fiduciary includes a person who has discretionary control or authority over the management of an account, including management over the account’s assets, or anyone who, for a fee or other compensation, renders investment advice with respect to an account.<sup>15</sup> Among other duties, fiduciaries have a responsibility to select and monitor investment options and service providers; report account information to the federal government and to participants; and ensure that the services provided to their account are necessary and that the cost of those services is reasonable.<sup>16</sup> Many actions needed to operate a qualified retirement account involve fiduciary decisions, whether an individual or plan hires someone to manage the plan or manages the

<sup>14</sup>Title I, Part 4 of ERISA generally applies to plans that are established or maintained by an employer or an employee organization or both. The prudence and exclusive benefit requirements of Title I generally do not apply to IRAs, which are primarily regulated under Title II of ERISA and section 408 of the Internal Revenue Code, or to solo 401(k) plans.

<sup>15</sup>Under ERISA, a fiduciary is anyone, such as a sponsor, trustee, investment adviser, service provider, or other person, to the extent they exercise any discretionary authority or control over plan management or any authority or control over the management or disposition of plan assets, or renders investment advice respecting plan money or property for a fee or other compensation, or have discretionary authority or responsibility for plan administration. 29 U.S.C. § 1002(21)(A).

<sup>16</sup>In April 2016, DOL issued a final rule defining who is a fiduciary as a result of giving investment advice to plan officials, plan participants, and beneficiaries and IRA owners. The final rule describes the kinds of communications that would constitute investment advice and describes the types of relationships in which such communications give rise to fiduciary investment advice responsibilities. Implementation of the rule is set to begin in April 2017. Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946 (Apr. 8, 2016).

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account themselves.<sup>17</sup> However, unlike conventional 401(k) plans, solo 401(k) plans are generally not covered under Title I of ERISA, including the fiduciary standards in Part 4, or subject to DOL oversight because they are sponsored by employers that have no employees.

The IRC generally requires plans (including certain IRAs and 401(k) plans) to hold plan assets in a trust fund maintained for the exclusive benefit of employees and their beneficiaries. The IRC establishes the requirements that a trust must satisfy in order to “qualify” for favorable tax treatment.<sup>18</sup> In some cases, both the employer and employee may contribute to the trust. The assets are held in trust until distributed to the employees or their beneficiaries according to the plan’s provisions.

Individuals who own a business or are self-employed can establish a 401(k) plan that allows unconventional assets, a solo 401(k) plan, either on their own or by consulting a professional or financial institution—such as a bank, mutual fund provider, or insurance company—to help them establish and maintain the plan. Because solo 401(k) plans generally do not have to comply with ERISA Title I, Part 4 fiduciary requirements, the individual, as plan sponsor, may also serve as the plan fiduciary and trustee.

Individuals can establish an IRA with a bank or qualified firm that acts as a trustee or custodian of investments contributed by the individual or purchased with funds contributed by the individual.<sup>19</sup> A traditional IRA is established after a custodial agreement (IRS Form 5305) is fully executed by both the grantor (account owner) and the trustee (custodian).<sup>20</sup> IRS developed a model Form 5305 and permits custodians who use the form to incorporate additional provisions as long as the provisions are agreed to by the account owner and custodian, and comply with federal and state

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<sup>17</sup>Some functions, such as those related to establishing a plan and choosing its design features, are considered settlor functions that are not subject to ERISA’s fiduciary standards. However, once the sponsor embarks on implementation of the strategy, such action would fall within the realm of its fiduciary role, requiring the sponsor to operate in the best interest of participants and beneficiaries.

<sup>18</sup>26 U.S.C. § 401(a).

<sup>19</sup>A trustee is a bank or such other person who demonstrates to the satisfaction of the Secretary of the Treasury that the manner in which the trust is administered is consistent with the requirements under section 408. 26 U.S.C. § 408(a)(2).

<sup>20</sup>IRS Form 5305 series includes similar model custodial agreements for several types of IRAs.

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requirements.<sup>21</sup> These additional provisions typically outline the parties' roles and responsibilities. Custodians are not required to use the model form, and are instructed not to file it with IRS.

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## Reporting Requirements

IRA custodians have several reporting requirements with respect to IRA investments. IRA custodians are required to submit annually a Form 5498 IRA Contribution Information to IRS for each IRA account under custody.<sup>22</sup> As part of this reporting, IRA custodians must ensure that all IRA assets (including those not publicly traded) are valued annually at their fair market value (FMV), and IRS requires custodians to report the year-end aggregate FMV of all investments in an IRA.<sup>23</sup> Starting with tax year 2015, IRS required custodians to report the aggregate FMV of investments falling in specified categories of unconventional assets and to identify the category in which the assets belonged. Custodians are also required to submit Form 1099-R Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., each year that an IRA withdrawal took place and detail the total distributions from the account during the calendar year. Form 1099-R also provides information about the IRA distributions, such as whether the distributions were taken before age 59½.<sup>24</sup>

A 401(k) plan's annual reporting requirements are generally satisfied through filing a Form 5500 Annual Return/Report of Employee Benefit

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<sup>21</sup>IRS instructions for the Form 5305 allow the provisions to include things such as definitions, investment powers, voting rights, exculpatory provisions, amendment and termination, removal of the trustee, trustee's fees, state law requirements, beginning date of distributions, accepting only cash, treatment of excess contributions, and prohibited transactions with the grantor. In addition, the parties can attach additional pages to the agreement.

<sup>22</sup>For additional information on Form 5498, why IRS began collecting data on unconventional assets, and how they plan to use the data they receive, see GAO, *Individual Retirement Accounts: IRS Could Bolster Enforcement on Multimillion Dollar Accounts, but More Direction from Congress Is Needed*, [GAO-15-16](#) (Washington, D.C.: Oct. 20, 2014).

<sup>23</sup>The total FMV of an IRA is the aggregate value of contributions and rollovers into the IRA, distributions from the IRA, investment earnings (such as interest and dividends), and any change in the market value of assets held in the IRA.

<sup>24</sup>Early distributions other than for specific exceptions are subject to an additional 10 percent tax, whereas distributions after age 59½ are generally not subject to an additional 10 percent tax on the amount distributed.



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Plan (Form 5500) and its accompanying schedules.<sup>25</sup> The Form 5500 is the primary source of information collected by the federal government regarding the operation, funding, expenses, and investments of employee benefit plans. The Form 5500 reporting requirements vary depending on the size and type of plan: plan sponsors required to submit the long form must fill out multiple schedules and attachments that collect information on particular aspects of the plan, such as the value and types of plan assets; plans allowed to complete the short form have fewer reporting requirements.

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## Prohibited Transactions

IRA owners and 401(k) plans are not permitted to engage in certain prohibited transactions. Prohibited transactions generally fall into two categories:

- Involving disqualified persons. An IRA owner and 401(k) plan are prohibited from engaging in a transaction with a range of entities, including a fiduciary, a person providing services, or members of the IRA owner's family, including a spouse, ancestor, or descendant.
- Involving self-dealing. An IRA owner and 401(k) plan fiduciary are prohibited from engaging in a transaction where the account owner or the fiduciary benefits from the asset prior to retirement.<sup>26</sup>

Unlike a 401(k) plan sponsor, who has an opportunity to voluntarily correct some prohibited transactions after they occur, IRA owners face adverse tax consequences when engaging in a prohibited transaction.<sup>27</sup> Examples of a prohibited transaction in an IRA may include: (1) directing the IRA to purchase a vacation home as a rental property for personal use; (2) selling their own property to the IRA; and (3) taking a salary from an IRA-funded business. Specifically, if the IRA owner engages in a prohibited transaction, the IRA loses its tax-favored status as an IRA, and the account is treated as distributing all of its assets to the IRA owner at

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<sup>25</sup>Additional information on the Form 5500 can be found at <https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/reporting-and-filing/form-5500>.

<sup>26</sup>"Self-dealing" specifically refers to the prohibited transactions set forth in 26 U.S.C. § 4975(c)(1)(D)-(F) and 29 U.S.C. § 41106(a)(1)(D) and 406(b).

<sup>27</sup>DOL established the Voluntary Fiduciary Correction Program to encourage employers and plan fiduciaries to comply with ERISA by allowing them to self-correct certain violations of the law.

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the FMV on the first day of the year in which the transaction occurred.<sup>28</sup> The IRA owner may also be subject to a 10 percent additional tax on early distributions unless an exception applies.<sup>29</sup>

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## Tax Liability in Retirement Accounts

Earnings and profits made in tax-favored savings vehicles are generally reinvested in the account with taxes deferred until distribution. However, two circumstances can generate current tax liability for retirement account owners:

- **Unrelated Business Taxable Income (UBTI):** Unrelated business taxable income is gross income generated from an ongoing trade or business (less allowable deductions) that is not related to the exempt or tax-deferred entity, such as an IRA. An IRA or 401(k) plan that earns \$1,000 or more of gross income from an unrelated business must file Form 990-T with IRS and pay related taxes.<sup>30</sup>
- **Unrelated Debt-Financed Income (UDFI):** Unrelated debt-financed income is a form of UBTI. If an asset purchased by an IRA is debt-financed (e.g., a mortgage on a rental property), income produced by that asset could be subject to taxes.

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## Regulatory Framework

Multiple federal, state, and independent entities provide regulatory oversight for retirement accounts invested in unconventional assets, although agency jurisdiction varies depending on the type of provider, the state in which it conducts business, and type of plan offered. Table 2

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<sup>28</sup>26 U.S.C. § 408(e)(2).

<sup>29</sup>26 U.S.C. § 72(t). If a disqualified person other than the IRA owner engages in a prohibited transaction, that person may be liable for a 15 percent excise tax on the amount of the prohibited transaction and a 100 percent additional tax if the transaction is not corrected. 26 U.S.C. § 4975(a) and (b).

<sup>30</sup>IRS, *Form 990-T, Exempt Organization Business Income Tax Return* is used to report unrelated business income and unrelated business income tax liability.

provides a summary of the regulatory activities of some of the major entities involved in overseeing these accounts.<sup>31</sup>

**Table 2: Federal, State, and Independent Entities Providing Oversight for Retirement Accounts Invested in Unconventional Assets**

Entity	Oversight role
Department of Labor (DOL)	Enforces laws and regulations governing 401(k) plans under Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Solo 401(k) plans, as one-participant plans sponsored by a business owner with no employees are not subject to Title I and do not fall under DOL's jurisdiction. DOL interprets the prohibited transaction provisions relating to IRAs. The Internal Revenue Service is responsible for enforcing those provisions. DOL may grant exemptions to prohibited transactions. DOL also collects complaint information and offers assistance to participants in Title I retirement plans.
Financial Industry Regulatory Authority (FINRA)	Regulates broker-dealers who buy, sell, and trade investments often found in retirement accounts. Oversees aspects of the securities business: from registering and educating industry entities to examining securities firms; writing rules; enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering the largest dispute resolution forum for investors and registered firms. Investors and others can submit a complaint to alert FINRA to any potentially fraudulent or suspicious activities by brokerage firms or broker-dealers.
Internal Revenue Service (IRS)	Enforces Title II of ERISA and helps taxpayers understand and meet their tax responsibilities. As part of that effort, multiple IRS units are responsible for enforcing IRA tax laws, enforcing rules on 401(k) plan contribution limits and taxation on distributions, and conducting outreach to increase taxpayers' understanding of the laws.
Office of the Comptroller of the Currency (OCC)	Charters, regulates, and supervises all national banks and federal savings associations that can also serve as IRA custodians as well as federal branches and agencies of foreign banks. OCC collects complaint information from the public about these entities.
Securities and Exchange Commission (SEC)	Oversees key elements of the securities industry, including securities exchanges, securities broker-dealers, investment advisers, and mutual funds. As part of these efforts, SEC regulates investment advisers who, in exchange for compensation, are engaged in the business of providing investment advice regarding securities that may be held in retirement accounts. SEC collects complaint information from members of the public regarding possible violations of federal securities laws.
State banking regulators	Supervise nearly 4,850 state-chartered financial institutions, including some IRA custodians, and regulate a variety of nonbank financial services providers. They also generally investigate consumer complaints filed against licensed entities and direct appropriate remedial action if the violations are substantiated.

<sup>31</sup>The Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUA) also play a role with regards to these accounts. FDIC supervises insured state-chartered banks that are not members of the Federal Reserve System, as well as insured state savings associations and insured state-chartered branches of foreign banks; insures the deposits of all banks and thrifts that are approved for federal deposit insurance; resolves all failed insured banks and thrifts; and may be appointed to resolve large bank holding companies and nonbank financial companies that are supervised by the Federal Reserve. Also, the FDIC has backup supervisory responsibility for all federally insured depository institutions. NCUA regulates, charters, and supervises federally-chartered credit unions and insures deposits in federal and most state-chartered credit unions.

Entity	Oversight role
State securities administrators	Regulate the securities industry and enforce the securities laws within their states. As part of their efforts, administrators investigate investor complaints and potential cases of investment fraud, including enforcement cases involving issuers of unconventional assets. In addition, the administrators generally collect and track complaints and other inquiries received from members of the public regarding fraudulent practices or potential violations of state securities laws.

Source: GAO analysis of information from federal, state, and independent entities. | GAO-17-102

## Full Extent of Retirement Account Investment in Unconventional Assets Is Unknown, but Custodians Reported Nearly Half a Million Accounts Invested in Unconventional Assets in 2015

### Federal Government Collects Limited Data on Unconventional Asset Holdings in Retirement Accounts

To date, federal data collection efforts capture limited information on the unconventional asset holdings in IRAs and solo 401(k) plans, making their overall prevalence unknown. Historically, IRS has not collected FMV data specific to unconventional asset holdings in IRAs. For tax year 2015, IRS began requiring IRA custodians to report selected information on unconventional asset holdings in IRAs.<sup>32</sup> IRS did not fund electronic

<sup>32</sup>Box 15b on the form provides eight codes for identifying the types of unconventional assets: (A) Stock or other ownership interest in a corporation that is not readily tradable on an established securities market; (B) Short- or long-term debt obligation that is not traded on an established securities market; (C) Ownership interest in a limited liability company or similar entity (unless the interest is traded on an established securities market); (D) Real estate; (E) Ownership interest in a partnership, trust, or similar entity (unless the interest is traded on an established securities market); (F) Option contract or similar product that is not offered for trade on an established option exchange; (G) Other asset that does not have a readily available fair market value; and (H) More than two types of assets (listed in A through G) are held in this IRA.

compilation for the 2015 data but plans to electronically compile data for tax year 2016 that will be filed in 2017. As of November 2016, IRS has not provided a date on when the new IRA asset type data will be available for further analysis. While estimates have been reported in recent years regarding the aggregate investment in IRAs that may hold unconventional assets, we could not determine the validity of these estimates based on the sources of data used to support them.<sup>33</sup> In addition, DOL collects no data on unconventional asset holdings in solo 401(k) plans because sponsors of solo 401(k) plans are generally not required to report their investment holdings. As a result, federal data collection on unconventional assets is incomplete and unspecific with respect to the types of assets held in these accounts. (See table 3.)

**Table 3: Current Extent of Federal Data Collection on Retirement Accounts with Unconventional Assets**

	IRAs	Solo 401(k) plans <sup>b</sup>
Number of accounts with unconventional assets	●	○
Total value of unconventional assets in accounts	●	○
Types of unconventional assets in accounts	◐ <sup>a</sup>	○
Value by unconventional asset type in accounts	◐	○

Legend: ● information collected ◐ partial information collected ○ no information collected

Source: GAO analysis of Form 5498 for individual retirement accounts (IRA) and the Form 5500 series for solo 401(k) plans. | GAO-17-102

<sup>a</sup>Beginning with tax year 2015, the Internal Revenue Service (IRS) requires custodians to separately identify the fair market value of IRA investment in unconventional assets including: nonpublicly traded stocks and real estate. Custodians are also to enter up to two codes identifying the unconventional asset types, but IRS does not require custodians to separately report the fair market value of each type of unconventional investment.

<sup>b</sup>Solo 401(k) plans are qualified retirement plans designed for the self-employed or owners of small businesses with no employees (beyond the owner and their spouse). Sponsors of solo 401(k) plans are generally not subject to filing requirements under Title I of the Employee Retirement Income Security Act of 1974. Instead, IRS requires them to file either a Form 5500-EZ on paper or a Form 5500-SF electronically to satisfy certain annual reporting and filing requirements imposed by the Internal Revenue Code. However, IRS requires these filers to report only total plan assets and does not require them to identify or report separately on investment in unconventional assets. Further,

<sup>33</sup>For example, in 2011 SEC’s Office of Investor Education and Advocacy and the North American Securities Administrators Association (NASAA) issued a joint investor alert that included an estimate compiled from various sources that investors held approximately 2 percent of total IRA retirement funds (\$94 billion) in IRAs that may allow investment in unconventional assets. A more recent industry estimate valued investments in these IRAs at \$152 billion, and attributed the source to Investment Company Institute reports. However, an Investment Company Institute official told us that the institute has never reported on the value of unconventional assets held in IRAs.

sponsors of solo 401(k) plans with less than \$250,000 in assets are generally not required to file any information on plan investment with federal regulators.

## Custodians Report Nearly Half a Million Retirement Accounts Are Invested in Unconventional Assets

Seventeen of the 26 custodians we identified who allow investment in unconventional assets reported holding an aggregate of more than 488,000 retirement accounts at the end of calendar year 2015. Custodians reported that owners of these retirement accounts invested in a range of unconventional asset types and identified real estate, private equity, and hedge funds as the most common asset types held in these accounts. In addition, they reported that account owners invested in Limited Liability Companies (LLC) and limited partnerships, precious metals, promissory notes, church bonds, and private placements. Custodians also reported that these accounts have an aggregate value of approximately \$50 billion; however, we could not determine whether the accounts exclusively held unconventional assets or, if not, which portion was attributable to cash or publicly traded assets held in the accounts.

IRAs made up the vast majority of accounts and assets reported, and solo 401(k) plans constitute less than 1 percent of reported accounts and assets. (See table 4.)<sup>34</sup>

**Table 4: Custodian-Reported Aggregate Number and Value of Retirement Accounts Investing in Unconventional Assets by Account Type, as of December 31, 2015**

	IRAs <sup>a</sup>	Solo 401(k) plans	Total
Aggregate number of accounts	485,517	2,816	488,333
Aggregate value of accounts	\$49,768,207,085	\$187,692,662	\$49,955,899,747

Source: GAO analysis of data on individual retirement accounts (IRA) and solo 401(k) plans provided from 17 custodians. | GAO-17-102

<sup>a</sup>We aggregated custodian responses for any IRAs invested in unconventional assets.

The aggregate data that custodians provided help establish a baseline of retirement account investment in unconventional assets, but these data are not comprehensive in that they exclude several other potential sources of such investment. For example, industry representatives stated

<sup>34</sup>The Investment Company Institute reported that the total assets in IRAs and 401(k) plans at the end of 2015 were \$7.3 trillion and \$4.7 trillion, respectively. See Investment Company Institute, *2016 Investment Company Fact Book* (Washington, D.C.: May 4, 2016).

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## Retirement Account Owners Investing in Unconventional Assets Are Responsible for Account Management and Compliance

that other banks, trust companies, and financial service providers may accommodate investments in unconventional assets, such as commercial real estate, for their high net worth clients. Additionally, some individuals with 401(k) plans who invest in unconventional assets serve as plan trustee and would not need to retain the services of a custodian to process account transactions. Therefore, it is likely that the total number of accounts invested in unconventional assets would be higher.

Transferring existing retirement savings to a new account or plan that allows investment in unconventional assets expands the roles and responsibilities of account owners for managing aspects of their accounts.<sup>35</sup> Many individuals seeking to set up a new account may be accustomed to tax-favored status for their IRA or 401(k) plan, but their decision to invest in unconventional assets is accompanied by a range of responsibilities that may be new and unfamiliar. For example, all 20 custodial agreements we reviewed required individuals to agree to be responsible for directing their investments; and oversee the selection, management, monitoring, and retention of all investments in the account. In addition, while account owners may seek the assistance of knowledgeable third parties, such as attorneys, accountants, tax advisors, and financial planners, the account owners bear the consequences of any mistakes made in managing their accounts. According to DOL, IRA and 401(k) plan investors often lack investment expertise and must rely on experts, but are unqualified to assess the quality of the expert's advice or guard against its conflicts of interest. Moreover, DOL notes that many of these experts often receive fees (or other forms of compensation) that may introduce conflicts of interest between them and the plan officials, plan participants, and the IRA investors they advise.

*Selecting an Appropriate Account Type.* Individuals seeking to save for retirement by investing in unconventional assets must first determine which type of retirement savings vehicle and investment aligns with their savings goals. Nine of 17 custodians reported that clients want to invest in unconventional assets for a variety of reasons, including avoiding the stock market, diversifying retirement portfolios, investing in a tangible or familiar asset, or investing in a company not yet publicly traded. One custodian said that most individuals seeking investment in unconventional assets did not own their own businesses, and that it was more common for these individuals to establish an IRA with a custodian that allowed this

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<sup>35</sup>Individuals can also fund an account by making an initial contribution.

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kind of investment. Self-employed individuals or owners of small businesses who employ no other full-time employees may qualify to sponsor a solo 401(k) plan. Two service providers who advise their clients on creating solo 401(k) plans to invest in unconventional assets said that their clients preferred the 401(k) plan for its higher annual contribution limits and the ability to take participant loans.<sup>36</sup>

*Establishing and Funding an Account.* An individual must take several steps to establish and fund an account that allows investment in unconventional assets. First, individuals opening an IRA must find a custodian willing to administer the asset.<sup>37</sup> Eighteen of the 21 service providers reported that in their experience most individuals wanting to set up an account had a specific investment or asset type in mind before making initial contact with them. Twelve of the 17 custodians reported that they placed some restriction on the types of unconventional assets that they would allow. For example, they reported that they did not allow investment in certain assets, including foreign-based assets, precious metals, person-to-person promissory notes, or single-member LLCs. One custodian noted that such restrictions were necessary because some assets were administratively infeasible for its business plan. For example, a custodian who does not specialize in foreign-based assets may not accept custody of these types of assets. Second, prospective IRA owners must sign a custodial agreement that outlines the respective roles and responsibilities of the account owner and custodian over the lifecycle of an account. Our analysis of agreements available on 20 custodians' websites found that 18 custodians used IRS's model custodial agreement to help IRAs conform to IRS requirements. The model agreement includes several articles that IRS has approved regarding contribution limits, prohibited assets, RMDs, and the treatment of beneficiaries, among other things. The agreement also provides custodians with an opportunity to amend the form with additional provisions as long as these provisions comply with applicable requirements of federal and state law. Third, the individual must authorize the custodian to fund the new account

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<sup>36</sup>Unlike an IRA, 401(k) plans, including solo 401(k) plans, may allow participants to take a loan from their account. The IRC sets the maximum amount that the plan can permit as a loan, generally, as (1) the greater of \$10,000 or 50 percent of a participant's vested account balance or (2) \$50,000, whichever is less. 26 U.S.C. § 72(p)(2).

<sup>37</sup>Individuals wanting to set up a solo 401(k) plan must adopt a written plan document, arrange a trust fund for the plan's assets, and develop a recordkeeping system. Once the plan has been established, the plan sponsor can set up a banking account for the plan and fund this account through a rollover from another qualified retirement account.



either through a new contribution, or through a transfer or rollover of funds from another qualified retirement account.

*Purchasing Assets.* The choice to purchase unconventional assets rather than publicly traded stocks and bonds in a retirement account marks a significant shift in the balance in account management responsibilities toward the account owner. On the one hand, solo 401(k) account owners sponsor the plan and can serve as its trustee, allowing them to purchase any asset permissible in the plan documents and deposit the asset in their designated trustee account. On the other hand, IRA owners investing in unconventional assets must locate an asset, determine its suitability for their retirement goals, and conduct due diligence on the investment and the investment sponsor. In addition, to finalize the purchase, these IRA owners must collect, review, and prepare all purchase documents and provide them to the custodian to execute the purchase on behalf of the IRA. IRA owners and custodians must complete this sequence of tasks each time an asset is placed in the account. (See table 5.)

**Table 5: Examples of Account Owner and Custodian Responsibilities Associated with the Purchase of Unconventional Assets in an Individual Retirement Account (IRA)**

<b>Responsibility</b>	<b>Account owner</b>	<b>Custodian</b>
Determining the appropriateness of an asset	•	
Determining the risk associated with an asset	•	
Reviewing for potential prohibited transactions	•	
Arranging with the investment sponsor to purchase an asset	•	
Providing documentation to support the asset purchase	•	
Providing direction to disburse funds to purchase asset	•	
Verifying that funds are correctly invested	•	
Determining an asset's administrative feasibility		•
Disbursing funds from IRA to purchase asset		•
Ensuring purchased asset is titled in the name of IRA		•
Facilitating the safekeeping of certificates, notes, or deeds		•
Providing periodic statements showing account's value		•

Source: GAO analysis of available custodian information. | GAO-17-102

The amount and type of documentation that account owners must provide to custodians before an asset can be purchased can vary considerably depending on the type of asset being purchased. Our analysis of custodian documentation found that assets like promissory notes or precious metals require minimal documentation from the account owner, while other assets, such as real estate or private equity, can require the account owner to provide considerable documentation before a purchase can be made. Depending on the asset type selected, an account owner may have to expend considerable time and effort to finalize an asset purchase. (See table 6.)

**Table 6: Examples of Documentation that Selected Custodians Require Before Certain Assets Can Be Purchased for an Individual Retirement Account (IRA)**

<b>Asset</b>	<b>Documentation required for purchase</b>
Unsecured promissory note	Investment authorization with funding instructions Original notarized note Note servicing agreement (if applicable) Amortization/payment schedule
Precious metals	Dealer's contact information Purchase authorization describing the quantity, metal type, form (bullion or coin), weight, and price
Private equity	Subscription documents (or other purchase agreement) Investment representation letter Articles of incorporation Certificates of limited partnership Articles of organization Other organizational documents Bylaws Shareholder agreements Partnership agreements Operating agreements Trust instruments Private placement memo
Real estate <sup>a</sup>	Request for earnest money deposit Purchase contract Current property tax bill Legal description of property Copy of executed property management agreement Instructions for sending check/wire at closing Copy of title insurance Copy of liability insurance

Asset	Documentation required for purchase
	Property appraisal Settlement statement and closing documents All loan documents (if property is being financed)

Source: GAO analysis of selected custodial forms. | GAO-17-102

<sup>a</sup>The documentation custodians require may change depending on the type of real estate purchased. For example, custodians may require account owners to produce lender documents for mortgaged properties, environmental reports for commercial or industrial properties, and property management agreements for income-producing properties.

Some IRA owners may choose to exercise greater control and limit a custodian’s direct involvement in the purchase of unconventional assets by adding a checkbook control feature to their IRA. In order to obtain checkbook control, the account owner must first establish an LLC that is owned by the IRA. Once this new LLC is established, a business checking account linked to IRA funds is set up, and account owners are named manager of the LLC with control of the checkbook. Using the checkbook owned by the IRA’s LLC, the account owner can take advantage of time-sensitive offers and purchase assets directly from investment sponsors without having to wait for a custodian to execute a purchase or sale.

*Account Management and Compliance.* Account owners who invest in unconventional assets typically agree to become responsible for the day-to-day management of their accounts and ensuring that the account remains compliant with laws and regulations, according to our review of selected custodial agreements. As an IRA custodian can only act on the direction of the account owner, an account owner generally must inform the custodian of the many tasks needed to maintain assets in their account—such as purchases, sales, earned income, payments due, requested distributions, and changes in the account’s value—and provide sufficient documentation to the custodian to facilitate each account transaction on their behalf. (See table 7.)

**Table 7: Account Owner and Custodian Responsibilities Associated with the Ongoing Individual Retirement Account Management and Maintenance, Based on Review of Selected Custodial Agreements**

<b>Responsibility</b>	<b>Account owner</b>	<b>Custodian</b>
Account administration	<p>Directs all investment transactions, including reinvestment of dividends, interest, and sales proceeds, as well as payments of insurance premiums, real estate taxes, utilities, or other charges (including penalties) related to an IRA investment.</p> <p>Provides documentation to support all directed account transactions.</p> <p>Ensures adequate liquidity to meet all account obligations.</p> <p>Conducts ongoing monitoring of investment performance, investment sponsor performance, and for potential prohibited transactions.</p>	<p>Executes account owner’s directions based on documentation provided.</p> <p>Reports known prohibited transactions and distributions from the account to regulators.</p>
Account recordkeeping	Ensures custodian receives accurate and complete information on all account transactions; verifies content of periodic account statements.	Maintains records of all account transactions and issues periodic account statements to account owner.
Tax reporting	<p>Monitors account for possible unrelated business income tax liability; prepares Form 990-T to report taxes; and directs custodian to disburse funds to pay tax liability.</p> <p>Provides custodian with annual fair-market value updates for all hard-to-value assets in the account.</p>	<p>Collects and files prepared Form 990-T and releases funds from the account to pay taxes owed.</p> <p>Reports the aggregate fair market value of all assets in an account and the owner-provided fair market value for certain categories of hard-to-value assets to Internal Revenue Service on an annual basis.</p>
Asset custody	None	Facilitates the safekeeping of original purchase documents and some physical assets.

Source: GAO analysis of IRS and selected custodial information. | GAO-17-102

The extent of custodian involvement in the ongoing management of an account can depend on the types of unconventional assets held in the account. For example, one custodian mentioned that promissory notes that promised a balloon payment of principal and interest at the end of a specified term generally required less recordkeeping from the custodian. The same custodian and another described the management of a real estate holding in an IRA as being a labor-intensive, manual process. In this case, a custodian would coordinate with the account owner to pay all expenses from IRA funds, such as maintenance, improvements, property taxes, condominium association fees, general bills, and insurance, and return any related income to the IRA.

Account owners need to be mindful of fees and expenses associated with plan investments and services to determine whether they continue to be reasonable in light of the services provided. Given that retirement accounts must be held in trust, IRA custodians generally charge a range of administrative and transactional fees for the services they provide throughout the lifecycle of an IRA. While some transactions like precious metal storage lend themselves to a flat fee, other transactions like real estate purchases can involve multiple transactions requiring greater involvement by a custodian, leading to a higher incidence of fees that must be paid out of the account.<sup>38</sup> In reviewing fee disclosures from custodians who made them publicly available on their websites, we found that custodians generally charged fees for similar services—account establishment, account maintenance, transactional fees, and account termination—but the type of fee structure used and amounts of fees charged varied among custodians. Custodians’ fee structures generally included a (1) flat fee; (2) a per-asset fee in an account; or (3) a fee based on a percentage of an account’s value. Some fee structures consisted of multiple categories, such as a flat fee plus a per-asset fee. The fee structure used can affect annual account costs, as shown in table 8.

**Table 8: Examples of How Selected Custodians’ Fee Structures for Annual Account Maintenance Could Affect the Overall Cost of Holding an Unconventional Asset Valued at \$100,000**

Example	Flat fee(\$)	Per asset fee (\$)	Based on account value (basis points) <sup>a</sup>	Cost to account (\$) <sup>b</sup>
1	65	—	—	65
2	600	350	—	950
3	95	48	—	143
4	320	120	—	440
5	195	—	26	455
6	—	—	120	1,195
7	—	—	60 (\$2,000 minimum)	2,000

Source: GAO analysis of publicly available custodian fee disclosures. | GAO-17-102

<sup>38</sup>As we have previously reported, account fees can significantly decrease retirement savings over the course of an account owner’s career. Even a small fee deducted from an account today could significantly reduce the account’s balance years later had it remained in the account. See GAO, *Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees*, [GAO-07-21](#) (Washington, D.C.: Nov. 16, 2006).

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<sup>a</sup>One basis point is equal to one one-hundredth of one percentage point (0.01%).

<sup>b</sup>Costs associated with fees charged per asset were calculated by multiplying the number of assets (i.e., one) by the fee charged per asset. Costs associated with fees based on account value were calculated by multiplying the account value (i.e., \$100,000) by the fee percentage. The cost calculations in the table were derived from the fee structures of seven separate custodians whose fee disclosures we reviewed. We selected these examples to demonstrate the range of fees and how fees were assessed. The cost calculations are intended for illustrative purposes and may not represent the total cost of holding unconventional assets in an account. Accounts holding unconventional assets may also be subject to other transactional or service fees that are not included here.

Finally, one fee disclosure we reviewed reminded account owners of their responsibility to monitor their accounts, noting that unfunded accounts and accounts with zero value would continue to incur fees until the account owner provided written instruction to close the account.

IRA owners with checkbook control can perform some tasks associated with maintaining the account without a custodian's assistance and thus avoid some of the custodian's administrative and transaction fees related to these services. For example, an IRA owner, as manager of the LLC owned by the IRA, can manage several administrative services associated with rental real estate in an IRA, such as paying property taxes, insurance premiums, and utility bills, and writing checks from the LLC bank account to cover property repairs and maintenance. However, whether using a custodian or not, the account owner, in signing a custodial agreement, agrees to be responsible for ensuring that transactions do not run afoul of the prohibited transaction rules and for determining whether transactions constitute contributions to or distributions from the IRA.

*Closing an Account and Distributing Assets.* As with purchasing assets and maintaining an account on an ongoing basis, account owners investing in unconventional assets are responsible for overseeing the distribution of assets from their accounts, such as determining the amount of any RMD and directing custodians to release the funds. Whether seeking to liquidate the assets in an account, take physical possession of the assets, or transfer assets to another custodian, account owners must direct the custodian to facilitate the removal or transfer of assets from the IRA.

- Distribution of assets. Either the account owner or the custodian can initiate a distribution of account assets. Account owners can submit a distribution request to the custodian. The custodian follows the account owner's directions to distribute account assets to the account owner either in cash or other in-kind distribution. In the case of an in-

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kind distribution of assets, the custodian may ask the account owner to provide an updated FMV for the assets before completing the distribution. A custodian can also initiate a distribution of account assets for a variety of reasons, including engaging in a prohibited transaction or nonpayment of fees. The custodian must report distributions to IRS and the account owner on Form 1099-R.

- Custodian-to-custodian transfer. The account owner can establish a new account with another custodian and authorize a transfer of assets from the old account to the new account. The new custodian works with the account owner to re-title illiquid assets in the name of the new account and forwards the transfer request to the current custodian for execution. The original custodian confirms that all fees and expenses have been paid and illiquid assets are properly re-titled; and transfers the assets to the new custodian. Custodians are generally not required to report such transfers between IRAs to IRS or to account owners on Form 1099-R.

Some custodial agreements contain provisions that a custodian may initiate a distribution of unconventional assets to the account owner (or transfer assets to another custodian) without an account owner's consent. When this occurs, the custodian notifies an account owner of the custodian's intent to resign and terminate an account, and generally gives the account owner 30 days to exercise their right either to request a lump sum distribution or to name a new custodian to initiate an in-kind transfer. If the account owner does not name a new custodian, the custodian can transfer the assets in-kind to another custodian of their choosing or distribute the account's assets to the account owner. If distributed to the account owner, the custodian must report the distribution to IRS and provide a Form 1099-R to the account owner.

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## IRA Owners with Unconventional Assets Can Face Challenges with Tax Liability, Valuation, and Distribution, and IRS Provides Limited Guidance to Assist Them

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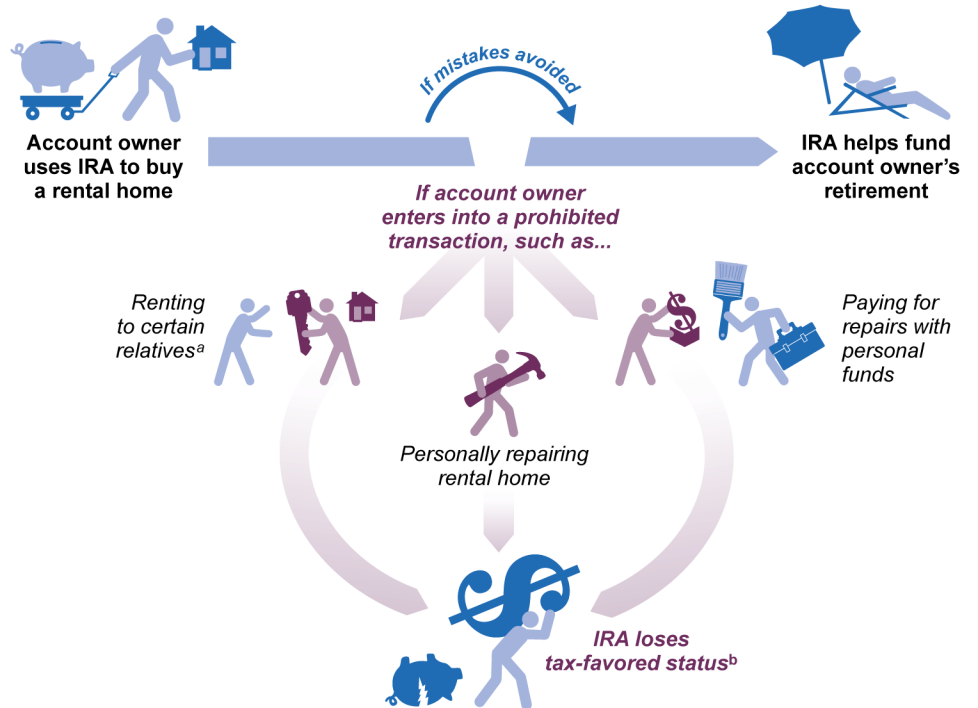
### Certain IRA Transactions Can Trigger Loss of Tax-Favored Status or Generate Immediate Tax Liability

#### Loss of Tax-Favored Status

IRA owners who invest in unconventional assets take on a heightened risk of engaging in a prohibited transaction and losing tax-favored status for their retirement savings. IRS officials stated that prohibited transactions are the most prominent compliance risk associated with investing IRA savings in unconventional assets. Prohibited transactions are more likely to arise with investments in promissory notes, private equity, and real estate because—unlike publicly traded stocks, bonds, and mutual funds—these investments can involve disqualified family members or other disqualified persons. Similarly, IRA investments in rental real estate, with its many transactions, for example, can leave IRA owners susceptible to a number of prohibited transactions, any one of which would result in the loss of the IRA's tax-favored status, as shown in figure 1.



**Figure 1: Examples of How an Individual Retirement Account (IRA) Owner Investing in Rental Real Estate May Unknowingly Engage in a Prohibited Transaction**



Source: GAO analysis of IRS publications. | GAO-17-102

<sup>a</sup>Retirement account owners or other disqualified persons are not permitted to benefit from an IRA other than as a vehicle to save for retirement. Disqualified persons include, for example, a person providing services to the plan and certain family members of otherwise disqualified persons (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant).

<sup>b</sup>IRA owner may decide to reinvest assets in another taxable arrangement after paying any applicable income taxes associated with an early distribution and additional excise taxes.

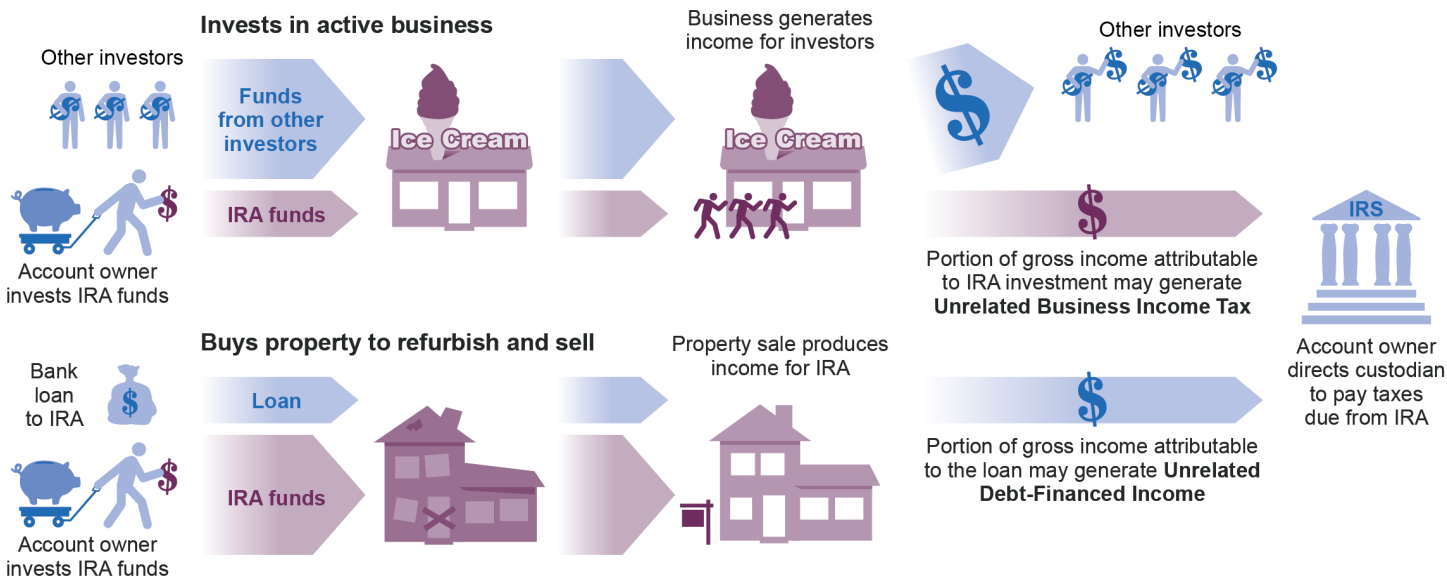
Some custodians can serve as gatekeepers for obvious prohibited transactions, such as an IRA owner purchasing his own property for the IRA, though account owners must navigate the IRA tax laws and can face additional taxes for noncompliance. Account owners who invest in an LLC inside an IRA with a checkbook control feature, which limits custodial involvement in transactions, also take on a heightened risk of engaging in a prohibited transaction and losing their IRA's tax-favored status. Checkbook control may offer IRA owners additional conveniences and reduce transaction fees charged by custodians, but these IRA owners must closely monitor each action for prohibited transactions. For example, IRA owners with checkbook control may pay IRA expenses directly without submitting requests through a custodian; however they must

avoid paying IRA expenses with personal funds, such as writing a check from a personal account rather than from their IRA checkbook, or making payments to themselves or another disqualified person. Six of 17 custodians said that they did not offer IRAs with checkbook control due to the lack of custodian oversight for prohibited transactions, among other things.

## Unforeseen Federal Tax Liability

Earnings and profits made in tax-deferred savings vehicles generally get reinvested in the account without generating current federal tax liability, but investments in certain unconventional assets can generate ongoing tax liability for IRA owners.<sup>39</sup> Certain investments can generate current tax liability from UBTI or UDFI earned in retirement accounts. Examples include using an IRA to invest in an active business or using debt to finance a portion of an asset's purchase. (See fig 2.)

**Figure 2: Examples of How Certain Individual Retirement Account (IRA) Investments Can Trigger Unforeseen Federal Tax Liability**



Source: GAO analysis of IRA publications and selected custodial agreements. | GAO-17-102

<sup>39</sup>Dividends, interest, certain other investment income, royalties, certain rental income, certain income from research activities, and certain gains or losses from the disposition of property are excluded when computing unrelated business income.

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IRA custodians need to monitor IRA investments for UBTI and pay any applicable taxes from the IRA, but we found custodians often delegated the responsibility for monitoring for tax liability to the account owner. IRS requires custodians of IRAs subject to these requirements to file a Form 990-T for any UBTI of \$1,000 or more. Most custodial agreements we reviewed required account owners to agree to monitor their IRA for business income; however, two service providers told us IRA owners familiar with investing in more conventional assets that do not generate business taxable income may not realize that the responsibility to monitor continues as long as the asset remains in the IRA.

Having to pay taxes from the IRA can pose additional challenges for account owners who invest in illiquid assets that cannot easily be sold to pay applicable taxes. First, illiquid unconventional assets, such as real estate, private equity, and promissory notes, may require account owners to find another investor to purchase their interest in the asset. Second, the account owner cannot pay the taxes with personal funds (a prohibited transaction) and must arrange to have a custodian pay the taxes from their IRA. Third, two service providers stated that IRA owners may not realize that once a retirement investment generates UBTI or UDFI, taxes must be estimated and paid quarterly if the tax is expected to be \$500 or more, necessitating a certain level of liquidity to be maintained in the account.

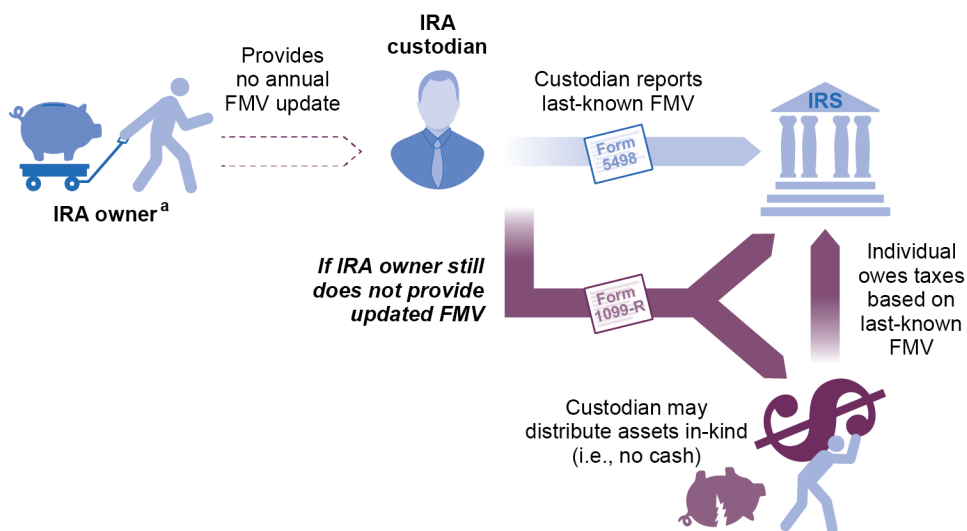
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### Difficulty Obtaining Fair Market Value for Hard-to-Value Assets Can Heighten the Risk of IRA Noncompliance and Fraud

IRA owners who invest in unconventional assets may face challenges meeting their responsibilities to provide updated FMV information to their custodian to meet IRS's annual FMV reporting requirement because some unconventional assets are inherently hard to value. Some unconventional assets, such as precious metals, have a readily available FMV; other assets, such as undeveloped land and private equity, may require IRA owners to obtain a third-party appraisal or rely on investment sponsors to provide the information. Many of the custodial agreements we reviewed made IRA owners responsible for obtaining and providing a year-end FMV of unconventional assets in their accounts to the custodian each year. However, some custodians contact the investment sponsor directly to obtain an updated FMV, and if unsuccessful, may report the last-known FMV or the original purchase price. As a result, the FMV reported to IRS may not reflect a nonpublicly traded asset's current value. IRA owners who fail to provide updated FMV to their custodian within a specified time limit run the risk of their custodian distributing their assets from the IRA, which could lead to a loss of the account's tax-favored

status if the owner cannot identify a successor custodian willing to hold the assets.<sup>40</sup> (See fig. 3.)

**Figure 3: Examples of Challenges from Individual Retirement Account (IRA) Owners Not Providing Updated Fair Market Value (FMV) Information to Their Custodians**



Source: GAO analysis of IRS information and selected custodial agreements. | GAO-17-102

<sup>a</sup>Custodians may obtain updated FMV information directly from the investment sponsor.

Even though the last-known FMV that the custodian reports to IRS may not necessarily reflect the current estimated value of an asset, it can be treated as an asset's true value and result in federal tax consequences for IRA owners. For example, the last-known FMV can be used to calculate federal tax liability for IRA owners:

- when calculating RMDs;
- when determining the distribution amount in the event the IRA engages in a prohibited transaction; and
- when reporting an in-kind distribution in the event a custodian resigns an account (e.g., IRA owner fails to pay custodial fees or to provide updated FMV).

<sup>40</sup>Three custodial agreements we reviewed specified time limits ranging from 6 to over 12 months after the year-end FMV update was due to the custodian.

Distributions of assets at their last-known FMV can be especially damaging if the asset distributed is found to be valueless and/or an updated FMV is unattainable.<sup>41</sup> Once a distribution is made from an account, the value of that distribution—even if based on a last-known FMV—becomes the value used to determine the account owner’s federal tax liability. IRS identifies noncompliance with IRA distribution rules through automated matching of custodians’ Form 5498 and Form 1099-R returns with taxpayers’ income tax returns. According to an IRS official, if a Form 1099-R incorrectly reported a distribution of a worthless asset as a distribution of a valuable asset, the individual receiving the incorrect distribution would be responsible for proving that the asset was worthless. The official further noted that, to remain compliant, the taxpayer could pay the tax due and subsequently file a claim for a refund, or report the depreciation of the distributed asset’s value on an annual income tax filing. Our review of consumer complaints found several examples of a custodian’s decision to report the last-known FMV creating tax consequences for account owners, as shown in table 9.

**Table 9: Examples of Retirement Account Owners Facing Federal Tax Consequences Based on an Asset’s Last-Known Fair Market Value (FMV)**

Source	Complaint description <sup>a</sup>
Better Business Bureau	Custodian initiated an in-kind distribution of a real estate investment at its last known FMV of \$25,000 to an account owner for failure to pay account fees. As a result, the account owner owed over \$2,600 in current taxes for an allegedly worthless real estate investment.
Better Business Bureau	Custodian initiated an in-kind distribution of private stock at its last-known FMV of over \$100,000 to an account owner for failure to pay account fees, triggering tax liability for the account owner. The account owner had not provided an updated FMV to the custodian to reflect the stock as worthless.
Better Business Bureau	Custodian initiated an in-kind distribution of private stock at its last-known FMV of \$140,000 to an account owner after the account owner did not provide the custodian with updated FMV information showing that the company that had gone out of business and the stock had no value. This distribution triggered tax liability for the account owner.

Source: GAO analysis of complaint data. | GAO-17-102

<sup>a</sup>We did not confirm the authenticity of these complaints or investigate any of the allegations made. In addition, we did not collect information about all of their resolutions.

<sup>41</sup>Reporting outdated values may also have consequences for IRS in the form of lost tax revenue.

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Custodians provided information to account owners through custodial agreements and other forms on owner responsibilities for providing FMV information for unconventional assets and supporting documentation to the custodian. For example, thirteen of the 20 custodial agreements we reviewed included custodian-specific policies informing account owners of their responsibilities to comply with IRS's annual FMV reporting requirements. We found a range of policies, varying by asset type and custodian, for the FMV information that would be reported to the IRS and for when account owners needed to obtain independent appraisals to substantiate an asset's FMV. For example, some of these agreements and other custodian forms:

- required IRA owners to obtain independent property appraisals for real estate investments at least once every 3 years;
- required IRA owners to obtain an annual comparative market analysis for real estate investments;
- collected FMV information directly from investment sponsors and other third-parties for certain assets, such as limited liability companies, limited partnerships, and hedge funds; and
- reported the purchase price for other assets, such as promissory notes.

However, some custodians also stated that requiring independent appraisals in years without a taxable event, such as a distribution, could be costly for account owners and discourage investments in certain types of assets.

The difficulty with obtaining and verifying FMV of certain unconventional assets can expose account owners to fraud and allow losses in value to remain undetected in retirement accounts for some time, eroding IRA owners' retirement savings. In 2011 SEC's Office of Investor Education and Advocacy and the North American Security Administrators Association (NASAA) issued a joint investor alert warning investors that money held in accounts that allow investments in unconventional assets presented attractive targets for fraud promoters seeking to engage in fraudulent conduct.<sup>42</sup> The alert included multiple examples of SEC and state enforcement cases that involved fraudulent schemes associated

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<sup>42</sup>SEC, Office of Investor Education and Advocacy, *Investor Alert: Self-Directed IRAs and the Risk of Fraud*. (Washington, D.C.: Sept. 1, 2011). <https://www.sec.gov/investor/alerts/sdira.pdf>

with IRAs that allow investments in unconventional assets. SEC officials said that even though the prevalence of accounts holding unconventional assets cannot be readily determined, the potential for fraud in these accounts remained high and that concrete examples of fraud involving these accounts have been, and continue to be, well documented. Three state securities administrators said complaints from account owners were often filed years after an account had lost value because these owners believed the periodic account statements sent by the custodian were correct. For example, if custodians, and in turn account owners, rely on the purchase price of a promissory note as an annual FMV, they may not realize when a borrower has filed for bankruptcy and thereby be unable to pay back the note. Similarly, according to the three state securities administrators, investment sponsors may report incorrect FMV information to custodians to perpetrate fraud. Finally, some account owners appeared to misunderstand the custodian’s responsibility to report annual FMV as a form of verification, leaving these account owners open to holding potentially fraudulent assets in their accounts. (See table 10.)

**Table 10: Examples of Potentially Fraudulent Assets in Retirement Accounts**

Source	Complaint description <sup>a</sup>
Securities and Exchange Commission	Account owner received periodic account statements from his custodian showing a large balance related to his investment. The account owner later discovered that the investment was part of an alleged Ponzi scheme and had never had intrinsic value.
Securities and Exchange Commission	Account owner relied on and did not verify the fair market value the custodian received from the company issuing the asset and reported to the Internal Revenue Service. The company was allegedly involved in a Ponzi scheme.
Securities and Exchange Commission	Account owner believed custodian should have made him aware of problems with an unpaid promissory note because many of custodian’s other clients were also affected by same issuer.

Source: GAO analysis of complaint data. | GAO-17-102

<sup>a</sup>We did not confirm the authenticity of these complaints or investigate any of the allegations made. In addition, we did not collect information about all of their resolutions.

### Some Unconventional Assets Are Difficult to Distribute as Retirement Income

Account owners may also face challenges when trying to liquidate certain unconventional assets to distribute as retirement income. Unlike publicly traded assets, which can be purchased and sold with relative ease in retirement accounts, account owners may experience difficulty finding a secondary market in which to sell certain unconventional assets. For example, account owners trying to liquidate a private equity investment must find other investors willing to purchase the asset. (See table 11.)

**Table 11: Examples of Retirement Account Owner Challenges Associated with Liquidating Unconventional Assets**

Source	Complaint description <sup>a</sup>
Securities and Exchange Commission	Account owner was unable to locate an investor to purchase her \$40,000 limited partnership interest in a new housing development.
Better Business Bureau	Account owner who was the beneficiary to her late husband's account tried unsuccessfully to obtain retirement income from the account on multiple occasions because the investment sponsor did not offer liquidation opportunities.
Better Business Bureau	Account owner could not distribute and close his IRA invested in an illiquid receivership claim. His only option for selling his investment was to find a third party to purchase the receivership claim.

Source: GAO analysis of complaint data. | GAO-17-102

<sup>a</sup>We did not confirm the authenticity of these complaints or investigate any of the allegations made. In addition, we did not collect information about all of their resolutions.

Account owners who have difficulty liquidating unconventional assets may instead be required to accept in-kind distributions rather than cash to comply with the minimum distribution requirements.<sup>43</sup> For example, an account owner invested in real estate may need to request that a custodian distribute a percentage of the property equivalent to their calculated annual RMD. In such a case, that individual would own an illiquid portion of the property personally while the account would own the rest. The account owner in this scenario would not be able to receive a cash distribution to use as retirement income, yet would be responsible for paying applicable income taxes on the in-kind distribution.

## IRS Provides Limited Guidance to Account Owners Who Invest Their Retirement Savings in Unconventional Assets

Current IRS guidance provides little information to help IRA owners understand their expanded responsibilities and potential challenges associated with investing in unconventional assets. For example, in our review of complaint data, some account owners appeared to misunderstand their responsibilities documented in the custodial agreements, and expected their custodian to provide due diligence, monitor investments, or compensate them for investment losses. (See table 12.)

<sup>43</sup>Account owners may also choose to direct the custodian to distribute IRA assets in-kind when their account has enough liquidity to make the RMD.



**Table 12: Examples of Retirement Account Owners Misunderstanding Their Responsibilities to Monitor Investments**

Source	Complaint description <sup>a</sup>
Securities and Exchange Commission	Account owner lost contact with company in which he had invested \$46,000 in private stock. Unable to retrieve his investment from the company, the account owner expected the custodian return the full amount of the investment.
Securities and Exchange Commission	Account owner expressed concern when company from which he purchased private stock stopped providing updated valuations. He demanded his custodian transfer his original investment amount back to his previous custodian.
Securities and Exchange Commission	Account owner discovered 7 years after his original \$51,000 investment in private stock that the stock had lost value. The account owner had expected the custodian to monitor the investment.

Source: GAO analysis of complaint data. | GAO-17-102

<sup>a</sup>We did not confirm the authenticity of these complaints or investigate any of the allegations made. In addition, we did not collect information about all of their resolutions.

Federal internal control standards require agencies to communicate effectively with external stakeholders to help achieve agency goals.<sup>44</sup> IRS’s Taxpayer Bill of Rights states that taxpayers have the right to know what they need to do to comply with the tax laws, and are entitled to clear explanations of the laws and IRS procedures in all tax forms, instructions, publications, notices, and correspondence.<sup>45</sup> In addition, IRS’s strategic plan states that IRS guidance should help taxpayers understand their tax responsibilities through targeted outreach, communications, and education.<sup>46</sup> We previously recommended that IRS outreach and education explicitly target the risk of noncompliance for IRA owners investing in unconventional assets.<sup>47</sup>

We found three areas, in particular, where IRS guidance lacks specific information for account owners investing in unconventional assets:

<sup>44</sup>See GAO, *Standards for Internal Control in the Federal Government*, GAO-14-704G (Washington, D.C.: September 2014).

<sup>45</sup>This document is available for download at <https://www.irs.gov/taxpayer-bill-of-rights#informed>.

<sup>46</sup>IRS Strategic Plan, Fiscal Years 2014-2017, Objective 2: Develop clear and focused outreach, communications, and education programs to assist taxpayer understanding of tax responsibilities and awareness of emerging tax laws.

<sup>47</sup>GAO-15-16.

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- Prohibited transactions. IRS officials said that engaging in prohibited transactions is the most prominent compliance risk associated with investing IRA savings in unconventional assets, but IRS has not yet compiled data to help provide targeted outreach to IRA owners who invest in unconventional assets.<sup>48</sup> In 2014, we recommended that IRS: (1) add an explicit caution in Publication 590 for taxpayers about the potential risk of engaging in a prohibited transaction when investing in unconventional assets; and (2) identify options to provide targeted outreach to taxpayers with unconventional IRA assets and their custodians to help them avoid losing their IRA tax-favored status by engaging in a prohibited transaction. In 2015, IRS added an explicit caution to IRA owners in Publications 590-A and 590-B about the heightened risk of engaging in a prohibited transaction, but has not compiled the data to help provide targeted outreach.<sup>49</sup> IRS said it could refine its outreach to those taxpayers with nonpublic IRA assets using the new asset type data once compiled electronically. Unless IRS augments outreach based on reliable data about unconventional IRA investments, these taxpayers at greater risk may not be able to ensure compliance with rules on prohibited transactions. Four service providers told us that additional guidance would help IRA owners investing in unconventional assets understand the risks for prohibited transactions.
  - Unrelated business taxable income. IRA owners unfamiliar with monitoring their investments for UBTI have limited guidance to assist them in identifying and calculating their tax liability. IRS Publications 590-A and 590-B, which together serve as a general IRA handbook for IRA owners, make no mention of UBTI or its tax consequences for IRAs. IRS Publication 598 -Tax on Unrelated Business Income of Exempt Organizations lists IRAs as one of many exempt entities subject to UBTI, and provides detailed examples of how to calculate

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<sup>48</sup>As of November 2016, IRS plans to electronically compile the IRA asset type data for tax year 2016 that will be filed in 2017, but IRS has not yet provided a date on when the new data will be available for further analysis.

<sup>49</sup>In June 2016, IRS outlined new information to be reported for nonmarketable IRA assets and included a general caution that IRAs with nonmarketable investments or assets under direct taxpayer control may be subject to a heightened risk of committing prohibited transactions. This caution—similar to those that IRS added to its publications about IRA contributions and distributions—is a step toward helping taxpayers better understand which investments pose greater risks. Publication 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*, Department of Treasury, Internal Revenue Service and Publication 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*, Department of Treasury, Internal Revenue Service.

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UBTI and file tax forms. However, the publication does not provide specific examples of how IRA investments in unconventional assets can generate UBTI. An IRS official said that the IRAs subject to UBTI represented a small percentage of 990-T filers, and that neither the frequency nor consequences of noncompliance met the threshold for including specific IRA-related content in the IRA and UBTI guidance. However, without an explicit caution or guidance from IRS, account owners may inadvertently invest in assets that require additional monitoring and filing obligations; failure to meet these obligations may subject account owners to underpayment penalties.

- Fair market value. Current IRS guidance includes no guidance or advice to custodians or IRA owners regarding how to determine the FMV for unconventional assets held in retirement plans. An IRS official stated that FMV is a commonly understood term and that many professional appraisal companies could provide an unbiased value for any IRA asset. However, 9 of the 17 custodians reported challenges obtaining FMV information, such as from nonresponsive account owners or investment sponsors, or in obtaining adequate supporting documentation. Further, securities administrators in one state said that guidance could be improved to indicate to custodians the type of information that they should rely on for substantiating FMV. In addition, three service providers said that account owners needed clearer guidance on FMV reporting, such as the types of information that would fulfill the requirements.

### Custodial Agreements That Follow the Model Form May Be Confusing

The inclusion of language from the IRS model form that a custodial agreement has been “pre-approved by the IRS” and the ability for custodians to amend the IRS model form may mislead account owners into thinking that IRS has reviewed and approved the entirety of the document they sign.<sup>50</sup> Fifteen of the 20 custodial agreements we reviewed retained language from the IRS model form stating that the agreement had been “pre-approved by the IRS,” but an IRS official said that the agency does not receive, review, or approve custodial agreements. In fact, the model form instructs IRA owners and custodians not to file the form with IRS.<sup>51</sup> In addition, 16 of the agreements resembled an IRS form, which may further lead account owners to

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<sup>50</sup>See appendix II for excerpts of language included in Form 5305-A.

<sup>51</sup>An IRS official told us that substantial resources would be needed to review the thousands of IRA documents offered to the public that were generally similar. By not requiring parties to file the form, financial and administrative costs were reduced, benefitting IRS and taxpayers.

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believe that the provisions contained within the form had been verified by IRS. For example, these agreements included the IRS form number, an IRC section reference, and the IRS 2002 revision date for the model form at the top of the first page. Lastly, we found that all 20 of the custodians amended the form to include multiple provisions designed to protect the custodian.<sup>52</sup> For example, some of these added provisions include:

- performing no due diligence on the investment and the investment sponsor;
- indemnifying the custodian of responsibility for sharing known information on troubled assets with account owners;
- reserving the right to liquidate IRA assets of the custodian's choosing; and
- employing and paying agents, attorneys, and accountants with IRA funds for any purpose deemed necessary.

The amended form may cause confusion on the part of IRA owners. For example, IRA owners may not be able to differentiate between the model IRS language and terms and conditions added by custodians. IRA owners may also read the “pre-approved by the IRS” statement and assume that the IRS has vetted the provisions added by custodians.<sup>53</sup>

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## Conclusions

With few restrictions on the types of assets that can be held in an IRA or a solo 401(k) plan, individuals can invest their retirement savings in an increasingly diverse range of unconventional assets—some of which may not have been imagined as retirement plan assets when the first IRAs or solo 401(k) plans came on the market. Unconventional assets, such as virtual currency and unsecured promissory notes, when placed in retirement accounts introduce different kinds of risk to account owners, and can have potential federal tax implications. These risks are particularly high for older workers nearing retirement who transfer savings accumulated over the course of their careers to establish new retirement

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<sup>52</sup>The 20 custodial agreements we reviewed that used the IRS model form ranged from 2 to 16 pages in length.

<sup>53</sup>IRS addressed a similar issue in the past. For example, in 2009 IRS issued a publication alerting IRA owners about questionable advertisements and solicitations for “IRS Approved” or “IRA Approved” investments. IRS, *An Important Message for Taxpayers with IRAs: The IRS Does Not Approve IRA Investments*, Publication 3125 (10-2009), Catalog Number 26091B (2009).

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accounts that allow investments in certain assets that they may not fully understand and may expand their responsibilities. IRS has published detailed guidance to assist account owners with directing their retirement investments, but this guidance has not kept pace with changes in investment options. As a result, account owners who take on responsibility for accounts invested in unconventional assets must rely on guidance better suited for investments in more conventional assets—publicly traded stocks, bonds, and mutual funds—which are often professionally managed. As account owners consider investing in unconventional assets, they should have a clear understanding of what is required to manage such investments in a retirement account, ensure proper valuation and tax reporting, and navigate a complex set of rules that govern tax-favored retirement investments. The consequences for account owners who make a mistake can be severe and jeopardize a lifetime of retirement savings.

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## Recommendations for Executive Action

To assist IRA owners in addressing challenges associated with investing their retirement savings in unconventional assets, we recommend that the Commissioner of Internal Revenue take the following three actions:

- Provide guidance to IRA owners on the potential for IRA transactions involving certain unconventional assets to generate unrelated business taxable income subject to taxation in the current tax year and subsequent years. For example, IRS could consider adding an explicit caution in Publication 590 Individual Retirement Arrangements (IRAs) and include a link in Publication 590 to Publication 598 Tax on Unrelated Business Income of Exempt Organizations to provide examples demonstrating how certain unconventional assets in IRAs can generate unrelated business income tax for account owners.
- Provide guidance to IRA owners and custodians on how to determine and document fair market value (FMV) for certain categories of hard-to-value unconventional assets. For example, IRS could consider updating Form 5498 instructions to custodians on how to document FMV for hard-to-value assets (e.g., last-known FMV based on independent appraisal, acquisition price) and provide guidance directed at account owners that provides examples of how to ascertain FMV for different types of unconventional assets.
- Clarify the content of the model custodial agreement to distinguish what has been reviewed and approved by IRS and what has not. For example, IRS could consider: (1) restricting custodians from stating that the form has been “preapproved by the IRS” on the form; (2)

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adding language to specify which articles have been preapproved by the IRS and which have not; and (3) limiting custodians from adding provisions to the model form other than those preapproved by the IRS.

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## Agency Comments and Our Evaluation

We provided a draft of this report to the Commissioner of Internal Revenue, the Secretary of the Treasury, the Secretary of Labor, the Chairman of the Securities and Exchange Commission, and the Chairman of the Federal Deposit Insurance Corporation for comment. In its written comments, reproduced in appendix III, IRS generally concurred with our findings and recommendations. In addition, each agency provided technical comments, which we incorporated as appropriate.

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As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Internal Revenue Service, the Department of the Treasury, the Department of Labor, the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, and other interested parties. In addition, the report will be available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact Charles A. Jeszeck at (202) 512-7215 or James R. McTigue, Jr. at (202) 512-9110. You may also reach us by e-mail at [jeszeckc@gao.gov](mailto:jeszeckc@gao.gov) or [mctiguej@gao.gov](mailto:mctiguej@gao.gov). Contact points for our Offices of Congressional

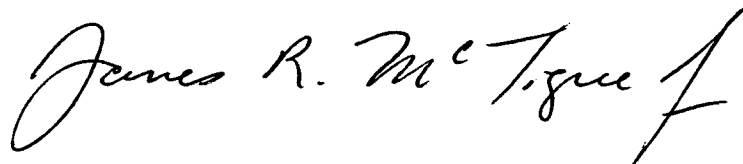
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Relations and Public Affairs may be found on the last page of this report.  
GAO staff who contributed to this report are listed in appendix IV.

Sincerely yours,



Charles A. Jeszeck  
Director, Education, Workforce,  
and Income Security



James R. McTigue, Jr.  
Director, Tax Issues  
Strategic Issues

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# Appendix I: Objectives, Scope, and Methodology

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The objectives for this study were to determine: (1) what is known about the prevalence of retirement accounts that invest in unconventional assets; (2) how these accounts are managed, and; (3) what challenges, if any, are associated with the administration of these types of retirement accounts.

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## Overall Methodology

Each of the engagement's three researchable objectives required us to identify various arrangements for investing individual retirement account (IRA) and 401(k) plan savings in unconventional assets. For all objectives, we reviewed pertinent federal laws, regulations, and guidance on the use of retirement account savings, as well as recent federal and state enforcement actions against entities involved with these types of retirement accounts. In addition, we searched for relevant scholarly and peer reviewed materials, trade and industry articles, government reports, conferences papers, research publications, and working papers. We also interviewed a range of federal and state regulators, industry stakeholders, and participant advocates.

To determine the prevalence of retirement accounts that invest in unconventional assets and better understand how these accounts are managed, we conducted multiple structured data collection efforts from custodians and service providers that allow investment in unconventional assets. To identify challenges associated with administering retirement accounts that invest in unconventional accounts, we analyzed investor complaint data from three federal agencies and two independent organizations. We also used the multiple structured data collection efforts from custodians and service providers to obtain their perspectives on potential challenges for account owners and providers. In addition, we reviewed publicly available custodian and service provider documentation, including application forms, fee disclosures, and custodial trust account agreements, which are used to establish a traditional IRA and specify account owners' roles and responsibilities. All data collected through these methods are nongeneralizable and do not necessarily reflect the experience of the entire population of custodians and service providers that hold retirement accounts invested in unconventional assets, and account owners who invest in unconventional assets. However, we believe the insights gained through these methods produced valuable information to better understand the extent and form of retirement account investment in unconventional assets.



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## Structured Data Collection Efforts

To identify custodians and service providers of retirement accounts who allow retirement account owners to invest in unconventional assets, we conducted a literature search, reviewed industry websites, interviewed industry stakeholders, and reviewed the Internal Revenue Service's (IRS) list of nonbank custodians. Through this process we identified 26 custodians and 48 service providers with experience working with account owners in establishing and managing such accounts.<sup>1</sup> We determined that these data were sufficiently reliable for the purpose of this report.

Next, to learn about the approximate number and value as well as types of retirement accounts held under custody at the end of calendar year 2015, we conducted a survey data collection effort from the 26 custodians that we had identified from available sources. We obtained responses from 17 custodians who varied in terms of the number and value of accounts they held, and the types of unconventional assets they allowed. We focused our effort on custodians as they are responsible under the Internal Revenue Code (IRC) for reporting the fair market value of all IRAs under custody to IRS. This removed the potential for double counting accounts and assets reported by both a service provider and the custodian they use to house clients' account assets. Through this effort, we also collected information on the types of unconventional assets account owners most commonly invest in. We confirmed the accuracy of account and asset data reported by 10 custodians who agreed to participate in a second structured data collection effort.

To examine how these retirement accounts are managed and get a sense of the challenges they present to account owners and providers, we conducted additional structured data collection efforts. We developed a follow-up set of questions for the same 17 custodians and received responses from 10 of them. We also developed a similar set of questions for the 48 service providers we identified who provide administrative support for IRAs and solo 401(k) plans, collecting information from 21 of

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<sup>1</sup>We collected data from a range of custodians and service providers. We identified custodians that were federally or state-chartered banks. These custodians varied in terms of value and type of assets they held. We also looked at nonbank custodians approved by the IRS, but none met our search criteria. The other service providers that we identified included account recordkeepers, facilitators of special transactions, attorneys, and accountants.

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them.<sup>2</sup> Through these efforts, we collected information on the steps needed to establish a retirement account for the purpose of investing in unconventional assets, as well as the roles and responsibilities of various stakeholders in managing and administering accounts. We also collected providers' perspectives on the reasons why some account owners choose to invest IRA and 401(k) plan savings in these types of assets and the challenges to account owners and providers may face in doing so. We determined that these data were sufficiently reliable for the purpose of this report.

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### Analysis of Investor Complaint Data

To augment our understanding of challenges associated with managing retirement accounts invested in unconventional assets, we analyzed 334 investor complaints obtained from three federal entities—the Department of Labor (DOL), the Office of the Comptroller of Currency (OCC), and the Securities and Exchange Commission (SEC)—and two independent organizations—the Financial Industry Regulatory Authority (FINRA) and the Better Business Bureau.<sup>3</sup> Our list of custodians and service providers was used to query databases for relevant complaints. We analyzed the complaints to develop general categories of challenges. We then conducted a two-step review and arbitration process to ensure proper categorization of each of the 211 complaints that we determined were directly associated with retirement accounts invested in unconventional assets based on available information. We did not confirm the authenticity of these complaints or investigate any of the allegations made. In addition, we did not collect information about all of their resolutions. We determined that the data we collected were sufficiently reliable for the purposes of this report.

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### Review of Custodial Agreements

To assess the clarity of information new IRA owners receive about their roles and responsibilities from custodians who allow investment in

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<sup>2</sup>We also developed questions to obtain data and information from eight service providers we identified who help account owners roll over existing retirement savings into a 401(k) plan that then funds a business the account owner starts or acquires. Though we collected information from four of the eight providers, including data on the approximate number of rollovers they facilitated in calendar year 2015, we determined that these data were not directly comparable to the assets held by custodians and not sufficiently reliable to include in this report.

<sup>3</sup>IRS officials told us that the IRS systems' configurations would not allow them to locate complaints on a specific topic.

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unconventional assets, we collected and reviewed 20 publicly available custodians' individual retirement custodial account agreements, which IRS requires custodians and account owners to complete to establish a traditional IRA. We analyzed the content of these agreements and compared their format with the format of the IRS model Form 5305-A.<sup>4</sup>

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<sup>4</sup>IRS stipulates that custodians and account owners may only incorporate additional provisions if they comply with state and federal requirements. However, IRS does not systematically review completed custodial agreements, as custodians and account owners are required only to keep records of completed agreements, not file them with IRS.

# Appendix II: Excerpts of Language Included in IRS Model Form 5305-A

Figure 4: Excerpts of Language Included in IRS Model Form 5305-A

**Front of form 5305-A**

**Do not file with the Internal Revenue Service**

**Form is not filed with IRS**

**Back of form 5305-A**

**IRS instructions indicate IRS preapproval of the form, but IRS does not review or approve any additional provisions included under Article VIII**

**Purpose of Form**

Form 5305-A is a model custodial account agreement that meets the requirements of section 408(a) and has been pre-approved by the IRS.

**The IRS model form allows custodians and account owners to include additional provisions to the agreement**

**Article VIII**

Article VIII may be used for any additional provisions. If no other provisions will be added, draw a line through this space. If provisions are added, they must comply with applicable requirements of state law and the Internal Revenue Code.

Source: GAO analysis of IRS information. | GAO-17-102

# Appendix III: Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

November 16, 2016

Charles A. Jeszeck  
Director, Education, Workforce, and Income Security Issues  
United States Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

James R. McTigue, Jr.  
Director, Tax Issues  
United States Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Mr. Jeszeck and Mr. McTigue:

Thank you for the opportunity to review the draft report of the Government Accountability Office entitled "**Retirement Security: Improved Guidance Could Help Account Owners Understand the Risks of Investing in Unconventional Assets**" (GAO-17-102, Job Code 100271). As noted in your report, individual retirement accounts (IRAs) are a key retirement savings vehicle for individuals, including small business owners, independent contractors and other workers not covered by an employer-sponsored plan. One of the biggest decisions an IRA owner has to make is how to invest IRA assets. IRA owners that invest in unconventional assets could potentially have unforeseen tax liability as well as risk not having sufficient assets to retire. We appreciate your acknowledgment of our efforts to gather information on unconventional assets by requiring custodians of IRAs to annually report those types of assets to the IRS.

We agree that current IRS guidance can provide more information to help IRA owners understand their roles and responsibilities. There is an item on the Department of the Treasury 2016-2017 Priority Guidance Plan entitled "Regulations under §§219, 408, 408A, and 4973 regarding IRAs," and we will recommend to Treasury that this item address how to determine and document fair market value of assets.

IRA jurisdiction spans multiple IRS divisions and we are addressing the risk of non-compliance with personnel from Small Business/Self Employed, Tax Exempt &

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Government Entities, and Chief Counsel. This coordination has resulted in revising Form 5498, *IRA Contribution Information*, to collect information on unconventional assets.

The draft report makes recommendations to issue guidance to IRA owners on unrelated business income and how to determine the fair market value of unconventional assets held in IRAs. Additionally, it recommends that IRS specifically state what language in the model custodial agreement has been reviewed and approved by the IRS. We have reviewed the draft report and, to the extent discussed in this letter, generally agree with its findings and recommendations. Responses to your specific recommendations are enclosed. We have provided technical corrections and comments under separate cover.

We appreciate the valuable feedback you have provided. If you have questions, please contact me, or a member of your staff may contact Robert Choi, Director, Employee Plans at 202-317-8700.

Sincerely,

  
John M. Dalrymple  
Deputy Commissioner for  
Services and Enforcement

Enclosure

Enclosure

To assist IRA owners in addressing challenges associated with investing their retirement savings in unconventional assets, we recommend that the Commissioner of Internal Revenue take the following three actions:

**Recommendation 1:**

Provide guidance to IRA owners on the potential for IRA transactions involving certain unconventional assets to generate unrelated business taxable income subject to taxation in the current year and subsequent years. For example, IRS could consider adding an explicit caution in Publication 590, *Individual Retirement Arrangements (IRAs)*, and include a link in Publication 590 to Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*, to provide examples demonstrating how certain unconventional assets in IRAs can generate unrelated business income tax for account owners.

**Comment:**

The IRS agrees with this recommendation and will consider how best to provide guidance to IRA owners. We will add, during the calendar year 2017 scheduled update, language to Publication 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*, cautioning IRA owners about the possibility of unrelated business taxable income if the IRA owner engages in certain transactions or purchases certain assets.

**Recommendation 2:**

Provide guidance to IRA owners and custodians on how to determine and document fair market value for certain categories of hard-to-value unconventional assets. For example, IRS could consider updating Form 5498 instructions to custodians on how to document FMV for hard-to-value assets (e.g., last-known FMV based on independent appraisal, acquisition price) and provide guidance directed at account owners that provides examples of how to ascertain FMV for different types of unconventional assets.

**Comment:**

The IRS agrees that guidance to IRA owners and custodians on how to determine and document fair market value would be helpful. This guidance could be provided as part of an item currently on the 2016-2017 Priority Guidance Plan. The determination and documentation of fair market value is within the scope of this guidance. We will recommend to Treasury that the regulation project address this issue. It would be premature to modify instructions to custodians on how to determine and document FMV for hard-to-value assets while this guidance project is pending.

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**Recommendation 3:**

Clarify the content of the model custodial agreement to distinguish what has been reviewed and approved by IRS and what has not. For example, IRS could consider: (1) restricting custodians from stating that the form has been "preapproved by the IRS" on the form; (2) adding language to specify which articles have been preapproved by the IRS and which have not; and (3) limiting custodians from adding provisions to the model form other than those preapproved by the IRS.

**Comment:**

The IRS agrees with this recommendation and will change, during the next scheduled update of the model agreements, the "pre-approved by IRS" statement to clarify that only the first seven articles of Form 5305, *Traditional Individual Retirement Trust Account*, and Form 5305-A, *Traditional Individual Retirement Custodial Account*, are approved by IRS.



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# Appendix IV: GAO Contacts and Staff Acknowledgments

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## GAO Contacts

Charles A. Jeszeck, Director, Education, Workforce, and Income Security Issues, (202) 512-7215 or [jeszeckc@gao.gov](mailto:jeszeckc@gao.gov)

James R. McTigue, Jr., Director, Tax Issues, Strategic Issues, (202) 512-9110 or [mctiguej@gao.gov](mailto:mctiguej@gao.gov)

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## Staff Acknowledgments

In addition to the contacts named above Christopher Falcone, Emily Gruenwald, David Lehrer, Jonathan S. McMurray, Jessica Moscovitch, Thomas Moscovitch, and MaryLynn Sergent made key contributions to this report. James Bennett, Amy Bowser, Caitlin Croake, Sheila McCoy, Jean McSween, Jessica Orr, Walter Vance, Kathleen Van Gelder, and Adam Wendel also provided support.

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