Investment Tax Traps

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INVESTMENT TAX TRAPS

Course objectives: The purpose of this course is to provide a discussion of tax issues involved in investments. Topics discussed include: Bitcoin, crowdfunding, different types of IRA investments, annuities in an IRA, unrelated business taxable income (UBTI), gold, reverse mortgages, exchange traded funds, timeshares, and much more.

This course will enable you to identify:

- How Bitcoin is taxed
- How crowdfunding proceeds are taxed
- What is and is not a prohibited transaction as related to an IRA invested in real estate
- The treatment of qualifying longevity annuity contracts under the required minimum distribution rules
- How UBTI is taxed
- Tax treatment of timeshares

Category: Taxes

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INVESTMENT TAX TRAPS

BITCOIN

WHAT IS BITCOIN?

Bitcoin is a digital currency system created in 2009 and managed by freely available software. The currency is not regulated or controlled by any country or bank. Bitcoin users can remain anonymous, and are only logged in the system as an identification number.

Mining

The process of creating bitcoins is called "mining." Bitcoins are mined and given to users whose computers are connected to the bitcoin network, in exchange for using their computing power to maintain the bitcoin ledger (a public system that verifies and processes payments). Bitcoin mining is designed to increase each year until 21 million bitcoins are in circulation. As of April 2014, about 12.6 million bitcoins have been mined. (https://blockchain.info/charts/total-bitcoins)

Daily change in value

The value of a bitcoin can fluctuate on a daily basis; in late 2013, the value of one bitcoin reached more than $1,000. Bitcoin value has decreased since the IRS issued guidance, falling from about $575 before Notice 2014-21 was released to about $520 as of this writing.

There are no physical bitcoins; the currency only exists as digital information in the ledger. Bitcoins are traded for goods or other currencies on exchanges, and they can be "spent" through computer and smartphone applications.

Bitcoin describes itself as "cash for the Internet," and also refers to itself as a prominent example of a triple-entry bookkeeping system. When a transaction takes place, it is recorded by the buyer, the seller, and the publicly accessible ledger described above.

To check bitcoin's current value, go to:

Website
www.coindesk.com/price/

Popularity

Because of its anonymity, the currency is popular among individuals who participate in illegal activity. Exchanges can be hacked and bitcoins can be stolen, and the technology does not allow for chargebacks. In October 2013, the FBI raided Silk Road, a black-market bitcoin exchange, and took control of $28.5 million in bitcoins.

Nonetheless, bitcoins are gaining popularity among merchants because the currency system does not charge the processing and transaction fees that are common among credit card companies. Overstock.com began accepting bitcoins in January 2014, and in two months customers used the digital currency to pay for more than $1 million worth of goods.

Other companies that accept bitcoin or are planning to do so soon include eBay, PayPal, Wordpress, and Zynga. While some brick and mortar stores do accept bitcoin, the digital currency remains most popular among Internet-based companies.

Bitcoin.org provides an FAQ page with more information on bitcoin and links to exchanges to buy and sell them:

Website
https://bitcoin.org

While some brick and mortar stores do accept bitcoin, the digital currency remains most popular among Internet-based companies like Overstock.com and eBay.

Bitcoin ATMs

Bitcoin holders may now use special ATMs to get dollars from their Bitcoin accounts. When using one of these machines, the account holder makes the request and a receipt is dispensed. The individual must wait for a short period of time for the transaction to process before returning to the machine and entering the slip to receive the cash.

IRS ISSUES A RULING ON CYBER CURRENCY

The IRS has issued its first official guidance on how bitcoin and other cyber currencies that are convertible into dollars or other official currencies are to be treated for tax purposes. (Notice 2014-21) The key point of the guidance is that bitcoins are to be treated as property, not as currency.

Many commentators think the IRS got it wrong. If bitcoins were treated as currency, taxpayers would be able to treat purchases using bitcoins much like purchases made while traveling abroad using pounds or euros. As property, every purchase, including a tiny purchase such as a cup of coffee, may have a gain or loss that must be recognized for income tax purposes. General tax rules apply.

General tax rules that apply to property transactions apply to transactions using virtual currency. Among other things, this means that:

- Wages paid to employees using virtual currency are taxable to the employee, must be reported on a W-2, and are subject to federal income tax withholding and payroll taxes;
- Payments made to independent contractors using virtual currency are taxable and self-employment tax rules apply. In addition, payers must issue a Form 1099;
- The character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer; and
- A payment made using virtual currency is subject to information reporting and backup withholding in the same manner as any other payment made in property.

Rapidly changing value

At the earliest issuance of bitcoins in 2009, they were valued at less than a penny. At press time, a single bitcoin had a value of about $520, having dropped from a high of over $1,000. As property, this means that gains and losses will arise in virtually every transaction in which bitcoins are used. Unless the holder of the bitcoins is a dealer, the gains or losses will be capital.

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Example of bitcoin for services

Francis is paid one bitcoin for performing services at a time when the value of a bitcoin is $300. She has $300 of compensation income. She later pays for a cup of coffee costing $4.50 using 0.01 bitcoin at a time when the value of a bitcoin is $450. Her basis in the 0.01 bitcoin is $3 (0.01 × $300). Therefore, she has $1.50 of capital gain on the transaction.

Sales taxes

Although the IRS did not address sales tax, the fact that they have ruled that cyber currency is property will definitely catch the interest of the 45 states that collect sales tax. In virtually every state that collects sales tax, a purchase of tangible property using bitcoins will be subject to sales tax.

The BOE has issued a notice addressing businesses and individuals who accept virtual currencies (such as bitcoin) as a payment method. (BOE Special Notice L-382 (June 2014)) The notice reminds anyone accepting virtual currency that they must apply sales and use tax to these transactions, as with any taxable transaction paid for with cash or credit card. In other words, if the purchase is of tangible personal property subject to sales or use tax, the tax applies.

In other words, the sales tax is figured using the normal sales price of the item (as it would be in a transaction paid for with cash), not the current value of the bitcoin received.

Can't pay in Bitcoin!

Additionally, while sales made using bitcoin are subject to tax, the tax cannot be paid to the BOE using bitcoin.

Is Bitcoin tangible personal property?

However, if bitcoin is property, the question is whether the bitcoin itself is tangible personal property subject to sales tax. This issue will likely be the subject of controversy, rulings, and litigation throughout the states, with different results depending on state law. In California, for example, it would seem that the purchase of bitcoins would not be taxable because they are not tangible personal property.

However, this issue will likely be the subject of controversy, rulings, and litigation throughout the states, with different results depending on state law. In California, for example, it would seem that the purchase of bitcoin would not be taxable because it is not tangible personal property. (R&TC §§6051 and 76201)

What it means for tax professionals

By now it seems clear that the Internet is not a fad. We've all grown accustomed to doing business and making a wide variety of purchases over the Internet. It should come as no surprise, then, that an Internet currency would arise — and it appears that virtual currency has become a legitimate financial asset. In the long run, a system in which all transactions are maintained in a single ledger may make the jobs of all the world's taxing authorities a great deal easier.

For now, it would seem that due diligence on the part of a tax professional would include making inquiries of clients as to whether they've engaged in transactions using virtual currencies. Beyond that, in the absence of further guidance, it's up to the individual professional to decide how much record keeping is needed to substantiate and document the bitcoin transactions of clients.

BITCOIN AND FBAR

In a recent webinar titled "Reporting of Foreign Financial Accounts on the Electronic FBAR," the IRS stated that for purposes of the June 30, 2014, FBAR filing season, taxpayers were not required to report bitcoin on the FBAR. However, IRS Senior Program Analyst Rod Lundquist cautioned that the IRS is still analyzing virtual currency and could change their position in the future.

For 2013, FBAR reporting was due June 30, 2014.

Err on the side of caution

A December 2013 an article in *Forbes* gave this advice regarding FBAR reporting of virtual currencies: "When in doubt, file," because "there's never a penalty for including too much on your form."

In his extensive analysis of bitcoin taxation, Tyler S. Robbins, Esq., states that depositing bitcoin into an online "wallet" is arguably not reportable if the taxpayer maintains possession of his own keys because the taxpayer has not entrusted anything to the third-party custodian.

However, depositing bitcoin into a brokerage where the user does not know the specific address of his coin is clearly the use of a custodial account. (Tyler S. Robbins, "A Primer on Bitcoin Taxation," www.bitcointax.info/)

Like the *Forbes* article, Robbins concludes by advising taxpayers to "err on the side of caution with respect to disclosing foreign assets." Note, too, that Robbins' treatise was written before the ***Hom*** decision, and he states that he "is aware of the opinion that online poker accounts are exempt from FBAR reporting."

In short, this issue is quickly evolving, and taxpayers should, indeed, err on the side of caution.

What about online poker?

The court recently ruled that a taxpayer using an account at FirePay.com, an online financial organization that receives, holds, and pays funds on behalf of its customers, to fund his online PokerStars and PartyPoker accounts was subject to FBAR filing. The court said the same reasoning applied here. He opened all three accounts in his name, controlled the accounts, and could carry balances in the accounts. FirePay, PokerStars, and PartyPoker functioned as banks. (***U.S. v. Hom*** (June 4, 2014) U.S. District Court, N.D. California, Case No. 3:13-cv-03721)

CROWDFUNDING

Crowdfunding is the latest way to raise money through websites such as Kickstarter. Although the IRS has not published specific guidance on the tax consequences of receiving money through these projects, tax consequences do exist.

POTATO SALAD

As a joke, Ohio resident Zack Brown asked visitors to the crowdfunding website Kickstarter to donate toward his $10 goal so he could buy the ingredients to make potato salad. The post went viral, and at its peak Brown had secured pledges north of $70,000. Subsequently some pledges were found to be bogus, and at press time he had 6,911 backers contributing $55,492 to his potato salad fund.

The Tax Foundation ran the numbers and found that the $70,912 in Kickstarter gifts would generate $21,167.49 in total taxes. That's a whole lot of potato salad.

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Here's how the Foundation did the math: Kickstarter takes 5% of pledged gifts as a finder's fee, which keeps them in business. That's $3,500. If Brown spends $1,500 on business expenses — he's pledged to give big donors their own recipe books and potato salad-themed hats, plus the ingredients he'll need to whip up all those side dishes — his pre-tax income will be $65,912.

What is crowdfunding?

According to Wikipedia, crowdfunding is:

The collection of finance from backers — the "crowd" — to fund an initiative, and usually occurs on Internet platforms. The initiative could be a nonprofit campaign (e.g., to raise funds for a school or social service organization), a political campaign (to support a candidate or political party), a charitable campaign (e.g., emergency funds for an ill person or to fund a critical operation), a commercial campaign (e.g., to create and sell a new product) or a financing campaign for a startup company.

Crowdfunding models involve a variety of participants. They include the people or organizations that propose the ideas and/or projects to be funded, and the crowd of people who support the proposals. Crowdfunding is then supported by an organization (the "platform") which brings together the project initiator and the crowd.

Tax treatment

Funds raised through Kickstarter, Indiegogo, PROfounders, and other such websites is either income, a capital investment, or a gift.

Funding a business venture

Generally, the taxpayer must report the contribution as income, subtracting ordinary and necessary business expenses.

For example, if the project needs $25,000 to design and produce a new video game, the amount collected is revenue, but if the company's expenses exceed its revenues (likely in its early stages), the net income would be $0.

Typically, the donor is offered something in exchange for the contribution. For example, a donor might be offered tickets to a movie being funded.

On the other hand, if the $25,000 is in exchange for a 1% interest in the product, it is a capital investment. In most cases, the "contribution" is for a small equity interest. In that case it is similar to venture capital, just on a smaller scale. If the business is not incorporated or is not an otherwise organized legal entity, the business is now a partnership, requiring the filing of a partnership return.

Funding a charitable event

Many crowdfunding projects are designed to raise money to pay for an individual's medical expenses, funeral expenses, or for families in crisis.

For the donor, the contribution is a nondeductible gift (unless the contribution is to an IRC §501(c)(3) organization). The gift would be subject to gift tax.

Some crowdfunding sites are partnering with 501(c)(3) organizations to provide a tax deduction to the donor. For example, Indiegogo partnered with Fractured Atlas, a nonprofit organization to provide a tax deduction for individuals funding an art project.

If the contribution is subject to gift tax, it would seem that the amount would not be income to the recipient.

The IRS has not opined on the taxation of contributions received nor the deductibility of expenses.

What Kickstarter says

Here is what Kickstarter's website (http://kickstarter.com/help/taxes) says about taxation of crowd funding:

"We can't give tax advice, but we have compiled this guide for U.S.-based financial professionals who may not be familiar with Kickstarter. This information is not intended to be used, and cannot be used, by any taxpayer for the purpose of (1) avoiding tax-related penalties under the US Internal Revenue Code or (2) promoting, marketing, or recommending to another party any tax-related matters. This information is just a start.

In general, in the US, funds raised on Kickstarter are considered income.

In general, a creator can offset the income from their Kickstarter project with deductible expenses that are related to the project and accounted for in the same tax year. For example, if a creator receives $1,000 in funding and spends $1,000 on their project in the same tax year, then their expenses could fully offset their Kickstarter funding for federal income tax purposes. If a creator receives funding in one year and spends money on their project in a later year, consider whether their expenses can still offset their Kickstarter funding using the accrual method of accounting.

Beyond deductions, a creator may be able to classify certain funds raised on Kickstarter as a nontaxable gift, and not income. A gift is something given out of "detached and disinterested generosity" for personal reasons and without the expectation of getting something in return.

Sales tax may also be applicable in certain cases depending on the local rules. In general, sales tax applies only if the creator has sufficient connection to the location of the backer."

Hobby?

We don't necessarily agree with Kickstarter's analysis, at least for the potato salad campaign.

Will the IRS consider the campaign a trade or business if it is a one-time event? In the case of the potato salad income, the IRS might consider it a hobby with income taxable to the recipient and the expenses deductible as miscellaneous itemized deductions subject to the 2% floor.

JOBS ACT

The 2012 JOBS Act exempts crowdfunding security offerings from the Securities Exchange Act registration and reporting requirements under certain circumstances. (§46 added to the Securities Act of 1933)

The SEC has released its proposed rules, which among other things:

- Allow a business to use the Internet, mobile technology, and social media to raise up to $1 million a year from investors via crowdfunding.
- Permit individual investors who wish to invest in crowdfunded investments to invest up to:
    - The greater of $2,000 or 5% of their annual income or net worth if their annual income and net worth are both less than $100,000; or
    - The greater of $100,000 or 10% of their annual income or net worth, with a maximum annual cap of $100,000 if the annual income or net worth is $100,000 or more.
- Do not allow investors to resell the securities for one year.

President calls for crowdfunding framework

In 2012, President Obama called for a national framework that allows entrepreneurs and small businesses to raise capital through crowdfunding. In its 2011 year-end report (http://files.jobs-council.com/files/2012/01/JobsCouncil_2011YearEndReportWeb.pdf), the President's Council on Jobs and Competitiveness stated:

"Through platforms like Indiegogo and PROfounders (which emulate the success Kiva has had in raising charitable microfinance funds), entrepreneurs can raise money from the crowd to finance their ventures. Fully leveraging these "crowdfunding" opportunities will require the regulatory changes discussed in our last report, including those that will allow smaller investors to contribute small amounts through crowdfunding platforms."

Note: PROfounders is an online platform that allows business startups to access the wisdom and resources of crowds to perfect their business plans and to raise money toward their ideas.

DIFFERENT TYPES OF IRA INVESTMENTS

WHAT YOU CANNOT PUT INTO AN IRA

There is only limited guidance from federal regulators regarding what are acceptable investments in IRAs. ERISA initiated the concept of asset guidelines as they pertain to qualified plans, but there are no such guidelines for IRAs. However, an IRA may not invest in collectibles, life insurance, a personal residence, or a disqualified transaction. These transactions will be treated as a distribution to the owner and subject the IRA owner to regular tax and additional taxes for premature distributions. (IRC §§408(m), 4975)

Additionally, using an IRA as security for a loan is a prohibited transaction. (IRC §408(e)(4)) Any portion of an IRA that is assigned or pledged by the owner is a deemed distribution to the owner.

Collectibles

IRA funds may not be invested in collectibles. IRC §408(m) lists the following collectibles:

- Any work of art;
- Any rug or antique;
- Any metal or gem (exception for bullion in IRC §408(m)(3);
- Any stamp or coin (however, exceptions for certain coins and bullion appear in IRC §408(m)(3));
- Any alcoholic beverage; and
- Any other tangible personal property specified by the IRS.

Investment in collectibles is treated as a distribution in an amount equal to the cost of the collectible at the time of the investment. The distribution is also subject to the additional tax on premature distributions under IRC §72(t).

Example of collectibles in IRA causing distribution

Samantha collects fine wines. She directs the custodian of her IRA to purchase a bottle of 1969 Chateau Montagne Rouge for $1,000 because she knows its value will increase. (If it doesn't, she reasons, she'll drink it with cheese puffs on a lonely Saturday night.)

Samantha's investment is treated as a distribution subject to federal (and possibly state) tax on the $1,000 purchase price and a 10% federal tax on a premature distribution from her IRA.

NONTRADITIONAL INVESTMENTS IN GENERAL — ADVANTAGES AND DISADVANTAGES

Nontraditional investments provide more depth of opportunity, allowing the account holder to go beyond the usual investment types. IRA owners who want to invest in nontraditional assets often want to manage their own IRA. Managing their own investments may offer an opportunity to save on custodial fees, as traditional IRA trustees reap fees and commissions in accordance with their firm's structure. Saving on custodial fees, in a nontraditional setting, however would be contingent on the fee arrangement negotiated with the trustee.

Disadvantages

One problem with nontraditional assets is the need to value assets that are not publicly traded. The trustee must file IRS Form 5498, reporting the value of an IRA to the IRS, and valuing nontraditional investments can be problematic.

Even after a year-end valuation is established, fulfilling any required minimum distributions (RMD) can be difficult if the IRA's only assets are illiquid investments. Either the IRA must have cash on hand to fulfill the RMD, or the IRA must distribute interests in an illiquid investment. Distributing partial interests in an illiquid asset results in shared ownership between the IRA and the participant, creating the potential for a prohibited transaction.

Also, the title to IRA assets must be held by a bank or other institution that has received IRS approval to hold IRA assets. (IRC §408(a)(2)) An individual cannot hold direct title to assets that are purportedly in his/her IRA. Therefore, incorrect titling can present problems, including a deemed distribution of the asset.

IRA LLCs

Taxpayers who want to invest IRA funds in nontraditional investments might look into the IRA LLC structure. With this structure, the account holder forms an LLC, naming his/her IRA typically as the single member. By doing so, the investment action switches away from the trustee and puts the actual account holder in charge of day-to-day investing. A checking account is opened by the LLC, thereby giving the account holder "checkbook control" over making investment decisions as they arise, without having to rely on the trustee. If the account holder sees a good investment opportunity for the IRA, a check can be written on the spot.

The viability of the IRA LLC structure was challenged in U.S. Tax Court in ***Swanson v. Commissioner*** (1996) 106 TC 76, with the court ruling for the taxpayer — that investing IRA funds in a wholly-owned entity was not a prohibited transaction. This position was later conceded by the IRS in a Field Service Advice memo. (FSA 200128011)

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IRA LLC structure — advantages and disadvantages

Those promoting IRA LLCs like to point to the checkbook control aspect — account holders can seize on investment opportunities that others might miss. And, of course, those feeling constrained by Wall Street can look outside the "street" for these opportunities.

In addition to allowing account holders greater investment control and opportunity, some claim an IRC LLC reduces fees, paperwork, processing delays, and titling issues. Although the trustee fees may be reduced, enlisting a facilitator to help set up the LLC and customize it to your IRA to make sure all applicable rules apply would be wise. Furthermore, obtaining legal counsel up front is prudent. In short, it appears the LLC structure provides additional layers of complication, as well as offering unlimited opportunities for a less-informed account holder to gum up the works.

Summary and recommendations

IRAs invested in nontraditional investments, including those with the LLC structure, should be owned by those investors fully informed in the traps and pitfalls. While there are numerous IRA LLC facilitators and firms specializing in nontraditional investing issues, great care should be taken in selecting the services and advice of either one or both. In addition, seeking legal advice from someone thoroughly knowledgeable in these areas is also recommended.

Caution: $800 to the FTB

For a Californian, the LLC holding the IRA will be subject to filing an LLC return and payment of the $800 annual tax as well as the fee on gross receipts.

PROHIBITED TRANSACTIONS

Running afoul of the prohibited transactions rules is costly. The IRA is disqualified, meaning that all the assets are deemed distributed as of the first day of the plan year at fair market value. (IRC §408(e)(2)) There are no provisions in the law to correct a prohibited transaction.

Keep in mind that the essence of the prohibited transactions rules is self-dealing; that is, an IRA owner cannot engage in a transaction in which he or she is directly or indirectly dealing with himself or herself.

A "prohibited transaction" means any direct or indirect:

- Sale or exchange, or leasing, of any property between a plan and a disqualified person;
- Lending of money or other extension of credit between a plan and a disqualified person;
- Furnishing of goods, services, or facilities between a plan and a disqualified person;
- Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;
- Act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account;
- Receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan; or
- Transfer to, or use by, a disqualified person, of income or assets of a plan. For example, securities purchases or sales by a plan to manipulate the price of the security to the advantage of a disqualified person is a use of plan assets by, or for the benefit of, a disqualified person. (IRC §4975(c)(1))

A "disqualified person" includes any of the following:

1. A fiduciary;
2. A person providing services to a plan;
3. An employer, any of whose employees are covered by the plan;
4. An employee organization (labor union, etc.), any of whose members are covered by the plan;
5. An owner, direct or indirect, of 50% or more of the combined voting power of all classes of stock entitled to vote, or the total value of shares of all classes of stock of a corporation that is an employer or employee organization described in 3 or 4, above;
6. An owner, direct or indirect, of 50% or more of the capital interest or the profits interest of a partnership that is an employer or employee organization described in 3 or 4, above;
7. An owner, direct or indirect, of 50% or more of the beneficial interest of a trust or unincorporated enterprise that is an employer or employee organization described in 3 or 4, above;
8. A member of the family (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant) of an individual described in 1–3 and 5–7, above;
9. A corporation in which 50% or more of the combined voting power of all classes of stock entitled to vote, or of the total value of shares of all classes of stock, is owned directly or indirectly or held by persons described in 1–7, above; or
10. A partnership in which 50% or more of the capital interest or the profits interest is owned directly or indirectly or held by persons described in 1–7, above.
(IRC §4975(e)(2))

IRA INVESTING IN REAL ESTATE

Real estate investments in an IRA run the gamut, and they highlight the fine distinctions between an allowable IRA investment and a prohibited investment.

At one extreme, IRA owners may not use IRA funds to purchase a principal residence because it falls under the "prohibited transaction" rules (i.e., it's self-dealing). (***Harris v. Comm.,*** TCM 1994-22) At the other extreme, IRA owners may use an IRA account to purchase shares in a real estate investment trust or a mutual fund that invests in real estate.

How it works

You must first find an independent IRA custodian that allows real estate investments, and work with that company to set up an IRA account. Most banks and brokerage companies limit your choices to certificates of deposit, stocks, mutual funds, annuities, and similar financial instruments. You cannot serve as the custodian of your own IRA, and the custodian holds title to the real estate.

Custodial fees vary, as do the services they provide to account holders. If the custodian holds real estate on your client's behalf but does not collect the rents, for example, the IRA may have to hire a property management firm.

Hurdles

While it is not impossible, there are several hurdles that only a few IRAs will be able to get over. Again, the essence of those hurdles is the prohibition against self-dealing.

You may not use the real estate owned by your IRA as a residence or vacation home, nor can your business lease space in your IRA-held property. The underlying premise for any real estate investment purchased with IRA funds is that you can't have any personal use of or benefit from the property.

Here are three key hurdles:

Hurdle 1 — Prohibited transactions

The "prohibited transaction" rules under IRC §4975 can affect an IRA's investment in real estate in several ways. First, an individual cannot place a property he or she already owns into an IRA, nor can the IRA purchase the property from a "disqualified person." (IRC §4975(e)(2))

Neither the taxpayer's spouse, parents, nor children could have owned the property before it was purchased by the IRA. Property owned by siblings may be allowed because IRC §4975 specifies that only "lineal descendents" are disqualified.

And what about that fixer-upper? While it may be a great way to build equity, if the IRA owner personally does the fixing, he or she is providing services to the IRA, and it's a prohibited transaction. (IRC §4975(c)(1)(C))

In fact, it would also be a prohibited transaction if any other disqualified person — such as a relative or related business entity — does the work.

Hurdle 2 — UBTI

Exempt organizations, such as IRAs, are taxed on UBTI (Unrelated Business Taxable Income). (IRC §§511–513) One such type of income is income earned from debt-financed property. (IRC §514) So, if an IRA has to take out a mortgage to buy the property, the portion of the IRA attributable to the mortgage is UBTI. If the IRA generates UBTI, it will have to file a tax return each year.

Unless the IRA has sufficient funds to purchase the property for cash, it will be forced to take out a nonrecourse loan collateralized only by the property, and it will be subject to UBTI.

Hurdle 3 — Cash flow

All property expenses, including taxes, insurance, and repairs, must be paid from IRA assets. While rental income may provide some of the needed cash, the IRA may experience a period of vacancy or a sudden need for a large, expensive repair that accrued rental income cannot cover.

Also, funds may be in short supply considering that the IRA owner can't contribute more than $6,000 to the IRA (if older than age 50) in any one year. If he or she pays a painter out of personal funds (which would be considered a contribution) but has already made the maximum contribution for the year, the IRA owner will be subject to the 6% excess contribution penalty. Loaning money to the IRA is a prohibited transaction. (IRC §4975(c)(1)(B))

Getting over the hurdles

While imposing, the hurdles are not insurmountable. Here's what you must do to make a real estate investment work inside an IRA:

Regarding prohibited transactions, the IRA trustee must:

- Purchase the property and hold title in the IRA;
- Purchase the property from an unrelated individual — that is, one who is not a disqualified person;
- Not benefit from the property — even indirectly — except as the owner of the IRA;
- Set up a checking account in the IRA to collect rents and pay bills; and
- Have either the custodian manage the property or hire a real estate management company to manage it. The IRA owner cannot provide services of any kind.

To avoid UBTI, you must either crunch the numbers to ensure that you will not run into UBTI or that the tax (and the cost of compliance) is acceptable to you. Otherwise, the IRA owner will have to purchase the property entirely with cash inside the IRA.

To meet cash flow needs, you will need to ensure that there are sufficient liquid assets inside the IRA to cover expenses after purchase costs.

RECENT CASES

IRA trustee doesn't allow real estate

A taxpayer who disregarded the investment rules of his IRA's trustee was found to have taken early distributions subject to the 10% penalty. (***Dabney v. Comm.***, TCM 2014-108) The Tax Court found that the taxpayer was correct in thinking that generally IRAs are permitted to invest in real estate; however, the problem was that Charles Schwab — the trustee holding his IRA — did not permit such transactions.

What happened

The taxpayer found a plot of land in Utah that he felt was being sold at below-FMV. He did some cursory internet research and found that IRAs may hold property as investment. When he contacted Charles Schwab, their customer service department advised him that this type of transaction was not allowed under their policy. This did not deter the taxpayer, who devised a plan to get around Schwab's limitation.

The taxpayer wire-transferred $114,000 from his Schwab account to the title company handling the sale.

The taxpayer's intent was to do a quick sale and recontribute the funds to the IRA. However, the taxpayer wasn't able to unload the property for two years — well outside the 60-day limit for making a tax-free rollover contribution. When he finally sold the property for $127,226, he wired the funds directly to his Schwab IRA and marked them as a rollover contribution, which Schwab accepted.

The taxpayer didn't report the $114,000 distribution on his tax return, claiming he never received the 1099 from Schwab. In court, the taxpayer argued that he merely acted as a conduit for the property purchase, and that the $114,000 was therefore not a distribution subject to tax and the 10% penalty. The IRS argued that the IRA didn't purchase the property because that type of transaction was not allowed by Charles Schwab.

The court agreed with the IRS, noting that while IRAs are permitted to hold real property, there is nothing in the code that *requires* a trustee to give an IRA owner the option to invest in any asset that is not prohibited under the code. In other words, just because it doesn't say you can't, doesn't mean you can. As trustee, Schwab had the power to prohibit the purchase of real property, and therefore the IRA was not capable of holding real property. Consequently, the IRA did not make the purchase, the taxpayer did.

A possible solution

The court pointed out that the taxpayer's intent wasn't flawed, but rather his execution. If he had instead transferred the IRA to another IRA — via a rollover or a trustee-to-trustee transfer (IRC §408(d)(3); Rev. Rul. 78-406)— to a trustee who permitted such an investment, then he would have avoided the tax consequences of trying to circumvent the rules at Schwab.

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Loan guarantees to IRA-owned company were prohibited transactions

Taxpayers were engaged in prohibited transactions when they personally guaranteed promissory notes issued by their self-directed IRAs. The notes were issued as part of the purchase of a company by the IRAs. (***Peek and Fleck v. Comm.*** (2013) 140 TC 12) The result:

- Their accounts ceased to be tax-exempt IRAs, and the full balances were deemed distributed; and
- The taxpayers were personally liable for tax on the capital gains realized on the later sale of the company stock.

Lawrence Peek and Darrel Fleck established self-directed traditional IRAs in 2001 and rolled funds into them from other IRAs and retirement accounts. They formed a corporation, FP Company, Inc., and directed the IRAs to purchase newly-issued stock of FP.

FP then used the funds from the sale of the stock to acquire the assets of AFS, Inc. Peek and Fleck personally guaranteed a $200,000 promissory note from FP to the sellers of AFS.

In 2003, each of them rolled over the FP stock from traditional to Roth IRAs. In 2006, after FP stock had appreciated substantially, they directed their Roth IRAs to sell all holdings in FP stock at a substantial gain.

The Tax Court ruled against the taxpayers, noting that extensions of credit were prohibited transactions, leaving each partner with a tax bill in excess of $250,000, including interest and penalties.

IRA's prohibited transaction causes deemed distribution

A taxpayer was found to have engaged in a prohibited transaction involving his IRA and the LLC he owned, resulting in the entire IRA being taxable to the taxpayer. (***Ellis v. Comm.***, TCM 2013-245)

The taxpayer used the majority of the funds from his IRA to start a used car business. He directed his IRA to invest almost $320,000— which represented 98% ownership interest — in CST, LLC, for which he was the general manager. (The remaining 2% was owned by an unrelated individual not party to the action.) During the tax years in question, CST compensated the taxpayer for his role as general manager.

The initial act of using the IRA funds to invest in CST was not considered a prohibited transaction. At the time that the transfer was made, CST was not a disqualified person because it had no outstanding owners or ownership interests. The court found this to be analogous to a corporation without shares or shareholders, which does not fit the definition of a disqualified person. (See IRC §4975(e)(2)(G); and relying on ***Swanson v. Comm.*** (1996) 106 TC 76, 88)

However, it was the subsequent act of CST paying the taxpayer compensation that fell under the prohibited transaction rules. The taxpayer argued that CST's payment of compensation was not a prohibited transaction because it was not the plan assets that were used, but rather the assets of a company in which the IRA had invested.

The court noted that CST was funded almost exclusively with assets from the taxpayer's IRA, and the assets of the IRA consisted only of the ownership interest in CST; the IRA and CST were substantially the same entity.

In addition to the full amount of the IRA being included in the taxpayer's income for the year in which he was first paid compensation by CST, the 10% early distribution penalty applied because the taxpayer had not yet reached age 59½.

Daley case — taxpayer wins

Language in a debtor's contract with an investment firm that granted the firm a lien on his IRA did not create a disallowed extension of credit that would have allowed the debtor's Chapter 7 bankruptcy proceedings to attach the IRA assets to satisfy the claims of creditors. (***Daley v. Mostoller*** (2013) Court of Appeals for the Sixth Circuit, Case No. WL 2922651)

James Daley opened an IRA account with Merrill Lynch and signed a "Client Relationship Agreement." As part of that agreement, Daley gave Merrill Lynch a lien on the IRA account that Merrill Lynch could use to satisfy any debts that Daley owed to Merrill Lynch, either relating to the IRA account or to any other account that Daley might open with the firm.

Daley never opened another account with Merrill Lynch, and no debts in connection with Daley's relationship with the firm were ever incurred. Daley never withdrew money from the IRA account.

Two years after opening the account, Daley filed a Chapter 7 bankruptcy. He invoked the Bankruptcy Code provision that allows IRAs to be excluded from the bankruptcy estate. However, the bankruptcy trustee objected, arguing that the IRA lost its exempt status when Daley signed the agreement granting a lien to Merrill Lynch. The bankruptcy court and the district court agreed with the trustee's position.

However, the Sixth Circuit reversed, finding that the phrase "any direct or indirect … lending of money or other extension of credit," (IRC §4975(c)(1)(B)) while broadly worded, still required an actual loan or extension of credit. Daley had never borrowed from the IRA, and Merrill Lynch had never loaned money to Daley based on his having established an IRA with the firm. The court stated that, while a lien may sometimes be granted as collateral in connection with a loan, that didn't mean that a loan had actually occurred.

ANNUITIES IN AN IRA

PROS AND CONS

Putting IRA funds into an annuity has been the subject of debate for many years. Understanding the benefits and pitfalls will help in making the correct decision. The major pitfalls are the surrender charge and complications of required minimum distributions (RMD). Let's look first at the negatives and then see when an annuity might make sense for your client.

Negatives for annuities

The issue is whether or not the sales fees and restrictions put on annuities make them an inappropriate investment for an IRA when the real benefit of annuities — tax deferral — is already present in an IRA. Also, a retiree may need the funds for current income or may have RMD and will need liquid funds to make required payments.

Example of investing entire IRA in an annuity

Jane rolled her entire pension plan into an IRA when she retired. She invested all of the funds in a variable annuity. One year later, she wants to withdraw $100,000 to pay off her home. The annuity is now worth less than she paid for it, and the cost to withdraw the funds is 6% of the value.

Benefits of annuities

People at or close to retirement fear stock market fluctuations. When used properly, an annuity can increase return and minimize risk. With current interest rates low, an annuity will often offer higher rates and inflation-protection riders.

Annuities within an IRA or other qualified structure can also address liquidity issues related to RMD. But this must be considered and handled when setting up the annuity to avoid problems later. Methods include:

- Annuitizing the payment stream; and
- Use of an income rider (attached benefit to a policy) as a drawdown method for lifetime income.

Lifetime income stream

An annuity can be structured to provide payments for the life of the IRA beneficiary. In addition, annuities within an IRA can be structured to add the spouse as an annuitant (payment recipient) to provide an income stream that neither can outlive.

Many annuity companies will not allow deferral past age 70½ and won't even run proposals past that age. For clients over age 70½, we suggest avoiding the use of annuities in an IRA even if the company will allow it, due to the RMD requirement.

Annuity benefits today

An annuity in a contract can kill two birds with one stone. If your client needs a lifetime income stream, he or she will obviously need to take RMD. Purchasing an annuity contract that makes monthly payments rather than putting money in a deferred annuity will provide income to pay the RMD, and the client can take additional distributions as needed.

However, on the other side of the coin is the client's ability to take distributions of more than the amount in the annuity. This could inhibit the client's estate and gift planning.

Example of using annuity to pay RMD

Janet has $500,000 in her IRA. Janet could put $250,000 in an annuity and annuitize it so it pays an annual amount that will cover the RMD. The balance of the account could be in stocks, bonds, and other liquid investments, and the RMD for that portion would be paid from those liquid assets.

Janet could also annuitize the entire $500,000, providing an income stream to pay the RMD. However, Janet would not be able to withdraw any additional amount from the annuity without high potential surrender charges.

A closer look by the government

Annuities should not be considered growth products, even though inexperienced or unscrupulous sales people may sell the products touting potential market growth. An annuity is a transfer-of-risk strategy that should be used considering RMD planning and the knowledge that there are fees and early surrender expenses.

After a number of complaints and lawsuits filed by individuals who were improperly sold annuities in 2004, the NASD Investor Education Foundation tried to put the brakes on inappropriate sales of annuities for tax-sheltered accounts by tightening the rules on annuity-selling practices, such as requiring manager approval for sales of annuities to tax-sheltered accounts.

The Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products (modified June 9, 2004) states: "With regard to sales of annuities in tax-qualified plans, the NASD states that when a registered representative recommends the purchase of a variable annuity for any tax-qualified retirement account (e.g., 401(k) plan, IRA), the registered representative should disclose to the customer that the tax-deferred accrual feature is provided by the tax-qualified retirement plan and that the tax-deferred accrual feature of the variable annuity is unnecessary."(www.sec.gov/news/studies/secnasdvip.pdf)

As a result, many broker-dealers now require manager approval for the sale of an annuity for an IRA or other qualified plan. But there are still many retirees who are not properly warned.

LONGEVITY CONTRACTS ARE HERE

On July 2, 2014, the IRS released final regulations on the treatment of qualifying longevity annuity contracts (QLAC) under the required minimum distribution (RMD) rules of IRC §401(a)(9). (TD 9673)

Removing RMD requirements

The cornerstone of the initiative is the removal of RMD requirements for assets placed in a QLAC. The regulations make it easier for retirees to address the risk of outliving their assets by using a limited portion of their savings to purchase a policy in the retirement plan (including an IRA) that will provide guaranteed income for life starting at an advanced age, such as age 80 or age 85. Once that risk is addressed, a retiree's task of generating income from the remaining assets would be more manageable because it would be limited to a fixed period of time.

The participant will still face the task of managing retirement income until the annuity commences, but that task generally is far less challenging than managing retirement income over an uncertain period.

Background on RMD

IRAs and employer-provided defined contribution qualified retirement plans are subject to RMD rules that force minimum annual distributions at the advent of certain events (such as retirement) or ages (generally, age 70½)

There is nothing to prevent an individual from purchasing a deferred or "longevity" annuity inside a retirement plan, but if the annuity is designed to not begin payouts until a later age — such as age 85 — the participant may find that before that age, he or she has depleted funds from retirement accounts and no longer has funds available to make required distributions.

The regulations modify the RMD rules by excluding the value of the QLAC from the total figure used to determined required minimum distributions. The regulations apply to contracts that satisfy certain requirements, including the requirement that distributions commence not later than age 85 (though the annuity contract could specify a beginning date earlier than age 85).

The IRS has concluded that this special QLAC treatment under the RMD rules should be limited to a portion of a participant's account to avoid deferral of the participant's entire interest.

Example of deferring RMD

When Ben retired, his IRA contained $1 million. Ben invested $100,000 in a deferred annuity that would begin distributions at age 85. However, when Ben reached age 70½, the value of the remaining $900,000 in his IRA was $500,000 due to a dip in the stock market and some poor investment choices.

Without the QLAC rules, Ben must compute his RMD for each year to include the stock account and the value of the deferred annuity. With the QLAC rules in effect, if his deferred annuity is a QLAC, he does not have to include the value of the deferred annuity in computing the RMD.

QLAC requirements

In order to constitute a QLAC, the amount of the premiums paid for all QLAC contracts for the benefit of any individual cannot exceed the lesser of $125,000 or 25% of the balance of the account. An individual who exceeds these limits on premium payments may correct the excess. The proposed regulations would have disqualified the entire arrangement.

Under a QLAC, a plan may provide that if purchasing retirees die before (or after) the age when the annuity begins, the premiums they paid but have not yet received as annuity payments may be returned to their accounts.

ANNUITY EXCLUDED FROM BANKRUPTCY ESTATE

A taxpayer who purchased an annuity contract with funds rolled over from a tax-exempt IRA was able to exempt the annuity from bankruptcy proceedings. (***Running v. Miller*** (November 4, 2013) BAP Eighth Circuit, Case No. 13-6026)

The issue was whether the annuity complied with IRC §408, which would allow it to be exempted from the bankruptcy estate under Bankruptcy Code §522(b)(3)(C). Because the annuity was purchased with funds from the rollover of a tax-exempt IRA, the court looked at whether the funds retained their tax-exempt status.

The bankruptcy trustee argued that because the annuity did not require the taxpayer to make yearly contributions, the annuity was not exempt because it did not satisfy the requirements of IRC §408(b)(2)(A) and (B). Additionally, the trustee argued that in purchasing the annuity with the rollover funds ($267,319), the taxpayer exceeded the yearly contribution amount in 2012 of $5,000 (now $5,500).

The court interpreted IRC §408(b)(2)(A) and (B) to mean not that annual premium payments are required, but that if there are annual payments, then they could not exceed the limitations. The purchase price of the annuity was not fixed; it was the amount that the taxpayer chose to roll over from his IRA. Additionally, the IRA agreement stated an intent to comply with IRC §408(b), specifically mentioning that limits on payments did not apply to rollover contributions.

The court noted:

"The clear purpose of the disputed language is tax-related: it is intended to limit the contribution amounts so that people cannot shield income from taxation by having all their income going into an IRA. We can conceive of no purpose served by requiring an annual premium in the case of a rolled-over IRA — no matter how *de minimis* — particularly where the owner is already old enough to withdraw funds for retirement without penalty."

UNRELATED BUSINESS TAXABLE INCOME

For the unwary IRA owner, the Unrelated Business Income Tax can be a nasty trap. Unrelated Business Taxable Income (UBTI) is taxed at trust tax rates which tops out at 39.6% for income exceeding $12,150 in 2014. The income can come from seemingly benign, passive sources, such as partnership interests and rental real estate.

WHAT IS UBTI?

The concept of UBTI is to ensure that tax-exempt organizations don't have an unfair competitive advantage over taxable organizations (that is, for-profit organizations). Obviously, if Entity 1 and Entity 2 are competitors, and Entity 1 has to pay tax and Entity 2 doesn't, Entity 2 has a competitive advantage.

Thus, nonprofit organizations (including pension plans) are not prohibited from engaging in for-profit activities, but they are taxed on those activities in spite of their nonprofit classification.

IRC §§511–514 impose a tax on the business income of certain tax-exempt organizations, if such income is unrelated to their tax-exempt purpose, in order to level the playing field with taxable entities. (Treas. Regs. §1.513-1(b)) Thus, fiduciaries of IRAs, SEPs, SIMPLEs, Roth IRAs, ESAs, MSAs, and qualified tuition programs that have over $1,000 or more of unrelated trade or business gross income must file Form 990-T, Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e)), and are subject to tax. (Treas. Regs. §1.6012-3(a)(5))

Two tests

The rules for UBTI are laid out neatly in four consecutive sections of the Internal Revenue Code (IRC §§511–514). Generally, income is unrelated business income if it meets two tests:

- It is income that meets the general tests of being trade or business income (primarily, that it is regularly conducted); and
- It is unrelated to the tax-exempt purposes of the organization.
  (IRC §513(a); Treas. Regs. §§1.512(a)-1, 1.513-1(b), (c), and (d))

Expenses related to the unrelated business income can be deducted. (IRC §512(a)) Dual-purpose expenses that are related to both the exempt activities and the unrelated business activities must be allocated on a reasonable basis. (Treas. Regs. §1.512(a)-1(c))

Passive investment income is specifically exempt, including interest, dividends, royalties, rents, and annuities. (IRC §512(b)) However, there are exceptions, as we'll see.

Example of UBTI in nonprofit

The Bushwood Country Club is a member-owned social and golf club that allows some outside play on its golf course to the general public and allows occasional wedding receptions in its clubhouse facilities. (Pursuant to Rev. Rul. 71-17, it carefully keeps its gross receipts from nonmember use under 15% to avoid losing its tax-exempt status under IRC §501(c)(7).) The receipts from outside use are unrelated business income. The club may allocate expenses related to the golf course and the clubhouse between tax-exempt use and outside use on any reasonable basis in arriving at UBTI.

IRAs ARE SUBJECT TO THE TAX

Retirement plans, including IRAs, are tax-exempt entities that may be subject to the tax on UBTI (including Roth IRAs). However, the risk is greater with IRAs because they are generally directed by the owners of the accounts, whereas pension plans are generally directed by professionals who understand to either avoid UBTI or accept some amount of UBTI if the cost of the tax is exceeded by any increase in investment returns.

Partnerships and S corporations in IRAs

If an IRA invests in a partnership, the IRA is treated as if it conducts the partnership business directly. (IRC §512(c)) No distinction is made between general and limited partners (Rev. Rul. 79-222), and investments by tax-exempt investors in publicly traded partnerships are treated the same as investments in other partnerships. (H. Rept. No. 103-111 (P.L. 103-66) p. 617)

A partner is required to advise the partnership of its tax-exempt status. (IRS Publication 598, Tax on Unrelated Business Income of Exempt Organizations) Net unrelated business taxable income is reported on Schedule K-1, line 20, code v. (Instructions to Schedule K-1 (Form 1065)) Because the IRA is treated as a direct owner, items of income that are generally exempt if held directly are also exempt when they flow through a partnership Schedule K-1 (for example, interest income reported on line 5 of Schedule K-1).

The rules are much harsher for interests in S corporations. In the case of an investment in an S corporation, all items of income are treated as UBTI regardless of the actual source or nature of the income. (IRC §512(e)) Thus, there is no equivalent to line 20, code v as found on the partnership Schedule K-1, because it's unnecessary.

Example of partnership generating UBTI

Don uses his IRA to purchase an interest in ABC partnership, a business engaged in making boxes. The IRA's Schedule K-1 shows $5,000 of line 1 ordinary business income, which is also the amount shown on line 20, code v. The Schedule K-1 also reports $1,000 of interest income on line 5. The IRA has $5,000 of UBTI.

Assume instead that ABC is an S corporation, and it has $5,000 of line 1 income and $1,000 of interest income. The entire $6,000 is UBTI to the IRA.

Debt-financed property

UBTI includes net income from debt-financed investments, including mortgaged property. This rule keeps the entity from leveraging an investment portfolio to use borrowed funds to acquire an income-producing asset and shelter from tax the resulting earnings. Thus, an IRA with rental property will have UBTI if the property is mortgaged. (IRC §514)

COMPUTING UBTI

UBTI is computed using this formula:

Net rental income × Average acquisition debt ÷ Average asset basis = UBTI

Example of computing unrelated business tax

Johnny's IRA contains one rental property. The basis of the property is $100,000. The average amount of its mortgage for the year was $40,000. Rents collected total $6,000, and related expenses for the year came to $500. Using the previously mentioned formula, Johnny's IRA UBTI includes the following amount as debt-financed income:

($6,000 - $500) × $40,000 ÷ $100,000 = $2,200

For many IRAs, this next provision will defeat the idea of owning real estate: The owner cannot loan his own funds to the IRA to make the purchase, and the IRA cannot pledge its own funds (both are prohibited transactions). As such, unless the IRA has sufficient funds to purchase the property for cash, it will be forced to take out a nonrecourse loan collateralized only by the property, and it will be subject to UBTI.

Filing and paying tax

IRAs (including SEPs and SIMPLEs), Roth IRAs, ESAs, and MSAs must file by the 15th day of the fourth month after the end of the tax year on Form 990-T, Exempt Organization Business Income Tax Return. The IRA may request an automatic three-month extension of time by using Form 8868, Application for Extension of Time to File an Exempt Organization Return, which may also be used to request an additional, but not automatic, three-month extension.

Estimated tax payments are required if the tax on UBTI is expected to be $500 or more. Use Form 990-W, Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations, to compute estimated tax liability, including any alternative minimum tax.

There may also be a state liability if the IRA trustee, custodian, or the property has situs in a state that imposes tax on UBTI.

EXCLUSIONS FROM UBTI

There are some exclusions from UBTI. Facts and circumstances will determine the actual nature of a particular item of income (Treas. Regs. §1.512(b)-1), and exclusions do not apply to the extent the property is debt-financed. (IRC §512(b)(4)) The following income is excludable:

- Dividends, interest, payments with respect to securities loans, amounts received or accrued as consideration for entering into agreements to make loans, and annuities (and all deductions directly connected with such income) (IRC §512(b)(2));
- Royalties, whether measured by production or by gross taxable income from the property (and deductions directly connected with such income);
- Rents, subject to special rules (and all deductions directly connected with excluded rents) (IRC §512(b)(3)); and
- Gains or losses from the sale or exchange of property, subject to special rules. (IRC §512(b)(5))

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Example of UBTI from entity

Jeff's IRA contains two partnership interests (a coffee house and an ice cream franchise). The Schedules K-1 report the following:

	Coffee Shop K-1	UBTI	Ice Cream K-1	UBTI
Net income	$1,000	$1,000	$1400	$ 1400
Interest income	$ 100	$ 0	$900	$ 900
UBTI		$1,000		$1,400

Jeff's IRA is subject to tax on a total of $1,400 ($2,400 - $1,000 specific deduction) of UBTI from the investments.

GOLD

ALL THAT'S GOLD DOESN'T GLITTER ON THE TAX RETURN

Joni Mitchell wrote, "We are stardust, we are golden," but she wasn't offering investment advice about the shiny yellow metal that has captivated mankind since the dawn of time. Gold is the stuff of dreams and legend, and it clearly has value, but is it all it's touted to be as an investment?

With a volatile stock market and T-bill rates at less than 1%, over the past four years, investors have flocked to the latest golden child of the investment world: gold. But beware, not only is gold as risky as the next investment, the tax consequences may tarnish some of the perceived benefits.

There are many ways to buy gold:

- Stock in a company that deals in gold mining;
- Exchange traded funds (ETFs);
- Mutual funds investing in gold;
- Gold coins and bars (with exceptions for certain coins and bullion listed in IRC §408(3)(A) and (B)); and
- Jewelry.

Gold stocks

An investment in a gold stock, such as Newmont Mining Corporation or Yamana Gold, is treated the same as any other stock. It is not a collectible. The same is true of a mutual fund invested in gold. The tax treatment is the same as any other mutual fund.

Collectibles

Gold is a collectible. (Treas. Regs. §1.6050I-1(c)(3)) So, unless you are buying stock or a mutual fund that is invested in the gold industry, sales of gold are treated as collectibles.

The gain from the sale of a collectible held for less than one year is treated as a regular short-term capital gain.

Long-term gains on the sale of collectibles are taxed at the 28% rate. (IRC §1(h)(4)(A)(i)) So when selling gold, the gain may not be taxed at the preferred rate.

If the sale of the collectible generates a capital loss, that loss may be used to offset long-term and short-term capital gain dollar-for-dollar, just like any other long-term capital loss. The difference for collectibles arises only when there is a net capital gain.

The 28% gain rate applies to the sum of collectibles gain and any IRC §1202 gain, minus the sum of any collectible loss, any net short-term capital loss, and any long-term capital loss carried to the taxable year. (IRC §1(h)(4))

This means that any capital losses the taxpayer has will first be used to reduce the 28% gain property.

Exchange traded funds

The IRS has stated that ETFs that directly invest in precious metals will generate collectibles gain or loss to their investors. (PTMA 2008-01809)

However, this tax treatment does not apply if the ETF invests only in futures or derivative contracts based on these underlying commodities.

You can find the memo at:

Website
www.irs.gov/pub/lanoa/pmta01809_7431.pdf

Jewelry parties

Like the Tupperware® parties of old, some folks hold gold and silver parties where they bring their old jewelry and coins to sell. These party-goers are generally not in the business of selling gold, so gains on the sale of the family jewels are taxed as collectibles, and losses are personal and nondeductible.

The same would hold true of a client who sells their gold to a jewelry store or by mail, and for coin collectors who sell their coins for a profit.

Investment expenses

Many gold ETFs (as well as other ETFs) are formed as partnerships. The investor receives a Schedule K-1, which reports net short-term capital gain, net long-term capital gain, and investment expenses. The investor must report the capital gains and losses on Schedule D, and the investment expense deductions are taken on Schedule A as a miscellaneous itemized deduction subject to 2%.

In contrast, a mutual fund that invests in gold or a gold stock will net the expenses before arriving at taxable income.

Gold in your IRA

While IRAs cannot hold collectibles, there is an exception for certain coins and bullion if such bullion is in the physical possession of a trustee. (IRC §408(m))

The restriction also does not apply when the IRA invests in a gold or silver ETF. (PLR 200732026 (gold) and PLR 200732027 (silver)) The gold and silver letter rulings issued in 2007 provide an exception to the collectibles prohibition for IRAs that purchase shares in an investment trust.

Although the acquisition of shares by an IRA does "not constitute the acquisition of a collectible," if the trust actually distributed the gold (or silver) bullion to the IRA, "such distribution would constitute the acquisition of a collectible." The conclusions in these letter rulings provide an

opportunity for IRAs to diversify into metals without running afoul of the collectibles prohibition. (PLR 200732026 and PLR 200732027)

However, another concern for gold investments in an IRA is that if the client invests in a gold ETF, there may be unrelated business income, which can cause additional current tax to the IRA.

Reasons why investors like gold

There are many reasons why investors are piling into gold. A full list would be too long to include here. But here are five of the most common reasons why investors think gold is a good investment:

- Gold is a hedge against inflation. The official 2010 rate of inflation in the U.S. according to the Consumer Price Index was 1.5%. However, that figure excludes the cost of food and energy. (www.usinflationcalculator.com/inflation/current-inflation-rates) At a March 11, 2011, meeting in New York, William Dudley, President of the Federal Reserve Bank of New York, told the audience about the low rate of inflation. A member of the audience jumped up and asked, "When was the last time, sir, that you went grocery shopping?" (http://my.auburnjournal.com/detail/173580.html)
- Foreign central banks, including those in China, Russia, India, and Middle Eastern countries are buying gold, thus taking large amounts of gold off the market. (http://seekingalpha.com/article/233838-central-banks-buying-gold-a-look-at-the-effects)
- Exchange traded funds, called ETFs, are also buying large amounts of gold and storing it in vaults, taking more supply off the market.
- Gold has been treated as a precious metal at least since biblical times. Most of the easy gold has been found and mined, and miners are now forced to drill deeper to find a lower-grade ore. (www.uncommonwisdomdaily.com/holy-cow-5-reasons-why-you-need-to-buy-gold-now-9516) These additional costs increase the price of gold.
- The U.S. dollar — and many other currencies — are losing value relative to gold. As the dollar and other currencies weaken, gold will rise in value. Not only are many central banks buying gold, so are many individuals all over the world. As demand for gold increases, so does the price.

Downsides to investing in gold

- Gold does not pay dividends or interest. If the price doesn't go up faster than the rate of inflation, your investment will lose value.
- Rising interest rates could cause the price of gold to go down.
- Gold coins and bullion, and ETFs that hold gold coins or bullion, are taxed as collectibles. Gains that would normally receive capital gains treatment are taxed at 28%. (www.irs.gov/taxtopics/tc409.html) However, some gold mining stocks and mutual funds pay dividends and do receive capital gain treatment.
- IRAs are not allowed to hold certain types of gold, with exemptions described in IRC §408(m)(3). However, IRAs can own gold ETFs, and the gain is not subject to the 28% rate. (PLR 200732026) Also, the gains in an IRA are not taxed until withdrawn.
- There is no guarantee that gold will continue to increase in price as it has over the past several years.
- Several hedge funds have taken large positions in gold in recent years. If they suddenly sell their holdings, it could seriously depress the price of gold.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. Which of the following is true regarding bitcoins?

    a) The value of a bitcoin is set at the beginning of each calendar quarter
    b) IRS Notice 2014-21 offers guidance on the treatment of bitcoin, and according to the Notice, bitcoins are to be treated the same as currency
    c) The IRS stated that for purposes of the June 30, 2014, FBAR filing season, there was no requirement for taxpayers to report bitcoin
    d) There are no internet or brick-and-mortar stores that are currently accepting bitcoins

2. In which of the following cases did a taxpayer successfully grant his investment firm a lien on his IRA, thereby shielding the IRA assets from the taxpayer's bankruptcy proceedings?

    a) ***Daley v. Mostoller***
    b) ***Ellis v. Comm.***
    c) ***Peek and Fleck v. Comm.***
    d) ***Dabney v. Comm.***

3. Which of the following is excluded from UBTI?

    a) Income that meets the general tests of being trade or business income (primarily, that it is regularly conducted) and is unrelated to the tax-exempt purposes of the organization
    b) Passive investment income
    c) All items of income from an investment in an S corporation
    d) Net income from debt-financed investments, which includes mortgaged property

SOLUTIONS TO REVIEW QUESTIONS

1. Which of the following is true regarding bitcoins? **(Pages 1-4)**

   a) Incorrect - The value of a bitcoin can change daily and has reached as high as $1,000 in late 2013 from an initial valuation of less than a penny.
   b) Incorrect - Notice 2014-21 dictates that for tax purposes, bitcoins are to be treated as property, not currency, which means that there may be significant issues that come into play, including: issues of gain or loss, whether bitcoin is tangible personal property for the purposes of sales tax, and whether the virtual currency is a capital asset for the taxpayer.
   c) Correct - Although the IRS may change their stated position, for purposes of the June 30, 2014, FBAR filing season, taxpayers were not required to report bitcoin on the FBAR. However, erring on the side of caution when disclosing foreign assets has been advised, and tax professionals should find out whether their clients use virtual currencies.
   d) Incorrect - There are brick and mortar stores that accept bitcoin, although it is currently more widely-used with Internet-based companies. The BOE has issued a notice reminding businesses that sales and use taxes apply when accepting bitcoin or other virtual currencies.

2. In which of the following cases did a taxpayer successfully give his investment firm the right to a lien on his IRA, therefore shielding the IRA assets from the taxpayer's bankruptcy proceedings? **(Pages 12-14)**

   a) Correct - In the ***Daley*** case, the taxpayer opened an IRA with Merrill Lynch and gave Merrill Lynch a lien on his account against any debts that he may owe them. The taxpayer subsequently filed Chapter 7 bankruptcy and elected the Bankruptcy Code provision allowing his IRA to be excluded from the bankruptcy estate. Although the bankruptcy trustee objected to the IRA's exclusion, and the bankruptcy court and the district court agreed with the trustee, the Sixth Circuit court reversed the decision, noting that there was never any actual loan or extension of credit from Merrill Lynch to Daley.
   b) Incorrect - In the ***Ellis*** case, a taxpayer used his IRA funds to invest in an LLC in which he had a 98% ownership interest. This investment was considered a qualified transaction; however, the LLC paid the taxpayer compensation, which the court noted was funded with assets from the taxpayer's IRA. This was deemed to be a prohibited transaction, as the IRA and the LLC were basically the same entity.
   c) Incorrect - In the ***Peek and Fleck*** case, the taxpayers used personally guaranteed promissory notes from their self-directed IRAs when purchasing a company. The Tax Court noted that extensions of credit are prohibited transactions for IRAs which resulted in the accounts no longer being self-directed IRAs and the balances were deemed distributed, as well as the taxpayers being liable for tax on capital gains from the subsequent sale of stock.
   d) Incorrect - In the ***Dabney*** case, a taxpayer disregarded the investment rules of his IRA's trustee, which prohibited the purchase of real property. Although he was aware that his investment in real estate was disallowed under his policy, he attempted to get around this limitation, to no avail.

3. Which of the following is excluded from UBTI? **(Pages 18-20)**

   a) Incorrect - UBTI is defined in IRC §§511–514 and must meet the two tests of 1) being characterized as mostly regularly conducted trade or business income , as well as 2) being income that is unrelated to the tax-exempt purposes of the organization.
   b) Correct - There are a number of exclusions from UBTI, such as passive investment income, which includes dividends, interest, payments with respect to securities loans, royalties, rents as specified in IRC §512(b)(3), and gains or losses from the sale or exchange of property, as specified in IRC §512(b)(5).
   c) Incorrect - For an S corporation, all items of income are treated as UBTI as specified in IRC §512(e), irrespective of the nature or source of the income.
   d) Incorrect - UBTI includes the retirement plan's or IRA's net income from debt-financed investments. So, for example, an IRA with rental property will be subject to UBTI if the property is mortgaged.

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REVERSE MORTGAGES

TYPES OF REVERSE MORTGAGES

There are several types of reverse mortgages:

- Federally insured Home Equity Conversion Mortgages (HECMs), administered by the Department of Housing and Urban Development (HUD), can be used for any purpose, are offered by mortgage companies or banks, and are less costly than other reverse mortgages that can be used for any general purpose;
- Single-purpose reverse mortgages, usually offered by state or local government agencies for a specific reason (home repairs, property taxes, etc.), are generally the least expensive reverse mortgages; and
- Proprietary reverse mortgages, offered by banks, mortgage companies, and other private lenders, can be used for any purpose and are generally the most expensive type of reverse mortgage, but maximum mortgage amounts exceed those offered under HECM.

Loan comes due when borrower leaves the home

The loans typically don't require payments as long as the borrower is living in the home. If the owner permanently moves to a new principal residence, the loan becomes due and payable. Also, if the last borrower fails to live in the home for 12 consecutive months, the loan becomes due. This often happens when the owner must stay in a nursing home for 12 months or longer or decides it's time for assisted living. The bank will require periodic occupancy statements to determine who is occupying the home.

During the loan period, the borrower remains the owner of his or her home and is still responsible for property taxes, homeowners insurance, and maintenance. And, of course, if the home is sold, the loan must be repaid in full — including all interest and other charges.

Reverse mortgage eligibility

To be eligible for a reverse mortgage through the FHA's HECM program:

- The homeowner must be at least 62 years old; and
- The home must be a single-family residence, duplex, triplex, four-unit residence, manufactured home, condominium (if approved), or planned-unit development.

The homeowner may opt to receive funds:

- As a lump sum;
- By establishing a line of credit;
- Via fixed monthly payment for life, based on age; or
- A combination of the above.

Regardless of which option the owner chooses, there are fees that are taken out of the proceeds of the loan and a mortgage insurance premium that must be paid up front.

The maximum loan amount is based on the amount of equity, the expected interest rate, and the age of the homeowner. Thus, for an elderly person with limited income, the home can provide an annuity for life even if the individual outlives his or her life expectancy.

Interest accrues on the outstanding balance of the loan, but principal and interest do not have to be repaid until the borrower dies, leaves the home, or sells the property. At that time, if the balance due on the loan exceeds the value of the home, FHA insurance pays the difference.

The funds your clients receive from reverse mortgages will not affect their qualification for Social Security or Medicare benefits. However, reverse mortgage proceeds are counted as "liquid assets" and could raise the borrower's assets to such a level that he or she no longer qualifies for SSI, Medicaid, or other need-based public benefits.

REQUIREMENTS AND COSTS

Limit on withdrawals

The mortgage loan limit for an FHA-insured reverse mortgage is $625,500. (HUD Press Release No. 13-184 (December 6, 2013)) In most cases, now borrowers cannot access more than 60% of their total loan.

However, there is an exception if the borrower's existing mortgage and other "mandatory obligations" exceed the 60% limit. In these cases, that borrower may take 60% plus an additional 10%. The additional 10% may include any set-aside amount such as repair costs.

Note: Mandatory obligations include loan costs, any delinquent federal debts, any remaining mortgage, amounts needed to extinguish a lien on the property, FHA-mandated repairs, etc. (Mortgagee Letter 2013-28) Credit card debt is not included in the calculation of mandatory obligations.

Example of maximum reverse mortgage

Luke and Laura are eligible to take a reverse mortgage of $100,000. They have an equity line of $40,000 that has to be repaid. So, they will only be able to draw $20,000:

Loan limitation (60% of their loan)	$60,000
Equity line	(40,000)
Repair costs	(0)
Funds available to draw	$20,000

Mortgage insurance premiums

The upfront mortgage insurance premium is 0.5% of the assessed value of the home. The upfront mortgage insurance premium for larger loans is an additional 2%, for a total of 2.5% of the home's appraised value. This applies to loans where more than 60% of the available principal is drawn due to the borrower's mandatory obligations.

The annual premium is 1.25% of the outstanding loan balance. (Mortgagee Letter 2013-28)

Financial assessment of borrowers

Beginning in January of 2014, lenders are required to verify that borrowers will be able to make their required tax and insurance payments, and still have a certain amount of monthly income left over (the exact amount depends on marital status and geographic region). (24 CFR §206.37) Borrowers must keep their homeowners insurance and property taxes current. Lenders will be required to assess a borrower's income sources, including income from work, Social Security, pensions, and retirement accounts.

Set-aside funds

Riskier borrowers can be denied, or required to create a "set aside" fund out of loan proceeds to pay certain taxes and insurance. (24 CFR §206.205) The set-aside amount will be based on the youngest borrower's life expectancy, and therefore it could substantially reduce any amount that the borrower may want to draw from. ("Summary of HUD Changes" available at: www.reversemortgage.org/About/SummaryofHUDChanges.aspx)

INTEREST DEDUCTION?

Accrued interest is not currently deductible, so until the taxpayer pays the interest, there is no deduction. (Rev. Rul. 80-248) When the interest is paid, the interest may be:

- Qualified residence interest:
  - Acquisition debt; or
  - Equity debt;
- Investment interest; or
- Personal interest.

Qualified residence interest

Unfortunately, cash-basis borrowers may not deduct interest from a reverse mortgage until the loan is paid off, because the interest on most reverse mortgages is added monthly to the outstanding loan balance (to be paid at the end of the loan). Interest is only deductible by the borrower when it is actually paid. (IRC §461(a))

Actual or constructive payment does not occur when the interest is added to the outstanding loan balance. (Rev. Rul. 80-248, 1980-2 C.B. 164) Actual payment means the taxpayer made the interest payment to the lender, while constructive payment means that the funds were available for the bank to draw upon at any time.

Because interest added to the outstanding loan balance is neither paid to the bank nor available for the bank to draw upon, there is no actual or constructive payment of the interest.

Assuming the homeowner actually pays the interest, the deduction may be limited. Unless the loan qualifies as acquisition indebtedness, interest deduction is not allowed to the extent the equity

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indebtedness exceeds $100,000. Plus, equity indebtedness interest is not deductible for alternative minimum tax purposes. (IRC §56)

Interest would be deductible if the loan is refinanced with another financial institution and the accrued interest is paid off by the new lender. If the loan is refinanced with the same financial institution, neither the interest nor the points would be deductible.

Benefits of reverse mortgages

Income: Provides monthly or lump-sum money.

Peace of mind: Provides degree of comfort and predictability with regard to finances.

Independence: Instead of moving to a nursing facility, seniors can remain in their home — without making monthly mortgage payments.

Oldest seniors are greatest beneficiaries: Benefits are realized over the senior's life; if the senior lives longer than life expectancy, the Federal Housing Administration's (FHA's) insurance will provide ongoing benefits.

Deferral of payments: Interest and principal do not have to be paid until the borrower dies or the home ceases to be the principal residence. Heirs are not personally liable for any remaining mortgage.

Easy qualification: Eligibility is based upon a senior's assets instead of credit. No cash is needed for closing.

Public benefits: Funds received do not affect Social Security or Medicare benefits.

Pitfalls of reverse mortgages

Costs: Fees can be high; generally this is not the most affordable option available.

Complexity: Options can be confusing, especially for the elderly.

Public benefits: Funds received could affect Supplemental Security Income, Medicaid, and other public benefits.

Interest deduction: No current-year mortgage interest deduction; deduction is limited to $100,000 of home equity debt unless proceeds are used for improvements.

Benefits take time: Again, benefits are realized over the senior's life; if the senior dies shortly after the reverse mortgage is created, benefits are not realized.

Family: Less money may be available for the decedent's heirs.

EXCHANGE TRADED FUNDS

Over the past few years, exchange traded funds — commonly called ETFs — have become a popular investment tool. Although there are some similarities between mutual funds and ETFs, there are also many differences. Trading ETFs is very similar to trading common stocks.

In 1993, the American Stock Exchange launched the first exchange traded funds (called Spiders), SPDR, which track the S&P 500. Soon, more ETFs were introduced to the market, such as the

Diamonds in 1998, which track the Dow Jones Industrial Average, and the Cubes in 1999, which track the NASDAQ 100. (www.etfport.com)

WHAT INVESTMENTS CAN THEY MAKE?

Both mutual funds and ETFs invest in "baskets" of foreign and domestic stocks, bonds, and currencies, etc. Also, they both offer broad-based funds and those that are targeted toward a narrow sector. ETFs are generally narrowly targeted and are heavily oriented toward index funds.

MINIMUM INVESTMENT, HOLDING PERIODS, AND EARLY WITHDRAWAL FEES

Most mutual funds have a minimum investment amount, such as $1,000 or $2,500, minimum holding periods, and early withdrawal fees. Some of the larger funds have minimum investments of $500,000, or more. However, ETFs generally do not have minimum investment amounts, minimum holding periods, or early withdrawal penalties.

MANAGERIAL AND OPERATIONAL EXPENSES

Both mutual funds and ETFs deduct management and operating expenses from the fund, but ETF expenses are generally lower than mutual fund expenses. The lower fees are in large part because mutual funds are "actively managed," including extensive research and hands-on management. ETFs, on the other hand, have very little research expenses because they invest mainly in indexes that require little if any research and management.

Many mutual funds are "no load," meaning that there is no fee to buy the fund. However, most of the funds sold by brokerage firms have a "load" (a polite term for sales fee) as high as 8.5%. Some mutual funds also charge a "redemption fee" of .75% to 4% when the fund is sold. ETFs do not have either of these fees.

SHORTING, MARGINS, AND OPTIONS

Mutual funds generally cannot be bought on margin, sold short, and are not optionable. ETFs can be bought on margin, sold short, and are optionable just like stocks.

When are they bought and sold?

Mutual funds can only be bought or sold at the end of the trading day at the net asset value (NAV) of the fund. ETFs, however, can be bought or sold at any time during the trading day, just like stocks. This can be a distinct advantage if you think the market is going to make a big move up or down and you want to either get in or get out in a hurry.

Self-traders can easily buy or sell both mutual funds and ETFs over the Internet, and ETFs can be bought and sold through most any broker. However, some mutual funds have exclusive agreements and can only be traded through certain brokerages.

ETFs also can and do invest in a variety of derivatives. Not only that, they can and do invest in short selling indexes, and even double-shorting and triple-shorting indexes, which make them more risky.

Comparison of Stocks, Exchange Traded Funds, and Mutual Funds		
Stocks	**Exchange Traded Funds**	**Mutual Funds**
No minimum investment	No minimum investment	Minimum investment req.
No holding period	No holding period	Holding period common
No early withdrawal fee	No early withdrawal fee	Early withdrawal fee common
No management fees	Low management fees	High management fees
No redemption fee	No redemption fee	Redemption fee allowed
Short sales allowed	Short sales allowed	No short sales
Options allowed	Options allowed	Options not allowed
Margin buying allowed	Margin buying allowed	No margin buying
Trade during trading day	Trade during trading day	Trade at closing NAV
Tax efficient	Tax efficient	Less tax efficient
Dividend reinvestment possible depending on company	No dividend reinvestment	Can reinvest dividends
No sales load or brokerage fee	No sales load but brokerage fee	Sales load common
Receive 1099 DIV	May receive K-1 or 1099 DIV	May receive 1099 DIV
Not subject to UBI tax	Not subject to UBI tax	May be subject to UBI tax

TAX ADVANTAGES

ETFs tend to have a tax advantage. When you buy a mutual fund, you are buying into a pool of assets, many of which may have a taxable basis below the current market value. So, you are buying an asset with a built-in taxable gain. However, ETF shares can only be redeemed by a broker through an in-kind transaction. Thus, the shares with significant gains tend to be those redeemed in-kind, reducing the taxable basis for new shareholders.

Also, because most ETF trades are between shareholders (rather than between one shareholder and the fund), redemptions do not force the fund to sell shares, potentially impacting the other investors in the fund. With a mutual fund, sales by other investors could cause you to have a capital gain even if you don't sell any of your shares.

DIVIDEND DIFFERENCES

Most mutual funds allow an automatic reinvestment of dividends, which are used to purchase additional shares. So, if the mutual fund pays out a cash dividend, your *pro rata* share is automatically reinvested in shares, or partial shares of the fund.

However, when an ETF pays a dividend, it goes into your brokerage account. If you want to reinvest that cash, you must make another purchase.

TAX REPORTING

Annual tax reporting for stock is generally the easiest of the three. The company issues a Form 1099 DIV, which reports the taxable dividends, listed as qualified or nonqualified. Occasionally the Form 1099 will also report return of capital or liquidating distributions.

Mutual funds also provide a Form 1099 DIV, which includes ordinary dividends, qualified dividends, capital gain dividends, foreign dividends, and foreign tax paid. There is more work for you to enter annual income from a mutual fund than from a stock on the tax return.

It is common for mutual fund shareholders to reinvest dividends. This can result in additional work tracking basis in order to compute gain or loss when the owner takes a distribution from the fund.

Schedule K-1 causes stress for some clients

Probably the biggest disadvantage to the ETF is that many of the funds are structured as partnerships. This means that the client will receive a Schedule K-1. The Schedule K-1 is often not received until the extended due date — or September 15. Sometimes clients do not realize that they will be receiving a Schedule K-1.

If you do not inquire and look at the client's brokerage statement carefully, you may complete their return and then have to amend it later when the Schedule K-1 arrives. Some clients may not want to wait until the Schedule K-1 arrives to file the return.

UBTI

Also, ETFs may have unrelated business taxable income (UBTI). If a client has a large amount of IRA money invested in ETFs, there might be tax on the UBTI if the total received in the fund exceeds $1,000. (IRC §512)

FOREIGN ETFs

One of the most common questions about ETFs is, "How do foreign ETFs compare with U.S. ETFs?" Here is information you might want to have to discuss foreign ETFs and stock purchases with your clients.

Advantages of foreign ETFs

Other things being equal, stock values of companies in faster growing economies should increase faster than stock values of companies located in slower growing economies. Most economic forecasters expect foreign economies — both developed and emerging — to grow at a faster rate than the U.S. economy.

Reasons to consider foreign ETFs include:

- Most financial advisors recommend a geographically diversified portfolio — across both sectors and industries. A quick and easy way to diversify geographically is to invest in foreign ETFs. Some advisors recommend that you invest 5% to 20% of your assets in foreign equities.
- The U.S. dollar is fairly weak against many foreign currencies. If the dollar continues to weaken relative to foreign currencies, the rate of return on foreign assets will increase as the dollar weakens.
- Most U.S. ETFs and many U.S. stocks pay little if any dividends. As a general rule, foreign stocks (and ETFs) pay higher dividends than do U.S. stocks and ETFs.
- Two-thirds of global markets are outside the U.S. If you only invest in U.S. equities, you are cutting yourself off from two-thirds of the world, including the world's fastest growing economies.

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Disadvantages of foreign ETFs

Consider the following disadvantages before buying foreign ETFs:

- Although you will benefit if the currency of the country in which you invest increases relative to the U.S. dollar, you will be penalized if the currency of the country in which you invest decreases relative to the U.S. dollar.
- You will probably need to spend more time studying and researching foreign ETFs and equities than you do researching U.S. equities. You will also need to determine how stable the government is in the country in which your ETF is located.
- Most countries with fast-growing economies also have some semblance of democracy and the rule of law. However, not so long ago, Chile suffered under ruthless dictator Augusto Pinochet, and Colombia was plagued by the Medellin drug cartel. So, in addition to watching foreign economies, you will also need to keep an eye on the government of the country in which they are located.
- There may be some minor tax consequences. You should check the foreign laws for tax credits and taxes on dividends and possibly capital gains. Sometimes the cost and work involved to claim the tax credit offsets the benefit. So, for practical purposes your return may be reduced by foreign tax.
- The cost to purchase individual foreign stocks may be more than the cost to purchase a U.S. equity. Like their U.S. counterparts, foreign ETFs have not been around as long as mutual funds, so there may not be much history to base the track record on.
- Some investors use mutual funds to purchase foreign investments. However, most funds do not concentrate on a single country or small group that the investor may want to target.

Where can you learn more about foreign ETFs?

You can learn more about foreign ETFs at these websites:

- http://etf.about.com/od/foreignetfs/a/Invest_in_Foreign_Markets.htm
- www.etftrends.com/2009/05/how-to-choose-international-etfs-that-fit-your-portfolio/
- http://etfdb.com/2010/guide-to-small-cap-international-etfs/
- www.marketwatch.com/story/find-a-safe-harbor-in-foreign-stock-etfs-2010-07-23
- www.weissresearchstore.com/p-56-international-etf-trader-1-yr-995.aspx

TIMESHARES

TAX ASPECTS OF OWNERSHIP

As with other ownership of real estate, owners of timeshares may often, but not always, deduct interest and property taxes.

Interest

Interest is deductible as home mortgage interest if the timeshare qualifies as a second residence. The tax law allows a deduction for most interest expense that an individual incurs to acquire a principal residence plus one other home, such as a vacation home. (IRC §163(h)(3)) However, to be deductible, the loan must be secured by the residence. In many, if not most, cases, the loans incurred are consumer loans, and many owners purchase their timeshare units using their credit cards.

If an owner has multiple timeshares purchased at different locations, only the interest expense on one of those properties will qualify as a second home for purposes of the interest expense deduction. It is not clear whether multiple timeshare units, with separate mortgages, at the same resort would qualify. The owner could argue that multiple weeks at that one location would constitute a single home.

Property tax

Property taxes are deductible if either the timeshare owner is billed directly by the property tax jurisdiction or the weeks are assessed individually, and the tax is identified separately on the timeshare maintenance billing. However, if the timeshare resort is assessed as one tax parcel or as parcels bigger than just the individual unit, no deduction is allowed.

Gain or loss on disposition

Many times timeshare owners tire of the annual cost and are either unwilling or unable to use the timeshare each year. The owners will sell the timeshare. Because a timeshare is a personal asset, any gain is taxable (gains are rare on the sale of timeshares), and a loss is nondeductible.

Renting out the unit

Fifteen-day rule generally doesn't apply

Generally, both rental income and expenses on a timeshare are included in a taxpayer's gross income. The fewer-than-15-days *de minimis* rule will generally not help.

If a dwelling unit is used by the taxpayer as a residence and is actually rented for less than 15 days during the tax year:

- The income derived from the rental use isn't included in the taxpayer's gross income; and
- No deduction pertaining to rental use is allowed (only those deductions for a personal residence, such as mortgage interest and property taxes (if applicable), are allowed. (IRC §280A(g))

However, in order for the property to be "used as a residence," the home must be occupied by the taxpayer for at least 15 days during the year. (IRC §280A(d)(1)) Therefore, the individual would have to own at least four weeks at a property and use it for three of those weeks (to reach 15 days) to use this rule. The individual could then rent out the fourth week and not have to report the income.

Passive loss (or worse)

As such, the taxpayer will generally have to report rental income and will be able to deduct expenses with limits. However, the rental of real estate is a passive activity. (IRC §469(c)(2)) Generally, taxpayers are allowed a $25,000 allowance for passive losses from rental real estate subject to certain income limitations. (IRC §469(j))

However, under the regulations, a property rented for average durations of seven days or less during the tax year is not treated as a rental activity. (Treas. Regs. §1.469-1T(e)(3)(ii)(A)) The activity is treated, therefore, as a passive activity that is not a rental activity and is not eligible for the $25,000 allowance. The only way losses can be deducted is if the taxpayer meets the requirements of material participation.

Passive loss or hobby loss

At least passive losses carry over. In a recent case, the court passed on considering whether the taxpayer's losses on timeshare rentals should be limited under the passive loss rules because the

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losses were limited under the hobby loss rules of IRC §183. (***Rundlett v. Comm.***, TCM 2011-229) The court reviewed the evidence and claims made by the taxpayers in light of the tests listed in the regulations to determine whether an activity is engaged in for profit. (Treas. Regs. §1.183-2(b)) The court determined that the taxpayers had failed all nine of the tests.

The taxpayer purchased several one-week timeshare units, mostly at a single development in Laguna Beach, California, with the intention of renting them to third parties. The taxpayer claimed that her ultimate goal with respect to the timeshare activity was to own 52 units and use the income to supplement the couple's retirement income.

In addition to the direct costs associated with the units, the taxpayer also incurred substantial travel expenses associated with previewing timeshares. During the four years in question, the taxpayers incurred net losses from the activity averaging about $50,000 per year. The couple had salaries averaging a combined $180,000 per year for those four years.

UNLOADING THE TIMESHARE

Go to eBay and search "timeshare," and you'll get about 1,000 hits — but a hefty percentage of the listings are for exactly $1. After paying upfront purchase costs, owners are finding that, even if they use the week or weeks they purchased, the annual maintenance fees may exceed the cost of staying in lower-end hotels in the area.

As difficult as it is to sell a timeshare, owners are finding creative ways of unloading them and, in recent months, some of those owners have found themselves in Tax Court. Owners are trying various alternatives, including selling, contributing, and renting.

Contributing use to charity

The Van der Lees donated a one-week use of their three-week timeshare in the Caribbean. (***Van der Lee v. Comm.***, TCM 2011-234) They deducted the fair rental value of the residence for one week plus one-third of their annual maintenance fees. (Henricus Van der Lee reasoned that because they were contributing one-third of their annual usage, they should get to deduct one-third of their annual costs.) The court denied the deduction because, generally, no deduction is allowed for partial interests in property. (IRC §170(f)(3)(A))

The issue here is that they donated a one-time, one-week **use** of the property. The result would have been the same even if they had donated use of all three weeks of their three-week ownership. A donation of a timeshare is a deductible charitable contribution only if you donate the *ownership* of the property. In that case, they could donate ownership of one, two, or all three weeks and get a deduction.

Contributing ownership to charity

If an owner wants to rid himself of a timeshare, donating the ownership is one possibility. However, relatively few charities will take timeshares. Virtually all that do accept such contributions will require any loan on the timeshare to be fully paid off and all fees and assessments paid currently. Some will even require upfront cash to the charity to accompany the donation of the timeshare.

For a list of organizations that accept timeshare donations, see:

Website

www.timesharetrap.com/charities_that_accept_timeshare_donations.html

The tax deduction for a donation of a timeshare is the fair market value. (Treas. Regs. §1.170A-1(c)(1)) Fair market value is not what the taxpayer paid for the week, nor is it the price at which developers are currently selling weeks. Because the marketplace is the resale market, the going price on that market is the best indicator of fair market value. The prices of other resales at the property are generally the best evidence of the approximate fair market value of a week.

If the donee organization sells the property within three years of contribution, the organization must file Form 8282, Donee Information Return, and send a copy to the donor. (Instructions to Form 8282) If the sale happens soon after the contribution, the sales price would, presumptively, be the best evidence of value. However, if the sale takes place more than a reasonable period of time after the contribution, the Form 8282 amount may not reflect fair market value. However, if the amount on Form 8282 differs substantially from the claimed amount, it may alert the IRS to a possible valuation overstatement.

If the claimed value is $500 or more, the taxpayer must file Form 8283. If the claimed value is $5,000 or more, the taxpayer must obtain a qualified appraisal for the property. (Treas. Regs. §1.170A-16(d)(1)(ii))

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REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

4. Which of the following is true of interest paid on reverse mortgages?
   a) Because reverse mortgage interest is accrued interest, it is not deductible until the interest is paid
   b) Interest on reverse mortgages is never deductible
   c) Accrued interest is always deductible when the mortgage is refinanced and the interest is paid
   d) Interest on a reverse mortgage is deductible as personal interest

5. There is a mortgage insurance premium that is assessed upfront which is based on the home's assessed value. That premium amount is _______%.
   a) 0.5
   b) 2
   c) 60
   d) 1.25

6. When comparing stocks, exchange traded funds, and mutual funds, which of the following statements is correct?
   a) Of the three, mutual funds are the most tax efficient
   b) ETFs must be traded at the end of the trading day at the closing net asset value (NAV) of the fund
   c) There is no dividend reinvestment with ETFs
   d) Stocks, ETFs, and mutual funds all may be subject to UBI tax

7. Regarding annual tax reporting, reporting is easiest for which of these three investment tools?
   a) Stocks
   b) ETFs
   c) Mutual funds
   d) Stocks, ETFs, and mutual funds all have the same ease of reporting

8. Reasons to consider foreign exchange traded funds include which of the following?
   a) There are no tax consequences
   b) Individual foreign stocks are typically less expensive than U.S. stocks
   c) It is easy to target your investments to a single country or small group
   d) Foreign stocks and ETFs typically pay higher dividends than those in the U.S.

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9. Which of the following correctly characterizes interest and property taxes as they pertain to timeshare ownership?
    a) If an owner has multiple timeshares purchased at different locations, the interest expense on all of those properties combined will qualify as a second home for purposes of the interest expense deduction
    b) Interest is deductible as home mortgage interest if the timeshare qualifies as a second residence
    c) For interest to be deductible, it is not required that the loan be secured by the residence
    d) Whether a timeshare is assessed as one tax parcel or as parcels bigger than just one individual unit, a property tax deduction is still allowed
10. Which of the following is true regarding donating a timeshare to a charity?
    a) The tax deduction for a donation of a timeshare is the basis in the property
    b) If the claimed value is $5,000 or more, the taxpayer must file Form 8283
    c) If the claimed value is $5,000 or more, the property must be appraised by a qualified appraiser
    d) If the donee organization sells the property within five years of contribution, the organization must file Form 8282, Donee Information Return, and send a copy to the donor

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SOLUTIONS TO REVIEW QUESTIONS

4. Which of the following is true of interest paid on reverse mortgages? **(Page 26)**

    a) Correct - This statement is true under Rev. Rul. 80-248. For cash-basis borrowers to be able to deduct interest, the loan must be paid off, and interest on reverse mortgages generally isn't paid off until the end of the loan.
    b) Incorrect - Interest may be deductible if it has been paid and is qualified residence interest.
    c) Incorrect - Interest is only deductible if the refinance occurs with a new lender, who would pay off the accrued interest. Interest would not be deductible if the loan is refinanced through the same lender.
    d) Incorrect - Personal interest is not deductible.

5. There is a mortgage insurance premium that is assessed upfront which is based on the home's assessed value. That premium amount is _______%. **(Pages 25-26)**

    a) Correct - The upfront mortgage insurance premium is 0.5% of the assessed value of the home.
    b) Incorrect - The upfront mortgage insurance premium increases by an additional 2% for larger loans, for a total of 2.5% of the home's appraised value.
    c) Incorrect - Borrowers typically cannot access more than 60% of their loan, which, for FHA-insured reverse mortgages, has a loan limit of $625,500.
    d) Incorrect - As noted in Mortgagee Letter 2013-28, the annual premium is 1.25% of the outstanding loan balance.

6. When comparing stocks, exchange traded funds, and mutual funds, which of the following statements is correct? **(Pages 27-29)**

    a) Incorrect - Many assets within a mutual fund may have a taxable gain that is below the current market value, so the asset may have a built-in taxable gain when purchased, making it less tax efficient than stocks and ETFs.
    b) Incorrect - ETFs are like stocks, in that they may be bought or sold during the course of the trading day. This flexibility is advantageous if you suspect the market is rapidly changing. Mutual funds can only be bought or sold at the end of the trading day at the net asset value (NAV) of the fund.
    c) Correct - Dividends for ETFs go directly into a brokerage account, requiring you to make another purchase, whereas mutual funds will automatically reinvest dividends.
    d) Incorrect - When comparing these three investment tools, one item of comparison is whether the tool is subject to UBI tax. Stocks and ETFs are not, while mutual funds are subject.

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7. Regarding annual tax reporting, reporting is easiest for which of these three investment tools? **(Page 30)**

   a) Correct - Annual tax reporting for stock is generally easier than for ETFs and mutual funds. The company will issue Form 1099 DIV, reporting taxable dividends.
   b) Incorrect - With ETFs, many of the funds are structured as partnerships, necessitating the issuance of a Schedule K-1, which may not be received until the September 15 extended due date and which many clients may not be expecting.
   c) Incorrect - Entering annual income from a mutual fund requires more work than entering income from a stock on the tax return, as the varied sources may include ordinary dividends, qualified dividends, capital gain dividends, foreign dividends, and foreign tax paid. Also, reinvested dividends can result in additional work when the owner takes a distribution from the mutual fund because the basis must be tracked in order to compute gain or loss.
   d) Incorrect - The reporting requirements differ in complexity when comparing these three investment tools.

8. Reasons to consider foreign exchange traded funds include which of the following? **(Pages 30-31)**

   a) Incorrect - There could be some minor tax consequences. Investors should refer to foreign laws for information on tax credits, tax on dividends, and capital gains and assess whether the cost and effort to claim the credit is worth any benefit derived.
   b) Incorrect - The cost may be greater when purchasing foreign stocks as compared to those in the U.S., and like U.S. ETFs, foreign ETFs have a limited track record based on their short history.
   c) Incorrect - Investors may use mutual funds when purchasing foreign investments; however, most funds typically do not focus on a single targeted country.
   d) Correct - An investment in foreign ETFs will generally pay higher dividends when compared to the U.S., because many U.S. stocks and most U.S. ETFs pay little or no dividends.

9. Which of the following correctly characterizes interest and property taxes as they pertain to timeshare ownership? **(Pages 31-32)**

   a) Incorrect - If an owner has multiple timeshares at different locations, the interest expense on only one of those properties will qualify as a second home for purposes of the interest expense deduction.
   b) Correct - Interest is deductible as home mortgage interest if the timeshare qualifies as a second residence. Under IRC §163(h)(3), a deduction is allowed for most interest expense that an individual incurs to acquire a principal residence plus one other home, such as a vacation home.
   c) Incorrect - For interest to be deductible, the loan must be secured by the residence.
   d) Incorrect - If the timeshare owner is billed directly for the property tax, or if the weeks are assessed individually and the tax is identified separately in the timeshare maintenance billing, then the property taxes are deductible by the timeshare owner. However, if the timeshare resort is assessed as one tax parcel or as parcels bigger than just the individual unit, no deduction is allowed.

10. Which of the following is true regarding donating a timeshare to a charity? **(Page 34)**

    a) Incorrect - Under Treas. Regs. §1.170A-1(c)(1), the tax deduction for a donation of a timeshare is the fair market value, which is appropriately based on the current resale market, not what developers are seeking when selling weeks.
    b) Incorrect - If the claimed value is $500 or more, the taxpayer must file Form 8283.
    c) Correct - Under Treas. Regs. §1.170A-16(d)(1)(ii), if the claimed value is $5,000 or more, the taxpayer must obtain a qualified appraisal for the property.
    d) Incorrect - If the donee organization sells the property within three years of the contribution, the organization must file Form 8282, Donee Information Return, and send a copy to the donor.

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GLOSSARY

Accrual method: a method of accounting in which income and expense items are determined based upon the right to receive or the duty to pay

Acquisition indebtedness: can be incurred with respect to a taxpayer's principal residence plus one other residence, such as a vacation home

Alternative minimum tax: a levy designed with the intent that everyone should pay a fair share of tax. The tax applies to individuals, estates, trusts, and corporations, and reduces the tax advantage of certain benefits known as tax preference items. The tax is imposed at a flat rate on the taxpayer's alternative minimum taxable income that exceeds certain specified exemption amounts. If the taxpayer's liability for the minimum tax exceeds his regular tax liability, the excess amount is payable in addition to the regular tax

Annuity: series of equal periodic payments or receipts. Examples of an annuity are semiannual interest receipts from a bond investment and cash dividends from a preferred stock

Asset: a resource expected to provide future economic benefits. Anything owned that has monetary value. Any interest in real or personal property. Property, including cash, that has value

Bankruptcy: typically, a formal petition filed in Bankruptcy Court under Chapter 7, 11, or 13

Basis: a figure or value that is the starting point in computing gain or loss, depreciation, depletion, or amortization

Beneficiary: an individual who will receive an inheritance upon the death of another

Capital gains: gain from the disposition or exchange of a capital asset

Capital loss: loss from the disposition or exchange of a capital asset

Conversion: the changing of assets from a traditional, SEP, or SIMPLE IRA to a Roth IRA. A Roth conversion is treated as ordinary income to the IRA owner. Except for amounts attributable to after-tax rollovers or nondeductible contributions, the conversion will be taxable

Dealer: a person or taxpayer that regularly buys and sells property or inventory to customers in the ordinary course of their business

Dividend: distribution of earnings paid to stockholders based on the number of shares owned

Exclusion: income which is allowed by the Code to be excluded from gross income. The term may also be used to refer to amounts which may be excluded for estate tax, gift tax, and self-employment tax purposes

Gain: excess of money or fair value of property received on sale or exchanged over the carrying value of the item

Gift tax: a tax levied on the transfer on of property or money made without adequate legal consideration. This tax is imposed on the donor of a gift and is based upon the fair market value of the property as of the date of transfer. Under the law, each parent may give each recipient $13,000 a year without gift tax consequences. Also, gifts between spouses are untaxed

Gross income: money, goods, services, and property a person receives that must be reported on a tax return. Includes unemployment compensation and certain scholarships. It does not include welfare benefits and nontaxable Social Security benefits

Holding period: a time interval that property has been owned by the entity

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Liquidating distribution: a distribution from an entity during the process of its liquidation

Partnership: form of business organization created by an agreement between two or more persons who contribute capital and/or their services to the organization

Personal residence: a home of an individual. It is the place to which an individual plans to return as a home after temporary absences

Required minimum distribution: distribution that must be taken from and IRA once the taxpayer reaches age 70½. If distributions are not taken, an excise tax applies to the excess undistributed accumulations in the IRA

Short sale: the lender and creditor agree to let a third party purchase the property for less than the loan balance, and the lender agrees to cancel the balance of the debt

Tax year: an annual accounting period for reporting income and keeping records

Trust: an agreement in which the trustee takes title to property (called the corpus) owned by the grantor (donor) to protect or conserve it for either the grantor or the trust's beneficiary. The trust is established by the grantor. The trustee is typically given authority to invest the property for a return. Trust may be revocable or irrevocable

Use tax: a tax on the use, consumption, or storage of personal property. Such taxes are usually imposed in connection with sales taxes to prevent goods from being purchased outside the territory of the taxing authority and being brought to a state, city, or county free of taxes

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INVESTMENT TAX TRAPS

Course description and study guide

Course objectives: The purpose of this course is to provide a discussion of tax issues involved in investments. Topics discussed include: Bitcoin, crowdfunding, different types of IRA investments, annuities in an IRA, unrelated business taxable income (UBTI), gold, reverse mortgages, exchange traded funds, timeshares, and much more.

Completion deadline and exam: This course, including the examination, must be completed within one year of the date of purchase. In addition, unless otherwise indicated, no correct or incorrect feedback for any exam question will be provided.

Category: Taxes

Recommended CPE Hours: CPAs/PAs — 2
EAs — 2 Federal Tax
CRTPs — 2 Federal Tax

Level: Basic

Prerequisite: None

Advanced Preparation: None

Course qualification: Qualifies for QAS and NASBA Registry CPE credit based on a 50-minute per CPE hour measurement

CPE sponsor information: Spidell Publishing, Inc. (Registry ID: 104931)

Expiration Date: May 2016*

*Exam must be completed within one year of the date of purchase

Learning assignment and objectives

As a result of studying the assigned materials, you should be able to meet the objectives listed below.

Assignment:

At the start of the materials, participants should identify the following topics for study:

- Bitcoins
- Crowdfunding
- Gold
- Timeshares
- Different types of IRA investments
- Annuities in an IRA
- Unrelated business taxable income
- Reverse mortgages
- Exchange traded funds

Learning Objectives:

After completing this course, you will be able to identify:

- How Bitcoin is taxed
- How crowdfunding proceeds are taxed
- What is and is not a prohibited transaction as related to an IRA invested in real estate
- The treatment of qualifying longevity annuity contracts under the required minimum distribution rules
- How UBTI is taxed
- Tax treatment of timeshares

After studying the materials, please answer exam questions 1-10.

Evaluation Form

Program title: _________________

If applicable, program instructor: ____

Program date: ___________ Participant name (optional):_________________________

Instructions: Please comment on all of the following evaluation points for this program and assign a number grade, using a 1-5 scale, with 5 as the highest.

1. Were the stated learning objectives met? ____________________________________

2. If applicable, were prerequisite requirements appropriate? ______________________

3. Were program materials accurate? ____

4. Were program materials relevant and did they contribute to the achievement of the learning objectives? _______

5. Was the time allotted to the learning activity appropriate? ______________________

6. If applicable, were the individual instructors effective? ________________________

7. Were the facilities and/or technological equipment appropriate? _________________

8. Were the handout and/or advance preparation materials satisfactory? _____________

9. Were the audio and visual materials effective? _______________________________

10. IRS Course Number (if applicable): _______________________________________

11. TTP Number: ____

12. Date course completed: ____

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Examination for Spidell's Investment Tax Traps

PLEASE: Place the correct response for each question on the attached answer sheet and retain this examination for your records. If you purchased the online version, or would like to complete your exam online, please log-in to your SpidellCPE online account to submit your answers to the exam. 70% or more (7 of 10) correct responses are necessary to receive credit for this course. This course must be completed within one year of the date of purchase.

Final Exam Questions

1. In Notice 2014-21, the IRS announced that rather than treating bitcoins as currency, they are to be treated as property for tax purposes. Therefore, general tax rules that apply to property transactions apply to transactions using virtual currency, which means which of the following is true?

   a) Wages paid to employees using virtual currency are not subject to federal income tax withholding and payroll taxes
   b) Wages paid to employees using virtual currency are taxable to the employee, must be reported on a W-2, and are subject to federal income tax withholding and payroll taxes
   c) Payments made to independent contractors using virtual currency are reported on a W-2
   d) Wages paid to employees using virtual currency are taxable to the employee, must be reported on a 1099

2. Which of the following is true regarding the use of crowdfunding contributions to raise money for funding a business venture?

   a) Generally, the recipient taxpayer must report the contribution as income, subtracting ordinary and necessary business expenses
   b) For the donor, the contribution is always a deductible gift, even if the gift is not made to an IRC §501(c)(3) organization
   c) The IRS has not ruled on the tax consequences when contributing to a fundraising account
   d) A and C are correct

3. Which of the following collectibles may be held in an IRA?

   a) Work of art
   b) All coins
   c) Diamonds
   d) Bullion described in IRC §408(m)(3)

4. Which of the following is not a prohibited transaction, as related to an IRA invested in real estate?

   a) Taxpayer uses real estate owned by his IRA as a residence or vacation home
   b) Taxpayer's business leases space in a property held by the taxpayer's IRA
   c) Taxpayer places property he already owns into his IRA
   d) Taxpayer uses an IRA account to purchase shares in a real estate investment trust or a mutual fund that invests in real estate

5. Which of the following is not true regarding how the required minimum distribution rules are applied to qualifying longevity annuity contracts?

   a) The regulations modify the RMD rules by excluding the value of the QLAC from the total figure used to determined required minimum distributions
   b) The regulations apply to contracts that satisfy certain requirements, including the requirement that distributions commence not later than age 85
   c) In order to constitute a QLAC, the amount of the premiums paid for all QLAC contracts for the benefit of any individual cannot exceed the lesser of $250,000 or 50% of the balance of the account
   d) An individual who exceeds the limits on premium payments may correct the excess

6. The tax rate for UBTI is ______ on income in excess of ________.

   a) 39.6% $1,000
   b) 39.6% $12,150
   c) 15% $1,000
   d) 15% $12,150

7. Regarding investing in gold, which of the following is true?

   a) An investment in a gold stock is treated as a collectible
   b) ETFs that directly invest in precious metals will not generate collectibles gain or loss to their investors
   c) People who throw jewelry parties are generally not in the business of selling gold, so gains on the sale of the family jewels are taxed as collectibles, and losses are personal and nondeductible
   d) IRAs cannot hold collectibles, there is no exception for coins and bullion

8. Interest paid on a reverse mortgage may be considered which of the following?

   a) Qualified residence interest (acquisition debt or equity debt)
   b) Investment interest
   c) Nondeductible personal interest
   d) Any of the above

9. Which of the following is true regarding exchange traded funds?

   a) Income from ETFs are always reported on Form 1099-DIV
   b) ETFs allow a taxpayer to reinvest dividends
   c) Income from ETFs is not subject to the UBI tax
   d) ETFs do not allow short sales

10. Which of the following is true when renting out a timeshare?

    a) The fewer-than-fifteen-days rule generally does not apply
    b) Any loss is passive and is covered by the $25,000 allowance under IRC §469(j)
    c) Purchasing multiple timeshares and renting them out avoids the hobby loss rules
    d) Renting the timeshare will allow the taxpayer to deduct mortgage interest, property taxes, and maintenance fees