

Checkbook IRAs And Digital Assets: A Bet Against The House

By **Seth Pierce** (June 21, 2018, 6:17 PM EDT)

Bitcoin's price increased roughly 2,000 percent between December 2016 and December 2017. Ethereum, Litecoin and Ripple increased approximately 13,000 percent, 7,500 percent and a whopping 46,000 percent, respectively, in roughly the same time period. Digital or cryptocurrency is no longer a fringe asset. It has gone mainstream and new digital currencies and initial coin offerings, or ICOs, are launching every day in the hope of being that next must-have asset.

Many, perhaps most, American buyers use after-tax dollars to purchase digital currencies — significantly limiting the size of the market, as most Americans do not have significant non-retirement savings or investment portfolios. But a 2014 tax ruling from the Internal Revenue Service — which held that digital currencies are not, in fact, currency but property akin to real estate — permits Americans to use retirement funds to purchase digital currencies and a growing number of people are doing just that, vastly expanding the pool of potential investors.

Americans have over \$23 trillion dollars in retirement savings — more than the federal deficit and the gross national product of the United States. Americans increase their retirement savings hundreds of billions of dollars each year — almost all of which is invested in tax deferred retirement accounts. These funds are primarily invested in stocks and bonds and other traditional assets.

While many investors prefer the straight and narrow path these funds provide, others crave alternative assets, like digital currency, and their prospects for higher — lottery like — returns, at least for a portion of their retirement portfolio. These investors know, or at least should know, that digital currencies are an inherently risky and highly volatile investment. The last few months are a testament to that volatility and the potential for loss — as well as gain. But disruptive technologies are rarely for the fainthearted and fortunes are seldom made by the risk averse.

Investors who wish to use retirement funds to purchase digital currencies can set up a self-directed individual retirement accounts. The digital currency is held by a custodian for the benefit of the investor, just like a traditional IRA or 401K account. This is a well-established solution that has been used for years to invest in precious metals, real estate and other hard assets.

While this is a “tried and true” solution, in the world of alternative investments some people look for alternatives, including the ability to exercise more direct control over their digital currency investments.



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If and when the next economic or technological opportunity or catastrophe arrives, they want to be able to act immediately and on their own, without relying on intermediaries or financial institutions.

Numerous investment companies have sprouted to meet this demand — promising “checkbook” IRAs, among other alternative control strategies. These companies purport to help investors set up their own limited liability company trustee, which can then hold their retirement funds. The investor then manages the LLC, including all investment decisions. Sounds great. No fees. Immediate decision-making. Immediate execution. But is it legal?

As it is the rare investor who can meet the applicable IRS rules for creating such a structure, the typical answer is “no.” The stakes, moreover, are incredibly high. If you set up the structure, but don’t qualify, your rollover to your LLC will be treated as a distribution, stripping your retirement investment of its tax deferred status. Early distribution means taxes — on the entire amount of the rollover — as well as a 10 percent penalty if you are under age 59 1/2. This could mean a tax hit of 35 percent or more of your portfolio’s value — on par with the losses sustained by many investors during the great recession. But unlike a market correction or decline, there is no coming back from this hit — it is permanent.

Not yet deterred? Thinking about gambling 35 percent or more of your retirement account on the legality of a checkbook IRA? Then read on ...

Self-Directed Individual Retirement Accounts

Investing in digital currency or other alternative assets, like precious metals or real estate with IRA funds is perfectly legitimate, within certain limitations,[1] but typically involves setting up a specialized self-directed IRA with an established custodian/financial institution. These companies act like traditional IRA custodians, such as Wells Fargo or Bank of America, but specialize in holding alternative assets.

Checkbook IRAs

Checkbook IRA providers, however, go much further. Playing on fear of things such as high custodial fees, the next global collapse, distrust of the government and large financial institutions, or touting simple expediency, they recommend a very non-traditional — and seemingly highly risky — investment structure. For example, one provider — who shall remain nameless — states the following (paraphrased):

- The process is fairly simple.
- We will set up an LLC for your IRA and appoint you the manager.
- You can set up your LLC’s bank account at any bank you choose.
- If you want to buy an asset for your retirement account, just write a check from your LLC checking account. That’s it.

These companies/websites likewise advertise the suitability — indeed, the benefits — of this vehicle for investing in digital currency (paraphrased):

- Once customers understand the process, they realize how perfect a checkbook IRA is for investing in cryptocurrencies.

- People have even commented that the whole approach seems too good to be true.
- But checkbook IRAs are not new, even if investing in digital currency is.
- People looking to invest in traditional mutual funds don't need the power and flexibility of a checkbook IRA. But for those interested in investing in cryptocurrency, there is no better solution.

Indeed, one site extols its A to Z, soup to nuts service (paraphrased):

- Investors can use our checkbook IRA platform to invest in all cryptocurrencies.
- The process is as simple as writing a check.
- We create the specialized LLC that will hold your IRA assets and do everything else to get you started. The only thing the customer needs to do is open a checking account.
- Once that step is taken, you can invest in Bitcoin the same way you would outside of an IRA, using the bank and checking account, exchange platform and wallet provider of choice.

In tiny print, this same company disclaims any responsibility for anything:

All of the information contained in our website is a general discussion for informational purposes only. [REDACTED] does not provide legal, tax or investment advice. Nothing of the foregoing, or [any other statement or communication from us] may be relied upon ... Prior to making any investment decisions, please consult with the appropriate legal, tax and investment professionals for advice.

I suspect customers are also required to sign a customer agreement that further limits or eliminates the company's liability, but not even Google could find that agreement online.

Therein lies the rub. The company makes absolutely no promise that any of this is legal. And the old adage is true, if it sounds too good to be true, it probably is. Indeed, as noted, one of the companies hazards this very outcome, while turning it into a marketing pitch — "People have even told us that it seems too good to be true."

Are Checkbook IRAs Legal?

Subject to other rules and restrictions which are beyond the scope of this article, the Internal Revenue Code permits IRA funds to be invested in digital currencies if, but only if, such currencies are placed in the physical possession of a "trustee" — as that term is described in Internal Revenue Code Section 408(a).

The IRC defines a "trustee" as a traditional bank — for example, your local Bank of America, or an insured credit union or other financial institution subject to regulation by state or federal bank regulators, or "[s]uch other person who demonstrates to the satisfaction of the Secretary [of the U.S. Treasury] that the manner in which such other person will administer the [IRA] will be consistent with the requirements of this section."

It is this second provision that checkbook IRA providers latch on to in advertising their services. But as when dealing with organizations and entities that tell you income taxes are unconstitutional so you

don't need to pay them, buyer beware.

Any entity wishing to comply with the second provision, such as the LLC set up to hold your digital currency, must complete a written application with the IRS demonstrating that the applicant satisfies a long list of requirements specified in the applicable regulations, including requirements relating to fiduciary ability, fiduciary experience, capacity to account, fitness to handle retirement assets, bonding, audits and net worth. Moreover, the applicant cannot act as a trustee until the IRS provides notice that the application has been approved. This reality is in stark contrast to the 1-2-3 step process promoted by some of the companies in this field, who promise that opening such an account is as easy as opening a bank account.

If the U.S. government had wanted to let people keep direct physical control over their retirement savings, it easily could have done so. It did not — it imposed the trustee requirement. This was not accidental. The government wants an independent trustee holding the assets to make sure the funds or assets are actually held and that any distributions are reported to the government. If you are holding your own assets, even under the guise of an LLC — that you own and control by the way — it is fair to say you are going to have difficulty “satisfying” the Secretary of Treasury of anything.

Checkbook IRA facilitators typically recommend various strategies to bolster the claim that the purchaser is administering the IRA consistent with the requirements of this section. For example, and these are only examples, they assist the purchaser in setting up a limited liability company or other corporate entity to physically hold the assets, since they cannot be held directly by the purchaser. Then they recommend that the LLC, not the purchaser, set up the digital wallet that will hold the currency. I could go on, but the strategy is clear — try to make the structure look as good and independent as possible. But that is all the purchaser is doing — creating an illusion. At the end of the day, in most instances, the purchaser is setting up an LLC under the purchaser's — or an immediate family members' — direct control and all actions, including processing, storing, borrowing against, liquidating and distributing the digital currency, are taken by the purchaser. Whatever the appearance, the reality is lost on no one — including the IRS.

Unlikely is not impossible. With sufficient legal expertise and advice, and depending on the exact structure created, it might be possible to convince the IRS that your checkbook IRA is legit and satisfies the applicable regulations. But let's pause for a minute and take stock of the situation, focusing on what is likely rather than what we want to hear. This is the IRS. Which is more likely — the IRS accepting this structure or rejecting it? To ask the question is to answer it.

Consequences

If your digital currency is not held by a qualified trustee, the rollover or purchase is treated as a taxable distribution from your retirement account. Your IRA assets will lose their tax deferred status and be subject to immediate taxation at current applicable rates. Also, if you are under age 59 1/2, you will face a 10 percent penalty for early withdrawal in addition to any taxes owed. Some states impose additional early withdrawal penalties.

Bottom Line

Investing in digital currencies is risky enough, without doing it through a structure that is very likely a sham that will subject you to immediate taxation and early withdrawal penalties if challenged. If you want to gamble, go to Vegas. Opening a checkbook IRA is much riskier, but far less fun.

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[1] See Internal Revenue Code, Section 408(m)(3)