THE CASE FOR AUTOMATION

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IN RETIREMENT ACCOUNTS WITH UNCONVENTIONAL ASSET

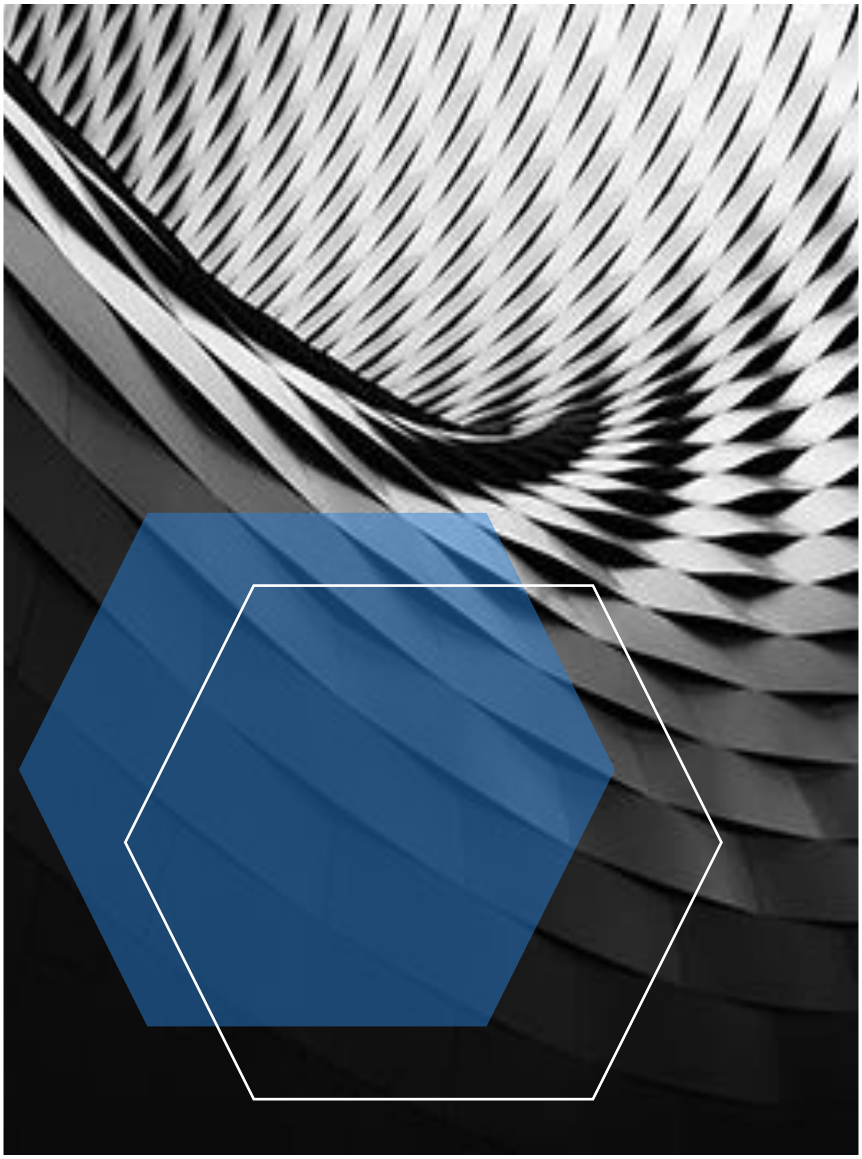
TAXPAYERS NEED BETTER TOOLS FOR MANAGING THEIR IRAS

An estimated 47.9 million taxpayers have IRAs with a total value of $12.2 trillion at the end of 2020[i]. According to a 2016 study, roughly 2 million of these IRAs are invested in assets other than marketable securities[ii]. The actual number today could be significantly higher than 2 million because of the boom in alternative investments that have been made available to smaller investors since 2016. This includes direct ownership of real estate, private businesses, precious metals, private loans and other alternative investments.

Retirement account owners are increasingly turning to unconventional assets, seeking alternatives that fit their needs and with a low correlation to the equity and bond markets. The challenges associated with this are that the complexity involved in determining the eligibility of an asset or transaction in an IRA is too high for most people. Inadvertent mismanagement of IRA investments, and in some cases deliberate mismanagement, is risking retirement savings in the US and leading to billions of dollars in uncollected tax revenue for the government. The IRS and the broader retirement services industry is currently working to address the issues of permissibility, reporting, taxes, and guidance for IRA owners. Many alternative investments and transactions in IRAs require a high level of scrutiny, but this is unattainable for the average investor.

IRA OWNERS BEAR THE RISKS

Self-directed IRA custodians are put in a difficult position and cannot solve the issue entirely on their own. Responsibility and risk ultimately falls on the IRA account owners themselves, who agree to this fact in their retirement account agreements and their filed tax returns. The responsibility and risks are assumed by people unprepared to take it on. Its not feasible for the millions of individuals with IRAs to engage with the relatively small number of qualified professionals for help. Millions of taxpayers are left to operate in information vacuums resulting in a high number of prohibited transactions, reporting failures, and billions in taxes not paid. The IRS and US GAO continue to study the problem and are developing ways to provide additional information, guidance and enforcement for IRAs.

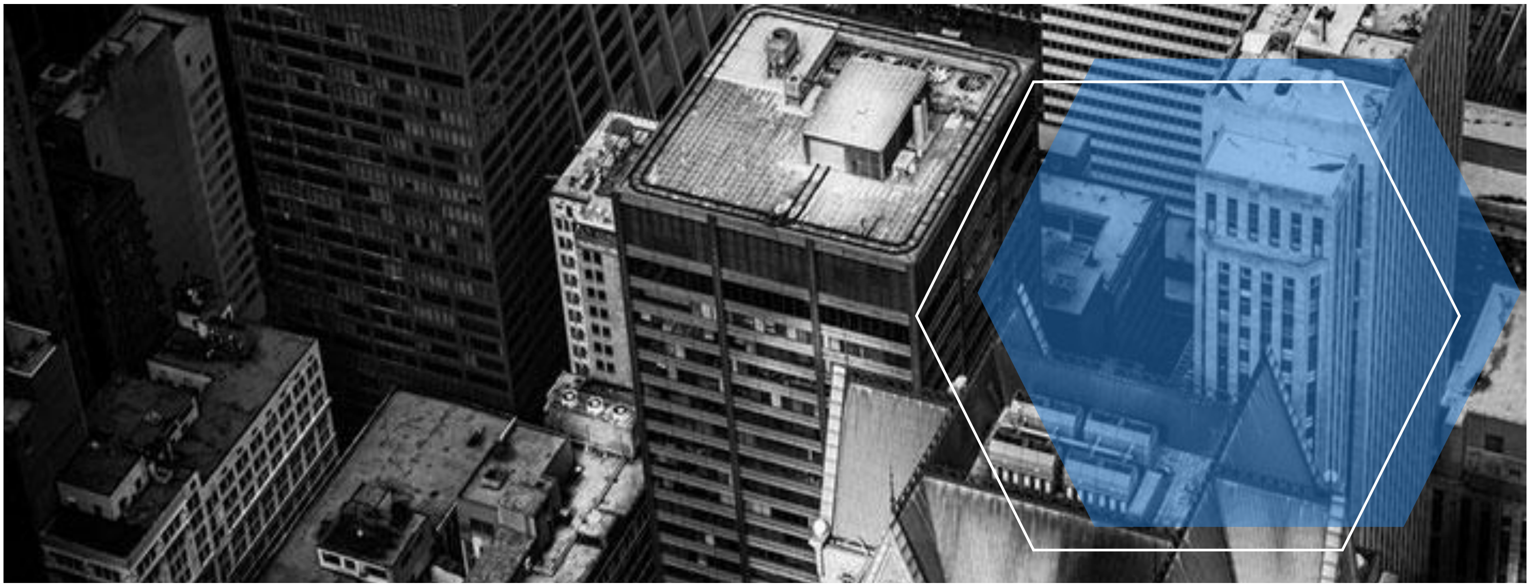


CHANGES AT THE IRS

The IRS has embarked on a six-year modernization plan estimated to cost between $2.3b to $2.7b, much of it in technology[iii]. President Biden has proposed an additional $80b to be provided to the IRS in an effort to collect unpaid taxes, mostly from higher wage-earners. Also in the works is additional cooperation between IRS departments and additional training materials provided to auditors to close the tax gap. Technology will be the major contributor to the solution, as the IRS, IRA owners, alternative investment sponsors, and IRA custodians take the steps necessary to ensure that unconventional assets in IRAs meet requirements. Services to IRA owners in the future need to include more comprehensive review of unconventional asset and transactions made in their accounts. This can be done in part by qualified professionals but will be accomplished by a much greater degree with automated evaluation of future transactions, and current asset holding.

WHAT THINGS COULD LOOK LIKE

Millions of planned IRA transactions annually could be scrubbed for permissibility and reporting requirements before they happen. Relevant information including the ongoing activity constraints of disqualified parties concerning the assets could be disseminated to IRA owners in an automated and digestible way. Roughly 20% of the 2 million IRAs that have been reported to own unconventional assets in 2016 were missing information that is required to be reported to the IRS[ii]. An additional percentage of the information that was reported was likely inaccurate. When alternative investments are purchased or private loans are made in an IRA, the relevant information about the transaction is often not analyzed. The ongoing activity of that asset or loan, and the changing reporting requirements are also not analyzed. Self-directed IRA custodians cannot play the roll of investigator or educator to retirement account owners. Custodians are not able to provide legal and tax advice, so this burden can’t fully land on their shoulders. Account owners assume full responsibility for investments made in their IRA, so they should be provided the tools to be able to do that.

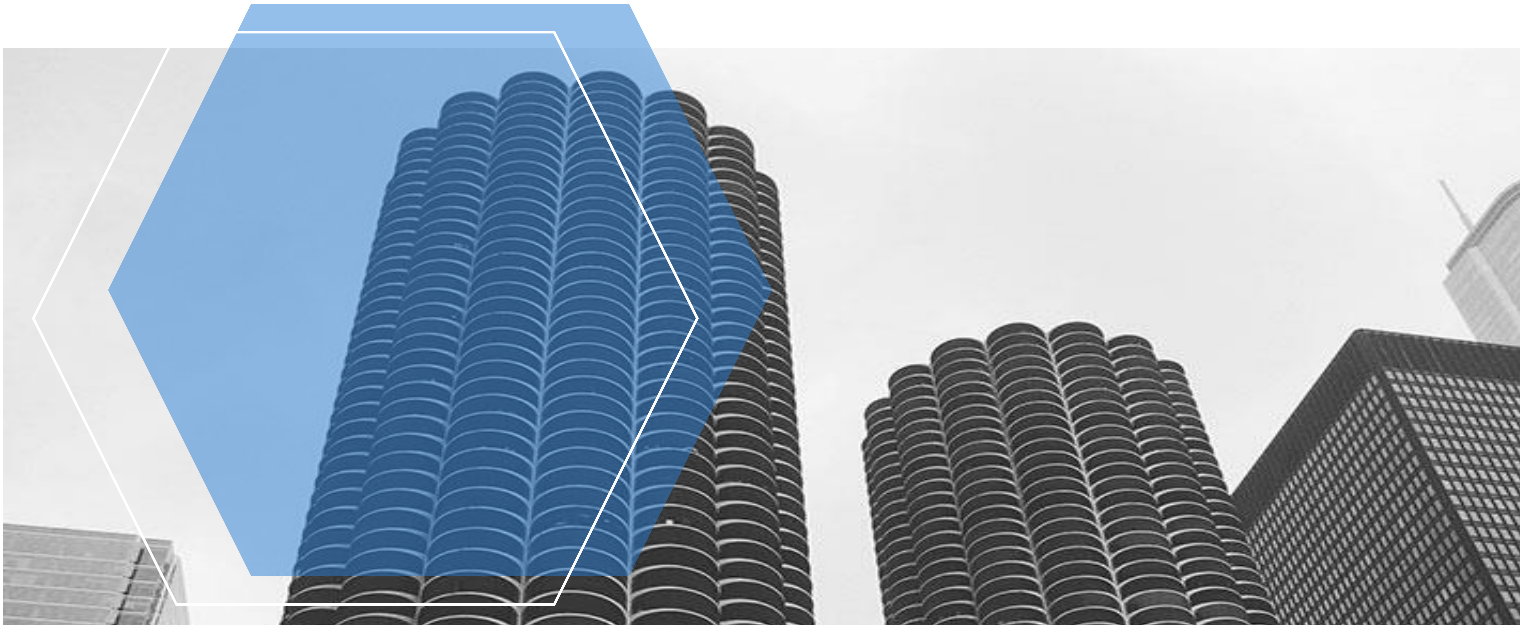


UNCONVENTIONAL ALSO MEANS NOT STATIC

Some of the challenges facing self-directed IRA custodians are due to the fact that many of their retirement accounts were funded with manual “non-ACATS˝ cash transfers over the past 30 years[iv]. The data stored about the contributions to the accounts, the IRA basis, and other data is lost. These accounts then added new assets with little data collected about their acquisition, as well as some of these asset holdings experienced changes over time. Over the years, these assets and their ownership have become “messier” and more complex. Too many of the IRA assets at these custodians are in some stage of “pending”, meaning the client and/or custodian is missing some form of records or processing. The number of assets many self-directed accounts hold is getting larger, while the complexity and confusion about the assets and the condition of their ownership by the custodian continues to escalate. IRA owners in these cases don’t know what to look for nor how to report changes to their investment holdings.

Changing business conditions is partly to blame. Custodians used to earn a higher net interest margin that comprised a significant percentage of their profits. The impact of low yields on short-term fixed income investments have contributed to the decline in the ability of many non-bank trust companies to administer retirement accounts in a comprehensive way. In February 2007, the One-Month Treasury Yield was 5.23%. But by January of 2017, the yield was just 0.50% and at the time of this report is less than .005%. Trust companies relying on a 5% net interest margin on their clients’ common trust funds of IRA cash had to make cutbacks in the face of increased volume of new accounts, unconventional asset changes, and vigorous pricing competition from other custodians.

Many alternative investments, by their very nature, are not static assets. Instead, they change over time. A private company investment made in an IRA might engage with new partners, take on new debt or reorganize. A real estate investment in an IRA may refinance a mortgage, or a real estate loan may foreclose on a property. The IRA may become an equity owner instead of a lender on a property, possibly changing if the asset is able to be held in that IRA anymore. Reporting requirements of the IRA could also change, and possibly taxes could now be owed since the changes happened. Restricting IRA investments to marketable securities would not be a good policy. But this and other retirement account related constraints are currently on the table and becoming an increasing risk if quality solutions are not provided soon to retirement account holders.



SUMMARY

New unconventional assets are being added to IRAs in the US every day. Investment decisions are being made without proper consideration of the rules. Changes to unconventional assets are occurring without notification to custodians, the IRS, or sometimes the IRA owners. In the rare occasions when the custodian or IRA owner is notified, the custodian or IRA owner all too often ignore the information because of the inefficient system of cooperation between the IRA owners and the custodians' systems. These issues, and other conditions, are leading to widespread misunderstanding of the status of millions of IRA assets. Savings in retirement accounts are being put at risk and the federal government is leaving tax revenue on the table. Continued investment in automation needs to be made by the IRA industry and the IRS in this area.

ABOUT THE AUTHOR

Joey DiDomenico is the founder of *Vetted Retirement Technologies*® in New York City. He was also the founder of *WealthFlex®*, a retirement plan administration company, that was acquired by the online crowdfunding portal *Yieldstreet®* in 2019. Joey believes in the spirit of the tax laws allowing the American people to save for retirement in a tax-advantage way and that care should be taken so that this hard-earned money being saved for retirement isn't jeopardized. His company is building the next generation of tools so that the growing "do-it-yourself" investing and saving society can invest in unconventional assets with their IRAs in a compliant way.

References

i. *Investment Company Institute* and Internal Revenue Service Statistics of Income Division

ii. United States Government Accountability Office, IRS Could Better Inform Taxpayers about and Detect Noncompliance Related to Unconventional Assets, February 2020

iii. Integrated Modernization Business Plan FY 2019 Key Insights Report, February 2020

iv. Transfers done outside of the *Automated Customer Account Transfer Service* (*ACATS*) that facilitates the transfer of securities from one trading account to another at a different brokerage firm or bank