

# Rollover Failure

Monday, November 6, 2023

**Take-Away:** While an IRA can invest in illiquid investments, those investments can easily lead to major problems, including a disqualification of the entire IRA.

**Background:** Many of us old enough remember the great actor James Caan from films like *The Godfather*, *Rollerball*, *Eraser*, and *Elf*. Mr. Caan died in the summer of 2022. Mr. Caan also played football for MSU. [He was the father of Scott Caan, who millennials probably remember from the three *Oceans 11* films.] Sadly Mr. Caan's name will now long be remembered as an example of how to screw up an IRA *rollover*.

*Estate of Caan v. Commissioner, 161 Tax Court 6 (October 18, 2023)*

**Facts:** Mr. Caan owned two IRAs at UBS. One IRA held a mix of cash, mutual funds, and stock in exchange-traded funds. The other IRA held a hedge fund investment called P&A Multi-Sector Fund, L.P., (for convenience referred to as P&A.) While a hedge fund can be held in an IRA the practical problem is that the Tax Code requires the IRA custodian to report the fair market value of these alternative assets each year determined as of 12/31. [IRC 408(i); Regulation 1.408-5.] Mr. Caan's IRA custodial agreements with UBS provided that it was Mr. Caan's responsibility to provide UBS with the year-end P&A fair market value. Mr. Caan failed to furnish the end-of-year values of his P&A investment for 2014 and 2015, which ultimately prompted UBS to refuse to continue to serve as his IRA custodian. UBS issued to Mr. Caan a Form 1099-R which reported to the IRA distribution of the P&A investment to him, using the 2013 (last known) year-end fair market value of the P&A investment.

**Rollover:** At about this same time, the UBS manager who handled Mr. Caan's IRAs moved from UBS to Merrill Lynch. Coming as no surprise, that manager then persuaded Mr. Caan to move all of his UBS investments to Merrill Lynch, including his two IRAs. All of the IRA assets, other than the P&A hedge fund, were automatically transferred directly from UBS to

Merrill Lynch as an IRA custodian-to-custodian transfer. As for the P&A investment the manager of the IRA directed the P&A Fund investment to be liquidated and the cash proceeds transferred to Mr. Caan's Merrill Lynch IRA. However, that cash transfer did not occur until almost a year after UBS had notified Mr. Caan that it had distributed the P&A investment to him.

Notice of Deficiency: On his 2015 Form 1040 Mr. Caan reported the distribution of the P&A interest but he claimed that it was 'nontaxable.' A Notice of Deficiency was issued by the IRS in 2018 that claimed a deficiency of \$779,915 in tax for 2015. Mr. Caan then filed his Petition with the Tax Court that challenged the Notice of Deficiency. Shortly after filing his Petition, Mr. Caan also requested a private letter ruling with the IRS in which he asked for a waiver of the 60-day rollover period. [IRC 408(d)(3)(1).] That request was denied by the IRS for the reasons described below.

Tax Court: Mr. Caan's estate lost at the Tax Court.

Private Letter Ruling: First, and a bit unusual, the Tax Court held that it had the jurisdiction to review the IRS's decision to deny Mr. Caan's private letter ruling request. Technically, this was a victory for Mr. Caan as the Tax Court seldom will review the IRS's refusal to grant a private letter ruling. [This part is not germane to the rollover issue so I won't add more to your reading- assuming that you even got this far!]

Non-Traditional IRA Assets: The Tax Court acknowledged that it is permissible to hold a 'non-traditional' asset in an IRA, but it then discussed the pitfalls for doing so, concluding: "*This case is a quintessential example of the pitfalls of holding nontraditional, non-publicly traded assets in an IRA. Failure to follow the labyrinth of rules surrounding these assets can mean forfeiting their tax-advantaged status.*"

No Distribution Defense: Mr. Caan's estate argued that UBS had never truly distributed the P&A interest to him, despite the clear correspondence from UBS to him that explicitly stated it was distributing the interest to

him in November of 2015. The Court found that Mr. Caan had constructive receipt of that private equity interest. The Court also noted in passing that UBS had no responsibility to find the value of the P&A investment interest in light of its custodial agreement with Mr. Caan where multiple responsibilities were allocated exclusively to him with respect to furnish a year-end value for the investment and to directly contact P&A to request the year-end value, or in the alternative, to obtain a fair market value appraisal of the investment.

Not a Rollover: The Court then found that no rollover occurred since Mr. Caan had failed to satisfy the 60-day limit on rollovers. *“Section 408(d)(3)(A)(i) provides that an IRA distribution is not taxable if ‘the entire amount received including money and any other property’ is contributed into another IRA within 60 days of the distribution. The taxpayer may not change the character of any noncash distributed property between the time of the distribution and the time of the contribution. Lemishow, 110 Tax Court at 113.”* Therefore, the cash sales proceeds were not the same property that had been deemed distributed and constructively received by Mr. Caan.

Not in a Single Deposit: Yet another problem was that the cash proceeds from the liquidation of the P&A interest was distributed to the Merrill Lynch IRA in three installments over the year after the manager’s direction as to its liquidation. *“Troublesome here is how the P&A interest was handled. Mr. Margiotta (acting on Mr. Caan’s behalf) submitted a withdrawal request to the P&A Fund in December 2016, asking it to fully liquidate the P&A interest and remit the proceeds directly to the Merrill Lynch IRA. This action occurred over a year after the UBS distribution. The P&A Fund then remitted a total of \$1,532,605 in three separate wire transfers between January 23, and June 21, 2017.*

Three Mistakes: The Tax Court then summarized the situation and the three mistakes that were made in Mr. Caan’s effort to rollover his two UBS IRAs to a new Merrill Lynch IRA:

*“There are three problems with the way the P&A interest was handled. First, and most importantly, in liquidating the P&A interest Mr. Caan changed the character of the property; yet section 408(d)(3)(A)(i) required him to contribute the P&A interest itself, not cash, to another IRA in order to preserve its tax-deferred status. Second, the contribution of the cash proceeds from the liquidation occurred long after the January 25, 2016 deadline. And finally, the P&A Fund’s three transfers to the Merrill Lynch IRA constituted three separate contributions; yet section 408(d)(3)(B) allows for only one rollover contribution in any one-year period, making only the first transfer potentially eligible for a tax-free rollover.”*

Tax Court is Not a Court of Equity: While the Court acknowledged that the estate’s request for equitable relief under the circumstances had some merit, it did not have the discretion to offer equitable remedies. *“The Estate urges us to adopt an equitable resolution to this case. Although we are sympathetic to the Estate’s situation, we are not a court of equity, and we cannot ignore the statutory law to achieve an equitable end.*

Conclusion: Yes, an IRA can hold some non-traditional assets as investments. But the IRA owner needs to think twice about all the hassles that go along with an illiquid investment, including the obligation to provide annually a December 31 fair market value for that IRA investment. The *Estate of Caan* decision never explains why there was trouble obtaining a year-end value of the P&A investment for two straight years, but that failure definitely put Mr. Caan’s IRA in jeopardy.