



IRS Says Separately Paid Wrap Fees Are Not Deemed IRA Contributions

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In February 2005, the Internal Revenue Service (IRS) issued Private Letter Ruling (PLR) 200507021, which clarified that Individual Retirement Account (IRA) owners can pay wrap fees with funds outside their IRAs without the payments being deemed contributions to their IRAs under section 408(a) of the Internal Revenue Code (Code) and/or Roth IRAs under section 408A of the Code, even though the fees cover brokerage as well as investment management costs.

This ruling is significant in that the IRS historically has taken the position, in both private and published rulings on IRAs and tax-qualified plans, that “brokerage” costs are transactional costs that may not be separately paid for and deducted by IRA owners or employer sponsors without such costs being considered contributions to the IRAs. Treating these payments as contributions reduces the amount available for investment in the IRA or plan. As IRAs are subject to annual contribution limits (\$4,000 for 2005), with a 6% penalty on excess contributions, paying the fees separately, outside the IRA, preserves the amount invested in the IRA and increases the opportunity for earnings to accumulate on a tax-deferred basis (or on a tax-free basis in the case of a Roth IRA). Qualified plans are likewise subject to contribution limits and penalties on any excess contributions.

While this ruling does not address tax treatment, separately paid wrap fees should be treated as administrative or overhead expenses and thus may be available as a miscellaneous itemized deduction for federal tax purposes. This approach is consistent with earlier published rulings that treat brokerage commissions as integral to the value of account assets, and therefore not a deductible expense, in contrast to recurring administrative or overhead expenses incurred in connection with ongoing account maintenance, such as a trustee’s or actuary’s fees, which would be deductible.

Although this ruling addresses only IRAs, a similar analysis should apply in the tax-qualified plan context. Applicable Treasury regulations provide that expenses incurred by an employer in connection with a tax-qualified retirement plan, which are not provided for by contributions under the plan, are deductible by the employer under section 162 of the Code (trade or business expenses) or section 212 of the Code (production of income), to the extent such expenses are ordinary and necessary. Accordingly, separately paid wrap fees treated as administrative or overhead expenses of the plan should be deductible by the employer, and should not be treated as contributions for purposes of applicable plan contribution and allocation requirements.

As a result of PLR 200507021, it would seem that a wrap-fee program offers some distinct advantages to an account owner over a commission-based brokerage account, with regard to opportunities for both wealth accumulation and tax deductibility. It is anticipated that more vendors will offer their clients a choice between having wrap fees swept from their accounts or paying those fees separately using outside funds. One cautionary note: A private letter ruling may only be relied upon by the taxpayer to whom it is issued. Nevertheless, it may be a useful indicator of the IRS's position on a particular issue. Vendors that have been reluctant to offer IRA customers an outside payment option because of the uncertainty surrounding this issue may seek to obtain their own private letter rulings on the subject, now that there is a higher degree of confidence in the outcome.

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