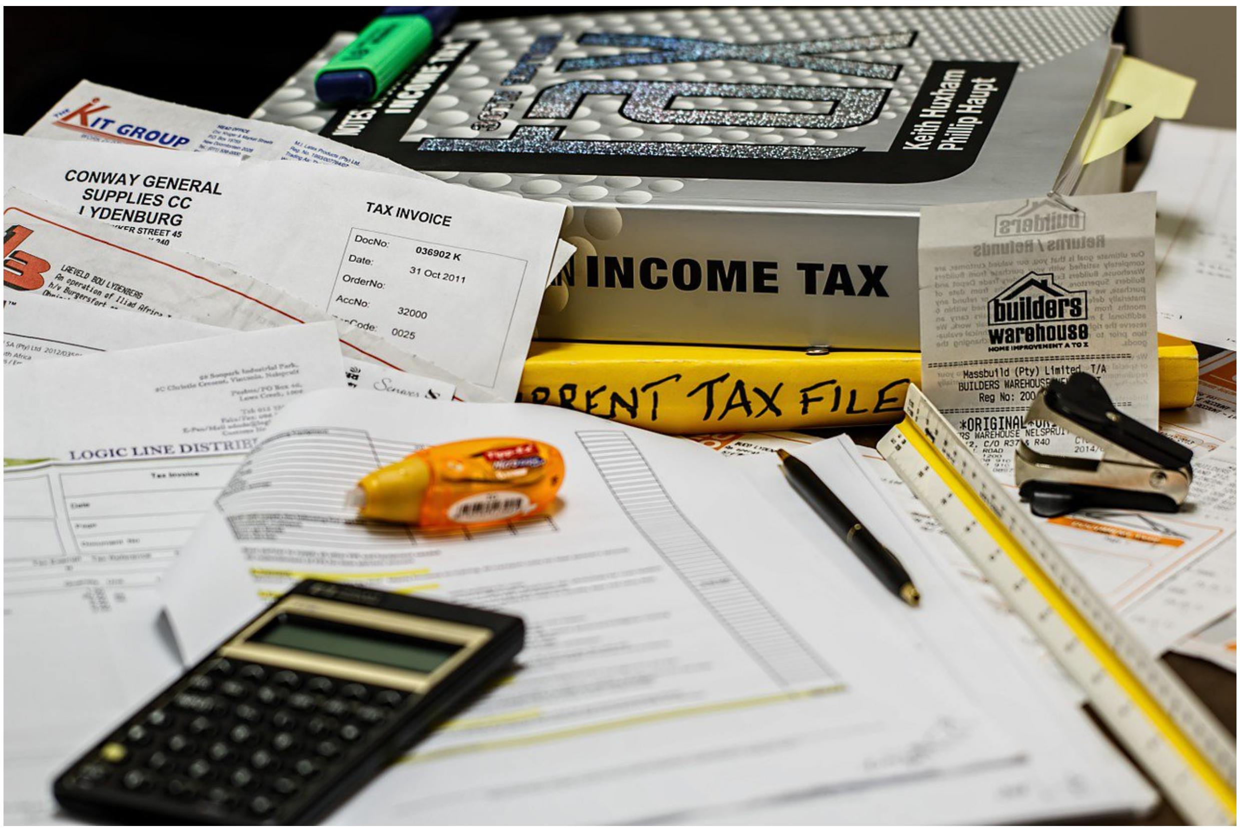
INVESTING

How to Hold Bitcoin in an IRA and Why It’s Still Not Easy

by **Scott Dylan** 05.29.17 4:32 PM



As bitcoin continues its bull run, more U.S. investors are looking for ways to protect their gains from taxation, and Individual Retirement Accounts (IRAs) are slowly emerging as a viable option.

While holding bitcoin in an IRA has technically been possible since IRS Notice 2014-21, which declared bitcoin property for tax purposes, the process remains complicated and fraught with liabilities.

Some regulators are trying to fix that. On January 9, the Government Accountability Office (GAO) released a report calling on the IRS to better inform taxpayers about the reporting requirements and potential liabilities of holding bitcoin and other cryptocurrencies in their IRAs.

But for adventurous and capable investors who want to bet some of their retirement on bitcoin, there are currently two ways to get the tax protection of an IRA.

First, investors will need to find a custodian to administer the IRA. Most IRA custodians allow "unconventional investments" like real estate and precious metals, but do not allow clients to hold bitcoin, at least not directly.

The alternative is to open an account with an IRA custodian that works with a fund like the Bitcoin Investment Trust (BIT), which holds bitcoin and issues shares based on its value. BIT is an approved investment vehicle offered by IRA custodians like PENSCO, Entrust, Millennium and Equity Institutional. However, there are several disadvantages to this method.

The first is that BIT shares are only available to accredited investors, those with a net worth of more than $1 million or with an annual income greater than $200,000. The second is that the account owner does not hold any bitcoin directly, only shares in a fund that promises to hold actual bitcoin on his or her behalf. The third is that the intermediary custodian who holds the asset, in this case shares in the BIT fund, charges fees to cover compliance and management costs.

For non-accredited investors who want to buy and hold bitcoin directly and avoid high custodial fees, there is really only one option, and that's to set up a Limited Liability Company within a self-directed IRA.

A self-directed IRA LLC allows investors to hold bitcoin directly without giving up their wallet keys to a custodian and without seeking custodial approval for transactions, but it comes with more paperwork and liability risk.

Investors will still need to find the right custodian. Any IRA custodian that offers "checkbook LLCs" should allow clients to hold bitcoin in an LLC. However, only a few custodians specialize in bitcoin specifically and can streamline the process.

BitcoinIRA, headed by former U.S. Mint director Edmund Moy, specializes in setting up self-directed IRAs for clients who want to invest in bitcoin, but it charges a hefty one-time fee for the service. IRA Financial Group recently announced a self-directed IRA structure that will allow investors to hold bitcoin directly in an LLC, without the intermediary of a fund like BIT.

There are many risks to holding bitcoin in a self-directed IRA LLC, including a lengthy list of "prohibited transactions" that can disqualify the tax protection of assets within the IRA.

Legally, an IRA and its owner are separate entities and must act separately. The list of "prohibited transactions" is intended to prevent account owners from drawing double benefits from the IRA's tax protection.

For example, account owners cannot put up the assets of their IRA LLC as security for a loan, since that would give them the double benefit of tax-protected assets and collateral.

Under these same rules, account owners cannot sell bitcoin to their own IRA LLC and must buy and store bitcoin in the name of the LLC, not their own names.

For investors who own bitcoin and want to transfer it into an IRA LLC, there's only one option: sell the bitcoin, then contribute the proceeds — in U.S. dollars — to the IRA LLC, and then buy bitcoin in the name of the LLC with its own cash assets.

As with real estate and other unconventional investments, it's also the responsibility of investors to report the fair market value of their assets to their custodian each year, whether those assets are held in an LLC or not.

For assets such as stocks and bonds, these values are assessed automatically. For real estate and unconventional investments like bitcoin, a third-party assessment is usually required.

If an account owner fails to report the value of their assets accurately to their custodian or engages in a "prohibited transaction," their IRA can be disqualified and all assets distributed and taxed. Last but not least, account owners must also file annual reports and pay fees to the Secretary of State where the IRA LLC is incorporated.

Even if account owners cross all the t's and dot all the i's, bad custodians can still get them in trouble.

In some cases, custodians have failed to update fair market values accurately in their reporting to the IRS, and account owners have had to pay taxes on assets that have gone down in value. However, the potential tax savings still make self-directed IRA LLCs an attractive option for many bitcoin investors.

As property, investors must pay capital gains tax on any increase in the value of their bitcoin. With a Roth IRA, investors can buy bitcoins with post-tax dollars and avoid paying any taxes on their gains when they cash out. As with any IRA, however, investors can only withdraw disbursements without suffering penalties after age 59 ½.

Although holding bitcoin in IRAs has been possible since 2014, regulators are still worried the complicated process could land unwary taxpayers in trouble. As the GAO's report pointed out, the IRS currently provides no guidance to IRA custodians or account owners about how to properly assess the fair market value of unconventional assets such as bitcoin, even though such assessments are mandatory.

This article is for general information purposes only and should not be taken as investment advice. Investors should conduct their own due diligence and consult with a qualified tax professional before attempting anything described in this article.

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