

## **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 payment being deemed a contribution to the IRA under section 408(a) of the Internal Revenue Code (Code) and/or Roth IRA under section 408A of the Code, even though the fee covers 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 the IRA owner or employer sponsor without such costs being considered a contribution to the IRA. Treating these payments as contributions reduces the amount available for investment in the IRA or plan. In particular, IRAs are subject to annual contribution limits (\$4,000 for 2005). Excess IRA contributions are subject to a 6% penalty. 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, or tax free (if a Roth IRA), basis. Qualified plans are likewise subject to contributions limits and penalties on any excess.

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

Although this ruling addresses only IRAs, a similar analysis should apply in the tax-qualified plan context. The 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 the account owner over a commission-based brokerage account, both as to opportunities for wealth accumulation and tax deductibility. It is anticipated that more vendors will choose to offer their clients a choice between having wrap fees swept from their accounts or paid 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 who 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 ruling on the subject, now that there is a higher degree of confidence in the outcome.