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Recent Tax Court Case Exposes Risks of Indirect Prohibited Transactions by IRAs

May 2013

Mark Hamilton
White & Case

Tax-qualified pension, savings and retirement plans and individual retirement accounts ("IRAs") are subject to complex prohibited transaction rules under § 4975 of the Internal Revenue Code of 1986, as amended (the "Code" (section references in this article are to the Code, unless indicated otherwise)). A recent United States Tax Court case, Peek v. Comm'r, 140 T.C. No. 12 (May 9, 2013), illustrates the complexity and breadth of these prohibited transaction rules and the draconian consequences visited upon an IRA that violates these rules. In particular, the case illustrates how an indirect prohibited transaction can disqualify a self-directed IRA.

Prohibited Transactions and IRAs

Section 4975(c) categorically prohibits certain classes of transactions between a plan (which includes an IRA) and a disqualified person.[1] These prohibited transactions include any direct or indirect (a) sale or exchange or leasing of property between a plan and a disqualified person; (b) lending of money or other extension of credit between a plan and a disqualified person; (c) furnishing of goods, services, or facilities between a plan and a disqualified person; and (d) a transfer of plan assets to, or use of plan assets by or for the benefit of, a disqualified person. Section 4975(c) also prohibits self-dealing by a plan fiduciary. An excise tax is generally levied under § 4975 on a disqualified person that participates in a prohibited transaction, and the prohibited transaction must be rescinded.

Essentially, disqualified persons have certain types of relationships with plans, such as acting as a fiduciary or service provider of the plan (such as a plan trustee, plan recordkeeper or broker-dealer that executes transactions for the plan) or an employer of employees covered by the plan.

An account that qualifies as an IRA is exempt from income tax. For example, if an IRA holds stock in a company and sells the stock for a gain, that gain is not subject to income tax. Only when distributions are made from the IRA to the IRA's beneficiary does the beneficiary pay income tax on the amount of such distributions. An IRA is subject to the prohibited transaction rules of § 4975, described above. However, if an IRA violates these rules and the disqualified person engaging in the prohibited transaction with the IRA is also the beneficiary of the IRA, then the penalty is not imposition of an excise tax, as described in the preceding paragraph, but disqualification of the IRA. Accordingly, the IRA ceases to qualify as an IRA as of the first day of the taxable year in which such prohibited transaction occurs. This means that all of the IRA's assets are deemed to be distributed to the beneficiary of the IRA on such first day, and the beneficiary recognizes as taxable ordinary income the fair market value (on such first day) of all such assets. Then, any future transactions involving those assets are taxable to the beneficiary.

1. Section 406 of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), contains prohibited transaction rules, which apply to ERISA-covered employee benefit plans, that for the most part parallel those of § 4975 of the Code. IRAs are generally not subject to the requirements of ERISA.

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Facts of the Case

The taxpayers in Peek were two unrelated individuals who wanted to acquire an existing business. In August 2001, a new corporation (FP Company) was formed to acquire the assets of the business. Each of taxpayers had established a traditional IRA. These were "self-directed" IRAs, meaning that each of the taxpayers determined how his IRA was invested. In September 2001, each of the IRAs purchased one-half of the newly-issued stock of FP Company. Later that same month, FP Company acquired most of the assets of the business. A portion of the purchase price paid by FP Company was a promissory note from FP Company to the seller. This promissory note was secured by personal guaranties from each of the taxpayers. In 2003 and 2004, the taxpayers converted their traditional IRAs to Roth IRAs. These guaranties remained in place until the IRAs sold FP Company for a gain to an unrelated buyer in 2006.

Prohibited Transactions

Each of the taxpayers was a fiduciary of his IRA because he exercised authority or control over the assets and management of his IRA. Consequently, each taxpayer was a disqualified person with respect to his IRA.

The Internal Revenue Service ("IRS") examined the taxpayers' tax returns for the years in which FP Company was sold and determined that their personal guaranties of the promissory note from FP Company to the sellers, described above, were prohibited transactions. In particular, the IRS argued that these guaranties ran afoul of § 4975(c)(1)(B), which prohibits "any direct or indirect . . . lending of money or other extension of credit between a plan and a disqualified person" (emphasis added). The taxpayers argued that their respective guaranties were not prohibited transactions because they did not involve the IRAs themselves, but rather the guaranties were for the benefit of FP Company, an entity owned by the IRAs.

In siding with the IRS, the Tax Court emphasized the broad "direct or indirect" language of the prohibited transaction definitions, citing a U.S. Supreme Court case. The Tax Court concluded that the guaranties in this case were prohibited indirect loans or extensions of credit between disqualified persons, the taxpayers, and their respective IRAs in two senses: (1) a person who guaranties repayment of a loan extended by a third party to a debtor is indirectly extending credit to the debtor, so the personal guaranties by the taxpayers in this case were extensions of credit, and (2) these were prohibited extensions of credit indirectly to their respective IRAs by way of the entity owned by the IRAs, FP Company. The Court reasoned that a prohibition only on a loan between a disqualified person and an IRA could be "easily and abusively avoided simply by having the IRA create a shell subsidiary" which would be an "obvious evasion" of the intent of Congress.

Consequences of Prohibited Transactions

If (a) the accounts in this case had continued to qualify as Roth IRAs, and (b) only § 408A "qualified distributions" were made from the Roth IRAs, the gains realized by the taxpayers from the sale of FP Company would never have been taxed to the taxpayers.

However, since the loan guaranties, which constituted prohibited transactions between the IRAs and disqualified persons who were beneficiaries of the IRAs, were made in 2001, the accounts holding the stock of FP Company ceased to be IRAs in 2001, and the stock was deemed to be distributed in 2001 to the taxpayers. As a result, the stock of FP Company was treated as owned by the taxpayers personally. Consequently, the taxpayers were liable for tax on the capital gains realized in 2006 and 2007 from the sale of the FP Company stock.

The IRS did not, in this case, assert deficiencies for 2001, when the prohibited transactions occurred. As discussed above, in general, the taxpayers would have been required to recognize as taxable ordinary income in 2001 the fair market value of all the FP Company stock held in their disqualified IRAs. The Tax Court opinion does not discuss this point in detail. The IRS may not have pursued this issue because the statute of limitations had run for assessments on those deficiencies by the time the IRS issued its notices of deficiency to the taxpayers in December 2010.

Additional Potential Prohibited Transactions

Notably, the Tax Court mentioned that, in addition to the prohibited transactions described above, the IRS contended that the IRA / FP Company arrangements resulted in additional prohibited transactions: (1) FP Company's payment of wages to the taxpayers (in violation of § 4975(c)(1)(D), which prohibits a transfer of plan assets to, or use of plan assets by or for the benefit of, a disqualified person), and (2) FP Company's payment of rent to an entity owned by the wives of the taxpayers (in violation of § 4975(c)(1)(E), which essentially prohibits self-dealing by a plan fiduciary). Because the tax court held that the loan guaranties were prohibited transactions, it did not reach these additional prohibited transaction questions.

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Observations

This case illustrates that where a self-directed IRA or its assets are directly or indirectly involved in a transaction with, or which may benefit, the IRA beneficiary (other than benefiting strictly as the beneficiary of the IRA (i.e., benefiting from the accumulation of assets in the IRA for future distribution)), any such transactions need to be carefully and fully analyzed to identify any direct or indirect prohibited transactions. These concerns are heightened by the complexity and breadth of the prohibited transaction rules and potential for indirect prohibited transactions such as the ones in this case.

The additional potential prohibited transactions raised by the IRS, mentioned above, illustrate the breadth of the prohibited transaction rules. The employment and compensation, even in the ordinary course, of the beneficiary of a self-directed IRA by a company in which the IRA has a significant ownership interest may be viewed as an indirect transfer of IRA assets to a disqualified person or a conflict of interest prohibited transaction. Also, any family member (defined to include, among others, spouses and children) of a disqualified person is also considered to be a disqualified person. So, for example, the leasing of property by the taxpayer's wife in this case (or an entity in which she had a significant interest) to FP Company may be a prohibited transaction.

The facts of this case could have resulted in additional prohibited transactions that were not mentioned in the Tax Court opinion. Section 4975(e) incorporates the constructive ownership rules of § 267(c), which provide, in relevant part, that interests owned directly or indirectly by or for a trust are considered as being owned proportionately by or for the trust's beneficiaries. Under these constructive ownership rules, each of the taxpayers in this case would be considered to own all of the FP Company stock owned by his IRA if the IRA is considered to be a trust of which the taxpayer is the sole beneficiary. If so considered, after investment by the IRA in 50% of the stock of FP Company, FP Company itself would be a disqualified person with respect to the IRA because it would be considered to be 50% or more owned by the taxpayer, a fiduciary and therefore a disqualified person with respect to his IRA. § 4975(e)(2)(G)(i); see Swanson v. Comm'r, 106 T.C. 76 (1996). In those circumstances, certain otherwise ordinary and permissible transactions between the IRA and FP Company may be prohibited transactions, e.g., any additional investment by the IRA in FP Company and any dividends or redemptions paid by FP Company to the IRA may be considered prohibited sales or exchanges between a plan and a disqualified person or a transfer of plan assets to, or use of plan assets by or for the benefit of, a disqualified person.

Mark Hamilton *counsels clients on employee benefits and compensation matters, including those arising in mergers and acquisitions, financing arrangements and other types of corporate transactions. He provides counsel regarding stock-based compensation arrangements, employment agreements, change-in-control agreements and all other executive compensation arrangements. His practice includes tax matters, such as Code Section 280G golden parachute issues, performance-based compensation compliance under Code Section 162(m) and the design of deferred compensation plans.*

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