Prohibited IRA Transactions & the Tax Court Ruling in Peek v. Commissioner

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Brief Overview of IRAs

- Individual Retirement Arrangements were introduced by the enactment of ERISA in 1974. These accounts were initially limited to cover employees not covered by an employer's qualified plan.
- In 1981, the Economic Recovery Tax Act (ERTA) allowed all taxpayers under age 701/2 to contribute to an IRA.
- The maximum annual standard contribution to an IRA is $5,500 for 2015
- By design, the laws favoring these accounts promote an employee saving for retirement.
- IRS Publication 590 covers these accounts in greater detail.
- Accounts governed by IRC § 408

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Income Tax Aspects of IRAs

- Generally, the taxpayer can deduct the full amount of the contribution.
  - However, if the taxpayer is also covered by a retirement plan at work, then the taxpayer may only deduct the full amount if her AGI (for 2015) is $61,000 or less. No deduction is allowed if AGI is above $71,000 for a single taxpayer.
- Generally, amounts in an IRA (including earnings and gains) are not taxed until distributed. And in some cases, amounts are not taxed at all if distributed according to the rules.
- Because of the tax-favored treatment of IRAs, it is estimated that as of 2011, 43 million taxpayers had IRAs with total reported market value of $5.2 trillion. Of that number, only about 600,000 taxpayers had accounts in excess of $1M. (GAO-14-878T; published Sep 16, 2014).

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Key Concepts with IRAs

- An IRA is just an account 'wrapper'.
- If you follow the rules and keep the 'wrapper' in place, you will reap the tax advantages.
- If you do not follow the rules, then the 'wrapper' goes away, and you are deemed to have taken a distribution from the IRA beginning in the year in which the account was no longer an IRA.
- IRA rules dictate how much a taxpayer can contribute, when distributions can be made, and in what amounts.
- IRA rules also dictate what the IRA can invest in.
  - For example, if an IRA invests in collectibles (*e.g.* Artwork, Antiques, Stamps, certain Coins, etc.) it is deemed to have made a distribution of the amount of the collectible in the year acquired. §408(m)

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Prohibited Transactions

- IRC § 4975 imposes a tax on certain prohibited transactions with respect to IRAs.
- Prohibited Transactions are explicitly defined as any direct or indirect
  1. Sale or exchange, or leasing, of any property between a plan and a disqualified person;
  2. Lending or money or other extension of credit between a plan and a disqualified person;
  3. Furnishing of good, services, or facilities between a plan and a disqualified person;
  4. Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;
  5. Act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account; or
  6. Receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving income or assets of the plan.

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Who is a Disqualified Person

- IRC § 4975(e) defines "disqualified person"
- The Tax Court has held the owner of an IRA account to be a "disqualified person"
- In addition, persons of certain familial descent are also disqualified persons. (*e.g.* Parents, Children (& Children-in-law), Grandchildren (& Grandchildren-in-law)
- Note however that Siblings, Nieces, Nephews, Aunts, Uncles, & Cousins are NOT disqualified persons.

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Effect of Prohibited Transaction on IRA

IRC § 408(e)(2). **Loss of exemption of account where employee engages in prohibited transaction**.

(A) In general. If, during any taxable year of the individual for whose benefit any individual retirement account is established, that individual or his beneficiary engages in any transaction prohibited by section 4975 with respect to such account, **such account ceases to be an individual retirement account as of the first day of such taxable year**. For purposes of this paragraph--

(i) the individual for whose benefit any account was established is treated as the creator of such account, and

(ii) the separate account for any individual within an individual retirement account maintained by an employer or association of employees is treated as a separate individual retirement account.

(B) Account treated as distributing all its assets. In any case in which any account ceases to be an individual retirement account by reason of subparagraph (A) as of the first day of any taxable year, paragraph (1) of subsection (d) **applies as if there were a distribution on such first day in an amount equal to the fair market value (on such first day) of all assets in the account (on such first day)**.

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Self-Directed IRAs

- Just because IRAs are prohibited from investing in collectibles and life insurance, doesn't mean that an IRA has to invest in all other types of investments.
- Traditional IRA plans invest in securities. The plan can impose stricter guidelines than the code.
- Example: What about a taxpayer wanting to invest in real estate?
  - Neither the IRA owner nor any disqualified person to the IRA owner may live in or use the property.
  - The owner cannot work on the property. Any remodeling, repair, improvement, and even maintenance must be performed by a paid third-party company at market rate.
  - Your IRA cannot purchase a property from you or any disqualified person. Similarly, you (or a disqualified person) cannot sell the IRA's property to yourself.
  - Neither you nor a disqualified person can guarantee a loan for an IRA property.
- Acts that are considered self-dealing are not allowed as part of the prohibited transaction rules.

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Peek v. Commissioner, 140 T.C. 216

The Key Facts:

- In 2001, Fleck wanted to buy a business that specialized in fire suppression and alarm systems known as AFS. AFS was a very promising business.
- AFS was offered for sale through a brokerage firm, and Fleck contacted the firm and also sought a partner, eventually settling on his attorney, Mr. Peek, to join him in the deal. Fleck and Peek are collectively known as the taxpayers.
- The brokerage firm introduced them to an accountant who structured the deal for them. The structure was this:
  - The taxpayers each set up a self-directed IRA and funded those IRAs with a rollover contribution from an existing IRA or 401(k).
  - The taxpayers created a new corporation (New Corp.) and then sold that corporation to their respective IRAs.
  - New Corp then purchased AFS.

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Peek (Cont.)

- When the taxpayers implemented the plan, they purchased AFS through New Corp. for $1.1M. As part of the consideration, they signed a promissory note secured by personal guarantees from both taxpayers pledging their personal residences as collateral.
- In 2006, they sold the business for around $3.4M.
- The IRS audited their returns for 2006 and adjusted their income to account for the gain. The IRS assessed about $250,000 in additional taxes to each taxpayer in addition to $50,000 each in accuracy-related penalties.
- Taxpayers contested and filed suit in Tax Court.

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Peek (cont.)

- The IRS argued that both taxpayers engaged in a prohibited transaction in 2001 when they executed personal guarantees as part of the purchase of AFS.
- The IRS contended that the IRA 'wrapper' was removed as of January 1, 2001. There was no audit for 2001 because the statute of limitations had elapsed.
- Therefore, when the business was sold in 2006, they realized that gain themselves, and the gain was not sheltered from tax by way of their IRA.
- The taxpayers argued that they did not lend money to their IRA, but rather a company that their IRA owned.
- They further argued that the accuracy-related penalties should not count because they relied on the advice of a CPA and acted in good faith.

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Peek (concluded)

- The Tax Court sided with the IRS and held that the taxpayers *indirectly* lent money to their IRA, which was prohibited by IRC 4975. Furthermore, in upholding the accuracy-related penalties, the court found that the CPA was an agent of the brokerage firm and not "a disinterested professional but rather an active promoter".

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