I CAN'T AFFORD IT BUT MY IRA CAN!

USING IRA ASSETS TO START A BUSINESS

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IRA cannot invest in:

- Life insurance contracts on IRA owner
- Collectibles (coins, artwork, stamps, classic cars, alcoholic beverages, antiques, etc.)
- S corporation stock
  - S stock is not prohibited under IRA rules, but IRA is not permissible S corp stockholder

IRA can invest in:

- Real estate (sole ownership or tenancy in common)
- Privately-held C corp stock
- LLC membership interests
- Limited partnership interests

But my IRA company tells me they can't invest in business assets ??

- Most IRA sponsors not set up to deal with IRA investments in business assets
- Need to find IRA custodian specializing in "self-directed IRAs"
  - Systems in place to deal with purchase and administration of alternative assets
- Pensco Trust Company, American IRA LLC, many others

Reasons Why Investors Choose to use IRA Assets to start a Business

- Frustration with low returns and volatility of traditional securities investments
- Ability to flip investments or compound returns on tax-deferred or tax-free basis
- That's where the money is!

Reasons not to use IRA Assets to start a Business

- For traditional (non-Roth) IRA
  - Eventual tax on capital appreciation at ordinary income tax rates
  - Income in respect of decedent – loss of step-up in basis
  - Problems with required minimum distributions
- Compliance with special tax laws.
  - Prohibited transaction rules
  - Unrelated business taxable income
- Greater potential for problems
  - Lack of awareness of limitations
  - Temptation to overlook limitations

Two Ways to Buy/Start Business with IRA that we'll cover

- "Checkbook control" IRA-owned LLC
- "ROBS" – Rollovers as Business Start-Ups
- First we need to understand:
  - Prohibit transaction rules
  - Unrelated business taxable income consequences

I. PROHIBITED TRANSACTION RULES

- Section 4975 of IRC prohibits certain transactions between IRA and "disqualified person" (DQP)
- Purpose: To encourage use of IRAs for accumulation of retirement savings and prohibit those in control of IRAs from taking advantage of tax benefits for their current personal benefit

PROHIBITED TRANSACTION RULES

- If IRA violates PT rules, it ceases to be IRA (IRC 408(e)(2))
  - IRA is deemed distributed, resulting in taxable income in year of transaction
  - 10% penalty if not age 59-1/2

Under IRC 4975, "Disqualified Person" Means

- The account owner - YOU
- Your spouse
- Your parents and grandparents
- Your children and grandchildren
- Spouses of your children and grandchildren (but not parents-in-law)
- Your IRA trustee or custodian

Under IRC 4975, "Disqualified Person" Means

- An entity more than 50% owned by any combination of foregoing
- A 10% owner, officer, director, or highly compensated employee of such entity
- A trust if 50% or more of beneficial interests are owned by DQPs
- Any person providing services to IRA (i.e., CPA preparing IRA tax return)
- Brothers, sisters, aunts, uncles, and cousins are NOT disqualified persons

Types of Prohibited Transactions under IRC 4975

There are 2 unofficial categories:

- Direct PTs
- Personal benefit/conflict of interest PTs

Direct Prohibited Transactions

IRC section 4975 prohibits:

- Sale, exchange, or leasing of property between IRA and DQP
- Lending of money or other extension of credit between IRA and DQP
- Furnishing of goods, services, or facilities between IRA and DQP
- Transfer to or use by DQP of income or assets of IRA (other than regular taxable distributions)

- Examples:
  - Sue sells interest in real estate owned by her IRA to son
  - Steve's spouse personally guarantees loan to his IRA by bank
  - John sells or leases real estate owned by his IRA to LLC owned 25% by John, 24% by his wife, and 10% by his father
  - Paul causes his IRA to buy beach rental house and uses it personally two weeks a year
  - IRA owns 100% of LLC and sells 10% interest to unrelated manager of LLC
  - Jill owns rental house in her IRA. House goes vacant for 2 months and, since IRA doesn't have cash to pay expenses, Jill pays expenses while house is vacant. She intends to reimburse herself from IRA once tenant is located.

Personal Benefit Prohibited Transactions

IRC section 4975 also prohibits:

- Indirect use of IRA income or assets for personal benefit of DQP
- Receipt of any consideration by DQP who is a fiduciary for his own account from any party dealing with IRA in connection with transaction involving income or assets of IRA

Examples:

- Purchase of LLC interest requires $100,000 minimum investment. Steve can't afford to invest with non-IRA assets, so invests $25,000 individually and $75,000 from IRA.
- Ben manages restaurants and wants to use his IRA to buy 10% interest in new restaurant LLC, with understanding he will manage restaurant for a fee

Prohibited Transactions – Plan Assets Rules

- Plan Asset Regulations; 29 CFR 2510 3-101
  - Plan asset rules apply to IRAs – ERISA Op Ltrs. 2000-10A, 2006-01A
  - If 100% of "operating company" is owned by one or more IRAs and DQPs, assets of company are deemed IRA assets
  - If 25% or more of "investment company" is owned by one or more IRAs and DQPs, assets of company are deemed IRA assets
  - In determining whether thresholds are met, **all** IRAs are considered, even if owned by unrelated individuals

- "Operating company" is entity engaged in production or sale of product or service other than investment of capital.
  - » Includes a "real estate operating company", where at least 50% of assets are invested in real estate which is managed or developed; company has right to substantially participate directly in management or development activities; and company in ordinary course of its business engages directly in such activities
  - » Includes "venture capital operating company" investing at least 50% of its assets in venture capital investments or derivative investments and exercising management rights with respect to one or more operating companies in which it invests.

Consequence of being under plan asset rules

- All assets of entity deemed owned by IRA
- Transaction between entity and DQP can be PT
- Examples:
  - Laura's IRA owns 100% of Alpha, LLC. Alpha makes loan to Laura's son. Loan is direct PT, since loan is deemed made by IRA.
  - Ben's IRA owns 100% of Delta, LLC Jerry is general manager of Delta. Ben and Jerry are unrelated. Ben's IRA is deemed to own assets of Delta, and Jerry is deemed to be fiduciary of Ben's IRA Loan or sale of asset by Delta to Jerry is direct PT.

II. Unrelated Business or Debt Financed Income

In addition to PTs, self-directed IRAs have another minefield to navigate:

- Unrelated business income tax (UBIT)
- Unrelated debt financed income (UDFI)

Unrelated Business Income Tax

- IRAs and plans (as well as charities and other non-profit entities) are subject to UBIT rules
- Rationale is that exempt organizations should not receive tax break for business activities not substantially related to performance of exempt purpose
- Net unrelated business income generated by IRA is generally subject to current taxation under IRC Section 511 at trust income tax rates
- IRA owner must report on Form 990-T.
- UBIT is taxed twice -- when earned and when distributed (no tax basis for previously taxed UBIT)

- Examples:
  - Net income from operation of restaurant owned by IRA
  - Net income from sale of products by company owned by IRA
- To apply, business must be operated in form of pass-through entity such as LLC or limited partnership owned by IRA
- Doesn't apply to IRA-owned C corporation

- Exceptions to UBIT:
  - First $1,000 of net income
  - Dividends and interest
  - Royalties
  - Rents from real estate (unless based on percentage of tenant's profits)
  - Gains from sale or exchange of property (except inventory)

❖ Due to exceptions for rents and sale proceeds, UBIT often is not a problem in IRA real estate transactions

❖ See IRS Publication 598 on UBIT

Unrelated Debt Financed Income (UDFI)

- Net income generated from debt financed property is subject to UDFI even if it would not be subject to UBIT
  - Applies to dividends, interest, royalties, rents
  - Applies to gain from sale or exchange of property

UDFI is calculated on pro rata basis, in proportion to current balance of acquisition indebtedness incurred to purchase the property:

Net Income from property during tax year (determined using straight-line depreciation)

TIMES

$$\frac{\textbf{Average acquisition indebtedness during tax year}}{\textbf{Average adjusted basis during tax year}}$$

UDFI is calculated at trust tax rates, except for capital gains rates on sale of property

III. "Checkbook Control" IRA-owned LLC

- Compare traditional self-directed IRA investment:
  - Ben Smith opens self-directed IRA account at Pensco Trust
  - Ben rolls over traditional IRA funds to new self-directed IRA
  - Ben directs Pensco to purchase apartment building
  - Pensco receives deed in name of Pensco Trust fbo Ben Smith IRA
  - Purchase price paid by Ben's IRA
  - All rent checks sent to Ben's IRA All on-going expenses paid by Ben's IRA

"Checkbook Control" IRA-owned LLC

- Ben opens self-directed IRA account at Pensco. Rolls over traditional IRA $ into Pensco IRA.
- Ben locates attorney to create LLC named Ben Smith Investments, LLC
- LLC Operating Agreement names Ben's Pensco IRA as sole member and Ben as manager of LLC
- Ben sets up LLC checking acct and has signature authority as manager
- Ben directs Pensco to capitalize LLC with IRA $ in exchange for 100% membership interest. Pensco's check for IRA $ is deposited in checking acct.
- LLC signs purchase agreement and closes apartment deal
- LLC takes title to property
- Ben writes all expense checks and deposits rents into checking acct
- Ben sends cash flow to Pensco

"Checkbook Control" IRA-owned LLC

- Potential pitfalls:
  - Ben pays attorney fees personally
  - Ben pays management fee to himself or member of family
  - Ben makes loan from LLC to his father
  - Ben rents one of apartments to his son, or allows son to live there rent-free
  - Ben owns 51% of management corp and hires it to perform leasing services What if he just owns 25%?
  - Ben guarantees bank loan to LLC used to buy apartment building
  - Ben finances 70% of purchase price with non-recourse bank loan and sells apartment building 5 years later for 2X amount paid

Legal Support for IRA-owned entities

- Swanson v. Commissioner
- IRS Field Service Advisory 200128011
- ERISA Opinion Letter 2006-01A
- Peek v. Commissioner (2013)
- Ellis v. Commissioner (2013)

- Swanson v. Commissioner, 106 T C 76 (1996):
  - Important case allowing IRAs to create and invest in entities – father of "checkbook control" LLC.
  - Mr. Swanson caused his IRAs to form and own two corporations. He was director of each but never owned any stock himself
  - Tax Court held that **initial formation and capitalization** of company by IRA is not a PT – a newly-formed, uncapitalized entity is not a DQP until the equity interests are initially issued
  - Court held that **receipt of dividends** by IRA from company was not PT, since this is "settlor function".
  - Court held that Swanson's performance of **management functions**, as director of the corporations, was not a PT.

- Example
  - John creates new entity initially owned 50% by his IRA, 25% by John, and 25% by John's son
  - Each capitalizes entity proportionately
  - Creation and capitalization of entity should not be PT in light of *Swanson*
  - Subsequent dealings must be closely scrutinized. Potential to cross the line in subsequent transactions is substantial
  - However, mere payment of dividends and participation in basic management functions without compensation should be permissible under *Swanson*
  - *Swanson* dealt with corporations wholly-owned by IRAs, and doesn't expressly approve joint formation of entity by IRA and DQPs

- IRS Field Service Advisory 200128011
  - Dad owned majority of S corp. His 3 children owned remaining shares.
  - Dad and each child created self-directed IRAs. Each IRA acquired 25% of foreign sales corp (FSC)
  - S corp entered into commission agreement with FSC
  - IRS advised that, based on *Swanson*, neither issuance of stock in FSC to IRAs nor payment of dividends by FSC to IRAs constituted direct PT
  - IRS warned that, based on facts, transaction could be indirect PT benefiting IRA owners
  - Note that FSC was jointly created by IRAs formed by related DQPs

- ERISA Opinion Ltr 2006-01A

- Berry owned 64% of S Corp; Learned (unrelated) owned 32%. Payne was controller of S Corp.
- Proposed transaction: Form LLC owned 49% by Berry's IRA, 31% by Payne's IRA, 20% by Learned LLC would buy real estate and lease to S Corp.
- Who are DQPs as to Berry's IRA? [Answer Berry, S Corp, Learned (10% owner of S Corp), Payne (officer of S Corp)]
- DOL didn't have problem with joint formation of LLC by DQPs of Berry's IRA for investment in real estate
- But, DOL held LLC was DQP also and lease to S Corp would be direct PT
- DOL also held, even if LLC was not DQP, it would be indirect PT due to personal benefit to Berry

- Peek v. Commissioner, 140 TC 12 (2013)

- Peek and Fleck each formed self-directed IRA. Also formed corporation called FP Company.
- Each IRA bought 50% of FP. Then, FP bought assets of alarm and fire protection business.
- Peek and Fleck named officers and directors of FP
- As part of purchase price, FP gave $200K note to seller. Peek and Fleck personally guaranteed note.
- Thereafter, FP paid wages to Peek and Fleck. It also paid rent to entity owned by Mrs. Peek and Mrs. Fleck.

- Peek v. Commissioner, 140 TC 12 (2013)

- IRS did not challenge formation and capitalization of FP by IRAs
- IRS claimed loan guaranties by Peek and Fleck, wages, and rent were all PTs
- Tax Court held guaranties were indirect lending of money or extension of credit between IRAs and DQPs (Peek & Fleck)
- IRAs disqualified in year of transaction resulting in tax on entire IRA balances
- Court did not consider IRS' other two PT allegations
- Peck and Fleck should have considered ROBS structure

- Ellis v. Commissioner, TC Memo 2013-245
  - Ellis, a used car salesman, formed CST, LLC Elected to be taxed as C corp.
  - Operating agreement, signed 5/25/05, named First Trust Co. fbo Ellis IRA as 98% member
  - On 6/7/05, Ellis formed self-directed IRA with First Trust
  - Rolled over $254K to IRA, then caused IRA to contribute $254K to CST
  - 2 months later, rolled over $67K to IRA and contributed $65K to CST IRA received single membership cert for 98%
  - CST paid comp to Ellis as general manager of CST

- Ellis v. Commissioner, TC Memo 2013-245

- Ellis also formed CDJ, LLC owned 50% by Ellis and 12 5% each by Ellis and his 3 kids
- CDJ bought real estate and leased it to CST
- IRS argued initial acquisition of 98% of CST was PT
- Tax court, citing *Swanson*, held CST was not DQP at time of formation since it then had no outstanding ownership interests. Therefore, initial payment for 98% was not PT
- IRS also argued other transactions were prohibited
- Tax court held payment of comp to Ellis was indirect PT as (a) use of IRA assets for own personal benefit and (b) transaction by fiduciary in his own interest

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- Ellis v. Commissioner, TC Memo 2013-245

- Ellis' mistakes:
  - Operating agmt naming IRA as member before IRA created
  - 2nd $65K contribution 2 months after first
    - CST becomes DQP upon initial capitalization!
  - Payment of comp to Ellis as general manager
  - Lease with CDJ
    - CDJ clearly was DQP
  - Ellis less than 59-1/2. IRA assets taxed at ordinary income tax rates plus 10% in year of transaction!

IV. Rollovers as Business Start-Ups (ROBS) – A Better Option?

- Steve was recently laid off. Has $500,000 rollover IRA. Wants to use IRA to buy franchise and start his own business. Steve will be President and draw his livelihood from the business.
- If Steve's IRA creates entity that buys franchise and employs Steve, this is direct and/or indirect PT
- Is there another structure that will work for Steve?

ROBS – A Better Option?

- Under a ROBS arrangement:
  - Steve incorporates new C corp
  - As initial director, Steve causes C corp to adopt 401(k) plan Steve is named as Trustee and hired as President
  - Plan states that 100% of its assets can be invested in employer stock.
  - Steve rolls over his $500,000 IRA to his account in 401(k) plan
  - 401(k) plan buys 100% interest in C corp in Steve's account in exchange for $500,000
  - C corp uses new capital to buy franchise, hire employees, and start business
  - Steve and other employees thereafter participate in plan and make traditional investments with their deferrals

Why Does This Work?

- ERISA 406 says, except as allowed by Sec. 408, plan is prohibited from acquiring employer securities
- ERISA 408(e) says that 406 doesn't apply to "eligible individual account plan" such as 401(k) plan ("EIAP") buying "qualifying employer securities" ("QES")
- QES defined as stock in corp
- EIAP can invest up to 100% of its assets in QES if plan so provides (ERISA 407)
- Under IRC 4975(d)(13), purchase of QES by EIAP is <u>exempt from PT rules</u>
- Under DOL Reg. 2510.3-101(h)(3), plan asset look-thru rules don't apply to QES owned by EIAP

IRS Scrutiny of ROBS

- 10/1/08 internal memo from IRS Director of Employee Plans to plan audit and rulings divisions
- "ROBS" – "Guidelines regarding Rollovers as Business Start-Ups"
- IRS director acknowledged technical justification but educated agents on common deficiencies and ways to attack plans
- But, memo legitimized properly structured ROBS plan and provided road map for how to comply
- Still, IRS will highly scrutinize these transactions

IRS Scrutiny of ROBS

- Areas of IRS inquiry:
  - Plan operation
  - Plan permanence
  - Adequate consideration paid for stock
  - Discriminatory right, benefit or feature

• Plan Operation

- Critical for plan to be documented and administered correctly
- Use of third party administrator is essential
- Third party appraisals of company stock in plan should be obtained annually

• Plan Permanence

- Must be on-going, bona fide retirement plan
- Can't make initial rollover to purchase company stock without commitment to make regular plan contributions
- Frequently designed as 401(k) plan without matching or other employer contribution features
  - Critical for client to receive some salary and make regular 401(k) deferrals
  - Other employees must have 401(k) deferral opportunity

• Adequate Consideration

- To qualify for PT exemption, adequate, FMV consideration must be paid
- At initial start-up where, after stock subscription, only asset of corp is cash, no appraisal should be required
  - IRS may ask for appraisal, however
- If ROBs plan established for operating business, current third party appraisal is essential

• No Discrimination

- Plan may not discriminate in favor of HCEs as to right, benefit or feature
  - Includes right to participate in company stock offering
- If there are other employees at time stock is bought by plan, plan could be disqualified if right to participate in stock offering not available to all
- However, discrimination rules don't apply to plan that has no HCEs.
  - If 401(k) plan buys 100% of stock offering at initial start-up, there may be no HCEs

Thoughts and Rules of Thumb

- Advise client not to engage in ROBS plan unless no other alternative exists
  - Clients inevitably mess these up
  - Many don't survive resulting in loss of retirement assets
- Entity must be C corp
  - Interest in LLC not recognized as QES under PT exemption rules
  - S corp can't have 401(k) plan as stockholder, plus allocation of profits on K-1 would be UBIT
- 401(k) plan must permit (a) participant-directed investments and (b) investment of 100% of plan assets in employer stock

Thoughts and Rules of Thumb

- Client should sign written investment direction to plan trustee
- If initial start-up, client's 401(k) account should subscribe to <u>all</u> stock authorized in corporate charter
- If plan adopted in existing company with employees:
  - Bona fide third party appraisal is essential
  - Stock offering must be available to all employees
- Plan must operate as bona fide, on-going retirement plan, with regular contributions
  - Designing plan as 401(k) deferral-only plan without other company contributions is typically preferred

Thoughts and Rules of Thumb

- Insist that client use third party administrator
- 401(k)-owned businesses I've set up:
  - Independent software sales rep
  - Bakery
  - Sleep diagnostics lab
  - Security systems
  - Real estate investments
  - Flavored water system sales
- Cost of implementation - $5,000 to $7,500

AMERICAN IRA
Self-Directed IRAs and 401Ks

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Self-Directed IRAs and 401Ks

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COMPANY PROFILE

American IRA is a *National Self-Directed IRA administrator* that offers administration of your **self-directed IRAs** and **self-directed Solo 401(k)s.** Since 2004, American IRA has been working hand in hand with financial industry professionals to help them deliver excellent service to their self-directed IRA clients.

CORPORATE PROFILE

- American IRA has $300 million in assets under administration.
- American IRA was established in 2004 by Jim Hitt, CEO.

PERFORMANCE RECOGNITION

- American IRA has employees recognized as Certified IRA Services Professionals (CISP) - a designation from the Institute of Certified Bankers (ICB).

OUR SCOPE

- American IRA is a National company with clients throughout the United States.

OUR EXPERIENCE

- American IRA officers are experienced investors who have invested in everything from single family homes to multi-million dollar commercial properties.
- American IRA CEO, Jim Hitt
  - Has taught investing techniques in North and South Carolina at UNC Asheville, AB Tech, and Lorman Educational Services
  - Is an experienced investor in the financing and acquisition of residential and commercial real estate, private offerings, mortgage lending, business's, joint ventures, partnerships, limited liability companies and more.
- American IRA, Senior Vice President, Sean McKay
  - Holds a B.A. Degree in Economics
  - Has been investing in residential rental properties and private lending for more than 10 years
  - Is an experienced IRA instructor teaching real estate professionals and investors for over 5 years

Jim Hitt

CEO of American IRA

Sean McKay

Senior Vice President

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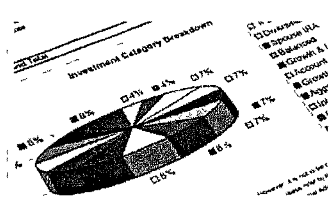

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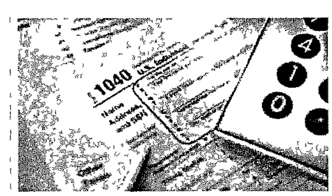

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Tax Court & Board of Tax Appeals Memorandum Decisions

Terry Ellis, et ux. v. Commissioner, TC Memo 2013-245 , Code Sec(s) 4975; 408; 72; 61.

TERRY L ELLIS AND SHEILA K ELLIS, Petitioners v COMMISSIONER OF INTERNAL REVENUE, Respondent

Case Information:

[pg 1983]

Code Sec(s):	4975, 408, 72, 61
Docket:	Dkt No 12960-11
Date Issued:	10/29/2013
Judge:	Opinion by Paris, *J*
Tax Year(s):	Years 2005, 2006
Disposition:	Decision for Taxpayers in part and for Commissioner in part

HEADNOTE

1. Prohibited transactions and IRAs—fiduciaries and disqualified persons. Taxpayer/general manager of used car business/LLC, which was held 98% by IRA to which taxpayer had transferred Code Sec 401(k) account balance, engaged in prohibited transaction under Code Sec 4975 when he caused corp to pay him compensation, resulting in deemed distribution and income inclusion under Code Sec 408 and Code Sec 72 (a) of entire account balance in stated year Argument that LLC was merely entity in which taxpayer's IRA invested and amounts LLC paid him represented its, not IRA's, income or assets was belied by facts that LLC was funded almost exclusively by IRA assets, which in turn consisted only of its ownership interest in LLC and relatively small amount of cash In effect, LLC and IRA were substantially same entity So, in causing LLC to pay him compensation, taxpayer, as IRA's fiduciary and beneficial shareholder of more than 50% of outstanding ownership interest in LLC, effectively engaged in transfer of plan income or assets for his own benefit in violation of Code Sec 4975(c)(1)(D) Moreover, in authorizing and effecting such transfer, he dealt with IRA income or assets for his own account within meaning of Code Sec 4975(c)(1)(E) However, prohibited transaction finding applied only to above and stated year and IRS's alternate determinations for subsequent year weren't upheld

Reference(s): ¶ 49,755 01(35) Code Sec 4975, Code Sec 408, Code Sec 72, Code Sec 61

2. 10% additional tax on early IRA distributions—deemed distributions. Code Sec 72(t) additional tax was upheld in respect to deemed IRA distribution taxpayer received as result of prohibited transaction at time he had not reached age 59 1/2

Reference(s). ¶ 725 19(37) Code Sec 72

3. Accuracy-related substantial understatement penalties—burden of proof and production—reasonable cause, good faith. Accuracy-related substantial understatement penalties were upheld against taxpayer and wife for year for which taxpayer engaged in prohibited transaction resulting in deemed IRA distribution IRS met its burden of production with evidence that understatement was substantial within meaning of Code Sec 6662(d), and no reasonable cause for same was shown

Reference(s): ¶ 66,625 01(3) ,¶ 74,915 03(10) Code Sec 6662, Code Sec 7491

Syllabus

Official Tax Court Syllabus

Counsel

Troy Renkenmeyer, for petitioners

Elizabeth Abigail Raines, for respondent

PARIS, *Judge*

MEMORANDUM OPINION

On March 28, 2011, respondent issued a notice of deficiency for tax years 2005 and 2006 to petitioners Terry L Ellis and Sheila K Ellis, taking alternative positions for these two tax years The notice determined a deficiency in petitioners' Federal income tax for tax year 2005 of $135,936 and an **[*2]** accuracy-related penalty under [pg 1984] section 6662(a) [1] of $27,187 In the alternative, the notice determined a deficiency in petitioners' Federal income tax for tax year 2006 of $133,067, an addition to tax under section 6651(a)(1) of $19,731, and an accuracy-related penalty under section 6662(a) of $26,613

Petitioners seek redetermination of the above-stated deficiencies, penalties, and additions to tax The issues for decision are

(1) whether petitioner Terry L Ellis participated in one or more prohibited transactions under section 4975 with his individual retirement account (IRA) in 2005 when he directed his IRA to invest in CST Investments, LLC (CST), pursuant to an arrangement or understanding whereby he was designated the general manager and would subsequently receive compensation and other benefits from that company,

(2) whether Mr Ellis participated in one or more prohibited transactions under section 4975 when he caused CST to pay him compensation of $9,754 in tax year 2005,

[*3] (3) whether Mr Ellis participated in one or more prohibited transactions under section 4975 when he caused CST to pay him compensation of $29,263 in tax year 2006,

(4) whether Mr Ellis participated in one or more prohibited transactions under section 4975 when he caused CST to pay rent to CDJ, LLC, an entity owned by petitioners and their children, in tax year 2006,

(5) whether petitioners received unreported retirement income as a result of Mr Ellis' participation in a prohibited transaction under section 4975 with his IRA in 2005, or, in the alternative, 2006,

(6) whether petitioners are liable for the 10% additional tax under section 72(t) for tax year 2005, or, in the alternative, 2006,

(7) whether petitioners are liable for the accuracy-related penalty under section 6662(a) for tax year 2005, or, in the alternative, 2006, and

(8) whether petitioners are liable for an addition to tax under section 6651(a)(1) for tax year 2006

Background

The parties submitted this case for decision fully stipulated under Rule 122(a) The stipulation of facts filed on June 12, 2012, is incorporated herein by this reference Petitioners resided in Missouri at the time their petition was filed

[*4] I. *Tax Year 2005*

A. *Formation of CST*

By 2005 petitioner Terry L Ellis had accumulated a sizable amount in his section 401(k) retirement plan account from his many years of service as an employee at Aventis Pharmaceuticals, Inc On or about April 19, 2005, Mr Ellis engaged the former law firm of petitioners' current counsel of record in this case to advise him regarding the restructuring of his investment holdings On May 25, 2005, the firm helped petitioners to organize CST, a Missouri limited liability company [2] The operating agreement of CST, also dated May 25, 2005, was signed by Mr Ellis on behalf of First Trust Co of Onaga FBO Terry Ellis IRA, an entity that did not yet exist The agreement listed the original members of CST to be First Trust Co of Onaga FBO Terry Ellis IRA, owning 980,000 membership units or 98% in exchange for an initial capital contribution of $319,500, and a member not a party to this action owning the remaining 20,000 membership units or 2% Mr Ellis also requested a Federal taxpayer identification number for CST on a Form SS-4, Application for Employer Identification Number, which was dated **[*5]** May 16, 2005 On June 2, 2005, a Federal tax identification number was assigned to CST

CST was formed to engage in the business of used vehicle sales It conducted its operations in Harrisonville, Missouri At all relevant times during tax years 2005 and 2006, Mr Ellis was the general manager of CST and, in addition, worked at the company in its used car business [3] [pg 1985]

On or about June 7, 2005, Mr Ellis submitted an application to establish an IRA with First Trust Co of Onaga (First Trust) On or about June 14, 2005, Mr Ellis, as general manager of CST, filed a Form 8832, Entity Classification Election, on behalf of CST, in which it elected to be treated as an association taxable as a corporation [4]

On or about June 22, 2005, Mr Ellis received a distribution of $254,206 44 from the section 401(k) account he had accumulated with his former employer, liability company and its members shall be classified and treated on a basis consistent with the limited liability company's classification for Federal income tax purposes **[*6]** Aventis Pharmaceuticals [5] Mr Ellis took the distribution check from his section 401(k) account and deposited the entire $254,206 44 into his newly opened IRA [6] On or about June 23, 2005, Mr Ellis caused his IRA to acquire 779,141 membership units of CST in exchange for a cash payment of $254,000 from the IRA to CST [7]

On or about August 19, 2005, Mr Ellis received a second distribution of $67,138 81 from the section 401(k) account he had accumulated at Aventis Pharmaceuticals [8] [9] As with the first distribution check, Mr Ellis deposited the entire $67,138 81 into his IRA On or about August 23, 2005, Mr Ellis caused his IRA to acquire 200,859 membership units of CST, in exchange for a payment of **[*7]** $65,500 from the IRA to CST [10] Following the completion of the $319,500 capital contribution, a single membership certificate for 980,000 units was issued to First Trust FBO Terry Ellis IRA on June 23, 2005

On or about November 28, 2005, First Trust, the custodian of Mr Ellis' IRA, requested a current estimate of the fair market value of the IRA's membership interest in CST On December 20, 2005, Mr Ellis provided a current valuation of CST to the IRA custodian Subsequently, on or about June 20, 2006, First Trust issued to Mr Ellis and to respondent a Form 5498, IRA Contribution Information, for tax year 2005 reflecting a fair market value of the IRA account of $321,253 This amount consisted of $319,480 of value in the 98% interest in CST and the remaining cash balance of $1,773 [11]

During tax year 2005 CST paid Mr Ellis $9,754 as compensation for his role as general manager of CST CST made these payments through checks issued from its corporate checking account, and not from the custodial account of Mr Ellis' IRA On or before March 15, 2006, CST filed a Form 1120, U S Corporation Income Tax Return, for tax year 2005 CST claimed a deduction from **[*8]** corporate income for compensation paid to corporate officers, which consisted only of the $9,754 paid to Mr Ellis [12] In addition to what appears to be normal operating expenses, CST also listed additional deductions of $12,106 for payroll expenses, $5,462 for bank service charges, and $8,910 for legal fees [13]

B. *Formation of CDJ, LLC*

On or about June 24, 2005, petitioners' counsel's former firm also organized CDJ, LLC (CDJ), a Missouri limited liability company, on behalf of Mr Ellis From that [pg 1986] point to the date the parties executed the stipulation of facts, the members of CDJ were Terry L Ellis (50%), Sheila Ellis (12 5%), and their three children Christopher Ellis (12 5%), Douglas Ellis (12 5%), and Jamie Ellis (12 5%) CDJ did not file a Form 8832 and did not otherwise elect to be classified as an association taxable as a corporation *** payable upon the investment by your IRA into the corporation "

[*9] The purpose of CDJ was to acquire investment property and to rent such property through the issuance of commercial leases On December 28, 2005, CDJ acquired title to a parcel of real property at 23621 S State Route 291, Harrisonville, Missouri (Harrisonville parcel) The purchase price for the Harrisonville parcel was $142,000 CDJ paid $12,000 down and obtained a mortgage for the balance of $130,000 from the Bank of Lee's Summit

On or before April 15, 2006, a Form 1065, U S Return of Partnership Income, was filed on behalf of CDJ for tax year 2005 This return reported neither gross income nor receipts but did report expense deductions of $3,598, resulting in a reported net loss of $3,598

C. *Petitioners' 2005 Return*

On or about May 6, 2006, petitioners filed their joint Federal income tax return for tax year 2005 Petitioners reported total income of $75,270, consisting of wages of $76,046, [14] taxable refunds of State and local income taxes of $1,473, and a loss on Schedule E, Supplemental Income and Loss, from CDJ of $2,249 [15]

[*10] On the return, petitioners also reported pension distributions of $321,266 but did not report any portion of these distributions as taxable Accordingly, petitioners reported their gross income as $77,519 for tax year 2005 Petitioners did not report that Mr Ellis' IRA purchased a total of 980,000 membership units of CST in tax year 2005 Petitioners likewise did not disclose that CST, an entity that had paid compensation to Mr Ellis in 2005, was thus owned primarily by his IRA

II. *Tax Year 2006*

A. *CST and CDJ Operations*

On January 1, 2006, CST entered into an agreement to lease the Harrisonville parcel from CDJ from January 1, 2006, to January 1, 2016 CST used this real estate to operate its used car business Throughout tax year 2006 CST made monthly rent payments to CDJ for use of the Harrisonville parcel as it operated its used car business These rent payments totaled $21,800 for tax year 2006

Also during tax year 2006 CST paid $29,263 of compensation to Mr Ellis for his role as general manager of CST in operation of its used car business Both **[*11]** the rent payments to CDJ and the compensation payments to Mr Ellis were made from CST's corporate checking account and not from the custodial account of Mr Ellis' IRA

On or before July 6, 2007, CST filed its corporate income tax return for tax year 2006 On this return CST claimed a deduction from corporate income for compensation paid to corporate officers, consisting only of the $29,263 paid to Mr Ellis On or before the same date, a partnership information return was filed on behalf of CDJ for tax year 2006 The first page of this return reported zero income and claimed zero deductions However, the form later reported net rental income from real estate of $830, subject to the following allocation to the members of CDJ $414 to Terry Ellis, $104 to Sheila Ellis, and $104 each to petitioners' three children, Christopher, Douglas, and Jamie

B. *Petitioners' 2006 Return*

On or about July 6, 2007, petitioners filed their joint Federal income tax return for tax year 2006 Petitioners did not, before April 15, 2007, file a request for extension of time to file Petitioners reported their total income to be $72,705 for tax year 2006 Petitioners reported that Mr Ellis had wage income from CST of $29,263, while Mrs Ellis had wage income from an unrelated employer of $41,967 Petitioners also reported that they [pg 1987] had taxable refunds of State and local **[*12]** income taxes of $863, pension income to Mr Ellis from T Rowe Price of $93, [16] and Schedule E income from CDJ of $519 [17]

Petitioners did not report any pension income other than the $93 from T Rowe Price Petitioners again did not disclose that CST, an entity that had paid compensation to Mr Ellis in 2005, was owned primarily by his IRA

III. *The Notice of Deficiency*

On March 28, 2011, respondent issued to petitioners a notice of deficiency for tax years 2005 and 2006 This notice reflected respondent's determination of a deficiency in income tax of $135,936 for tax year 2005, or, in the alternative, a deficiency in income tax of $133,067 for tax year 2006 The notice further reflected respondent's determination to impose on petitioners an accuracy-related penalty under section 6662(a) of $27,187 for tax year 2005, or, in the alternative, $26,613 for tax year 2006 The notice also reflected respondent's determination of **[*13]** an addition to tax for failure to timely file a return under section 6651(a)(1) of $19,731 for tax year 2006 [18]

Respondent's determinations in the notice of deficiency were based on the premise that at one of a few alternative points during tax years 2005 and 2006, Mr Ellis engaged in a prohibited transaction under section 4975 with his IRA Respondent further determined that as of the first day of the taxable year in which the prohibited transaction occurred, Mr Ellis' IRA ceased to be an "eligible retirement plan" under section 402 and the fair market value of the IRA was deemed distributed to him on the first day of that taxable year under section 408

Respondent determined that a prohibited transaction under section 4975 occurred at one of the following points (1) when Mr Ellis caused his IRA to engage in the sale and exchange of membership interests in CST in tax year 2005, (2) when Mr Ellis caused CST, an entity owned by his IRA, to pay him compensation in tax year 2005, (3) when Mr Ellis caused CST, an entity owned by his IRA, to pay him compensation in tax year

2006, or (4) when Mr Ellis **[*14]** caused CST, an entity owned by his IRA, to enter into a lease agreement with CDJ, an entity owned by both petitioners and their children in tax year 2006

The notice of deficiency also reflected respondent's determination that, for the year in which the prohibited transaction occurred petitioners are liable for the additional tax under section 72(t) for early distributions from a qualified retirement plan

On June 1, 2011, petitioners filed a petition in this Court for review of respondent's determinations with respect to tax years 2005 and 2006

Discussion

I. *Section 4975*

A. *Introduction*

Section 4975 sets forth certain prohibited transactions with respect to a qualified retirement plan, including an IRA described in section 408(a) Section 4975(c) defines these prohibited transactions as any direct or indirect (1) sale or exchange, or leasing, of any property between a plan and a disqualified person, (2) lending of money or other extension of credit between a plan and a disqualified person, (3) furnishing of goods, 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 **[*15]** fiduciary whereby he deals with the income or assets of a plan in his own interests 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 the income or assets of the plan These enumer[pg 1988] ated prohibited transactions are not mutually exclusive, one transaction may fall within the parameters of more than one of the identified transactions under section 4975 Janpol v Commissioner, 101 T C 518, 525 (1993)

The purpose of section 4975, in part, is to prevent taxpayers involved in a qualified retirement plan from using the plan to engage in transactions for their own account that could place plan assets and income at risk of loss before retirement See generally sec 4975, S Rept No 93-383 (1974),1974-3 C B (Supp) 80, H R Rept No 93-807 (1974), 1974-3 C B (Supp) 236 The enumerated transactions set forth in section 4975 are meant to exhibit per se examples of this kind of self-dealing, and participation in such prohibited transactions is just that — prohibited See Leib v Commissioner, 88 T C 1474, 1481 (1987) The fact that a transaction would qualify as a prudent investment when judged under the highest fiduciary standards is of no consequence Id

[*16] B. *Fiduciary and Disqualified Person Status*

For the purposes of section 4975, a fiduciary is defined as any person who (1) exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (2) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (3) has any discretionary authority or discretionary responsibility in the administration of such plan Sec 4975(e)(3) Further, a fiduciary with respect to a qualified retirement plan is also a disqualified person for the purposes of section 4975 Sec 4975(e)(2)(A)

Mr Ellis certainly exercised discretionary authority over his IRA and likewise exercised control over the disposition of its assets Mr Ellis seeded his plan in June of 2005 with the proceeds from his section 401(k) plan account with his former employer Mr Ellis then exerted control over his IRA in causing it to engage in the purchase of membership units of CST Accordingly, Mr Ellis was a fiduciary of his IRA within the meaning of section 4975 and consequently a disqualified person with respect to that plan

[*17] C. *Formation of CST*

As previously stated, section 4975 prohibits any direct or indirect sale or exchange of any property between a plan and a disqualified person Sec 4975(c)(1)(A) In addition to a fiduciary as defined above, the term "disqualified person" under section 4975(e)(2) also includes a corporation or a partnership of which 50% or more of (1) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation, or (2) the capital interest or profits interest of a partnership, is owned directly or indirectly or held by a fiduciary as described in section 4975(e)(2)(A) Sec 4975(e)(2)(G) Section 4975(e)(4) incorporates the constructive ownership rule of section 267(c)(1), which provides that "[s]tock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries"

Petitioners argue that Mr Ellis did not engage in a prohibited transaction by causing his IRA to invest in CST Petitioners rely on Swanson v Commissioner, 106 T C 76, 88 (1996), to show that CST was not a disqualified person at the time the investment was made In Swanson, the taxpayer organized a domestic **[*18]** international sales corporation [19] known as Swanson's Worldwide, Inc (Worldwide) The taxpayer then established an IRA at Florida National Bank and subsequently executed a subscription agreement for the exchange of IRA funds for 2,500 shares of Worldwide original issue stock The Court stated that a "corporation without shares or shareholders does not fit within the definition of a disqualified person under section 4975(e)(2)(G) " Id The Court concluded that it was only after Worldwide issued its stock to the taxpayer's IRA that Worldwide had become a disqualified person under section 4975(e)(2)(G) [pg 1989]

The Court finds in this context that an LLC that elects to be treated as a corporation and does not yet have members or membership interests is sufficiently analogous to a "corporation without shares or shareholders" Mr Ellis organized CST without taking any ownership interest in the company [20] In the original operating agreement, dated May 25, 2005, Mr Ellis' IRA is shown as an investing member with a 98% ownership interest in CST in exchange for an initial capital contribution of $319,500 Mr Ellis' IRA was subsequently created on June 7, **[*19]** 2005, and the initial capital contribution was effected through the transfer of funds to CST in payments of $254,000 and $65,500 on June 23 and August 23, 2005, respectively The end result of this transaction was the creation of a new entity, CST, with Mr Ellis' IRA as a founding member with a 98% ownership interest CST had no outstanding owners or ownership interests before the initial capital contribution and therefore could not be a disqualified person at the time of the investment by Mr Ellis' IRA

Accordingly, petitioners did not engage in a prohibited transaction when they caused Mr Ellis' IRA to invest in CST [21]

D. *Compensation paid by CST to Mr. Ellis*

The direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan is a prohibited transaction under section 4975(c)(1)(D) Similarly, an act by a disqualified person who is a fiduciary whereby he directly or indirectly deals with the income or assets of a plan in his own interest or for his own account is a prohibited transaction under section 4975(c)(1)(E)

[*20] As detailed above, Mr Ellis was a fiduciary of his IRA and therefore a disqualified person In addition, Mr Ellis was the sole individual for whose benefit the IRA was established and therefore the beneficial owner of 98% of the outstanding membership interests of CST See secs 4975(e)(4), 267(c)(1) Because Mr Ellis, a fiduciary of his IRA, was the beneficial shareholder of more than 50% of the outstanding ownership interest in CST, CST met the definition of a disqualified person under section 4975(e)(2)(G) See Swanson v Commissioner, 106 T C at 88 n 15

During tax year 2005 CST paid $9,754 to Mr Ellis On CST's corporate income tax return for tax year 2005, this amount is reflected as officer compensation Section 2 3 of the operating agreement for CST states that “the General Manager shall be entitled to such Guaranteed Payment as is approved by the members ” It is unclear whether Mr Ellis was issued compensation under this guaranteed payment provision or as wages However, as the fiduciary of his IRA—a member of CST with 98% of the outstanding ownership interest—and the general manager of CST, Mr. Ellis ultimately had discretionary authority to determine the amount of his compensation and effect its issuance in either circumstance

Petitioners argue that Mr Ellis did not engage in a prohibited transaction when he caused CST to pay him compensation because the amounts it paid to him **[*21]** did not consist of plan income or assets of his IRA but merely the income or assets of a company in which his IRA had invested However, CST was funded almost exclusively by the assets of Mr Ellis' IRA Furthermore, the assets of Mr Ellis' IRA consisted only of its ownership interest in CST, valued at $319,480, and $1,773 in cash To say that CST was merely a company in which Mr Ellis' IRA invested is a complete mischaracterization when in reality CST and Mr Ellis' IRA were substantially the same entity. In causing CST to pay him compensation, Mr Ellis engaged in the transfer of plan income or assets for his own benefit in violation of section 4975(c)(1)(D) Furthermore, in authorizing and effecting this transfer, Mr Ellis dealt with the income or assets of his IRA for his own interest or for his own account in violation of section 4975(c)(1)(E) [pg 1990]

Petitioners also argue that section 4975(d)(10) exempts the payment of compensation by CST to Mr Ellis in tax year 2005 from being classified as a prohibited transaction That section provides that the prohibited transactions set forth under section 4975(c) shall not apply to receipt by a disqualified person of any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan However, the amounts CST paid as compensation to Mr Ellis were not for services provided in the administration of a qualified retirement plan in managing **[*22]** its investments, but rather for his role as general manager of CST in connection with its used car business

Accordingly, section 4975(d)(10) does not apply See Lowen v Tower Asset Mgmt , Inc , 829 F 2d 1209, 1216 (2d Cir 1987) (finding that section 408(c)(2) of the Employee Retirement Income Security Act of 1974 (ERISA), the parallel provision to section 4975(d)(10), exempts the fees and compensation paid pursuant to a plan's investment management agreement, but not other compensation from companies in which the plan is invested) [22]

In essence, Mr Ellis formulated a plan in which he would use his retirement savings as startup capital for a used car business Mr Ellis would operate this business and use it as his primary source of income by paying himself compensation for his role in its day-to-day operation Mr Ellis effected this plan by establishing the used car business as an investment of his IRA, attempting to preserve the integrity of the IRA as a qualified retirement plan However, this is precisely the kind of self-dealing that section 4975 was enacted to prevent For **[*23]** the foregoing reasons, the Court sustains respondent's determination that Mr Ellis engaged in prohibited transactions under section 4975(c)(1)(D) and (E) when he caused CST to pay him compensation of $9,754 in tax year 2005 [23] [24]

II. *Effect of the Prohibited Transaction*

A. *Inclusion in Gross Income*

If, during any taxable year of an individual for whose benefit any IRA is established, that individual or his beneficiary engages in a prohibited transaction under section 4975, the account will cease to be an IRA as of the first day of the taxable year Sec 408(e)(2)(A) In such a case, the IRA in question will no longer be exempt from tax under section 408(e)(1) Further, where such an account ceases to be an IRA by reason of section 408(e)(2)(A), the account is deemed to have been distributed on the first day of the taxable year in an amount equal to the fair market value of all the assets of the account on that first day Sec 408(e)(2)(B), sec 1 408-4(d)(1), Income Tax Regs

[*24] Section 61(a) defines gross income as all income from whatever source derived, including (but not limited to) annuities and pensions See sec 61(a)(9), (11) Section 408(d)(1) provides "Except as otherwise provided in this subsection, any amount paid or distributed out of an individual retirement plan shall be included in gross income by the payee or distributee, as the case may be, in the manner provided under section 72 " See Arnold v Commissioner, 111 T C 250, 253 (1998), sec 1 408-4(a), Income Tax Regs

As detailed above, petitioners engaged in a prohibited transaction under section 4975 in tax year 2005 Accordingly, the entire amount of $321,366 25 converted from Mr Ellis' section 401(k) plan account is deemed distributed on January 1, 2005, under section 408(e)(2)(A) That amount is therefore includible in petitioners' gross income for tax year 2005 under sections 408(d)(1) and 72(a) Because respondent determined alternative deficiencies for tax years 2005 and 2006, petitioners are therefore not liable for respondent's [pg 1991] determinations with respect to tax year 2006 [25]

[*25] B. *Section 72(t)*

Section 72(t) provides for a 10% additional tax on early distributions from qualified retirement plans unless the distribution falls within a statutory exemption The most common of these exemptions include distributions that are made on or after the date on which the taxpayer attains age 59 1/2 and distributions that are attributable to the taxpayer's being disabled Sec 72(t)

The parties have stipulated that Mr Ellis had not attained the age of 59 1/2 by January 1, 2005 Petitioners allege no other exemption under which they would escape the additional tax imposed by section 72(t) Accordingly, petitioners are liable for the 10% additional tax on the $321,366 25 deemed distribution for tax year 2005

III. *Section 6662(a) Penalty*

Section 6662(a) and (b)(1) and (2) imposes an accuracy-related penalty equal to 20% of an underpayment attributable to any substantial understatement of income tax or to negligence or disregard of rules or regulations Under section 7491(c), the Commissioner has the burden of production to show that the imposition of a penalty under section 6662(a) is appropriate

Section 6662(d) defines a "substantial understatement of income tax" as an understatement that exceeds the greater of (1) 10% of the amount of tax required **[*26]** to be shown on the return, or (2) $5,000 "Negligence" includes any failure to make a reasonable attempt to comply with the provisions of the Code, and "disregard" includes any careless, reckless, or intentional disregard of rules or regulations Sec 6662 (c)

On their 2005 tax return petitioners reported total income tax due of $4,986 Respondent has demonstrated that the amount of tax required to be shown on petitioners' 2005 return was $140,922 [26] Petitioners' understatement of $135,936 is therefore greater than 10% of the tax required to be shown on the return, which is greater than $5,000 Accordingly, respondent has met his burden of production under section 7491(c)

No penalty will be imposed under section 6662(a) if the taxpayer establishes that he acted with reasonable cause and in good faith Sec 6664(c)(1) Circumstances that indicate reasonable cause and good faith include reliance on the advice of a tax professional or an honest misunderstanding of the law that is reasonable in light of all the facts and circumstances Sec 1 6664-4(b), Income Tax Regs The taxpayer has the burden of proving that he acted with reasonable cause and in good faith Rule 142(a), Higbee v Commissioner, 116 T C 438, 446-447 (2001) Regulations promulgated under section 6664(c) further provide **[*27]** that the determination of reasonable cause and good faith "is made on a case-by-case basis, taking into account all pertinent facts and circumstances " Sec 1 6664-4(b)(1), Income Tax Regs

The parties have agreed in the stipulation of settled issues filed on June 12, 2012, that petitioners have not provided sufficient evidence and have not otherwise proven reasonable cause for relief from the penalty determined under section 6662(a) Accordingly, petitioners are liable for the section 6662(a) accuracy-related penalty for tax year 2005

All other adjustments for tax year 2005 reflected on petitioners' notice of deficiency are computational The Court has considered all of the arguments made by the parties and, to the extent they are not addressed herein, they are considered unnecessary, moot, irrelevant, or without merit

To reflect the foregoing, An appropriate decision will be entered

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1

All section references are to the Internal Revenue Code in effect for the tax years at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated

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2

Despite its name, CST Investments, LLC is not a registered investment company under the Investment Company Act of 1940

3

Mr Ellis was the designated general manager in the operating agreement for CST Article II of the operating agreement further stated "The General Manager shall have full authority to act on behalf of the Limited Liability Company" See also Mo Rev Stat secs 347 065, 347 069 (2012)

4

Mo Rev Stat sec 347 187 2 (2012) provides that a Missouri limited liability company and its members shall be classified and treated on a basis consistent with the limited liability company's classification for Federal income tax purposes

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5

The distributor, T Rowe Price, issued to petitioners a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRA's, Insurance Contracts, etc , for tax year 2005 to report the $254,206 44 distribution

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6

This transaction was reported as a rollover contribution by T Rowe Price

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7

After this payment to CST and applicable fees, $191 in cash remained in the IRA account

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8

The distributor, T Rowe Price, issued to petitioners a second Form 1099-R for 2005 to report the $67,138 81 distribution

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9

The record also reflects that, at some point during tax year 2005, Mr Ellis received a third distribution of $21 from the sec 401(k) account he had accumulated with Aventis Pharmaceuticals This distribution was also reported by T Rowe Price on a Form 1099-R for tax year 2005

10

After this payment to CST and applicable fees, $1,794 in cash remained in the IRA account

11

The cash balance was reduced by approximately $21 in custodial fees between August 23 and December 20, 2005

12

This amount was reported on a Form W-2, Wage and Tax Statement, issued to Mr Ellis for tax year 2005 and subsequently reported by petitioners on their 2005 Federal income tax return as wages As discussed below, the original operating agreement of CST authorized Mr Ellis to be paid guaranteed payments by the company in his role as general manager It is unclear whether this amount paid as "officer compensation" was issued under the guaranteed payment provision of the operating agreement or was issued as wages to Mr Ellis

13

The original engagement letter with petitioners' counsel's firm listed a legal fee of "3% of the amount accessed from deferred compensation accounts *** payable upon the investment by your IRA into the corporation "

14

Petitioners reported that Mr Ellis had wage income from Aventis Pharmaceuticals of $25,713 and CST of $9,754, while Mrs Ellis had wage income from an unrelated employer in the amount of $40,579

15

This loss consisted of the $1,799 allocable to Mr Ellis and the $450 allocable to Mrs Ellis out of CDJ's net loss of $3,598 for tax year 2005 Petitioners' Schedule A, Itemized Deductions, did not reflect any legal fees as an expense paid for the production of income

16

Petitioners also reported their liability for an early distribution tax under sec 72(t) of $9 (10% of $93)

17

This income consisted of the $415 allocable to Mr Ellis and the $104 allocable to Mrs Ellis out of CDJ's net income of $830 for tax year 2005

18

Petitioners' return as originally filed reflected an overpayment of $1,527 for tax year 2006 Respondent has asserted that petitioners will be liable for the addition to tax under sec 6651(a)(1) only to the extent the Court determines a deficiency for tax year 2006

19

Domestic international sales corporation is commonly referred to as "DISC"

20

Under Mo Rev Stat sec 347 037 (2012), "[a]ny person, whether or not a member or manager, may form a limited liability company by signing and filing articles of incorporation for such limited liability company with the secretary "

21

Respondent has also argued that Mr Ellis engaged in a prohibited transaction when he caused his IRA to invest in CST because the investment was made as part of an arrangement whereby it was expected that a prohibited transaction would later occur under sec 4975(c)(1)(D) or (E) In light of the following analysis, the Court finds it unnecessary to address these arguments at this time

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22

The Court has previously found that to the maximum extent possible the prohibited transaction rules are identical in the labor and tax provisions, so they will apply in the same manner to the same transaction Thus, the caselaw interpreting ERISA is instructive with regard to interpreting the prohibitive transactions under sec 4975 See Leib v Commissioner, 88 T C 1474, 1480-1481 (1987)

23

Since the Court has determined that a prohibited transaction occurred in tax year 2005, it is unnecessary to consider whether any later transactions engaged in by petitioners were prohibited under sec 4975

24

Unlike this case, the Court in Peek v Commissioner, 140 T C __, __ (slip op at 3 n 2) (May 9, 2013), concluded it did not need to reach the additional question of whether prohibited transactions occurred under secs 4975(c)(1)(D) and (E) when the company made payments of wages to the taxpayers

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25

This includes the entire deficiency as well as the associated addition to tax under sec 6651(a)(1) and the accuracy-related penalty under sec 6662(a)

26

This amount includes the additional tax of $32,137 under sec 72(t)

END OF DOCUMENT -

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

OCT 1 2008

MEMORANDUM FOR DIRECTOR, EMPLOYEE PLANS EXAMINATIONS
DIRECTOR, EMPLOYEE PLANS RULINGS & AGREEMENTS

FROM Michael D Julianelle, Director, Employee Plans, SE T EP

SUBJECT Guidelines regarding rollovers as business start-ups

Recently, personnel in our examination and determination letter functions have identified a retirement plan design that appears to operate primarily to transact in employer stock, resulting in the avoidance of taxes otherwise applicable to distributions from tax-deferred accumulation accounts.

Although we do not believe that the form of all of these transactions may be challenged as non-compliant *per se*, issues such as those described within this memorandum should be developed on a case-by-case basis Those cases currently in process or held in suspense should be worked within the context of these guidelines. Please cascade this memorandum to your managers and technical employee staff as appropriate.

EXECUTIVE SUMMARY

A version of a qualified plan is being marketed as a means for prospective business owners to access accumulated tax-deferred retirement funds, without paying applicable distribution taxes, in order to cover new business start-up costs. For purposes of this memorandum, these arrangements are known as Rollovers as Business Startups, or ROBS While ROBS would otherwise serve legitimate tax and business planning needs, they are questionable in that they may serve solely to enable one individual's exchange of tax-deferred assets for currently available funds, by using a qualified plan and its investment in employer stock as a medium. This may avoid distribution taxes otherwise assessable on this exchange. Although a variety of business activity has been examined, an attribute common to this design is the assignment of newly created enterprise stock into a qualified plan as consideration for these transferred funds, the valuation of which may be questionable.

BACKGROUND

Employee Plans first identified ROBS provisions giving rise to these transactions through our regular compliance processes, including determination letter submissions and later project examination activity. They are proprietary defined contribution plans, generally established in the form of profit sharing plans coupled with a cash or deferred arrangement (CODA) Several different promoters have crafted variations on this design, but the elements of each are sufficiently similar that they can be addressed generally.

Although ROBS arrangements may operate as profit sharing plans, their primary purpose appears to be to provide funding for the establishment of a business or franchise. They are designed to allow a newly created business entity to retrieve available tax-exempt accumulation funds from its principal in exchange for its capital stock, simultaneously avoiding all otherwise imposable distribution income and excise taxes that would ordinarily apply to the transaction.

The typical ROBS customer is an individual seeking to start up a personal business, and having accumulated tax-deferred investment funds, usually in the form of a defined contribution account created under a prior employer's plan.[1] From our review of open cases, franchises are often the business form of choice, and this design is marketed as a funding method on various internet sites.

After client engagement, the practitioner-promoter apparently advises the individual to create a C-corporation A number of corporate shares may be created, but they are not issued After incorporation is complete, the practitioner installs a qualified profit sharing plan, sponsored by the shell corporate entity. The plan document used is generally a "pre-approved" specimen, but is usually supplemented with a single amendment This amendment generally exists as either a stand-alone amendment or a tack-on addition to a qualified plan adoption agreement, and consists of a one paragraph provision to permit the plan to invest plan assets attributable to rollover accounts up to 100% in employer securities.

The individual then executes either a rollover or direct trustee-to-trustee transfer of the proceeds from the available tax-deferred investment account into this newly created plan. At this point, the prior account is usually liquidated, all proceeds are parked in a rollover account held in trust under the shell corporation's plan.

The amendment provision is then acted on immediately, and the individual directs the corporation to issue and then exchange all of its capital stock into its qualified plan in exchange for the proceeds held in the rollover account The corporate shares, now held as plan assets, are valued and booked equal to the value of available account proceeds.

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[1] At the time the ROBS transaction is executed, some of these amounts may remain as deferred separated accounts held under a prior plan trust, and some appear to have been rolled over into a "conduit IRA", which was a common utility for individual retirement arrangements prior to the expanded portability provisions enacted by the Economic Growth Tax Relief and Reconciliation Act of 2001.

Usually, after the exchange of stock is complete, no other plan participant will ever receive any ability to invest in employer stock. In some ROBS versions, the provision permitting the stock investment is eliminated immediately after exchange, by means of a second amendment that serves to prospectively redact that provision. In all versions, the exchange fully allocates all of the stock to the rollover sub-account created for the benefit of the individual, and no further allocations of stock to future participants are permitted.

A ROBS transaction therefore takes the form of the following sequential steps:

- An individual establishes a shell corporation sponsoring an associated and purportedly qualified retirement plan. At this point, the corporation has no employees, assets or business operations, and may not even have a contribution to capital to create shareholder equity.

- The plan document provides that all participants may invest the entirety of their account balances in employer stock.

- The individual becomes the only employee of the shell corporation and the only participant in the plan Note that at this point, there is still no ownership or shareholder equity interest.

- The individual then executes a rollover or direct trustee-to-trustee transfer of available funds from a prior qualified plan or personal IRA into the newly created qualified plan. These available funds might be any assets previously accumulated under the individual's prior employer's qualified plan, or under a conduit IRA which itself was created from these amounts Note that at this point, because assets have been moved from one tax-exempt accumulation vehicle to another, all assessable income or excise taxes otherwise applicable to the distribution have been avoided[2].

- The sole participant in the plan then directs investment of his or her account balance into a purchase of employer stock The employer stock is valued to reflect the amount of plan assets that the taxpayer wishes to access.

- The individual then uses the transferred funds to purchase a franchise or begin some other form of business enterprise. Note that all otherwise assessable taxes on a distribution from the prior tax-deferred accumulation account are avoided.

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[2] Distributions from tax-deferred accumulation accounts would generally be taxed under IRC § 72, which specifies treatment for various forms of annuity or non-annuity payments. In general, a single sum distribution would be taxed as ordinary income, at the individual's effective tax rate. Of particular concern here, the distribution would generally also be subject to the 10% "premature distribution" penalty provided by IRC § 72(t), unless the individual was at least 59½ years old on the transaction date, or met one of the other limited statutory exceptions ROBS transactions effectively avoid all § 72 concerns.

- After the business is established, the plan may be amended to prohibit further investments in employer stock. This amendment may be unnecessary, because all stock is fully allocated. As a result, only the original individual benefits from this investment option. Future employees and plan participants will not be entitled to invest in employer stock.

- A portion of the proceeds of the stock transaction may be remitted back to the promoter, in the form of a professional fee. This may be either a direct payment from plan to promoter, or an indirect payment, where gross proceeds are transferred to the individual and some amount of his gross wealth is then returned to promoter.

PROCEDURAL DEVELOPMENT OF CASES

Employee Plans has received numerous alerts from practitioners regarding the promotion of this scheme in the marketplace. Questions regarding the legitimacy of ROBS-type transactions have been posed to the Service at various employee benefits and practitioner conferences.[3]

We have currently identified 9 promoters of this transaction. Most are actively promoting the use of ROBS at seminars that are held to assist individuals purchase business franchises. A referral to the Lead Development Center (LDC) has already been made and an LDC Investigator has been assigned

We have also coordinated our consideration of ROBS plans with the Department of Labor (DOL). As will be noted later, the transfer of enterprise stock within a ROBS arrangement could raise ERISA Title I prohibited transaction issues. Although our coordination efforts are not yet finalized, they remain ongoing.

Additionally, SB/SE has reviewed several returns of employers who have engaged in ROBS transactions. Their examinations have largely started with a review of business tax returns, and then moved on to a review of promoter activity.

Determination Letter Contacts

EP Determinations identified numerous determination letter submissions for taxpayer adoptions of these plans. Most are filed by a named representative who is also a pre-approved document platform provider. Since the type of plan used for this promotion is a prototype plan with a minor amendment that permits the investment in employer securities, we have issued some favorable determination letters for these plans. We are also likely to receive many more submissions within the two-year EGTRRA pre-approved adoption window created by Announcement 2008-23, 2008-14 I.R.B. 731.

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[3] For example, a fact pattern describing a ROBS arrangement was presented at the American Bar Association's 2003 Joint Committee on Employee Benefits "Q&A". See *http.//www abanet org/jceb/2003/qa03irs pdf,* question 9 therein

A major promoter was first identified through our determination letter program as the sponsor of a pre-approved prototype, or "M&P", which has been approved by the Service under our pre-approved opinion letter program. This document is then marketed to clients, and is ultimately adopted by employers by the execution of adoption agreements The base document from which client plans are administered is thus a pre-approved M&P specimen supplied by the provider which was reviewed and approved by the Service with a favorable opinion letter.

Because of the unique rules regarding scope of reliance applicable to M&P adopters, a modification of an M&P generally requires submission for a determination letter application as an individually designed plan. Thus, we are confident that the determination letter database will eventually hold a registry of most, if not all, of this promoter's clients, once the two-year window closes on April 30, 2010.

Current Examination Contacts

We have examined a number of these plans – having opened a specific examination project on them based off referrals from our determination letter program – and found significant disqualifying operational defects in most For example, employees in some arrangements have not been notified of the existence of the plan, do not enter the plan or receive contributions or allocable shares of employer stock. Additionally, we have identified that plan assets are either not valued or are valued with threadbare appraisals. Required annual reports for some plans have not been filed. In several situations, we have also found that the business entity created from the ROBS exchange has either not survived, or used the resultant assets on personal, non-business purchases.

Again, considering business activity that occurs, it is likely that many ROBS plans did in fact file returns that are currently in place on RICS. The amount of the asset transfer is likely to exceed the minimum $100,000 that would otherwise eliminate filing of Form 5500EZ, *Annual Return/Report of Employee Benefit Plan.*[4]

In those cases, however, where the appropriate Form 5500 or 5500EZ was not filed, issues may arise as to the proper way to correct a failure to file. For example, issues may arise due to DOL's mandate for electronic filing beginning with the 2009 plan year and the resulting limitations on filing paper returns. It is anticipated that additional guidelines will be issued to address these situations.

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[4]Form 5500 filing is triggered by when the value of trust assets reaches a specified level. See Treas Reg.§ 301.6058-1(a)(1), et seq. Note that Section 1103(a) of the Pension Protection Act of 2006, Pub L. 109-280, increased the amount of assets required for filing by one-participant plans from $100,000 to $250,000 effective for plan years beginning after December 31, 2006. Note also that Form 5500EZ will be replaced with Form 5500-SF, beginning with year 2009 filings.

PRIMARY ISSUES RAISED:

The two primary issues raised by ROBS arrangements are (1) violations of nondiscrimination requirements, in that benefits may not satisfy the benefits, rights and features test of Treas. Reg. § 1.401(a)(4)-4, and (2) prohibited transactions, due to deficient valuations of stock.

Benefits, Rights & Features Discrimination

Because ROBS transactions generally benefit only the principal involved with setting up a business, and do not enable rank-and-file employees to acquire employer stock, we believe that some of these plans violate the anti-discrimination provisions of the Code and Regulations, on a case-by-case basis.

IRC § 401(a)(4) provides that, under a qualified retirement plan, contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees (HCEs).

IRC § 414(q)(1)(A) provides that an HCE is defined as either (1) a 5% owner, defined under the attribution rules of § 318, or (2) receives compensation over $80,000 (indexed, and subject to a "top-paid group" election by the employer.)

IRC § 318(a)(2)(B)(i) precludes attribution of stock owned by a plan described in § 401(a) to any participant in the plan for whom the stock is held for the benefit of, in trust.

Treas. Reg. § 1.401(a)(4)-1(b)(2) provides that in order to satisfy § 401(a)(4), either the contributions or the benefits under a plan must be nondiscriminatory in amount.

Treas. Reg. § 1.401(a)(4)-4(e)(3) provides that the plan's benefits, rights and features (BRFs) are tested to see if they are nondiscriminatory in effect. BRF testing considerations can arise in many forms, including as here, the right to make investments in employer securities.

Treas. Reg. § 1.401(a)(4)-4(b)(1) indicates that whether any given BRF is "currently available" (i.e. nondiscriminatory in result) should be tested under the nondiscriminatory classification test used for coverage testing. Further, Reg. § 1.401(a)(4)-4(c) provides that a BRF must also be "effectively available" to non-highly compensated employees (NHCEs), on the basis of all facts and circumstances.

Treas. Reg § 1.401(a)(4)-5 provides that whether the timing of a plan amendment or series of plan amendments has the effect of discriminating specifically in favor of HCEs involves a facts and circumstances determination.

In a typical ROBS arrangement, there may not be any individual who meets the statutory HCE definition At the time when rollover funds are used to purchase employer stock, the stock acquires identity as a trust asset and is not attributed to the individual participant Compensation paid then becomes the determining factor in resolving HCE status questions.[5]

In most of our cases, the amount of compensation being paid to the individual who starts-up the business is ostensibly below the IRC § 414(q)(1)(B) dollar limit, at least for initial years. While this may leave open the question as to whether true compensation being paid to the individual is actually higher than reported compensation, absent a personal tax review of the individual no one may receive compensation at or above the HCE indexed dollar limit

Even if the ROBS initiator is an HCE, in many of our cases, there are no other employees in the initial year of the transaction or for some number of future years thereafter. Therefore, as no finding regarding discrimination can be made in absence of NHCEs in the transaction year, the current availability testing standard for plan BRFs is satisfied. This does not, however, signify that the effective availability standard is similarly resolved

Effective availability testing requires a facts and circumstances determination regarding whether a plan feature benefits NHCEs. This determination requires consideration of factors or conditions precedent that must be satisfied in order to accrue a benefit, including timing elements and whether the transaction was structured to intentionally avoid BRF testing issues Furthermore, Treas. Reg. § 1 401(a)(4)-5 requires consideration as to whether the timing of plan amendments serves to preclude other NHCEs from receiving stock allocations.

Given that ROBS arrangements are designed to take advantage of a one-time only stock offering, the investment feature generally would not satisfy the effectively available benefit requirement The issue of discrimination arises because the plan is designed in a manner that the BRF will never be available to any NHCEs. For this reason, ROBS cases should be developed for discrimination issues whenever a given plan covers both HCEs and NHCEs, and no extension of the stock investment option is afforded to NHCEs.

Prohibited Transactions – Valuation of Stock

In all ROBS arrangements, an aspiring entrepreneur creates capital stock for the purpose of exchanging it for tax-deferred accumulation assets The value of the stock is set as the value of the available assets. An appraisal may be created to substantiate this value, but it is often devoid of supportive analysis We find this may create a prohibited transaction, depending on true enterprise value.

[5] In several of our examined cases, the transaction did not exactly follow the sequential series of steps outlined earlier. Instead, the principal received shares of the shell corporation prior to the sale back to the plan. This timing made the principal a 100% owner for a short period of time. In such a case, HCE status is conferred on start-up, perhaps creating an imminent BRF testing issue. This might also raise related prohibited transaction concerns.

IRC § 4975(a) imposes a tax on a prohibited transaction equal to 15% of the amount involved in the transaction. IRC § 4975(b) imposes a tax equal to 100% of the amount involved in any case where a prohibited transaction is not corrected within the taxable period, as defined at § 4975(f).

IRC § 4975(c)(1)(A) defines a prohibited transaction as a sale, exchange or lease of any property between a plan and a disqualified person.

IRC § 4975(e)(1)(F) defines a plan as any trust, plan, account or annuity that is exempt from tax under § 501(a), or was ever determined by the Secretary to be so exempt.

IRC § 4975(e)(2)(C) defines a disqualified person as an employer, any of whose employees are covered by the plan.

IRC § 4975(e)(2)(E)(i) defines a disqualified person as an owner, direct or indirect, of 50% or more of the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation which is an employer described in § 4975(e)(2)(C).

IRC § 4975(d)(13) provides an exemption from prohibited transaction consideration for any transaction which is exempt from ERISA § 406, by reason of ERISA § 408(e), which addresses certain transactions involving employer stock.

IRC § 4975(f)(2) defines the taxable period as the period beginning with the date on which the prohibited transaction occurs and ending on the earlier of the dates on which a) a notice of deficiency with respect to the tax imposed by § 6212(a) is mailed, b) the date on which the tax imposed by § 4975(a) is assessed, or c) the date on which correction of the prohibited transaction is completed.

IRC § 4975(f)(5) defines correction as the undoing of the transaction, to the extent possible, such that the plan is restored to a financial position not worse than it would have been absent the transaction.

ERISA § 408(e), and ERISA Reg. § 2550.408e promulgated thereunder, provides an exemption from ERISA § 406 for acquisitions or sales of qualifying employer securities, subject to a requirement that the acquisition or sale must be for "adequate consideration." Except in the case of a "marketable obligation", adequate consideration for this purpose means a price not less favorable than the price determined under ERISA § 3(18).

ERISA § 3(18) provides in relevant part that, in the case of an asset other than a security for which there is no generally recognized market, adequate consideration means the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations.

An exchange of company stock between the plan and its employer-sponsor would be a prohibited transaction, unless the requirements of ERISA § 408(e) are met. Therefore, valuation of the capitalization of the new company is a relevant issue. Since the company is new, there could be a question of whether it is indeed worth the value of the tax-deferred assets for which it was exchanged. If the transaction has not been for adequate consideration, it would have to be corrected, for example, by the corporation's redemption of the stock from the plan and replacing it with cash equal to its fair market value, plus an additional interest factor for lost plan earnings.

A valuation-related prohibited transaction issue may arise where the start-up enterprise does not actually "start-up." Here, the start-up entity might record "cash" as its only asset, without any real attempt to secure, for example, a franchise license, property, plant and equipment or other assets necessary to start a bona fide business The valuation ostensibly legitimizing the exchange is unsupported.

Many examiners have been provided with a single sheet of paper, signed by a purported valuation specialist. This appraisal "certifies" that the value of the enterprise stock is a sum certain, the amount of which approximates the amount of available proceeds from the individual's tax deferred retirement account.

These appraisals are questionable. Because the valuation usually approximates available funds, consideration needs to be given to whether inherent value in the plan-acquired entity actually exists. The lack of a bona fide appraisal raises a question as to whether the entire exchange is a prohibited transaction.[6]

Prohibited Transactions – Promoter Fees

In the case where the plan purchases the stock of the employer, and the employer immediately pays professional fees to the promoter out of the proceeds, prohibited transactions may occur.

IRC § 4975(c)(1)(E) prohibits a fiduciary from dealing with the assets of the plan in his own interest or his own account.

IRC § 4975(e)(3) defines a fiduciary as any person who exercises any discretionary authority or control, renders investment advice for a fee, or has any discretionary authority or responsibility in the administration of the plan.

Treas. Reg. § 54.4975-9(c) defines when a person would be providing investment advice as defined in § 4975(e)(3)(B)

ERISA Reg § 2510-3.21(c) further clarifies the meaning of the term "investment advice " Under that regulation, a person is deemed to render investment advice if such person renders advice to the plan as to the value of securities or other property, or makes a recommendation as to the advisability of investing in, purchasing, or selling securities or other property and such person either directly or indirectly has discretionary authority or control, whether or not pursuant to an agreement, arrangement or understanding, with respect to purchasing or selling securities or other property for the plan The advice would have to be rendered on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding, written or

[6] We note that deficient valuations can also raise qualification issues. See e.g. Rev Rul. 80-155, 1980-1 CB 84.

otherwise, between such person and the plan or a fiduciary with respect to the plan, that such services will serve as a primary basis for investment decisions with respect to plan assets, and that such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of plan investments.[7]

If the promoter meets these requirements, his status may rise to that of plan fiduciary. Where a fiduciary directly receives a remit-back from the plan of a portion of tax-deferred accumulation assets, this payment may be a violation of IRC § 4975(c)(1)(E). Essentially, plan assets are being transferred in exchange for services and investment advice. Specialists will need to ascertain whether this is discernable from the facts presented on their examination, and whether the requirements of Treas Reg § 54.4975-9(c) have been met.

Note that IRC § 4975(f)(1) provides that where more than one person is liable for prohibited transaction excise taxes, all persons are jointly and severally liable for any deficiency. Therefore, assessments against promoters for direct receipt of plan assets may be made even where assessments are proposed against the corporation or individual for invalid appraisal of the underlying stock.[8]

OTHER ISSUES:

Permanency

Because ROBS benefits are designed to be used only once, we have considered whether they are truly a "permanent" retirement program. Permanency is a qualification requirement for all retirement plans.

IRC § 401(a)(1) provides that a trust is established for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan.

Treas. Reg. § 1.401-1(b)(1)(ii) provides that a profit sharing plan is established to enable employees or their beneficiaries to participate in the profits of the employer's trade or business, or in the profits of an affiliated employer who is entitled to deduct his contributions to the plan under IRC § 404(a)(3)(B), pursuant to a definite formula for allocating the contributions and for distributing the funds accumulated under the plan.

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[7] DOL has taken the position that this definition of fiduciary also applies to investment advice provided to a participant or beneficiary in an individual account plan that allows participants or beneficiaries to direct the investment of their accounts See ERISA Reg. § 2509 96-1(c).

[8] In an attempt to "insulate" client adopters against prohibited transaction issues, one promoter has apparently created a multiple employer plan within the meaning of IRC § 413(c), with each client adopting-in as a participating employer. Notwithstanding this attempt, the analysis supplied by this memorandum should be applied to these cases.

Treas. Reg. § 1.401-1(b) provides that a qualified plan must be created primarily for the purposes of providing systematic retirement benefits for employees. Treas Reg § 1.401-1(b)(2) requires that the plan be a permanent, as distinguished from temporary, arrangement, and provides a general rule that if a plan is discontinued within a few years after its adoption, there is a presumption that it was not intended as a permanent program from its inception, unless business necessity required the discontinuance, termination or partial termination

Rev Rul. 69-25, 1969-1 C.B. 113, provides that for purposes of invoking this "business necessity" exception, the necessity must have been unforeseeable when the plan was adopted, and cannot be within the control of the employer.

Consider that business reasons – tax motivated or otherwise – are generally the only reasons why a retirement arrangement is installed. Similarly, they are likely to be the only reason why they are terminated as well. For this reason, permanency is not an area where the Service has aggressively challenged plan terminations or design considerations. Additionally, Regulations address permanency within the context of an entire plan arrangement, not necessarily to a feature within a plan.

Therefore, a plan containing a ROBS arrangement would have to be shown to be non-permanent in its entirety Many of the ROBS arrangements we have examined also contain a CODA feature. Plans which suffer from permanency failures are generally deficient in that they do not receive substantial and recurring contributions. Because CODA features receive contributions only if participants make contributions, the issue of permanence is resolvable in favor of the employer.

Under the specific facts presented by the cases we have examined, we are unable to find that all ROBS arrangements violate the permanency rule. However, facts of particular cases should be considered on a case-by-case basis.[9]

Exclusive Benefit

As noted earlier, ROBS arrangements typically involve direction of some amount of plan assets to the promoter in payment of professional fees for setting up the transaction. In some cases, the newly created business purchased assets that were essentially personal assets for the benefit of the individual We considered whether this violates the "exclusive benefit" requirements of the Code

IRC § 401(a)(2) provides, in relevant part, that a plan is not qualified unless it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, for any part of the corpus or income to be used for or diverted to purposes other than for the exclusive benefit of employees or their beneficiaries.

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[9] In fact, as will be noted later, some plans appear to have been established with CODAs that do not receive contributions and may not have been adequately communicated to employees. These plans would not be insulated against permanency issues.

Treas. Reg. § 1.401-1(a)(3)(iv) provides that it must be impossible "under the trust instrument at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries.

Treas Reg. § 1.401-2 outlines the specific provisions that a plan must follow to meet the exclusive benefit rule for purposes of Title II of ERISA Other applicable exclusive benefit issues are contained in corresponding Title I provisions.

We have reviewed ROBS arrangements to determine whether they are truly for the exclusive benefit of employees. The facts unique to each of our ROBS cases are disparate as to the eventual disposition of tax deferred accumulation assets. In a few cases, these assets wound up purchasing personal assets, like recreational vehicles But in many, if not most of the transactions, the assets were in fact used to purchase legitimate business or franchises, plus attendant start-up costs Courts have generally held that whether a Title II exclusive benefit violation has occurred largely depends on whether benefits to third parties are not merely an incidental side effect of an investment of trust assets, but are instead a major purpose of the investment.

Therefore, we believe that the typical ROBS design does not violate the exclusive benefit requirement in form.[10] Examiners will need to develop specific operational issues, such as where trust assets were used to pay purely non-business expenses prior to pursuing exclusive benefit violations.[11]

Plan not communicated to employees

In some cases, we have found that the existence of the plan is not communicated to people hired after the newly created business is up and running. "Participants", as identified on employee census information provided to our examiners, are not even aware that they merit this classification. If this can be established, the plan may be in violation of Treas. Reg. § 1.401-1(a)(2), requiring that it be a definite, written program communicated to employees. In some cases, employees may not reach participation status into the plan on their required entry dates, causing the plan to fail IRC § 410(a) requirements.

Inactivity in cash or deferred arrangement

A large number of reviewed plans contain election provisions in the adoption agreement to utilize a CODA. Often, low number of participants actually chose to make salary reduction contributions. However, many of our examiners found this issue and raised it, and usually received a response that the CODA was "inactive." In fact, many of these

[10] However, we are aware of arrangements in which the individual transferring tax-deferred assets into the plan is not an employee, participant or owner, such as where the arrangement is used to set up a business for a spouse. Such a transfer might be one where the exclusive benefit issue is properly raised.
[11] As a reminder, exclusive benefit revocation cases must be submitted for technical advice consideration under established procedures within each business unit

plans have provisions describing a CODA feature, including applicable elections in the employer's signed adoption agreement. There being no such thing as an "inactive" CODA, examiners should consider whether all the procedures for allowing employees to participate in the CODA were followed, whether new employees just chose not to defer, or whether employees were not even offered salary reduction elections. If it is established that employees were not permitted to make elective deferrals, the plan would violate IRC § 401(k)(2)(D) in that it did not permit eligible employees to elect salary deferral contributions.[12]

COMPLETION AND MOVEMENT OF CASES

Determination Letter Contacts

We have specifically considered whether the form of the plan, as presented, is entitled to a favorable determination letter ruling There is no inherent violation in the form of a plan containing a ROBS arrangement that would otherwise prevent a favorable ruling. The issues described herein are inherently operational, and beyond the scope of a determination letter ruling. Accordingly, determination letter applications for plans with ROBS features can be reviewed and approved as appropriate. However, we will monitor the volume of approval letters issued to these plans in a manner similar to those issued to IRC § 412(i) arrangements. Current procedures for these notifications, including review by EP Determinations Quality Assurance, are to be followed for ROBS determination letter submissions.

Open Examination Cases

Open examination cases should be worked within the context of these guidelines. Cases presenting prohibited transaction issues should be worked under existing procedures for processing delinquent returns in agreed cases, and under unagreed procedures for all other circumstances, including appropriate referral to and coordination with DOL. Cases in which BRF discrimination is an issue should be processed first under the appropriate Employee Plans Compliance Resolution System (EPCRS) correction program. If EPCRS is not appropriate or available, then unagreed qualification procedures should be followed.

Statute of Limitation Concerns

For BRF discrimination and other disqualification cases, normal control procedures for protection of applicable statutes of limitation on trust and related taxable returns should be followed. This may involve converting non-calendar year plans, and annualizing income in accordance with IRC § 645(a) Related returns should be protected, generally for the individual and employer sponsor only.

[12] Also, to the extent that a CODA supports the permanency of a plan, that support expires if in fact the CODA is not in fact communicated to employees.

Similar procedures are also applicable for prohibited transaction cases, however, specialists are cautioned that one other consideration may block pursuing deficiency determinations for these cases

IRC § 6501(a) provides that the amount of any tax, including those imposed by Chapter 43 (such as IRC § 4975) may be assessed within three years after the "return" was filed

IRC § 6501(l) further provides that, for this purpose, the term "return" means the annual Form 5500 series return required to be filed by plan/trust for the year in which the act occurred. Therefore, in most instances, the statute of limitation to make a prohibited transaction assessment on a ROBS transaction begins with the filing of Form 5500 for the year in which the stock transaction is executed.

IRC § 6501(e)(3) provides, however, that if this information return does not adequately disclose the existence of this transaction, the ordinary limitation period on assessment is extended to six years Adequacy of disclosure is largely a facts and circumstances determination, developed through judicial interpretation.[13]

Prohibited transactions are classifiable into either "discrete" one-time transactions, or "continuous" recurring transactions.[14] ROBS arrangements fall into the former. In a discrete transaction, a taxable event occurs in the initial or "source" year when the prohibited exchange of stock occurs, and is deemed to be carried forward into later taxable periods until corrected.[15]

The Service's position with respect to administering the limitation period on assessment applicable to discrete transactions is that the source year must be open in order to make any assessment in the source or any later year. If this source year is barred by elapse of the relevant limitation statute, no excise tax deficiency may be assessed Given the length of time that has elapsed since many of these transactions first were created and the time involved moving these cases through our determination letter and audit cycle processes, it is likely that the three-year limitation period has either elapsed or is imminent for most of these transactions.

Therefore, ROBS prohibited transaction cases are likely to require a determination as to whether a six-year statute is open, under a failure to make adequate disclosure of the existence of the transaction in the source year. For this purpose, coordination with Area Counsel will be required.[16] Specialists are reminded that statutes are to be protected, and assessments perfected, against the correct parties. Where the 3-year limitation period is open, it should be protected in lieu of relying on a 6-year period.

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[13] See e.g. *Janpol v Commissioner*, 102 T.C. 499 (1994)

[14] Note that these terms are not derived from statute or regulation, but are administrative creations.

[15] Unlike a continuous transaction, in which the taxable amount involved accumulates with a future interest factor in the manner known as "pyramiding", a discrete transaction's taxable amount is simply replicated forward in later years.

[16] Peter Gavagan, of Northeast Area Counsel, will coordinate application of 6-year statutes of limitation to open ROBS examination cases.

CONCLUSION

ROBS transactions may violate law in several regards. First, this scheme might create a prohibited transaction between the plan and its sponsor. At the time of the exchange between plan assets and newly-minted employer stock, the value of the capitalization of the entity is equivalent to the value of all plan assets, when in reality, the entity may be valueless and asset-less for an indefinite period of time. Additionally, this scheme may not satisfy the benefits, rights and features requirement of the Regulations. The primary utility of the arrangement may only be available the business's principal individual.

Specific facts will need to be evaluated on a case by case basis in order to make a proper determination as to whether these plans operationally comply with established law and guidance. Technical advice requests may be submitted after consultation with group managers. For this reason, employee plans specialists are directed to resolve open ROBS cases as described herein.[17]

[17] As additional reference material, see IRM § 4.72 8, *Valuation of Assets,* and § 4.72 , *Prohibited Transactions*