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LEGAL ALERT

May 22, 2013

Tax Court Finds Indirect Prohibited Transaction in IRA

In *Peek v. Commissioner* (May 9, 2013), the U.S. Tax Court ruled that two taxpayers had engaged in an indirect "prohibited transaction" with their individual retirement accounts (IRAs) when they provided personal guarantees for promissory notes issued by a company owned by the IRAs.[1] The Court found that the taxpayers had provided an indirect extension of credit to the IRAs, a prohibited transaction under Internal Revenue Code § 4975 that disqualified the IRAs.

Prohibited Transactions with IRAs

Section 4975(c) prohibits specified transactions between (i) various plans including IRAs and (ii) "disqualified persons" (or "parties in interest" under the ERISA version of these rules), which in the case of an IRA includes the IRA owner. Subject to certain exemptions, a disqualified person cannot engage in transactions with the plan that, among other things, constitute direct or indirect:

- Sales, exchanges, or leasing of property;
- Lending of money or other extension of credit;
- Furnishing of goods, services, or facilities; or
- Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan.

While the penalty for a § 4975 violation is normally an excise tax, a prohibited transaction between an IRA and its owner results in the tax disqualification of the IRA under § 408(e)(2), in which case the IRA assets are treated for tax purposes as distributed to the IRA owner.

The Court's Opinion

In 2001, two taxpayers sought to use self-directed IRAs to acquire a business. The taxpayers established self-directed IRAs using 401(k) rollovers, created a new company (FP Company), and then directed the IRAs to purchase the common stock of FP Company with the cash in the IRAs. FP Company then sought to purchase the business. To consummate the purchase, in addition to the cash and other credit lines, FP Company provided a promissory note to the sellers. This promissory note was backed by the personal guarantee of the taxpayers, and the guarantees were then backed by the deeds to the taxpayers' homes. In 2003 and 2004, the taxpayers converted their traditional IRAs to Roth IRAs. In 2006 and 2007, the IRAs sold FP Company for a gain.

If (i) the transactions were respected and (ii) only § 408A "qualified" distributions were made from the Roth IRAs, that gain would never have been taxed to the taxpayers. The Internal Revenue Service (IRS) challenged the transactions on the ground that, among other things, the personal guarantees on the promissory notes were prohibited transactions that under § 408(e)(2) stripped the IRAs of their tax qualification.

[1] 140 T.C. 12 (2013).

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The Tax Court found that the taxpayers had committed prohibited transactions, that the IRAs had ceased to be IRAs as of the beginning of 2001, and that the capital gain from the sale of FP Company by the IRAs was immediately taxed to the taxpayers.

- The taxpayers agreed that personal loan guarantees could be extensions of credit for purposes of the prohibited transaction rules, but argued that only guarantees running to the IRA itself were prohibited.

- The Court disagreed, reasoning that since § 4975 prohibits both "direct and indirect . . . lending of money or extensions of credit" between an IRA and its owner, it did not matter that the loan guarantee by the taxpayers was to FP Company and not the IRAs directly.

- The Court reasoned that a prohibition only on loans directly between the IRA and the disqualified person could be "easily and abusively avoided" by creating shell companies, which would be an "obvious evasion" of the intent of Congress.

The Court also sustained [§ 6662 "substantial understatement" penalties] assessed by the IRS, finding that the taxpayers could not reasonably and in good faith rely on the promoter of the overall plan as a defense against those penalties.

Observations

The *Peek* decision is noteworthy in two respects.

- *Peek* adds to the limited body of authority elaborating the application and enforcement of the prohibited transaction rules specifically in respect of IRAs.[2]

- *Peek* also adds to the limited guidance on the circumstances in which "indirect" transactions fall within the § 4975 prohibition. Shortly after the enactment of ERISA, the U.S. Department of Labor provided guidance suggesting that an "arrangement" between the plan and the disqualified person to do through an intermediary that which they were prohibited from doing directly – for example, for the plan to invest in a mutual fund with the understanding that the mutual fund would purchase securities from a disqualified person – was generally the hallmark of an indirect prohibited transaction.[3] No more than a handful of court cases have previously considered the "indirect" issue.[4] None of these prior authorities was cited in the Tax Court opinion.

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[2] For other authorities finding prohibited transactions with respect to IRAs, s*ee, e.g.*, *In re Daley*, 459 B.R. 270 (Bankr. E.D. Tenn. 2011), *upheld in Daley v. Mosteller*, No. 3:11–cv–565 (E.D.Tenn. Sept. 17, 2012) (IRA cross-collateralization agreement with broker-dealer); DOL Advisory Ops. 2009-03A, 2011-09A (same); *Harris v. Comm'r*, T.C.M. 1994-22 (purchase by IRA of home for IRA owner).

[3] 29 C.F.R. § 2509.75-2 (2012).

[4] *See, e.g., Reich v. Compton*, 57 F.3d 270 (3d Cir. 1995)(transaction between plan and alter ego of party in interest not prohibited); *Brock v. Citizens Bank of Clovis*, 841 F.2d 344 (10th Cir.), *cert. denied*, 488 U.S. 829 (1988)(no violation where bank caused plan to make loan and borrowers used loan to repay separate loans to bank); *Dole v. Lundberg*, 11 EBC 1411 (N.D. Tex. 1989)(loan to third party for transfer to plan sponsor was prohibited); *McDougall v. Donovan*, 552 F. Supp. 1206 (N.D. Ill. 1982) (indirect purchase of airplane by plan from party in interest was prohibited); *Donovan v. Bryons*, 566 F. Supp. 1258 (E.D. Pa. 1983)(loan to third party for transfer to plan sponsor was prohibited).

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