
NAEPC
Journal
of Estate & Tax Planning
Click here to view the First Quarter 2014 Issue

Cannon Insights
A Monthly Publication by Cannon Financial Institute

Cannon Insights: January 2014 - www.cannonfinancial.com

Taxes—Watch Out for Prohibited Transactions in Self-Directed IRAs

It appears the clients and their advisors never tire of looking for ways to tax-shelter capital gain realized on the sale of appreciated assets. The recent Tax Court case of *Peek and Fleck v. Comm'r* illustrates a situation in which the taxpayers were a little too clever for their own good.

Background
Self-directed IRAs have gained popularity in recent years for allowing clients to have greater control over the selection and management of assets. In particular, self-directed IRAs are often used to acquire "alternative assets" including closely held business interests.

Self-directed IRAs offer tax-deferred, or in the case of Roth IRAs, tax-free gains. However, like all IRAs, self-directed IRAs must comply with the rules and regulations. Among these is a rule against "prohibited transactions."

Generally, a prohibited transaction is any improper use of an IRA account or annuity by the IRA owner, his or her beneficiary, or any disqualified person.

Disqualified persons include the IRA owner's fiduciary and members of his or her family (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant).
The following are examples of prohibited transactions with an IRA:

- Borrowing money from it;
- Selling property to it;
- Receiving unreasonable compensation for managing it;
- Using it as security for a loan; and
- Buying property for personal use (present or future) with IRA funds.

Generally, if an IRA owner or his or her beneficiaries engage in a prohibited transaction in connection with an IRA account at any time during the year, the account stops being an IRA *as of the first day of that year.* The effect is that the account is treated as distributing all its assets to the IRA owner at their fair market values on the first day of the year. If the total of those values is more than the basis in the IRA, the IRA owner will have a taxable gain that is includible in his or her income.

Peek and Fleck v. Comm'r
Peek and Fleck were looking to use their retirement funds to buy a business, grow the business, and eventually sell it for a gain. After contacting a business broker and targeting a business ("AFS") for purchase, they consulted with a CPA who offered them a tax strategy for sheltering the eventually anticipated gain on the sale of the business.

Here's how the strategy played out:

1. Fleck and Peek each established self-directed IRAs, over which they each retained all discretionary authority and control concerning investments;

2. Fleck rolled over funds on August 17, 2001, into his IRA (the "Fleck IRA") from an existing 401 (K) account;
3. Peek rolled over funds on August 30, 2001, into his IRA (the "Peek IRA") from an existing IRA;
4. On August 27, 2001, the articles of incorporation for FP Company, Inc. ("FP Company") were filed;
5. On September 11, 2001, at the respective owner's direction, each IRA purchased 5,000 shares of newly issued stock in FP Company and thereby acquired a 50 percent interest in FP Company;
6. In a transaction closed in mid-September 2001 (but with an agreed effective date of August 28), FP Company acquired most of AFS's assets for a price of $1,100,000, consisting of: (a) cash (derived from a bank loan to FP Company from a credit union and proceeds of the sale of FP Company's stock to the IRAs); (b) a promissory note from FP Company to the business broker and (c) a promissory note from FP Company to the sellers, *secured by personal guaranties from Fleck and Peek*;
7. As part of Fleck's and Peek's personal guaranties, a deed of trust (a mortgage) on their personal residences was also granted to the sellers;
8. In 2003 and 2004, Fleck and Peek converted their self-directed IRAs to Roth IRAs;
9. In 2006 the Roth IRAs sold FP Company to Xpect First Aid Co. for a considerable gain received in installments during 2006 and 2007 over the original purchase price;
10. Both Fleck and the Peek timely filed Federal income tax returns for the years 2006 and 2007, but did not report the gain on the sale of the FP stock (said stock being owned by their Roth IRAs at the time of sale;
11. The IRS examined those returns, adjusted petitioners' income to include capital gain from the sale of FP Company stock and in the alternative imposed excise tax; and
12. The IRS issued statutory notices of deficiency to Peek on December 9, 2010 and to Fleck on December 14, 2010.

Tax Court Opinion

The IRS contended that the Fleck and Peek IRAs (and their successor IRAs) ceased to qualify as IRAs as of the first day of 2001 through 2006, because Fleck and Peek made loan guaranties to the IRAs that were "prohibited transactions." If the IRAs failed to qualify as such, the gain on the sale of FP Company in 2006 should have been reported as income by Fleck and Peek.

Fleck and Peek disputed the IRS's contention that any prohibited transactions occurred, and instead contended that the IRAs remained qualified and therefore remained exempt from tax. Fleck and Peek argued that their personal guarantees of FP Company's note to the sellers of AFS were not the equivalent of a loan to the "plans," but a loan to FP Company.

While conceding that the loan guaranties at issue were between disqualified persons (Fleck and Peek) and an entity other than the plans, that is, FP Company, the Tax Court went on to say that (1) because Fleck and Peek each retained all authority and control over their IRAs they were "disqualified persons," and (2) that while their loan guarantees were *directly* to FP Company, they were *indirectly* to the IRA plans.

Unfortunately for Fleck and Peek, the statute prohibits both direct and indirect loans by disqualified persons to their IRAs.

Bottom Line

It's worth noting that the tax strategy suggested by the CPA contemplated the rollover of retirement funds to the Fleck and Peek IRAs and the use of those funds to subsequently acquire a business interest. However, an opinion letter from the CPA warned against prohibited transactions including loans by the IRA owners to their IRAs. There was no documentation indicating that Fleck and Peek

informed the CPA that they intended to personally guarantee loans taken by FP Company.

Taxes and similar topics are covered in great detail in many of Cannon's professional development solutions. To find out more visit: www.cannonfinancial.com.

Subscribe to Cannon Insights at http://www.cannonfinancial.com/newsletter/subscribe

---

WWW. CANNONFINANCIAL.COM