DEALING WITH ATYPICAL ASSETS IN IRAS AND QUALIFIED PLANS

By

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I. Introduction

When a qualified plan or an IRA invests in investments outside of the typical brokerage supplied investments, a number of potential qualification, taxation and fiduciary concerns and issues can arise. Such non-traditional investments may include investments in LLCs, partnerships, hedge funds, derivatives or even real estate in an IRA.

II. Prohibited Transactions Concerns

A. Overview

The prohibited transaction provisions of both the Internal Revenue Code ("Code") and of the Employee Retirement Income Security Act of 1974 ("ERISA") are designed to prohibit certain transactions between the plan and those persons whose relationship with the plan is so close as to raise questions as to whether they can ever actually deal at arm's length. Both ERISA and the Code prohibit transactions between the plan and certain persons. While the two statutes are virtually identical, ERISA contains a slightly more expansive listing of parties unable to engage in such transactions with the plan. [See ERISA §3(14) and Code §4975(e)(2)]

B. Transactions Prohibited

The transactions that are prohibited are the direct or indirect:

1. sale or exchange, or leasing, of any property between the plan and a party-in-interest;

2. lending of money or other extension of credit between the plan and a party-in-interest;

3. furnishing of goods, services, or facilities between the plan and a party-in-interest;

4. transfer to, or use by or for the benefit of, a party-in-interest, of any assets of the plan; or

5. acquisition, on behalf of the plan, of any employer security or employer real property absent compliance with the statutory exemption.

[ERISA Section 406(a); IRC Section 4975(c)(1)]

In addition, a transfer of real or personal property by a party-in-interest to a plan is treated as a prohibited sale or exchange if the property is subject to a mortgage or similar lien which the plan assumes or is subject to a mortgage or similar lien placed on the property by the party-in-interest within the 10 year period ending on the date of the transfer. [ERISA Section 406(c)]

ERISA describes the prohibited parties as parties in interest while they are described under the Code as a disqualified person. For ease of understanding, this outline uses the ERISA designation of parties-in-interest.

1. Direct or Indirect Transactions Prohibited

It is important to note that not just direct transactions between the parties are prohibited, but <u>indirect transactions</u> as well. For example, if an IRA sold an investment, for example, a limited partnership interest, to an unrelated third party who was not a party-in-interest who then in turn sold the investment to the IRA owner, the transaction could be collapsed and treated as an indirect prohibited transaction.

Similarly, the prohibition on the lending of money or other extension of credit between a qualified plan and a party-in-interest precludes not only direct loans between the two, but any transaction having the effect of a loan or extension of credit. For example, a prohibited transaction would occur if a loan to the plan is guaranteed by a disqualified person. Similarly, an attempt to purchase a previously issued and outstanding promissory note by an IRA in which the IRA owner and his spouse were the obligors similarly constituted a prohibited transaction. [Advisory Opinion 2011-04A, February 3, 2011]

Similarly, if a participant in a qualified plan borrows against his/her account and then lends the funds to the plan sponsor, i.e., the employer, such constitutes an indirect prohibited transaction.

2. Transfer or Use by a Disqualified Person

In addition, it should be noted that the prohibition on the transfer to (or use by or for the benefit of) a party-in-interest of any plan assets does not necessitate that the assets of a plan actually be transferred to a party-in-interest in order to come within the prohibition. Rather, it will be sufficient if the assets are used so as to benefit a party-in-interest.

<u>Rollins v. Commissioner</u>, TC Memo 2004-260 involved an accountant who, through his 100% owned corporation, maintained a Section 401(k) plan. As the trustee, he engaged in a series of loans from the plan as investments to various entities, in none of which did he own any amount close to a controlling interest. Rather, his ownership interest in the receiving entities (considering in some instances, ownership of his wife as well) was 15.18 (in an entity that had 28 other shareholders); 26.8% (in an entity with more than 80 other partners the next greatest interest being a couple who, between their two IRAs held an aggregate 8.8197%); and 33.165% (in an entity with more than 70 other partners with the next greatest ownership interest being 4.8809%). In none of the receiving entities was his interest anywhere close to 50%. However, he did appear to be the mover and shaker in each entity—signing each promissory note on behalf of the receiving entities and serving in some official capacity with each entity (Secretary or some other capacity).

Despite the fact that the court agreed that none of the receiving entities constituted a party-in- interest, the court agreed with the IRS that the arrangements constituted a prohibited "transfer to, or use by or for the benefit of, a party in interest" of the income or assets of the IRA.

Although the loans did not directly go to the taxpayer, a party-in-interest in his capacity as the fiduciary of the plan and owner of the plan sponsor, he sat on both sides of the table. The court noted that the taxpayer, while not owning a majority interest in any of the receiving entities, owned the largest interest in each of the borrowers. Further, the legislative history to ERISA indicates, the court states that a prohibited use of plan assets for the benefit of a party-in-interest may occur even though there was not a transfer of money or property between the plan and a party-in-interest.

The court seemed to find the following significant:

(1) while not a majority owner, the taxpayer owned the largest interest in each entity;

(2) the taxpayer effectively sat on both sides of the transactions both signing the checks from the plan and signing the promissory notes on behalf of the entities, and

(3) when one of the receiving entities was not able to make timely payment, the taxpayer made the payments with the understanding that ultimately he would be repaid when that particular investment was sold.

IRS also argued that the loans were transfers of plan assets that benefited the taxpayer and that the loans were dealings with the plan's assets in the taxpayer's own interest in violation of Section 4975(c)(1)(E). That is, in addition to arguing self-dealing as a result of a transfer to or use by or for the benefit of, a party-in- interest, of any assets of the plan, the IRS also argued self-dealing as a result of dealing with the assets of the plan in his own interest or for his own account. The IRS argued there that the taxpayer benefited from the loans in that the loans enabled the borrower/entities in which the taxpayer owned an interest—to operate without having to borrow at arm's length from other sources.

Because the court found that the arrangements violated Section 4975(c)(1)(D), (i.e., transfer of or use by a party in interest) it found no reason to reach the question as to whether they also ran afoul of Section 4975(c)(1)(E) (i.e., dealing with the assets of the plan for his own account).

Also of importance is the court's reminder that the taxpayer has the burden of proving by a preponderance of the evidence that the loans did not constitute uses of the plan's income or assets for his own benefit and he failed to do so.

A violation also occurs if the transfer or use is intended to benefit, not the fiduciary directly, but a member of the family of a fiduciary, i.e., the spouse, ancestor, lineal descendant or spouse of a lineal descendant of the fiduciary. [IRC Section 4975(e)(2)(F); IRC Section 4975(e)(6)] For example, an IRA owner proposed to have his IRA purchase a school and surrounding land run by his daughter and son-in-law subject to a proposed leaseback at fair market rents or less, based upon the ability of the school to pay. The DOL concluded that the arrangement would constitute a use of plan assets for the benefit of a party-in-interest in violation of Section 4975(c)(1)(D). [Advisory Opinion 933-33A, 12/16/1993]

C. Prohibited Parties

1. Parties Identified

The parties prohibited from engaging in the various transactions prohibited by the statute include:

(1) a fiduciary (including, but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of such plan;

(2) a person providing services to the plan;

(3) an employer any of whose employees are covered by the plan;

(4) an employee organization any of whose members are covered by such plan;

(5) an owner, direct or indirect, of 50 percent or more of

a. the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of the corporation;

b. the capital interest or profits interest of a partnership; or

c. the beneficial interest of a trust or unincorporated enterprise,

which is an employer or an employee organization described in 3 or 4 above;

(6) a spouse, ancestor, lineal descendant, or spouse of a lineal descendant of any individual described in 1, 2, 3, or 5 above;

(7) a corporation, partnership, or trust or estate of which (or in which) 50 percent or more of:

a. the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation;

b. the capital interest or profits interest of such partnership; or

c. the beneficial interests of such trust or estate; or

is owned directly or indirectly, or held by persons described in 1, 2, 3, 4, or 5 above;

(8) an employee, officer, director (or an individual having powers or responsibilities similar to those of directors or officers) or a 10 percent or more shareholder directly or indirectly, of a person described in 2, 3, 4, 5, or 7 above, or of the employee benefit plan; or

(9) a 10 percent or more (directly or indirectly in capital or profits) partner or joint venturer of a person described in 2, 3, 4, 5, or 7 above.

[ERISA Section 3(14)]

The prohibited transaction rules are designed to prevent a covered plan, or in the case of an IRA, the IRA, from dealing in transactions with individuals or entities so closely affiliated with the IRA that it is deemed impossible that the two could actually deal at arms-length.

2. IRA Owner

It should be recognized that in a self-directed IRA, the owner is a fiduciary by virtue of his/her control over the investment of the assets. [See IRC Section 4975(e)(2); ERISA Advisory Opinion 89-03A] As such, transactions between the IRA and the IRA owner or any entity controlled by the IRA owner would constitute a prohibited transaction, absent an exception or exemption.

D. Consequences of a Prohibited Transaction under a Qualified Plan

1. Consequences in General

Engaging in a prohibited transaction in a qualified plan results in the imposition of an initial excise tax followed by a second tier excise tax if the prohibited transaction is not timely corrected. [IRC Section 4975(a) & (b)]

Governmental plans and church plans that have not elected to be covered under ERISA are not subject to the excise tax but rather lose their tax exemption in the event of a prohibited transaction. [IRC Section 503(a)(1)(B)]

The first tier tax is equal to 15 percent of the amount involved with respect to the prohibited transaction for each year, or part thereof, in the taxable period. The tax is to be paid by the disqualified person (party in interest) who participates in the prohibited transaction other than a fiduciary acting only as such. [IRC Section 4975(a)]

However, if the prohibited transaction is not corrected within the taxable period, an additional tax equal to 100 percent of the amount involved will be due. [IRC Section 4975(b)]

The taxable period begins on the date of the prohibited transaction and ends on the earliest of (1) the date of mailing of a notice of deficiency with respect to first tier tax; (2) the date on which the first tier tax is assessed; or (3) the date on which correction of the prohibited transaction is completed. [IRC Section 4975(f)(2)] If more than one person is liable for either of the taxes, all such persons are to be jointly and severally liable with respect to the transaction. [IRC Section 4975(f)(1)]

2. Possible Quick Fix To Prohibited Transaction

A prohibited transaction will generally not include a transaction in connection with the acquisition, holding, or disposition of any security or commodity if the transaction is corrected before the end of the correction period. [IRC Section 4975(d)(23)] Correction means, essentially undoing the transaction.

The correction period means, for purposes of this special rule, the 14-day period beginning on the date on which the disqualified person discovers, or reasonably should have discovered, that the transaction would (without regard to this special rule) constitute a prohibited transaction. [IRC Section 4975(f)(11)]

The special rule is not available with respect to any transaction between the plan and a plan sponsor or affiliate that involves the acquisition or sale of employer securities or the acquisition, sale or lease of employer real property. The special rule is also not available if the disqualified person knew (or reasonably should have known) at the time of the transaction is entered into that the transaction would (without regard to the special rule) constitute a prohibited transaction. [IRC Section 4975(f)(11)]

Where this special rule is available, the excise tax is not assessed.

While the excise tax is not applicable to IRAs, the fact that it is the application of Section 4975 to an IRA that would cause the IRA to lose its tax exempt status would suggest, although not entirely clear, that the special rule should, most likely, be applicable to IRAs as well.

Note, however, that the exemption is from transactions under Section 4975(c)(1)(A), (B), (C) or (D), but not from the two of the self-dealing prohibitions contained in Section 4975(c)(1)(E) or (F).

E. Participant-Directed Accounts in Qualified Plans—Nonpublic Investments

If a participant directing the investment of his/her account is not otherwise a party in interest, he or she does not become a disqualified person, for purposes of ERISA, simply by virtue of directing the investment of his/her account. This is because ERISA Section 404(c)(1)(A) provides that a participant or beneficiary is not deemed to be a fiduciary by reason of such exercise.

However, there is no similar relief provided in the applicable Code definition of disqualified person. Rather, for purposes of Section 4975, the term “fiduciary” is defined to mean 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.

[IRC Section 4975(e)(3)]

This means that plans with open window investment options must still ensure that a participant does not cause the plan to engage in a prohibited transaction by virtue of the participant’s investment options.

For example, take the case of Flahertys Arden Bowl, Inc. v. Comm., 115 T.C., No. 19 (9/25/00), affirmed, 271 F. 3d 763 (8th Cir. 2001).

Flaherty, an attorney, participated in a qualified plan through his law firm that allowed him to direct the investment of his account. Flaherty directed the plan's bank trustee to make loans to a corporation unrelated to the law firm but in which Flaherty owned 57 percent.

Before making the loans, however, Flaherty had consulted with the bank's attorney who advised him that the loan would not constitute a prohibited transaction. The notes carried market interest rates and were repaid in full.

However, the IRS subsequently determined that the unrelated entity was a disqualified person under Section 4975 and that therefore, the loans constituted prohibited transactions and that the prohibited transaction excise tax was due as well as failure to file penalties attributable to the failure to file Form 5330.
The IRS concluded that the entity was a disqualified person as more than 50% was owned by the participant who was, as to the participant's own account, a fiduciary.

The argument was that by virtue of Flaherty's right to direct the investment of his account, he was, by definition of plan fiduciary and since he owned more than 50% of Flaherty's Arden Bowl, that entity was a disqualified person. Flaherty, on the other hand, argued that although he was a fiduciary for purposes of Section 4975, ERISA Section 404c contains a specific exemption providing that participants who direct their accounts will not be treated as fiduciaries. Therefore, the taxpayer argued that Flaherty's Arden Bowl could not be a disqualified person if Flaherty is not a fiduciary.

The tax court held in favor of the IRS concluding that because IRC Section 4975 does not contain a parallel exemption from the definition of fiduciary for participants who direct their own investments, Flaherty could be and in fact was a fiduciary for purposes of the Code prohibited transaction provisions.

F. Prohibited Transactions and IRAs

1. Consequences

Unlike a qualified plan where a prohibited transaction results in an excise tax, the consequences to an IRA are much more severe.

Where an IRA owner engages in a prohibited transaction, the consequences to the IRA owner of such a prohibited investment by an IRA is full disqualification of the IRA (and not just the amounts involved) and therefore, income inclusion of the full amount of the IRA subject, if applicable, to the early distributions excise tax of Section 72(t) as well. [IRC Section 4975(c)(3); 408(e)(2)(A); 408(e)(4)]

2. Analyzing the Proposed IRA Transaction or Investment for Prohibited Transactions

If the proposed investment vehicle itself is a party-in-interest, the proposed transaction would constitute a *per se* prohibited transaction and would be prohibited. Engaging in the transaction would result in full disqualification of the IRA.

A determination as to whether the proposed investment is itself a per se party in interest requires merely an objective application of the definition of "party-in- interest," i.e., disqualified person, to determine whether directly or taking into consideration the applicable attribution rules, the entity, individual or investment would fall within the definition of a party in interest.

For example, the owner of a self-directed IRA proposes to have her IRA invest in the stock of a corporation owned 100% by the IRA owner. Since the IRA owner is a fiduciary of her IRA, this is in essence a proposal to have the IRA engage in a sale or exchange between the IRA and a party-in-interest, that is, the corporation. The corporation is a party in interest because in the example 50 percent 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 such corporation is owned directly or indirectly, or held by a fiduciary to the IRA.

In this example, we only had to look at the IRA owner's interest to determine whether the proposed investment was itself a prohibited transaction. However, the provisions of the Code, but not of ERISA, includes a constructive ownership rule that we must also be mindful of and which will have application in dealing with issues of ownership. Specifically, the Code's statutory provisions governing prohibited transactions, but not ERISA, apply the provisions of Section 267(c), i.e., the Code rules that would be used to deny deductions for losses attributable to transactions among related parties for purposes of determining whether the more than 50% test of Items 5 or 7 are satisfied.

Section 267(c) provides three rules of interest here:

(1) stock 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;

(2) an individual shall be considered as owning the stock owned, directly or indirectly, by or for his family, except that, in accordance with Section 4975(e)(4) and (6), family members include the spouse, ancestor, lineal descendants and any spouse of a lineal descendant, and

(3) an individual owning (other than by family attribution) any stock of a corporation shall be considered as owning the stock owned, directly or indirectly by or for his partner. (partner to partner attribution rule).

[IRC Section 267(c)]

With the exception to the third rule, which applies only to a corporation where its shareholders are also investors in a partnership, these rules are to be applied to both corporations as well as partnerships.

Since the Department of Labor (DOL) actually has jurisdiction over the application of the prohibited transaction provisions to IRAs but has no comparable Code Section 267 attribution rule in its statutes, it was not immediately clear whether, in exercising its jurisdiction, the DOL would apply these constructive ownership rules. Two DOL Advisory Opinions (essentially, equivalent to an IRA Private

Letter Ruling) suggest that, although the DOL does not have the authority to interpret Section 267, it may well endorse its application to determine party-in-interest status. In the earliest Advisory Opinion in which Section 267 became an issue, the DOL did not find it necessary to its resolution to actually apply its aggregation rules but appeared to endorse the statute's use. [Advisory Opinion 79-37A, 06/20/1979] In a more recent Advisory Opinion, while the DOL did not itself interpret and apply Section 267, it used the result in its resolution. [Advisory Opinion 2009-02A, 09/28/2009]

As such, in determining whether a proposed investment constitutes a per se prohibited transaction, it is necessary to look, not only at direct ownership, but ownership by attribution as well.

For example, Advisory Opinion 2006-01, January 6, 2006 involves the following facts. An S corporation in a community property state was owned 68% by the marital community (i.e., husband and wife) with the remaining 32% owned by a third party ("third party"). The husband proposed to create an LLC that would purchase land, build a warehouse and lease the property to the S Company. The investors in the LLC would be the husband's IRA (49%) and two unrelated (as to the husband) individuals' IRAs, i.e., "R"31% and "G" 20%. The two unrelated individuals would manage the LLC.

In terms of the parties-in-interest, the ownership of the LLC was such that it would not be a party in interest as to the husband's IRA. However, by virtue of being owned 68% by the husband and wife, S is a party-in-interest as to the husband's IRA

The DOL concludes that a lease of property between the LLC and S Company would be a prohibited transaction under Code Section 4975, at least as to the husband's IRA.

In analyzing the proposed transaction, the DOL first notes that a transaction between a party-in-interest, in this case, the S Company, and a corporation in which a plan has invested (i.e., the LLC) does not generally give rise to a prohibited transaction. However, Labor Regulation Section 2509.75-2(c) and DOL opinions interpreting it have made clear that a prohibited transaction occurs when a plan invests in an entity as part of an arrangement or understanding under which it is expected that the corporation will engage in a transaction with a party-in-interest.

According to the representations, the husband's IRA would invest in the LLC under an arrangement or understanding that anticipates that the LLC will engage in a lease with S company, a party-in-interest. Therefore, the lease would amount to a transaction between the husband's IRA and S in violation of the prohibition on sales, exchanges and leases between a plan and a party-in-interest notwithstanding the indirect nature of the transaction. It should also be noted that the transaction would also be deemed to run afoul of other prohibitions as well, specifically, Code Sections 4975(c)(1)(D) and (E).

III. Self Dealing Concerns

A. Even if the Proposed Investment is Not itself a Party-In-Interest, would it constitute Self-Dealing?

Aside from the more objective prohibitions of the prohibited transaction provisions, a fiduciary, including in the case of an IRA, the IRA owner, is prohibited from engaging in certain acts of self-dealing. These rules, with their more subjective provisions, can ensnare a proposed transaction even where the investment would not itself constitute a prohibited transaction. The prohibited transactions provisions apply to any party that becomes a party-in-interest while the self-dealing rules prohibit a fiduciary from, directly or indirectly:

(1) dealing with the assets of the plan in his own interest or for his own account;

(2) in his individual or in any other capacity, acting in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or

(3) receiving any consideration for his/her own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

[ERISA Section 406(b)]

One of the primary problems with the self-dealing prohibitions is that, unlike the basic prohibited transaction rules which are mostly objective, the self-dealing prohibitions are much more subjective and lack any numerical ownership test.

To avoid self-dealing, the plan's fiduciary has to in all events avoid circumstances in which the fiduciary makes money as a result of the plan's investment. For example, a fiduciary who also runs a hedge fund would need to avoid receiving income as a result of having his IRA or the qualified plan in which he is a fiduciary invest in that fund. While there is a statutory exemption for the payment of reasonable compensation to a party-in-interest for the provision of services necessary for the establishment or operation of the plan, the DOL's position is that the list of exemptions apply solely for purposes of the prohibited transaction prohibitions and not as exemptions from self-dealing. Not all courts have agreed with the DOL's interpretation, however. [ERISA Section 408(b)(2); IRC Section 4975(d)(2); Labor Reg. Section 2550.408b-2(e(1), but see Harley v. Minnesota Mining and Manufacturing Co., 284 F. 3d 901 (8th Cir. 2002) and Lowen v. Tower Asset Management, Inc., 829 F. 2d 1209 (2d Cir. 1987)]

However, issues of self-dealing can also arise even where the fiduciary is not receiving any direct compensation as a result of the plan investment. In fact, there are a number of situations addressed by the DOL in Advisory Opinions where the person proposes to use funds from an IRA to provide a loan or to purchase an interest in an entity that is itself not a party-in-interest but where the affiliation is such that the DOL believes the plan or IRA owner may have divided loyalties.

B. Investing in Entities Where There is a Prior Relationship

The DOL is always concerned that when a plan or an IRA invest in an entity with which the IRA owner or plan has a relationship. The concern is whether the fiduciary will place the interest of that entity ahead of the best interest of the plan thus resulting in self-dealing.

For example, where individuals who were employed by a privately held company wished to purchase stock of that corporation in their IRAs, the DOL would only state that "depending on the degree (if any) of the IRA participant's interest in the transaction, the purchase and holding of the company stock by IRA participants, such as officers or directors of the company, who may have an interest in the transaction which may affect their best judgment as fiduciaries of the IRAs raises questions under section 4975(c)(1)(D) and (E) (i.e., the prohibited transaction prohibition on the transfer to or use by or for the benefit of a party in interest of assets of the IRA and the self-dealing prohibition listed in (1) from the list above). [PWBA Letter 04/09/1993]

In DOL Advisory Opinion Letter 88-18A, 12/23/1988, the owner of a self-directed IRA made a loan to a corporation in which the owner and related parties owned a 48.14% interest. Because the ownership was less than 50%, the corporation was not a party in interest. Nevertheless, without even being asked the question, the DOL takes the opportunity to remind the individual that the regulations describe these types of transactions as "arrangements involving the use of authority by fiduciaries to cause plans to enter into transactions when those fiduciaries have interests which may affect the exercise of their best judgment as fiduciaries." The agency goes on to remind that the IRA owner is a fiduciary with respect to the IRA and also has a substantial ownership interest in the corporation. Therefore, the DOL states, "the Corporation is a party in whom [the IRA owner] has an interest which might affect his best judgment as a fiduciary. Accordingly, a prohibited use of plan assets for the benefit of a disqualified person under section 4975(c)(1)(D) or an act of self-dealing under section 4975(c)(1)(E) is likely to result if [the IRA owner] directs the IRA to loan funds to the corporation.

C. Parallel Investments

1. Background

The self-dealing provisions can be applied where the DOL thinks that a possible investment by both the IRA owner individually and by the IRA, (or by a qualified plan), results in a potentially conflicted fiduciary.

In this context, the DOL is always suspicious of parallel investments, that is, investments where both the IRA owner and the IRA invest in the same investment. The concern by the DOL is for the then current or potential for a conflicted fiduciary who will take his/her own individual needs into account at the expense of the needs of the plan, i.e. IRA.

If the entity in which the investment is made is itself a party-in-interest, the general prohibited transaction provisions discussed above would control. Where, as is often the case, the entity does not itself qualify as a party- in-interest, such as where the underlying investment vehicle is a limited partnership and the ownership interest is such that the partnership itself is not a party-in-interest with respect to the IRA, issues may nevertheless arise as to whether the fiduciary, by allowing the IRA to invest in an entity where a party-in-interest is also an investor, is (1) dealing with plan assets in his/her own interest or for their own account or (2) representing a party whose interests are adverse to the IRA, or (3) receiving personal consideration from a party dealing with the IRA in connection with the transaction. Owing to the lack of specific regulatory guidance, the issue is addressed most frequently through less official guidance.

2. Alpert Leasing

An Information Letter dated September 4, 1981, [Opinion Letter (Sept. 4, 1981)—Alpert Leasing] involved a partnership that had been formed to invest in land and to hold it for resale. The partnership was constructed to consist of two groups: (1) the finder and (2) the cash group. The finder would own 50 percent and the cash group would own the remaining 50 percent. However, the entire purchase price for the land was to be paid by the cash group. Once the property was contributed to the partnership, the amount paid by the cash group was to be considered 50 percent as an investment in the partnership and the remaining 50 percent as a loan to the finder. The plan as well as parties-in-interest invested as part of the cash group.

The DOL notably concluded that there is no per se prohibition on concurrent investments by the plan and a party-in- interest. Rather, the DOL concluded that a *potential* conflict of interest exists. Such a conflict may develop where, for example, the fiduciary causes the plan to retain its interest or to dispose of its interest in the partnership when the action would not be in the plan's best interest. Further, the DOL noted that where the underlying assets of the partnership are considered plan assets, (discussed below) transactions involving the partnership might also give rise to prohibited transactions.

Similarly, in Advisory Opinion 82-08A, where four brothers owned 100% of a corporation with each owning less than 50% individually, the brothers requested a ruling that each could make a loan from his IRA to the company without running afoul of the basic prohibited transaction rules. However, rather than addressing whether the corporation was a disqualified person, i.e, a party-in-interest as requested, the DOL instead went to the question of self-dealing. Rather than addressing whether such a loan would constitute a loan to a party-in-interest, the DOL instead turns to the self-dealing prohibitions. Because each brother had a substantial ownership interest in the company, the company was viewed by the DOL as a party in whom the brothers have an interest that might affect their best judgments as fiduciaries. Therefore, the response concludes that self-dealing would be likely to result if one of the brothers directed his IRA to loan funds to the company. In light of this conclusion, the DOL saw no reason to address the issue of whether the company was a party in interest.

However, more recently, the DOL concluded that the investment of an IRA in a family partnership in which the fiduciary and various relatives had invested in order to allow the IRA to meet the minimum capital necessary to be invested by Bernie Madoff would not constitute a prohibited transaction. The ruling concludes that the partnership would not constitute a party-in-interest. Moreover, the DOL notes in that ruling that a violation of Code Sections 4975(c)(1)(D) or (E) will not occur merely because the fiduciary derives some incidental benefit from a transaction involving IRA assets. [Advisory Opinion 2000-10A, 07/27/2000]

Given the lack of clear cut standards as to whether a transaction will run afoul of one of the self-dealing prohibitions, where the transaction is contemplated to involve some, but not all of an IRA, consideration should be given to first dividing the IRA into two IRAs, one of which will remain unexposed.

E. Self-Dealing and Consulting and Other Ancillary Compensation Arrangements

Sometimes, by becoming an investor in the limited partnership or other arrangement, the IRA owner or qualified plan fiduciary may also be eligible to serve as a consultant to the arrangement or otherwise be paid for providing services. This may occur, for example, in the context of free standing physician owned medical clinics where the investing physician will also be paid for providing services.

Where the IRA owner will be receiving other benefits as a result of his IRA investment, whether in the form of consulting compensation or additional stock in the investment, a similar argument could be made. That is, the argument could be made that it constitutes the transfer to, or use by or for the benefit of, a party in interest, of assets of the IRA. In addition, it could be argued that it constitutes the receipt of consideration for his/her own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan. Until they added an administrative exemption, the DOL ruled that things such as free checking received on a personal account when someone transferred their IRA or Keogh account to a bank ran afoul of this provision.

IV. Using the Plan to Purchase a Business

A. Background

One Tax Court case has spurred the development of an industry promoting the use of rollover retirement funds or IRAs to purchase a business. The IRS refers to these arrangements as ROBs (rollover business start-ups) as they usually involve the use of a rollover account from a prior employer, such as a Section 401(k) plan.

Under some of these arrangements, the business start-up firm provides the potential business owner with a new shell C corporation which then establishes a Section 401(k) plan designed to allow for investment in stock of the corporation. Funds from the new shareholders old Section 401(k) account from his/her prior employer are then rolled into the new Section 401(k) plan and used to purchase stock in the company.

Where established in an IRA, it may involve the establishment of a limited liability company as a wholly owned subsidiary of the IRA.

B. How it's Presented

There are on-line businesses promoting this approach. In addition, it is often discussed at conferences for those interested in purchasing a franchise.

It is generally presented as a turn-key approach pursuant to which, a fee is paid for the necessary off the shelf corporate establishment documents, plan documents as well as instructions as to how it is to be done. They are generally referred to as Roll-over as Business Start-Ups or ROBs.

Essentially, the business start-up firm provides a new shell C corporation which then establishes a Section 401(k) plan designed to allow for investment in stock of the corporation. Funds from the new shareholders old Section 401(k) account from his/her prior employer are then rolled into the new Section 401(k) plan and used to purchase stock in the company.

Accordingly, a ROB transaction follows the following sequential steps as described by the IRS in an internal memorandum:

(1) 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.

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

(3) 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.

(4) 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.

(5) 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.

(6) 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.

(7) 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.

(8) 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.

[Memorandum for Director, Employee Plans Examinations Director, Employee Plans Rulings & Agreements, from Michael D. Julianelle, Director, Employee Plans, SE:T:EP, October 1, 2008; http://www.irs.gov/pub/irs-tege/robs_guidelines.pdf

C. How the Arrangement is Viewed by the IRS

The IRS views these arrangements as, in the best case scenario, operating in a gray area, and in the worst case fraught with potential violations and disqualifying features.
The IRS has raised several concerns with ROBs and issued a Memorandum directed to agents in the examination and determination letter functions discussing the issues and which is discussed in the following analysis. [Memorandum for Director, Employee Plans Examinations Director, Employee Plans Rulings & Agreements, from Michael D. Julianelle, Director, Employee Plans, SE:T:EP, October 1, 2008; http://www.irs.gov/pub/irs-tege/robs_guidelines.pdf

1. Nondiscrimination Issues

As a condition of tax qualification, a retirement plan must satisfy the nondiscrimination requirements of IRC Section 401(a)(4). These rules include a requirement that a plan's benefits, rights and features be nondiscriminatory. Because ROBs are generally established such that only the identified potential business owner involved is to be allowed to purchase shares in the company, the examining agent is directed to review whether the ability to purchase stock in the company impermissibly benefits highly compensated employees.

The term "highly compensated participant" means either: (1) a 5% owner, defined using the attribution rules of IRC § 318, or (2) receives compensation over $80,000 (indexed, and subject to a "top-paid group" election by the employer) [IRC Section 414(q)(1)] For purposes of determining stock ownership for this purpose, stock owned by a retirement plan is not attributed to the participant in the plan in whose account the stock is allocated. [IRC § 318(a)(2)(B)(i)]

In order for a benefit, right or feature to satisfy the nondiscrimination requirements, it must be both "currently available" and "effectively available." [Treas. Reg. § 1.401 (a)(4)-4(a)] The stock purchase is likely to satisfy the "current availability" prong of the requirement as it is likely that at the time of the actual purchase, no one qualifies as a highly compensated employee.

However, the IRS believes that such arrangements may fail to satisfy the "effective availability" requirement. Treas. Reg. § 1.401 (a)(4)-4(c) provides that a benefit, right or feature must also be "effectively available" to non-highly compensated employees determined based upon all facts and circumstances. In addition, 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 highly compensated employees involves a facts and circumstances determination.

Effective availability testing requires a facts and circumstances determination regarding whether a plan feature benefits non-highly compensated employees. 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 benefits, rights or features testing issues. Furthermore, Treas. Reg. § 1.401 (a)(4)-5 requires consideration as to whether the timing of plan amendments serves to preclude other non-highly compensated employees from receiving stock allocations. Given that ROBs arrangements are designed to take advantage of a one-time only stock offering, the IRS argues that the investment feature generally would not satisfy the effectively available benefit requirement because the plan is designed in a manner that the benefit, right or feature will never be available to any non-highly compensated employees.

For this reason, IRS agents are instructed that 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.

2. Prohibited Transaction—Valuing the Stock

In the ROB transaction, ultimately, the capital stock of the company is exchanged for qualified plan assets. The value of the stock is set as the value of the available assets. The IRS states in the internal Memorandum that, if there is an appraisal, it is generally a fairly simple analysis designed to support the valuation of the stock as being equal to the value of the available corporate assets.

The general rule is that a sale or exchange between a plan and a party-in-interest (a term that includes the plan sponsor), is a prohibited transaction which must be undone and which is subject to a 15% excise tax. [IRC §4975]

However, there is an exception for the acquisition or sale of qualifying employer securities provided that, among other requirements, the acquisition or sale is for “adequate consideration.” [ERISA § 408(e)]

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). That section provides 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. [ERISA § 3(18)] This means that, an exchange of company stock between the plan and the company would be a prohibited transaction unless the requirements of ERISA §408(e) are satisfied.

Since the company is new, the agent is advised that there may be a question as to whether it is indeed worth the tax deferred dollars exchanged. The IRS notes in the Memorandum that many of the valuations are essentially unsupported with the business owner providing the examiner 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. The IRS views these appraisals as questionable at best. Because the valuation usually approximates available funds, the agent is instructed to give consideration as 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.

3. Prohibited Transaction—Promotion Fees

The IRS may also raise concerns where fees for the firm promoting the arrangement are paid from the plan. Specifically, the IRS argues that the relationship may be such that the business promoter is effectively rendering “investment advice” to the plan within the meaning of Labor Reg. Section 2510.3-21(c). In such case, the business promoter would become a functional fiduciary to the plan.

Where the functional fiduciary status does arise, paying that business promoter with plan assets would itself constitute a prohibited transaction. [IRC § 4975(c)(1)(E)] The IRS points out 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 the business promoter 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.

The Memorandum notes that in an attempt to "insulate" client adopters against prohibited transaction issues, one business promoter has created a multiple employer plan with each client adopting-in as a participating employer. Notwithstanding this attempt, the IRS instructs its agents that this analysis applies equally in such cases as well.

4. Plan Not Communicated to Employees

Treas. Reg. § 1.401-1(a)(2) provides that, as a condition of tax qualification, the plan must not only be a definite, written program, but it must also be communicated to employees. In the case of ROBs, agents are instructed to determine whether this requirement has been satisfied and, if not, the plan may fail to qualify.

If the plan is a Section 401(k) plan, if the agent can establish that employees were not permitted to make elective deferrals, the plan would also violate IRC § 401 (k)(2)(A) in that it did not permit eligible employees to elect salary deferral contributions.

D. Avoiding a Prohibited Transaction on the Set Up

In all events, the business is purchased in a way designed to avoid having the plan purchase the business interest in a way that would give rise to a prohibited transaction. Each attempts to fall within the Tax Court’s decision in Swanson v. Commissioner, 106 T.C. 76 (1996)

In that case, the taxpayer, James Swanson, the sole shareholder of H&S Swanson’ Tool Co. Swanson subsequently organized Swansons’ Worldwide Inc. (Worldwide), a domestic international sales corporation. At about the same time, he arranged the formation of a self-directed IRA. Swanson directed the bank trustee of the IRA to subscribe to 2,500 shares of Worldwide original issue stock, and those shares were issued to the IRA, which became Worldwide’s sole shareholder. Swansons’ Tool paid commissions to Worldwide, receiving preferential treatment under section 991, and Worldwide paid dividends to the IRA, which were tax deferred under section 408.

The IRS concluded that the sale of stock to the IRA constituted a prohibited transaction. Swanson, however, argued that there could be no transaction with a party-in-interest because the shares, being original issue, were purchased directly between the IRA and Wholesale which at that point, had no owners.

The Tax Court agreed concluding that the Worldwide stock acquired in that transaction was newly issued — prior to that point in time, Worldwide had no shares or shareholders. A corporation without shares or shareholders does not fit within the definition of a party-in-interest. The court goes on to state that it was only AFTER Worldwide issued its stock to the IRA that petitioner held a beneficial interest in Worldwide's stock, thereby causing Worldwide to become a party-in-interest. That is, when the initial stock of Worldwide was issued to the IRA, the newly issued stock was not owned by anyone at the time of the sale. Thus, the sale of stock to the IRA was not a sale or exchange of property between the IRA and a party in interest.

Even if the prohibited transaction provisions can be avoided upon initial establishment, these arrangements often run afoul of other rules down the line. For example, if the IRA owner subsequently personally guarantees loans for the business a prohibited transaction could arise. [See, e.g., Peek v. Comm., 140 T.C. 216] Indeed, after the stock is issued, any subsequent transactions between the plan and the entity could give rise to a prohibited transaction.

E. Other IRS Challenges to the Arrangement

1. Payment of Compensation

For example, in Ellis v. Commissioner, TC Memo 2013-245, where the taxpayer established an LLC as a wholly owned subsidiary of his IRA, following the approach in Swanson, he was able to avoid a prohibited transaction upon establishment of the arrangement. However, the court found that the payment of compensation to the taxpayer from the LLC as the general manager of the business constituted a prohibited transaction.

The court was unpersuaded by the taxpayer's argument that the payment of compensation was from the company's bank account and not from the IRA and consisted merely of the income or assets of a company in which his IRA had invested. Rather, the court points out that 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).

2. Substance over Form—Avoidance of IRA Limits

The IRS has other avenues to challenge ROBs.

For example, in Summa Holdings, Inc., TC Memo 2015-119 TC Memo 2015-119, the Tax Court held that a series of transactions involving Roth IRAs were just intended to avoid the contribution limits.

Parents James and Sharen Benenson were trustees of a trust in which their two sons were beneficiaries. Summa was the parent corporation of a consolidated group of manufacturing companies. In 2001, each of the sons established Roth IRAs and transferred $3,500 to their respective IRAs and each IRA then purchased 1,500 shares of stock in JC Export, a Delaware corporation. JC Export filed a Form 4876-A, Election to be Treated as an Interest Charge DISC (DISC election). Summa entered into several transactions with the DISC which ultimately resulted in payments of several million dollars to JC Export which in turn paid most of what it received to the Roth IRAs as payments of dividends.

The IRS determined that the payments made to JC Export were in substance dividends to Summa's shareholders, followed by contributions by the shareholders into the sons' Roth IRAs. Accordingly, the IRS (1) disallowed the DISC commission deductions that Summa claimed for the payments it made and the deduction for expenses that it paid on behalf of JC Export and JC Holding during 2008; (2) determined that James Jr. received $2,239,006 in dividends from Summa as the shareholder of Summa (or in the alternative, that he received $519,002 and the Benenson Trust received $1,702,764 in dividends from Summa on the basis of their respective ownership interests in Summa); and (3) determined that Summa's shareholders contributed $1,119,503 to each of the Benenson Roth IRAs. Since the contributions to the Roth IRAs exceed the annual contribution limits for Roth IRAs, the IRS assessed excise taxes for the overcontribution of $67,170 for 2008. The IRS also determined that Summa was liable for other penalties in the amount of $56,182 for its taxable year ending on April 30, 2008.

The Tax Court agreed with the IRS applying the doctrine of substance over form. The parties had stipulated that the petitioners' sole reason for entering into the transaction was to transfer money into the various Roth IRAs. The court had little trouble holding that the payments to JC Export were not DISC commissions, but rather dividends to Summa's shareholders followed by contributions to the Roth IRAs and accordingly, the court granted the IRS's motion for partial summary judgment and denied the petitioners' motion for summary judgment.

The IRS reached a similar result in <u>Polowniak v. Commissioner</u>, TC Memo 2016-31.

Polowniak operated as a consultant through his Subchapter Scorporation Solution Strategies, Inc. ("Strategies'). After meeting with an attorney who advocated something he referred to as a Private IRA Corporation (PIRAC), Polowniak set up Bevco Investments (Bevco) a subchapter C corporation adopting a January 31 year end. Polowniak was the sole officer, director and employee of Bevco. In a PIRAC arrangement, an individual's new Roth IRA would purchase the stock of a new corporation. In most such arrangements, the PIRAC would then engage in transactions with the individual's preexisting business, generally a pass through entity such as a Subchapter S entity like Strategy.

Polowniak then set up a new Roth IRA founded with an initial contribution of $2,000. Polowniak then directed his Roth IRA to purchase 98% of Bevco's voting stock, with 2% nonvoting stock purchased by Polowniak's administrative assistant. Thereafter, Polowniak's then wife also established a Roth IRA, funded with $655 which was used to purchase 6% of Bevco stock from her husband.

Following the establishment of Bevco, Strategies and Bevco entered into a subcontracting agreement for Polowniak's consulting services. The agreement provided that Strategies would pay Bevco 75% of the revenue it received from its consulting services.

In exchange for this payment Bevco was expected to provide certain specified services for Strategies which would be provided personally by Polowniak. These services were enumerated as follows: (1) propose worldwide structure changes for six divisions of Delphi (Bevco's primary client); (2) create business planning models to include forecasting and pricing models: (3) hire and appoint sales leadership positions; and (4) build business strategies for Delphi to implement with worldwide customers. This was the only contract ever executed between Bevco and Strategies. Delphi was never informed of this subcontracting agreement. Before Strategies made payments under the contract, petitioner's accountant suggested that research be reviewed to verify the propriety of disclosing excess contributions made to petitioner's Roth IRA to “capitalize” Bevco, but no Form 5329 was filed.

The IRS determined that Strategies had failed to report income it received from Delphi. In addition, the IRS assessed Polowniak for the 6% excess IRA contribution under Section 4973. The notice of deficiency used the gross receipts reported on Bevco's Form 1120 to measure the excess contribution amount and then determined that Polowniak was liable for $89,905 in excise tax on the following amounts: (1) Bevco's gross receipts of $782,390 for its taxable year ending January 31, 2003, reported on its 2002 Form 1120 and (2) Bevco's current fiscal year gross receipts of $719,537 for its taxable year ending January 31, 2004, reported on its 2003 Form 1120 but (3) less the allowable Roth IRA contribution amount for 2004.

In addition to other income tax adjustments for the entities, the IRS determined that Polowniak was liable for excise tax under section 4973. Because section 4973 provides for a 6% excise tax on the total amount of excess contributions remaining in a Roth IRA on a yearly basis, the IRS included the cumulative excess contributions from Polowniak's previous tax years 2003 and 2004 as well as 2005. The notice of deficiency again used the gross receipts reported on Bevco's Form 1120 to measure the excess contribution amount and then determined that petitioner was liable for $130,646 in excise tax under section 4973 on the following amounts: (1) Bevco's gross receipts of $782,390 for its taxable year ending January 31, 2003, reported on its 2002 Form 1120; (2) Bevco's gross receipts of $719,537 for its taxable year ending January 31, 2004, reported on its 2003 Form 1120; and (3) Bevco's gross receipts of $680,000 for its taxable year ending January 31, 2005, reported on its 2004 Form 1120; but (4) less the allowable Roth IRA contribution amount for 2005.

In addition, the IRS determined in both notices of deficiency that petitioner failed to file Form 5329 to report the excess contributions either to a Roth IRA or prior year excess contributions in his Roth IRA. The IRS determined that Polowniak failed to file Form 5329 and was, therefore, liable for additions to tax under section 6651(a)(1) for failure to timely file and section 6651(a)(2) for failure to timely pay. Respondent also determined petitioner failed to attach to his income tax return any Forms 8886, Reportable Transaction Disclosure Statement, and determined enhanced accuracy-related penalties under section 6662A for understatements attributable to listed transactions.

Again applying the substance over form doctrine, the Tax Court quickly found that the preponderance of credible evidence compels a finding that the resulting transfers from Strategies of the Delphi payments to Bevco were nothing more than a mechanism for transferring value to the Roth IRA. The subcontract agreement did not change the services provided to Delphi, and Polowniak continued to do all of the work as he had done before the contract was put in place and after the payments were made to Bevco. Accordingly, the Court finds that the amounts transferred from Strategies to Bevco constituted excess contributions to Polowniak’s Roth IRA. [citing Repetto v. Commissioner, T.C. Memo. 2012-168 [2012 RIA TC Memo ¶2012-168]

3. Prohibited Transactions after Initial Set-up

In Peek v. Commissioner, 140 T.C. No. 12 (2013), the Tax Court held that taxpayers had engaged in a prohibited transaction when they personally guaranteed a loan to purchase an existing business through their newly established company owned by their IRAs.

The IRS argued, and the court agreed that the taxpayers' personal guaranties of the $200,000 promissory note to the sellers as part of the company's asset purchase constituted a direct or indirect lending of money or other extension of credit between a retirement plan and a disqualified person in violation of the prohibited transaction provisions.

The court agreed with the IRS quickly dispensing with the taxpayers' argument that the prohibiting only extended to direct loans. The court notes that if the statute prohibited only a loan or loan guaranty between a disqualified person and the IRA itself, then the prohibition could easily and abusively be avoided simply by having the IRA create a shell subsidiary to whom the disqualified person could then make a loan. The language of the statutory prohibition, the court finds, when given its obvious and intended meaning, prohibited the taxpayers from making loans or loan guaranties either directly to their IRAs or indirectly to their IRAs by way of the entity owned by the IRAs.

V. Valuation Issues Including 5500 Filings

A. Valuation

Assets of a plan must be properly valued at least annually to allow for proper distribution to participants as well as to avoid fiduciary breaches and/or prohibited transactions. Failure to properly value could mean that participants have been paid too much or too little. Valuation issues can arise when dealing with non-publicly traded or otherwise hard to value assets. These types of investments can also give rise to other plan issues.

The IRS is particularly concerned about the proper valuation of stock purchased as part of a ROB (i.e, where rollover funds are used to purchase a business through a qualified plan or IRA). The purchase or sale of stock between a plan and a party-in-interest, including the plan sponsor, is a prohibited transaction unless, among other requirements, it is purchased or sold for adequate consideration. [ERISA Section 408(e)] Adequate consideration means, in the case of a non-publicly traded security, 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. [ERISA Section 3(18)] This requires valuation by an independent appraiser.

IRS agents are advised when reviewing a ROB transaction to scrutinize the valuation to ensure that it is not simply designed to value the stock so that it equals the rollover amounts used to purchase the shares. Since the company is new, the agent is advised that there may be a question as to whether it is indeed worth the tax deferred dollars exchanged. Rather than being the case, agents are told that many of the valuations are essentially unsupported with the business owner providing the examiner 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. The IRS views these appraisals as questionable at best. Because the valuation usually approximates available funds, the agent is instructed to give consideration as 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. [Memorandum for Director, Employee Plans Examinations Director, Employee Plans Rulings & Agreements, from Michael D. Julianelle, Director, Employee Plans, SE:T:EP, October 1, 2008; http://www.irs.gov/pub/irs-tege/robs_guidelines.pdf]

In addition to the need to pay for the cost of an annual valuation of the investment, maintenance of a non-traditional investment can increase plan cost in other ways, particularly with respect to the cost of filing an annual Form 5500.

B. Loss of Small Plan Audit Exemption

Large qualified plans are required to file an independent qualified accountant's report with each Form 5500. However, the opinion need not be expressed as to any statements prepared by a bank or similar institution or insurance carrier regulated and supervised and subject to periodic examination by a State or Federal agency if such statements are certified by the bank, similar institution, or insurance carrier as accurate and are made a part of the annual report. [ERISA Section 103(a)(3)(A)]

Small plans (i.e., plans with fewer than 100 participants as of the first day of the plan year), may be exempt from the audit requirement provided they satisfy other conditions for exemption.

1. Qualifying Assets Exception

The general waiver condition satisfied by most small plans is that:

(1) at least 95 percent of the assets of the plan constitute "qualifying plan assets" within the meaning of Labor Reg. Section 2520.104-46(b)(1)(ii);

(2) the plan must include certain information in the Summary Annual Report furnished to participants and beneficiaries in addition to the information ordinarily required, and

(3) in response to a request from any participant or beneficiary, the plan administrator must furnish without charge copies of statements the plan receives from the regulated financial institutions holding or issuing the plan's "qualifying plan assets" and evidence of any required fidelity bond.

[Labor Reg. Section 2520.104-46(b)(1)(i)(A)(1)]

The term "qualifying plan assets" means:

(1) any assets held by any of the following regulated financial institutions:

a. a bank or similar financial institution as defined in 29 CFR 2550.408b-4(c);

b. an insurance company qualified to do business under the laws of a state;

c. an organization registered as a broker-dealer under the Securities Exchange Act of 1934; or

d. any other organization authorized to act as a trustee for individual retirement accounts under Code section 408.

(2) shares issued by an investment company registered under the Investment Company Act of 1940 (e.g., mutual funds);

(3) investment and annuity contracts issued by any insurance company qualified to do business under the laws of a state, and

(4) in the case of an individual account plan, any assets in the individual account of a participant or beneficiary over which the participant or beneficiary has the opportunity to exercise control and with respect to which the participant or beneficiary is furnished, at least annually, a statement from a regulated financial institution referred to above describing the assets held or issued by the institution and the amount of such assets.

[Labor Reg. Section 2520.104-46(b)(1)(ii)]

The plan's investment in an atypical investment, depending upon its size, could cause a small plan to fail to satisfy the 95 percent test and thus, to potentially lose its audit exemption. This would mean that a plan with fewer than 100 participants would be required to be subject to an independent audit each year.

2. Enhanced Fidelity Bond Alternative

However, as an alternative to the 95 percent "qualifying asset rule," the plan can instead purchase an enhanced bond.

Under the enhanced fidelity bond option, a fidelity bond must be purchased to insure any person who handles assets of the plan that do not constitute qualifying plan assets. The enhanced bond must essentially satisfy the normal requirements of ERISA Section 412 for a fidelity bond, except that the amount must be not less than 100% of the value of the non-qualifying assets. This means, for example, that the bond must name the plan as the insured, not include a deductible or similar feature and must be issued by a DOL and Treasury approved surety company. [For a list of the approved surety companies go to www.fms.treas.gov/c570/c570.html
[Labor Reg. Section 2520.104-46(b)(1)(i)(A)(1)] In addition, it will need to cover any individuals associated with the non-qualifying asset who are deemed to handle plan assets.

Where the enhanced bond is used, the amount of the bond must cover the entire non-qualifying asset and not just the value that causes the plan to exceed the 5% threshold. [DOL, Frequently Asked Questions, Small Pension Plan Audit Waiver Regulation]

Thus, for example, a small plan with an investment in a hedge fund that exceeds 5% of plan assets, could avoid the audit requirement by obtaining a fidelity bond that includes not only insiders at the plan that handle plan assets, but those who manage the hedge fund as well.

Either the plan or the investment provider can purchase the bond. In all events, plans will want to ensure that they continue to maintain the basic bond requirement. In some instances, however, the amount of the basic bond could be sufficient to satisfy the enhanced bond requirement for the specific non-qualifying asset.

For example, a person may handle a total of $1 million in plan funds, but only $50,000 are non-qualifying plan assets. In that case, the ERISA section 412 bond covering the person should be equal to or greater than $100,000, which would be more than the value of the non-qualifying assets the person handles. For that person, the ERISA section 412 bond would also satisfy the audit waiver enhanced bonding requirement. [DOL, Frequently Asked Questions, Small Pension Plan Audit Waiver Regulation]

However, even where the amount of the existing basic bond is insufficient to meet the audit waiver requirement, plans may want to consider increasing the size of the basic bond rather than getting a new separate fidelity bond.

From a cost standpoint, plans may also find it less costly to get a quote from the plan's existing carrier. Many large carriers now have fairly sophisticated procedures to deal with the enhanced bond requirements for non-qualifying assets.

VI. Plan Asset Issues

A. Look-Through if Not Publicly-Traded

The DOL regulations contain definitions of what constitutes "plan assets." While generally, ERISA rules do not apply to IRAs established individually, (that is, not by an employer), the Preamble to the final DOL plan asset regulations make it clear that its regulations apply equally to the determination of what constitute "plan assets" for all purposes under the definitional provisions of ERISA and parts 1 and 4 of Title I of ERISA and Section 4975 of the Code (i.e., the list of plans subject to the Code's prohibited transaction provisions which includes IRAs).

Under these rules, where an IRA or a qualified plan invests in another entity, the IRA's or plan's assets include its investment, but do not, solely by reason of such investment, include any of the underlying assets of the entity.

However, in the case of a plan's investment in an equity interest of an entity that is neither a publicly-offered security nor a security issued by an investment company registered under the Investment Company Act of 1940 its assets include both the equity interest and an undivided interest in each of the underlying assets of the entity, unless it is established that:

(1) the entity is an operating company, or

(2) equity participation in the entity by benefit plan investors is not significant.

What this means is, where a qualified plan or an IRA invests in an equity interest other than a publicly-traded equity, the rules will result in a look-through, (i.e., the underlying assets will be treated as an asset of the investing IRA) unless one of the exceptions applies. The practical consequences of a look-through is that those who actually manage the underlying assets would be forced to manage those assets in conformance with the fiduciary rules and prohibitions that apply to IRAs---a standard that would essentially be impossible to adhere to for those actually trying to run a business.

If the look through applies, ERISA's fiduciary and prohibited transaction sections apply to parties dealing with the assets of the investment in which the plan invest directly such as the investment fund's investment manager.

Where no exception from the look-through rules can be found, it often makes it impossible for a plan or IRA to invest in such investments as a hedge fund or limited partnership.

B. Exceptions

An operating company is an entity that is primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital. Despite this general definition, the term "operating company" will be deemed to also include a venture capital operating company or a real estate operating company. [Labor Reg. Section 2510.3-101(c)] Private equity most often relies upon this exception.

The operating company exception recognizes that a plan's investment may be more than a mere passive investment but rather may involve management as well. The operating company exception is the exception most often relied upon by private equity firms accepting investments by plans.

As a practical matter, if the investment vehicle cannot qualify as a basic operating company, the most likely exception available will be the exception for Insignificant Equity Participation.

Under this exception, the look-through rules do not apply if "benefit plan investors" hold less than 25% of each class of equity interest. [Labor Reg. Section 2510.3-101(a)(2)(ii); 2510.3(f)(i)] For purposes of this determination, the value of any equity interests held by a person, other than a benefit plan investor, who has discretionary authority or control with respect to the assets of the entity or any person who provides investment advice for a fee, direct or indirect, with respect to such assets, or any affiliate of such a person is to be disregarded. The insignificant participation exception is generally used by hedge funds.

C. DOL's Interest In Plans Investing in Hedge Funds and Private Equity Funds

The DOL, through its 2011 ERISA Advisory Council has examined the issues of plans investing in hedge funds and/or private equity funds. Through testimony and research, the Council developed a tip sheet that plans, considering such investments, may want to consider. The DOL is particularly concerned that plan sponsors review and address the following issues:

1. identification of the type of due diligence required in making the investment;
2. understanding the liquidity needs of the plan;
3. the application of an ERISA requirement that plan assets must be diversified;
4. the application of the "prudent investor rule" in which a plan fiduciary has the obligation to consult with individuals or entities who have the necessary expertise regarding these investments when the fiduciary does not possess the expertise itself;
5. the underlying long-term investment goals of the pension plan, and how this aligns with the investment goals of the hedge fund or private equity fund;
6. the fee structure of the investment option being considered and the transparency of the investment option, or lack thereof;
7. the ability and opportunity to evaluate the expertise of the investment manager of the investment option being considered; and
8. the ability to value the investment option being considered, the investment return of such investment, and the compatibility of these factors with the pension plan.

VII. Ancillary Issue Impacting Plan Sponsors—Evolving Status of Portfolio Companies

Entities are sometimes established and operated solely to acquire ownership in other operating entities. This might occur where a holding company is established to purchase various active companies as an investment. The goal of the holding company is not to operate an active business but rather to invest in other business for a profit.

The question arises as to how the controlled group rules apply in such cases with the holding company or private equity fund taking the position that it is not a part of a controlled group because, as a passive investor, it is not engaged in a trade or business and therefore cannot be part of a controlled group.

However, the PBGC had cast doubt on the viability of this approach by concluding that a private equity fund established as a limited partnership had a parent-subsidiary controlled group relationship with a company that had incurred, but was unable to pay, withdrawal liability. Accordingly, the PBGC ruled that the fund, as well as its other portfolio companies were jointly and severely liable for the withdrawal liability in the amount of $3,234,699 plus interest in the amount of $772,987.

After filing an appeal, the PBGC Appeals Board Opinion Letter dated September 26, 2007 affirmed the agency's decision as applied to the parent company.

http://www.pbgc.gov/documents/apbletter/decision--(liability%20within%20a%20group%20of%20companies)%202007-09-26.pdf

In Sun Capital Partners III, LP; Sun Capital Partners III QP, LP; Sun Capital Partners IV, LP v. New England Teamsters & Trucking Industry Pension Fund, 2013 WL 3814984 (1st Cir. 2013), the First Circuit reversed the decision of the district court which had held that the private equity firms were not responsible for the withdrawal liability incurred by a portfolio company.

The district court had concluded that the Funds were not in a trade or business but were instead merely passive investors. Absent a trade or business, the entities could not be part of a controlled group with the portfolio company and could not therefore be jointly liable for its withdrawal liability.

On appeal, the First Circuit held that an "investment plus" approach should be used to determine whether the Funds were merely passive investors on involved in a trade or business.

Applying the "investment plus" approach, the court saw no need to set forth general guidelines for what the "plus" is, nor, it noted, has the PBGC provided guidance on this. However, applying this approach the court concluded that Sun Fund IV is a "trade or business" for this purpose. In reaching this conclusion, the court looked to the Fund's limited partnership documents that indicated that the Funds are actively involved in the management and operation of the companies in which they invest. For example, each agreement recognized as a principal purpose of the partnership, the "management] and supervision]" of its investments. In addition, the general partners of the Funds were given wide-ranging management authority, empowered through their own partnership agreements to make decisions about hiring, terminating, and compensating agents and employees of the Sun Funds and their portfolio companies, and they received a percentage of total commitments to the Sun Funds and a percentage of profits as compensation—just like the general partner of the equity fund in the PBGC Opinion Letter the court noted. Moreover, the strategic plan developed initially when a company is purchased is, as the documents provide, "consistently monitored and modified as necessary."

Because of these factors, the First Circuit concluded that Sun Funds IV was in a trade or business and reversed the lower court's grant of summary judgment on this issue. The case was then remanded to the district court to determine the status of Sun Funds III as well as to determine whether the common control test is met with respect to either or both funds.

On remand, the district court found that both Funds qualified as operating in a trade or business and further found them liable for the now bankrupt portfolio company's withdrawal liability. [Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Plan, Civil Action No. 10-10921-DPW (D.C. Mass. 2016)]

VIII. Unrelated Business Taxable Income

Generally, earnings of an IRA or of a qualified plan are tax deferred. However, in recognition of the unfair competition that would result if nontaxable entities were allowed to compete with taxable entities in business enterprises, the Code imposes a tax on income inside of an IRA or a qualified plan that results from either unrelated business taxable income ("UBTI") or from unrelated debt-financed income.

UBTI is defined to mean gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by the Code which are directly connected with the carrying on of such trade or business. [IRC Section 512(a)(1)] Essentially, when dealing with a retirement plan, virtually any private business in which it invest will constitute a trade or business regularly carried on by the trust with the term "trade or business" defined in accordance with the definition under IRC 162.

Taxable income in the context of such plans either arises from UBTI or by the plan's investment in debt-financed property including such things as the purchase of stock on margin.

In Revenue Ruling 79-222, 1979-2 C.B. 236, an exempt employees' trust became a limited partner in a partnership which regularly carried on a trade or business. The limited partnership did not participate in the management of the partnership and their liability was limited to the amount of their contributions. The Revenue Ruling states that section 512(c) of the Code uses the term "member" of a partnership without qualification and makes no distinction between general and limited partners. The Revenue Ruling concludes therefore that the exempt trust's investment as a limited partner in a partnership carrying on a trade or business may result in unrelated business taxable income.

Some types of income, even though from an unrelated trade or business is excluded in determining the plan's UBTI. As such, in addition to the deductions normally allowed that are associated with and directly related to the operation of the trade or business, the calculation of UBTI is subject to the following exclusions:

1. all dividends, interests, payments with respect to securities loans (as defined in Section 512(a)(5), amounts received or accrued as consideration for entering into agreements to make loans, and annuities, and all deductions directly connected with such income;

2. all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income;

3. all rents from real property (including property described in Section 1245(a)(3)(C) and all rents from personal property (including for purposes of this paragraph as personal property any property described in Section 1245(a)(3)(B)) leased with such real property if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service (all deductions directly connected with rents excluded under this paragraph are also excluded);

4. all gains or losses from the sale, exchange, or other disposition of property other than:

    a. stock in trade or other property of a kind that would properly be includable in an inventory if on hand at the close of the taxable year, or

    b. property held primarily for sale to customers in the ordinary course of the trade or business (this exclusion does not apply with respect to the cutting of timber, which is considered, on the application of Section 631, as a sale or exchange of such timber);

5. the net operating loss deduction provided in Section 172 is also allowed, except that in computing the net operating loss, the amount of the net operating loss carryback or carryover and the net operating deduction are to be determined without taking into account income or deductions allowed as an exclusion in determining the UBTI and without inclusion, for purposes of the loss carryover, of net operating losses for years in which the trust was not subject to the unrelated business tax; and

6. in addition, a deduction of $1,000 may be taken from the UBTI; however, the $1,000 is the maximum amount of the deduction without regard to the number or the extent of the UBTI, and the deduction is not allowable in determining any net operating loss deduction to the plan.

So essentially, passive types of income are excluded.

The application of the UBTI does not disqualify the IRA or the plan but results in the income from the trade or business being taxable and the plan or IRA having to file a Form 990 and pay the tax.

The tax is imposed on the UBTI, meaning the gross income the IRA or qualified plan derived from the unrelated trade or business, less the deductions allowed by the Code that are directly connected with the carrying on of the trade or business, such as the ordinary and necessary expenses pursuant to Section 162 and/or depreciation expenses under the Code. [IRC Section 512(a)(1)] There are other special deductions that apply as well as a general deduction of $1,000 that can be applied. [IRC Section 512(b)] Included among the exclusions are many types of passive income including dividends, royalties and interest.

IX. Custodian for Atypical IRA Assets

Generally, both the assets of an IRA and of a qualified plan must be held in trust. [IRC Section 401(a)(2); 408(a)] With respect to an IRA, the trustee must also be entity qualified to serve as such, such as a bank, or other person who demonstrates to the satisfaction of the Secretary of the Treasury that the manner in which such other person will administer the trust will be consistent with the requirements of Section 408. [IRC Section 408(a)(2)]

A custodial account is, however, also treated as an IRA if it otherwise meets all other requirements for such an IRA except that it isn't a trust and the assets of the account are held by a bank or such other qualified person. The custodian of such an account is treated as if he were a trustee of the account. [IRS Section 408(h)] A nonbank entity must obtain permission from the IRS to become an IRA trustee or custodian. [Treas. Reg. Section 1.408-2(e)]

This means that when an IRA wants to hold atypical investments, it must also find a qualifying entity to serve as the trustee, or more likely, the custodian. There are a handful of entities that specialize in such accounts.

The IRA with a wholly owned LLC subsidiary is often touted for its ability to give the owner total control over plan assets. These arrangements are generally established such that the LLC interest are held by a bank or custodian but the LLC's checking account generally is not. The question arises as to whether the underlying assets themselves are required to also be held in trust. While there is no comparable provision under the Code, it is clear that for purposes of ERISA, the entities assets are not required to be held in trust. This is because regulations provide that if assets of an entity in which a plan invests include plan assets by reason of the plan's investment in the entity, the trust requirement is satisfied if the indicia of ownership of the plan's interest in the entity are held in trust. [Labor Reg. Section 2550.403a-1(b)(3)] As such, having a custodian or trustee hold the indicia of the LLC interest would prove sufficient for purposes of ERISA.

X. Unwinding

In unwinding an investment, the same land minds avoided in purchasing the investment must be similarly avoided in unwinding the investment.

A. DOL Voluntary Fiduciary Correction Program

Certain transactions may be corrected and undone if unwound voluntarily by use of the DOL's Voluntary Fiduciary Correction Program. These include the following:

(1) Loan at Fair Market Interest Rate to a Party in Interest

(2) Loan at Below-Market Interest Rate to a Party in Interest

(3) Loan at Below-Market Interest Rate to a Non-Party in Interest

(4) Loan at Below-Market Interest Rate Due to Delay in Perfecting Plan's Security Interest

(5) Purchase of an Asset by a Plan from a Party in Interest

(6) Sale of an Asset by a Plan to a Party in Interest

(7) Sale and Leaseback of Real Property to Employer

(8) Purchase of Asset by a Plan from a Non-Party in Interest at More Than Fair Market Value

(9) Sale of an Asset by a Plan to a Non-Party in Interest at Less Than Fair Market Value

(10) Holding of an Illiquid Asset Previously Purchased by a Plan

(11) Payment of Benefits Without Properly Valuing Plan Assets on Which Payment is Based

B. Private Letter Ruling on Rollover

A Private Letter Ruling may provide some insight into unwinding a ROB.

The Taxpayer in Private Letter Ruling 201236035, 09/07/2012, received a distribution from his prior employer. The Taxpayer decided to purchase a healthcare franchise. While he had sufficient personal assets to purchase it, he was convinced to use his rollover in a ROB. The Taxpayer said he would not do so unless a tax attorney told him it was okay. He consulted a tax attorney who said, although there were some red flags, the IRS has not issued any guidance prohibiting ROBs and that he could safely proceed. The Taxpayer met with a company promoting ROBs and they forwarded the corporate and plan documents. Relying upon the advice from the company and the attorney, the Taxpayer set up the ROB.

The following year when his accountant was preparing his taxes, the accountant learned of the transaction and convinced him to consultant another attorney. Following that consultation the Taxpayer adopted a Board Resolution to rescind the transaction.

He then asked the IRS for a waiver of the 60 day rollover period. Pursuant to Section 402(c)(3)(B), the IRS waived the 60- day rollover requirement with respect to the distribution. The Taxpayer was granted a period of 60 days from the issuance of the ruling letter to contribute the original rollover amount into a rollover IRA or another qualified plan.

If a client initially starts the steps towards establishing a ROB and then thinks better of it, they may wish to ask the IRS for a waiver of the 60-day rollover period to allow the individual to undue the transaction and roll the funds back into an IRA.

C. IRS Employee Plans Voluntary Closing Agreements Program

1. Overview of EP Closing Agreements Program

The Employee Plan's Division of the IRS, like other parts of the IRS, has available a Voluntary Closing Agreements Program.

Employers may request, including on an anonymous basis initially, a closing agreement to resolve certain income or excise tax issues involving tax qualified plans under Section 401(a), as well as with respect to plans subject to Sections 403(a), 403(b), 408(k) or 408(p). The issues submitted must not be issues that could be resolved under the IRS' Employee Plans Compliance Resolution System, meaning that the issues submitted for correction under the Voluntary Closing Agreements Program generally cannot be qualification failures.

The IRS will not consider a request for a voluntary closing agreement if "under examination or investigation." The entity is viewed as under examination if the plan, plan sponsor or entity responsible for signing the closing agreement: (a) is under any IRS examination or investigation at the time the request is submitted, or (b) has any matters in Appeals or before the Tax Court.

If the audit begins after submission is made under the Voluntary Closing Agreements Program, the entity must inform EP Voluntary Compliance. Depending on the situation, this may prevent them from processing the request for a closing agreement.

2. Issues Eligible and Ineligible for Resolution

Qualification failures or issues eligible for correction using the Voluntary Correction Program component of the Employee Plans Compliance Resolution System are generally not eligible for resolution under the Voluntary Closing Agreements Program. If a submission has issues that are eligible under Voluntary Correction Program and issues that are not eligible, the IRS may conclude that a Voluntary Closing Agreement is available, however, generally any issues eligible for resolution under the Voluntary Correction Program will be resolved in accordance with the rules that govern that program.

Plan failures related to IRC Section 457(b) are also generally required to be resolved under the Voluntary Correction Program and not via a Voluntary Closing Agreement.

IRC Section 457(f) plans are also ineligible for the Voluntary Closing Agreement Program.

If the plan, plan sponsor or any other party to the closing agreement was or may have been a party to an abusive tax avoidance transaction, the IRS may determine that it is inappropriate to enter into a closing agreement.

The IRS will generally view a Voluntary Closing Agreement as inappropriate where there has been a willful or intentional plan to avoid or evade paying or reporting taxes.

So the things that can be resolved through the Employee Plan’s Voluntary Closing Agreements include issues that result in an excise tax, rather than the loss of tax qualification, but which are not listed as eligible for correction under Rev. Proc. 2013-12. Such issues might include a prohibited transaction under Section 4975 or a minimum funding violation under Section 430.

3. Submission for a Closing Agreement

No special forms exist for submission for a Closing Agreement. Rather, submission is made by submission of a letter that describes what occurred in detail. This can be done initially on an anonymous basis. The submission, however, must be made by someone who is either an authorized employee of the plan or plan sponsor, or a legally authorized representative of the affected taxpayer who is eligible to sign Form 2848.

If submitted on an anonymous basis, the representative must also submit the following penalty of perjury statement:

> Under penalties of perjury, I declare that I am an authorized representative of the taxpayer who would be party to any closing agreement. I comply with the power of attorney requirements described in 26 C.F.R. § 601.501-601.509 (2005). I will submit an executed Form 2848 upon the disclosure of the identity of the taxpayer to the IRS. I also declare that the issues and information included with this request are true, correct, and complete to the best of my knowledge and belief.

The letter that constitutes the submission must include:

(1) an explanation of the problem, including how and why it occurred, number of people affected, and amount of contributions, distributions, etc.;

(2) an explanation of how you will correct the identified problem or issue;

(3) an explanation of how you calculated the tax, interest or penalties;

(4) calculations of any tax or correction method included in your request;

(5) proposed sanction amounts and an explanation justifying the amount

4. Resolution

1. In most cases, the IRS won't bargain or negotiate over any income or excise tax amounts, including interest, but may discuss penalty abatement.

2. If the plan is subject to ERISA, the employer must generally correct a prohibited transaction by use of the DOL's Voluntary Fiduciary Correction Program before applying or a Voluntary Closing Agreement.

3. All actions identified in the closing agreement must be completed by the date the taxpayer signs the closing agreement.

4. A closing agreement request does not preclude any IRS examination of the plan or plan sponsor. If the plan or plan sponsor is examined after submitting a voluntary closing agreement request, EP Voluntary Compliance will consult with the examination function to see if the issue under consideration should be precluded from the examination while EP Voluntary Compliance considers the closing agreement request. For anonymous closing agreement requests, if the plan or plan sponsor is under examination after they have submitted their request, but before they have disclosed their identity to the IRS, then EP Voluntary Compliance cannot consider their request. Instead, the issues in the closing agreement request will have to be resolved as part of the IRS examination.

5. A voluntary closing agreement is not appropriate to address a future event that may impact the tax-favored status of a retirement plan or to seek guidance on issues or actions that may impact retirement plans.

6. If the IRS determines that there was a willful or intentional plan to avoid or evade paying or reporting taxes, EP reserves the right to convert the voluntary closing agreement submission into an examination referral.

The specifics of the EP Voluntary Correction Program are set forth on the IRS' website at: http://www.irs.gov/Retirement-Plans/Employee-Plans-Voluntary-Closing-Agreements