

March 13, 2006

Research Memo: Self Directed IRA – The NAFEP ICO

Authority For the ICO Concept. Most professional advisors will find it fairly easy to accept the concept of owning non-traditional investments in an IRA. But some may have difficulty in accepting the concept of the ICO. However, the U.S. Department of Labor (DOL), the IRS and the Tax Court have all made decisive statements, rulings and opinions in the favor of this concept. The concept is not aggressive, risky or even new.

One decisive Tax Court opinion (*Swanson v. Commissioner*, 106 TC 76106 TC No. 3, 1996) was a case where the taxpayer, Mr. Swanson, upon advice of legal counsel opened a new, self directed IRA, formed a new corporation, named himself as director and then later as president of the corporation. (The court held that the corporation was a “domestic international sales corporation” (DISC) under section 991 of the tax code, and except for the taxes imposed by chapter 5 of the tax code, a DISC is not subject to income tax.) Swanson then directed the IRA custodian to purchase the shares of the corporation. The IRA was the only shareholder. Mr. Swanson, as president of the corporation, directed, with the custodian’s consent, that the corporation pay its dividends to the IRA.

In this case, the ICO corporation acted as a commissioned sales agent for a manufacturing company which Mr. Swanson also owned. The effect of this arrangement was that income which would normally be taxed to the manufacturing corporation was instead funneled to the ICO corporation as sales commissions. As a DISC (see above paragraph), the corporation was not a taxable entity. So the gross income was then paid out on a tax deferred basis to the IRA of Mr. Swanson. Apparently Mr. Swanson was the person who handled the sales for the ICO corporation, because it had no employees. And he took no wages or salary, so all or most of the corporation’s income flowed tax deferred to the IRA. Neither the IRS nor the Tax Court challenged this aspect of the Swanson arrangement.

The IRS audited this transaction and initially held that it violated the prohibited transaction rules of section 4975 of the tax code. After protracted wrangling between Swanson and the IRS, the IRS eventually agreed that the entire ICO type transaction was legal. By this time, Swanson had significant legal fees in battling the IRS over a position which they, in effect, agreed was wrong. Swanson then demanded payment of his legal fees, which the IRS refused. So Swanson pursued his claim for legal fees in Tax Court. Without any difficulty, the tax court reached two major conclusions: (1) Mr. Swanson’s ICO type arrangement was not illegal, and (2) the IRS had to pay Swanson for a reasonable amount of his legal fees. Specifically, the Tax Court stated:

“... the dividends paid to IRA #1 were tax deferred pursuant to section 408. Thus, the net effect of these transactions was to defer recognition of dividend income that otherwise would have flowed through to any shareholders of Worldwide”. (Worldwide was the ICO corporation – NAFEP)

“At all pertinent times IRA #1 was the sole shareholder of Worldwide (the ICO corporation – NAFEP); (2) since the 2,500 shares of Worldwide issued to IRA #1 were original issue, no sale or exchange of the stock occurred; (3) from and after the dates of his appointment as director and president of Worldwide, Mr. Swanson engaged in no activities on behalf of Worldwide which benefited him other than as a beneficiary of IRA #1; (4) IRA #1 was not maintained, sponsored, or contributed to by Worldwide during the years at issue; (5) at no time did Worldwide have any active employees;” “... We find that it was unreasonable for respondent (the IRS – NAFEP) to maintain that a prohibited transaction occurred when Worldwide’s stock was acquired by IRA #1. The 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 disqualified person

under section 4975(e)(2)(G). It was only after Worldwide issued its stock to IRA #1 that petitioner held a beneficial interest in Worldwide's stock, thereby causing Worldwide to become a disqualified person under section 4975(e)(2)(G). Accordingly, the issuance of stock to IRA #1 did not, within the plain meaning of section 4975(c)(1)(A), qualify as a "sale or exchange, or leasing, of any property between a plan and a disqualified person". Therefore, respondent's (IRS's – NAFEP) litigation position with respect to this issue was unreasonable as a matter of both law and fact. (Underlining is NAFEP's)

"Section 4975(c)(1)(E) addresses itself only to acts of disqualified persons who, as fiduciaries, deal directly or indirectly with the income or assets of a plan for their own benefit or account. Here, there was no such direct or indirect dealing with the income or assets of a plan, as the dividends paid by Worldwide did not become income of IRA #1 until unqualifiedly made subject to the demand of IRA #1. Sec. 1.301-1(b), Income Tax Regs. Furthermore, respondent has never suggested that petitioner, acting as a "fiduciary" or otherwise, ever dealt with the corpus of IRA #1 for his own benefit."

"A corporation without shares or shareholders does not fit within the definition of a disqualified person under section 4975(e)(2)(G)."

"Furthermore, we find that at the time of the stock issuance, Worldwide was not, within the meaning of sec. 4975(e)(2)(C), an "employer", any of whose employees were beneficiaries of IRA #1."

In 2001, the IRS followed up on the Swanson case with a field service advisory memo (FSA 200128011). This memo was written by the Senior Technical Reviewer of the Office of the Chief Counsel of the IRS, and addressed to the IRS counsel at a regional branch. The IRS was considering whether or not to challenge another ICO type arrangement which was nearly identical to Swanson's. One variation from Swanson in this case was that the ICO entity was owned by four separate IRAs. These IRAs belonged to a father and his three children (related parties). The IRS concluded that they should not challenge this ICO type arrangement, primarily in light of the Swanson case. Here are the relevant passages from this memo:

"There is no specific Code Provision or regulation prohibiting an IRA from owning the stock of an FSC. (analogous to an ICO – NAFEP) The type of investment that may be held in an IRA is limited only with respect to insurance contracts, under section 408(a)(3), and with respect to certain collectibles, under section 408(m)(1)."

"The court in Swanson concluded that, when the initial issuance of DISC (or. FSC) stock to the IRA was made, the issuing company was not a "disqualified person" because 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 a plan (the IRA) and a disqualified person within the meaning of section 4975(c)(1)(A)." ... "The payment of dividends (in Swanson – NAFEP) by a DISC (or FSC) to an IRA was held not to be the use of IRA assets for the benefit of a disqualified person within the meaning of section 4975(c)(1)(D) because the dividends did not become IRA assets until they were paid."

"In light of Swanson, we (the IRS – NAFEP) conclude that a prohibited transaction did not occur under section 4975(c)(1)(A) in the original issuance of the stock of FSC A to the IRAs in this case. Similarly, we conclude that payment of dividends by FSC A to the IRAs in this case is not a prohibited transaction under section 4975(c)(1)(D). We further conclude, considering Swanson, that we should not maintain that the ownership of FSC A stock by the IRAs, together with the payment of dividends by FSC A to the IRAs, constitutes a prohibited transaction under section 4975(c)(1)(E)." (Underlining by NAFEP)

"Accordingly, this case should not be pursued as one involving prohibited transactions."

Substituting a properly structured limited liability company (ICO) for the DISC in the Swanson case, or an ICO for the FSC in the field service advisory above, should yield the same positive results for the ICO. For purposes of an ICO type arrangement, there is little risk or likelihood that either the IRS or the courts would treat the ICO any differently than the Swanson court treated the DISC, or that the IRS treated the FSC. An ICO, like a DISC or FSC, is a pass through tax entity. An ICO, like the DISC, can be managed by the IRA owner. Without employees the ICO would be ignored for tax purposes just as the DISC was (a “disregarded entity”).

In the Swanson case, the IRS, after some wrangling, and the Tax Court both agreed that the ICO type arrangement was legal. The IRS followed up with that same conclusion again in the field service advisory referred to above. Not to be forgotten, the Department of Labor (DOL) has issued numerous Advisory Opinions on ICO type arrangements, and DOL has regularly viewed them as legal under federal tax law, and DOL opinion is binding on the IRS with regard to pension and retirement plans, including IRAs. One DOL opinion that is particularly definitive and on point is Advisory Opinion 2000-10A. The physical arrangement approved by DOL in this opinion used a partnership instead of a limited liability company. And in this case, Mr. Adler, the IRA owner, also owned a 6.5 percent interest in the partnership. In Opinion 2000-10A, DOL stated the following:

“Specifically, you ask whether allowing the owner of an IRA to direct the IRA to invest in a limited partnership, in which relatives and the IRA owner in his individual capacity are partners, will violate section 4975 of the Code. (Note from NAFEP: This is an existing partnership, not one to be newly formed for investment by partners.)

“Mr. Adler will be the only general partner in the Partnership and will own 6.52%. The limited partners and their percentage ownership interests will be as follows: Andrea Raskin — 1.35%; Steven Adler — 3.07%; IRA of Leonard Adler — 39.38%. (Note from NAFEP: Adler, plus his son, daughter and his IRA, will own a combined, 50.32% of the partnership.)

“Finally, you represent that Mr. Adler does not and will not receive any compensation from the Partnership. He likewise will not receive any compensation as a result of the acquisition by the IRA of its limited partnership interest.

“The Code defines “disqualified person,” in relevant part, to include a fiduciary, a relative, and a partnership, of which (or in which) 50 percent or more of the capital interest or profits interest of such partnership is owned directly or indirectly, or held by a fiduciary. (Underlining by NAFEP. Note from NAFEP: Apparently the restriction on owning 50 percent or more is on a fiduciary, not a disqualified person, unless that disqualified person is also a fiduciary.)

“As a trustee with investment discretion over the assets of his IRA, Mr. Adler is a fiduciary, and therefore, a disqualified person under section 4975(e)(2) of the Code. Mr. Adler is also a disqualified person in his capacity as the general partner of the Partnership to the extent he exercises discretionary authority over the administration or management of the IRA assets invested in the Partnership. In addition, although Mr. Adler, his son and his daughter are disqualified persons, you represent that the investment transaction is between the Partnership itself and the IRA, and not with Mr. Adler and his family, except as fellow investors in the Partnership. (Underlining by NAFEP)

“..., it is the opinion of the Department that the IRA’s purchase of an interest in the Partnership would not constitute a transaction described in section 4975(c)(1)(A) of the Code (prohibiting any direct or indirect sale or exchange or leasing of any property between a plan and a disqualified person).

In this regard, the Department notes Mr. Adler does not and will not receive any compensation from the Partnership and will not receive any compensation by virtue of the IRA's investment in the Partnership.

"Mr. Adler (the IRA owner – NAFEP) owns only 6.5 percent of the Partnership, and therefore the Partnership itself is not a disqualified person under section 4975(e)(2)(G) of the Code which defines a disqualified person to include a corporation, partnership or trust or estate of which 50 percent or more of the capital interest is owned directly or indirectly, or held by persons described as fiduciaries." (Underlining by NAFEP. Note from NAFEP: Apparently the restriction on owning 50 percent or more is on a fiduciary, not a disqualified person, unless that disqualified person is also a fiduciary.)

Since both the ICO and partnerships are pass through entities, there is no material difference between an ICO (LLC) and a partnership for purposes of an ICO discussion. In fact, if an ICO has more than one owner (member), it will be treated as a partnership under tax law.