Taxpayers' "rollover as business startup" Account Wasn't Valid Retirement Plan

Powell v. U.S., (Ct Fed Cl 3/16/2016) 117 AFTR 2d ¶ 2016-515

The Court of Federal Claims has denied taxpayers' claim for refund, rejecting their argument that their Individual Retirement Account (IRA) withdrawals were nontaxable distributions that were rolled over into a "Business Owners Retirement Savings Account," or BORSA—essentially, a variation of a "rollover as business startup" (ROBS) account. The Court found that, because there was no written plan in existence under which the IRA distributions were reinvested, the arrangement couldn't be a qualified trust under Code Sec. 401.

In general, an IRA is a trust (or custodial account) created for the exclusive benefit of an individual or his beneficiaries on which no tax is paid on the income earned on contributions until the retirement savings are distributed. An IRA requires, among other things, a written plan and designation of an appropriate trustee. (Code Sec. 408(a), Reg. § 1.408-2(b)) There is no immediate tax if distributions from an IRA are rolled over to another IRA or other eligible retirement plan (i.e., qualified trust, governmental Code Sec. 457 plan, Code Sec. 403(a) annuity, or Code Sec. 403(b) tax-shelter annuity). For the rollover to be tax-free, the amount distributed from the IRA generally must be recontributed to the IRA or other eligible retirement plan no later than 60 days after the date that the taxpayer received the withdrawal from the IRA. (Code Sec. 408(d)(3))

There are certain requirements for qualification which must be met by all qualified plans. In general, Code Sec. 401(a) prescribes the requirements which must be met for qualification of a trust forming part of a pension, profit-sharing, or stock bonus plan. One such requirement is that a plan be a definite written program. Failure to meet one of the Code Sec. 401(a) requirements disqualifies the plan.

IRS views a ROBS as a questionable, but not necessarily abusive, mechanism for individuals to use their existing retirement accounts as seed money for funding new businesses without first paying taxes on distributions from those retirement accounts. IRS has stated that a ROBS may work as a legitimate tax planning entity but recommends assessment on a case-by-case basis through IRS determination letters. It outlines the steps generally to create a ROBS as follows:

- (1) The individual creates a new corporation for the purpose of sponsoring a purportedly qualified retirement plan.
- (2) The new corporation creates a qualified employee retirement plan and allows participants to invest the entirety of their retirement plan account balance in the corporation's stock.
- (3) The individual becomes an employee of the corporation and enrolls in the plan.
- (4) The individual either conducts a rollover or direct trustee-to-trustee transfer of funds from a qualified personal IRA or previous employer's Code Sec. 401 plan into the new corporate retirement plan.
- (5) The individual directs his account balance in the qualified retirement plan to purchase stock of the newly formed corporation.

- (6) The individual then uses the transferred funds to begin a business enterprise.

A “one-participant plan” is a retirement plan (that is, a defined benefit pension plan or a defined contribution profit-sharing or money purchase pension plan), other than an employee stock ownership plan (ESOP), that covers: (1) only an individual (or an individual and his or her spouse) who wholly owns a trade or business, whether incorporated or unincorporated; or (2) only the partners or the partners and their spouses. Such a one-participant plan with fewer than 100 participants is exempt from filing an annual return/report (other than for the final plan year to indicate that all assets have been distributed) if it has assets (either alone or in combination with one or more one-participant plans maintained by the employer) of $250,000 or less at the end of the plan year.

James Clement Powell and Lucy Hamrick Powell, husband and wife, ran an energy business. They timely filed their 2004 joint federal tax return on which they listed $78,000 in IRA distributions as includible in income. They subsequently filed an amended 2004 return in which they claimed an overpayment of taxes based on the fact that they had purportedly rolled the $78,000 IRA distributions into another retirement account involved in commercial real estate investment, which they referred to as a “Business Owners Retirement Savings Account,” or BORSA. IRS denied the refund claim, and the taxpayers sought relief in court.

IRS's requested from the Powells documentation on the existence of the IRA which allegedly received the distributions, and specifically sought its written plan and the identity of the trustee, which they failed to provide. At oral argument before the court, Mr. Powell conceded that there was no written agreement and no trustee. He admitted that they purchased the property in their individual capacities and held it individually until 2012, when it was sold to a corporation. The property had never been held in trust or in an IRA account. Mr. Powell's understanding was merely that any money withdrawn from an IRA and invested in a business still counted as being in an IRA.

The taxpayers also conceded that they did not follow the formal steps required for a ROBS. No corporation was created for purposes of running a qualified retirement plan. The entity which appeared to currently hold title to the property was created in 2012.

Parties' positions. The taxpayers argued that they had rolled over the $78,000 distribution into a valid retirement plan, making the distributions nontaxable. They argued that this other retirement account was a one-participant plan with less than $250,000 worth of assets which wasn't required to file an annual report until its final year of existence.

On the other hand, IRS argued that the taxpayers failed to show that the real estate investment in question met the requirements of a qualifying IRA under Code Sec. 408. And, even if their claims were construed to be based on a one-participant retirement plan, they failed to show evidence supporting the existence of such a plan.

Court's conclusion. The Court of Federal Claims held that the taxpayers weren't entitled to a refund. There wasn't a nontaxable rollover of the IRA distributions. Rather, the

taxpayers withdrew money from their IRAs to purchase land in their individual capacities. The land was not purchased through or held by another IRA. As no IRA existed into which the taxpayers could have rolled the 2004 IRA distributions, IRS properly classified the distributions as income.

The Court agreed with IRS that, under Code Sec. 401 and its regs, one-participant retirement plans need written trust instruments and must meet certain other formalities. And while it may be true that one-participant plans with less than $250,000 worth of assets aren't required to file annual reports until their final year of existence, to be plans in the first place, such entities need trust instruments and a definite written program and arrangement. While the Powells may have had a business plan concerning the real estate purchased with the IRA distributions, there wasn't a written plan for an IRA through which the investment was made. With no written plan in existence under which the IRA distributions were reinvested, the arrangement could not have employed a qualified trust under Code Sec. 401.

The Court also noted that, because the corporation which currently held the investment property wasn't in existence when the IRA distributions were made and the proceeds reinvested, it couldn't have played a role in a ROBS transaction.