Zabolotny v. Commissioner, 107 T. C. 205 (1996)

A sale of real property to an employee stock ownership plan (ESOP) by disqualified persons is a prohibited transaction under ERISA unless it meets specific statutory exemptions.

Summary

In Zabolotny v. Commissioner, the Tax Court addressed whether the sale of real property by Anton and Bernel Zabolotny to their ESOP constituted a prohibited transaction under ERISA. The court determined that the petitioners were disqualified persons due to their roles within the corporation and the plan. The sale did not qualify for an exemption under ERISA because the property did not meet the statutory definition of 'qualifying employer real property,' lacking geographic dispersion. The court upheld the first-tier excise tax but relieved the petitioners of additions to tax for failure to file returns due to their reasonable reliance on professional advice.

Facts

Anton and Bernel Zabolotny sold three tracts of farmland in North Dakota to their newly formed ESOP on May 20, 1981, in exchange for a private annuity. The ESOP later leased the surface rights back to Zabolotny Farms, Inc. , while retaining the mineral rights. The IRS issued notices of deficiency for excise taxes under section 4975(a) of the Internal Revenue Code, asserting that the sale was a prohibited transaction. The petitioners argued that the sale qualified for an exemption under ERISA section 408(e), claiming the property was 'qualifying employer real property. '

Procedural History

The IRS issued notices of deficiency to Anton and Bernel Zabolotny for the years 1981 through 1986, assessing first and second-tier excise taxes under section 4975(a) and (b). The petitioners challenged these deficiencies in the Tax Court, asserting that the sale to the ESOP was exempt from prohibited transaction rules.

Issue(s)

1. Whether petitioners are disqualified persons under section 4975(e)(2).
2. Whether the sale of real property by petitioners to the ESOP is a prohibited transaction described in section 4975(c).
3. Whether the sale is exempt from excise tax under section 4975(d)(13).
4. Whether the sale was simultaneously corrected pursuant to section 4975(f)(5).
5. Whether an addition to tax under section 6651(a)(1) for failure to file excise tax returns is applicable.

Holding

1. Yes, because petitioners were fiduciaries, major shareholders, and officers of the corporation, fitting the definition of disqualified persons under section 4975(e)(2).
2. Yes, because the sale of property to the ESOP was between the plan and disqualified persons, constituting a prohibited transaction under section 4975(c)(1)(A).
3. No, because the property did not meet the requirement of geographic dispersion under ERISA section 407(d)(4)(A) and thus did not qualify as 'qualifying employer real property. '
4. No, because correction under section 4975(f)(5) requires an affirmative act to undo the transaction, which had not occurred.
5. No, because petitioners reasonably relied on professional advice that no taxable event had occurred, excusing their failure to file under section 6651(a)(1).

Court's Reasoning

The court applied the statutory definitions under ERISA and the Internal Revenue Code to determine the status of the transaction. The petitioners were disqualified persons due to their roles within the corporation and the ESOP. The sale to the ESOP was a prohibited transaction under section 4975(c) because it involved disqualified persons. The court rejected the petitioners' claim for an exemption under section 4975(d)(13), as the property did not meet the 'qualifying employer real property' criteria due to a lack of geographic dispersion. The court emphasized the need for an affirmative act to correct the transaction under section 4975(f)(5), which had not been done. The court also found that the petitioners had reasonable cause for not filing excise tax returns, relying on the advice of their accountants. The decision was supported by references to prior cases like Lambos v. Commissioner and Rutland v. Commissioner, highlighting the strict application of ERISA's prohibited transaction rules.

Practical Implications

This decision reinforces the strict application of ERISA's prohibited transaction rules, particularly in the context of sales to ESOPs. Legal practitioners must ensure that transactions involving ESOPs comply with the statutory definitions and exemptions, especially regarding the geographic dispersion of real property. The case also highlights the importance of seeking and following professional advice in complex tax matters, as reliance on such advice can mitigate penalties for failure to file. Subsequent cases may need to address the nuances of what constitutes 'geographic dispersion' and the conditions under which transactions can be considered corrected. Businesses and legal professionals should be cautious in structuring transactions with ESOPs to avoid inadvertently triggering excise taxes.

