Peek v. Commissioner, 140 T. C. 12 (2013)

In Peek v. Commissioner, the U. S. Tax Court ruled that personal loan guarantees by IRA owners to a corporation owned by their IRAs constituted prohibited transactions under IRC section 4975(c)(1)(B). This decision resulted in the disqualification of the IRAs, leading to taxable capital gains from the sale of corporate stock held by the disqualified IRAs. The ruling underscores the strict prohibitions against indirect extensions of credit between IRAs and disqualified persons, impacting how individuals can structure investments within retirement accounts.

Parties

Lawrence F. Peek and Sara L. Peek, and Darrell G. Fleck and Kimberly J. Fleck were the petitioners in these consolidated cases. The respondent was the Commissioner of Internal Revenue. At the trial level, the petitioners were represented by Sheldon Harold Smith, and the respondent by Shawn P. Nowlan, E. Abigail Raines, and John Q. Walsh, Jr.

Facts

In 2001, petitioners established traditional IRAs and formed FP Corp. , directing their IRAs to purchase all of FP Corp. 's newly issued stock. FP Corp. then acquired the assets of Abbott Fire & Safety, Inc. (AFS) with funds partly from a bank loan personally guaranteed by the petitioners. In 2003 and 2004, petitioners converted the FP Corp. stock held in their traditional IRAs to Roth IRAs, reporting the stock's value as income. In 2006, after the stock appreciated significantly, petitioners directed their Roth IRAs to sell all FP Corp. stock. The personal guarantees remained in effect until the stock sale. The Commissioner argued that these guarantees were prohibited transactions, resulting in the IRAs' disqualification and taxable gains from the stock sale.

Procedural History

The IRS issued statutory notices of deficiency to the Peeks on December 9, 2010, and to the Flecks on December 14, 2010, asserting deficiencies in income tax and accuracy-related penalties for tax years 2006 and 2007. Both sets of petitioners timely filed petitions with the U. S. Tax Court. The cases were consolidated and submitted fully stipulated under Tax Court Rule 122 for decision without trial.

Issue(s)

Whether Mr. Fleck's and Mr. Peek's personal guarantees of a loan to FP Company constituted prohibited transactions under IRC section 4975(c)(1)(B)?

Whether the petitioners owe accuracy-related penalties under IRC section 6662(a)?

Rule(s) of Law

IRC section 4975(c)(1)(B) prohibits “any direct or indirect. . . lending of money or other extension of credit between a plan and a disqualified person. ” IRC section 408(e)(2)(A) states that an account ceases to be an IRA if the individual for whose benefit the IRA is established engages in any transaction prohibited by section 4975. IRC section 6662(a) imposes accuracy-related penalties for underpayments due to negligence or substantial understatements of income tax.

Holding

The Tax Court held that the personal guarantees by Mr. Fleck and Mr. Peek were indirect extensions of credit to their IRAs, constituting prohibited transactions under IRC section 4975(c)(1)(B). Consequently, the IRAs ceased to be qualified under IRC section 408(e)(2)(A), and the gains from the 2006 sale of FP Corp. stock were taxable to the petitioners. The court also upheld the accuracy-related penalties under IRC section 6662(a) for both years in issue.

Reasoning

The court interpreted IRC section 4975(c)(1)(B)’s prohibition on “indirect” extensions of credit to include loan guarantees made to entities owned by IRAs. The court rejected the petitioners’ argument that the prohibition only applies to transactions directly between the IRA and a disqualified person, finding that such an interpretation would allow easy evasion of the statute’s purpose. The court emphasized the broad language of the statute, supported by Supreme Court precedent in Commissioner v. Keystone Consol. Indus. , Inc. , indicating Congress’s intent to prevent indirect extensions of credit that could undermine the tax benefits of IRAs. The court also found that the petitioners were negligent in failing to report the gains from the stock sale, given their awareness of the risks of prohibited transactions and their failure to disclose the guarantees to their accountant. The court rejected the petitioners’ reliance on advice from their accountant, noting his role as a promoter of the investment strategy and the lack of specific advice on the loan guarantees.

Disposition

The Tax Court entered decisions under Rule 155 affirming the deficiencies in income tax and the accuracy-related penalties for tax years 2006 and 2007.

Significance/Impact

This case significantly impacts the structuring of investments within IRAs, reinforcing the strict prohibition on indirect extensions of credit between IRAs and disqualified persons. It highlights the risks of engaging in transactions that could be deemed prohibited under IRC section 4975, potentially leading to the disqualification of IRAs and the immediate taxation of their assets. The ruling also underscores the importance of full disclosure to tax advisors and the potential consequences of relying on advice from promoters of investment strategies. Subsequent courts have cited Peek in similar cases involving prohibited transactions, emphasizing its role in clarifying the scope of IRC section 4975(c)(1)(B).

