ED SLOTT'S IRA ADVISOR

© 2014 Ed Slott, CPA

February 2014

TAX & ESTATE PLANNING FOR YOUR RETIREMENT SAVINGS

IRA Owner's Salary from IRA-Owned Business Creates Prohibited Transaction

Terry L. Ellis & Sheila K. Ellis v. Comm., TC Memo 2013-245, October 29, 2013

The Tax Court ruled that an IRA owner engaged in a prohibited transaction (self-dealing) when a business owned by his IRA paid him for being the general manager of that business. His entire IRA was disqualified and deemed distributed, resulting in the assessment of income taxes and the 10% early distribution penalty on the full amount. He was also hit with the accuracy-related penalty for underpayment of income taxes.

His entire IRA was disqualified resulting in the assessment of income taxes and the 10% early distribution penalty.

Facts of the Case

Terry Ellis worked for many years at Aventis Pharmaceuticals and accumulated a sizeable balance in his 401(k). In 2005, a law firm helped Ellis start a limited liability company (LLC) called CST, a business that would sell used cars. Mr. Ellis acted as the general manager of CST with full authority to act on behalf of the company. He also worked in CST's used car business.

The operating agreement of CST called for Ellis to open a new IRA that would own 98% of CST in exchange for a capital contribution of $319,500. The other 2% would be owned by an unrelated party. Because there isn't any stock in an LLC, the IRA would own CST by purchasing membership certificates which represented 98% ownership.

After CST (the LLC) was formed in May 2005, Ellis began putting the plan in place. First, he established an IRA with First Trust Co. of Onaga (First Trust) in early June 2005. On June 22, 2005 he received a distribution from his Aventis Pharmaceuticals 401(k) plan of $254,206 which he rolled over to his newly opened IRA. The next day, his IRA bought part of CST for $254,000 cash.

In August he received a second 401(k) distribution of over $67,000

WHAT'S INSIDE?