Using 401(k) Rollover Funds to Start a Business
Not Good Idea if the Individual Becomes a Compensated Employee

Many individuals would like to start their own business and then manage this business. They wonder if they can rollover 401(k) funds into an IRA, have the IRA establish the business, and then they manage the business.

On October 29, 2013, the U.S. Tax Court in Ellis and Ellis v. Commissioner of Internal Revenue ruled against Mr. and Mrs. Ellis. In 2005 Mr. Ellis had rolled over his 401(k) funds into a traditional IRA and used such funds to establish CST Investments, LLC, a used vehicle dealership. His IRA owned a 98% interest in CST and an unrelated person owned the other 2%. For reasons discussed below, the court found that a prohibited transaction occurred with respect to Mr. Ellis' traditional IRA and consequently his IRA with a value of $321,366.25 was deemed distributed as of January 1, 2005, and federal income and penalty taxes were owed. Since a joint income tax return was filed for 2005, Mr. and Mrs. Ellis owed income tax on the $321,366.25, the 10% additional tax as he was not yet 59½ and the accuracy related penalty tax of 25%.

The prohibited transaction rules as set forth in the Internal Revenue Code section 4975 do not prohibit an IRA accountholder from investing in a start-up business, but they do prevent a person from working at or for the start-up business and receiving compensation or some other personal benefit from the business. Mr. Ellis learned a tax lesson the difficult way.

The Tax Court found that the IRA's act of establishing CST was not a prohibited transaction. This had been accomplished by Mr. Ellis instructing the IRA custodian to purchase certain stock membership units. The Tax Court found, "CST had no outstanding owners or ownership interests before the initial capital contribution and therefore could not be a disqualified person at the time the investment by Mr. Ellis' IRA. Accordingly, Mr. Ellis did not engage in a prohibited transaction when they caused Mr. Ellis' IRA to invest in CST."

The Tax court did find, however, that when Mr. Ellis caused CST, an entity owned by his IRA to pay him compensation of $9,754 for 2005 that a prohibited transaction had occurred. The court's rationale. "To say that CST was merely a company in which Mr. Ellis' IRA invested is a complete mischaracterization when in reality CST and Mr. Ellis' IRA were essentially the same entity. In causing CST to pay him compensation, Mr. Ellis engaged in the transfer of plan income or assets for his own benefit in violation of section 4975(c)(1)(D). Furthermore, in authorizing and effecting this transfer, Mr. Ellis dealt with income or assets of his IRA for his own interest or for his own account in violation of section 4975(c)(1)(E)." Mr. Ellis had tried to argue that the prohibited transaction exemption of Code section 4975(d)(10) applied allowing a disqualified person to receive reasonable compensation for plan administration services rendered, or for the reimbursement of expenses properly incurred. The Tax Court found the exemption did not apply as "the amounts CST paid as compensation to Mr. Ellis were not for services provided for the administration of a qualified retirement plan in managing its investments, but rather for his role as a general manager of CST in connection with its used car business."

The IRS had argued that other transactions were also prohibited transactions. One example, another business was established with the owners being Mr. Ellis, Mrs. Ellis and their children. This business purchased real estate which it leased to CST over a 10-year period. The court made clear that it was unnecessary for it to determine if these other transactions were also prohibited transactions. There only needs to be one

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prohibited transaction to have the adverse tax consequences. One can expect that there will be other tax cases such as this one dealing with whether an IRA accountholder's investment of funds rolled over into an IRA and invested in a start-up is a prohibited transaction.

Cardinal rule – the IRA must be making an investment with an unrelated party and all of the earnings or benefits from such investment must belong to the IRA.

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