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Tax Court Nixes Roth IRA Tax Shelter

How much can you stuff into your Roth IRA before the Internal Revenue Service comes calling? In a recent case in U.S. Tax Court, Jan Jansson, a southern California business owner, made initial $2,000 deposits into Roth IRAs for himself, his wife and his two adult sons. Then, over a six-year period, via a conduit limited liability company, Block Developers, another $800,000 poured into the Janssons' Individual Retirement Accounts. During the 2006 tax year alone Block Developers distributed $65,000 in patent royalties to each Jansson Roth IRA—that year the contribution limit was just $4,000.

The Court found that Block Developers was "just a conduit to shunt money to the Janssons' Roth IRAs and not engaged in any real business activity." Therefore, the transfer to the Roth IRAs were excess contributions that triggered excise tax and penalties. The tax code imposes a 6% excise tax on excess IRA contributions; it applies each year until the excess is removed.

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In this case, each family member owed $12,000 in excise tax for the excess contributions and $4,500 in "failure to file" and "failure to pay" penalties. Going forward, the excess

contributions would need to be removed, or the additional 6% per year penalty would apply, says Warren Baker, a Seattle tax lawyer who specializes in Individual Retirement Account issues. "They got slapped on the wrist, but it could have been far worse," he notes. If the IRS had found that the transfers from the father to Block Developers (the IRA-owned LLC) were a prohibited transaction, the whole IRA could have been invalidated.

The Court relies on IRS Notice 2004-8, advising taxpayers that certain transactions using Roth IRAs and your own business are viewed as abusive tax-avoidance transactions. Basically, if you already have a business, it already makes money and then you set up a structure to shift some of your personal income into a Roth IRA, that's not allowed. On the other hand, if you already have a Roth IRA and invest in a privately-held business not tied to you personally, that's kosher.

Jansson, a developer of interlocking concrete blocks used to construct homes and roads on hillsides, testified that he was unfamiliar with estate planning, and wanted his businesses to survive his retirement. He met a lawyer at a retirement planning seminar, William Maxam, who helped him form Block Developers, with Maxam becoming tax partner with a 5% share, and the Jansson family members controlling 95%.

Jansson argued that Block Developers was set up for legitimate purposes, and that the sale of the patents and royalty transfers to the IRAs were at fair market value so Notice 2004-8 doesn't apply. But the Court found otherwise: "Jansson's claim that Block Developers had a legitimate business purpose falls apart rather quickly after even a cursory view of the records." And: "We must find it more likely than not that the estate planning involved centered on creating large and sporadic royalty deductions from the moneys of profitable businesses to tax-free Roth IRAs using Block Developers as an otherwise nonfunctional conduit." So, the whole deal lacked substance.

The Court acknowledges that "the substance-over-form doctrine is not something the Commissioner can use to pound every Roth IRA transaction he doesn't like." For example, in Summa Holdings, the 6th Circuit okayed a huge Roth IRA tax shelter, slamming the doctrine and overturning a district court decision in favor of the IRS. Forbes' contributor Peter Reilly has the story on Summa Holdings here. Lawyers of record for Block Developers didn't say if their client intends to appeal–it would be to the 9th Circuit.

What's the moral? It's the duty of the IRA owner to learn the rules—and follow them—when it comes to excess contributions, valuation requirements, prohibited transactions and UBIT (unrelated business income tax). And if something seems too good to be true, get a second opinion.

The Tax Court opinion, Block Developers v. Commissioner, is online here.

See also:

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