BE CAREFUL NOT TO USE RETIREMENT MONEY FOR IMPROPER PURPOSES

How should you go about funding the acquisition of a new business?

Many of us would use liquidity from our investments as a down payment and then leverage the remainder of the purchase with debt carried by the seller or held by third parties, such as banks.

Those of us with significant holdings in a retirement account might be tempted to use those funds instead. It is important to recognize that numerous tax traps exist when using funding from a qualified plan to acquire and operate a business.

In a recent case, *Lawrence Peek* , 140 TC No. 12 (2013), a taxpayer had his self-directed IRA capitalize a new entity that in turn purchased an existing business. The new entity bought the assets of that business for $850,000 in cash and a $200,000 promissory note to the sellers. The sellers required personal guarantees from the individual taxpayer. A few years later, the shares of stock of the new entity were sold. The taxpayer took the position that the sale was exempt from income tax because it occurred within the IRA.

Unfortunately any personal guarantee made by an IRA owner on a loan made to a company owned by the IRA is considered to be a prohibited transaction by the IRS. The personal guarantee can result in disqualification of the IRA, thereby causing any gain from the sale of the stock to be personally taxable to the taxpayer.

In this particular case, the IRS determined on audit that the loan guarantees were prohibited transactions under IRC Sec. 4975(c)(1)(B), which prohibits "lending of money or other extension of credit between a plan and a disqualified person." A loan guarantee is treated as an indirect extension of credit.

The taxpayers in that case argued that the credit extension was between them, as individuals, and a company owned by the plans, not the plans themselves. However, the IRS did not agree with their position and ultimately, the tax court agreed with the IRS.

This case illustrates the importance of carefully planning a business acquisition and weighing the tax risks associated with a particular action plan. Sometimes the potential hazards can far outweigh the possible tax benefits.

It should be noted that even if the IRS had lost this case, the result still might not have been very beneficial for the taxpayer. This is because even though an IRA is tax exempt, moneys withdrawn from it are always taxed at ordinary income rates instead of long-term capital gain rates. Therefore, all the IRA really does in this type of transaction is to obtain tax deferral. However, that tax deferral comes at a significant cost: conversion of long-term capital gains to ordinary income.

At Large & Gilbert we are committed to keeping you up to date on the latest tax laws and helping our clients accomplish transactions in the most tax-efficient manner possible, within our clients' parameters of risk tolerance. If you have any questions, please contact:

Joseph C. Skalski, CPA, JD at 770-671-1533, ext. 219, jskalski@largeandgilbert.com
Matthew S. Kaynard, JD at 770-671-1533, ext. 209, mkaynard@largeandgilbert.com
Reshma Patel at 770-671-1533, ext. 210, rpatel@largeandgilbert.com