The Mazzei Roth IRA Case – An End to Magical Schemes

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The Tax Court took a major step in the direction of curtailing SDIRA abuse. The case will put the kibosh to a great many "IRA Stuffing" schemes – of which I have seen a myriad.

Basic Description

The transactions in this case were pretty typical for a lot of what we've seen in Tax Court cases – and the Tax Court was clearly sick & tired of dealing with it. In this case, the taxpayer's Roth IRA set up a company (Roth Inc.) and "invested" a $500 nominal amount in it. The taxpayer's business ("Taxpayer Incorporated") paid Roth Inc for services. The services were deductible to Taxpayer Incorporated, mostly tax-free to the Roth,[1] and resulted in large amounts of money ($533,000 in this case) being "stuffed" into the Roth. Magic! Creative! Superior tax planning!

Bogus.

The Tax Court correctly ruled that transactions were bogus, that it constituted excess contributions to the Roth, and imposed a tax of about $40,000.

The Court's reasoning is very important to REI. Based on "substance over form" principles, it ruled that the IRA did not really own Roth Inc for two main reasons:

- The IRA' were exposed to no significant risk; and
- An independent person in the IRA's shoes could not realistically have expected a benefit.

Since the IRA did not really "own" Roth Inc, the income really belonged to the taxpayer – and putting that money into the IRA resulted in a taxable "excess contribution".

More specifically, the court held that a $500 investment, absent any other significant risk, does not give rise to any real risk for the IRA. The IRA had no real skin in the game.

The court also asked what benefits an independent holder of Roth Inc's stock could realistically have expected based on the objective nature of the stock. An analysis of the transactions showed that Taxpayer Incorporated had 100% control over whether commissions were paid at all as well as control over how much was paid to Roth Inc. In this case, Taxpayer Incorporated even had the ability to reach in and pull previously paid commissions out of Roth Inc. Because

[1] Roth Inc paid tax on some of its profits, but at a low rate because of its status as a "Foreign Sales Corporation" or FSC.

the relationship was very friendly ("incestuous" is probably a better word), that control was not used against Roth Inc. But if IRA Inc were owned by a completely independent party, that party would have no reason to pay commissions to Roth Inc. In other words, an independent owner of Roth Inc would have no reasonable expectation of upside if the parties were truly unrelated.

So, the IRA had nothing at risk and no reasonable expectation of upside but for the parties in the relationship being all cozy. Simply put, the structure & scheme were bogus. The Tax Court therefore ignored what was "on paper", looked at what was actually going on ("the substance"), and imposed the over-contribution tax.[2,3]

This approach spells the end of all the "magically stuff your Roth" schemes I have seen. For example:

Taxpayer has his Roth enter into a contract to buy a property for a mere $100. The Roth then sells the contract for $20,000 to an investor. Presto, the Roth has lots of money!

Not so fast. First off, I think the Tax Court would view such a transaction as "running one's personal services (here brokerage services, aka putting buy & seller together for a fee) through a Roth", treat the profit on the "assignment" of the contract as personal services, treat the money in the Roth as an excess contribution, and penalize the taxpayer for failure to file the excise tax return (Form 5329) & failure to pay the tax thereon.

In light of this case, I think that the Court would certainly view an IRA with an assignment deal as "not at risk" – all it has in the deal is $100. The court would also find that if the creator of the contract were an independent person, the IRA would have no reasonable expectation of upside because no independent person would do all that work for nothing & sell it (via the buy-sell contract) to the IRA for $100.

In short, such transactions would be deemed bogus ("no substance") and disallowed.

Ditto "Magical Option Contracts". I've seen a number of deals where a Roth buys an option on a "financial friend's" rehab for $1,000. The strike price is such that the option is going to result in lots of money to the Roth IRA, usually $10,000 to $20,000. Of course, few people have

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[2] The taxpayer got _**very**_ lucky. The statute of limitations had passed for the IRS to audit Taxpayer INCORPORATED and disallow the deductions for commissions paid to IRA Inc. In addition, I am willing to bet that the statute of limitations had also passed for Prohibited Transactions. Either one of these items could have cost the taxpayer *far* more than a mere hundred grand or so.

[3] The taxpayer's CPA was at least somewhat on the ball. He filed Form 8886, Reportable Transaction Disclosure Statement. That filing matters immensely because these sorts of transactions are "Listed Transactions" (see IRS Notice 2004-8) – meaning that if a taxpayer does not report them (most do not), then a fine of 75% of the taxes saved would have been due – that'd be on top of the taxes owed and the other penalties & interest due! Of course, filing that form is likely what caused the audit to begin with…..

friends who are willing to functionally give away 5-figure sums – there's always a quid-pro-quo or payback of some sort, somehow, somewhere.

Oh, but the IRS will never figure it out! Hmmmm. Take a look at this case and the vast amount of detail the IRS uncovered. Or the *Block Industries* case from the Summer of 2017 where the Tax Court unraveled a "Magical Options Contracts Make Roth IRA Instantly Huge" scheme. Or just ask me about the 2 Roth IRA audits I directly handled. In all of these cases, the audits were very, very thorough and the details came out.[4]

There are so many ways to make lots of money in IRA's & other self-directed accounts. There are also legitimate ways to make very small accounts into very large accounts. The Tax Court is on to BS games and shortcuts. Just do it right from Day One and avoid the Magic That Never Was.

John Hyre is an exceptional tax attorney with 23 years of experience. Prior to venturing into private practice, John worked for a Fortune 500 company as Tax Counsel and for two of the "Big Three" accounting firms as a Tax Consultant. John has been involved in tax planning for start-ups, large corporate and partnership/INCORPORATED transactions, international transactions, REIT's, and executive compensation arrangements. John's present practice focuses on the taxation of real estate and self-directed IRA's & 401(k)'s. John has successfully defended such clients in IRS audits and Tax Court.

John frequently speaks on the topics of taxation of real estate investors and the taxation of self-directed IRA's & 401(k)'s throughout the United States. John also personally invests in rental real estate. John is licensed in Ohio. Given the nationwide applicability of federal income taxation, John's clients are from all areas of the United States as well as from overseas.

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[4] I took on two SDIRA audits directly and consulted on multiple others. The two I took on both went to Tax Court – and the IRS ultimately decided to concede the cases rather than go to trial in both cases. In short, both of my clients paid zero to the IRS.