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DUTIES AND RIGHTS OF AN AGENT UNDER A FINANCIAL POWER OF ATTORNEY

by DeEtte L. Loeffler, J.D., L.LM, Taxation

Have you agreed to be an agent under a financial power of attorney for someone else? If so, do you understand all of your legal responsibilities under this document?

As an agent, you have agreed to act on behalf of the "principal" (the individual who appointed you) to bind that person in financial transactions. In other words, you have agreed to act as that person for all financial purposes. If you sign a contract (or waive a right) in the future, the principal is legally responsible for that decision.

Your authority to act may be immediately effective or may be delayed until a future event (usually the incapacity of the principal). You may also be named as a "successor" agent. A successor agent does not have any power (or duty) to act for the principal until the person or persons named to act before you have resigned.

Under a power of attorney, you have five major and one special duty. First, you must act solely on behalf of that principal. For example, if you are appointed as agent to sell the principal's home, you cannot also act on behalf of a proposed buyer of the house and disclose to that prospective buyer any confidential information you receive from the seller (such as a lowest acceptable offer).

Second, you must only act within the "scope" of your appointment as set forth in the written appointment. If you are appointed solely to sell the principal's car, you cannot also buy a new car for him or her with the sales proceeds or swap the car for some asset other than cash.

Third, you must use appropriate care and diligence in exercising powers on behalf of the principal. If you agree to pursue a claim against a third party, you should act quickly to secure legal representation and to file the appropriate claim in a timely manner so that the claim is not lost. You also should not abandon the claim without the knowledge and approval of the principal.

Fourth, as an agent, you are a "fiduciary", meaning that you must avoid conflicts of interest and act in the best interests of the principal. For example, you must not engage in "self-dealing" (where you benefit from the exercise of your powers, such as where you buy the principal's car for your child at a "sweetheart" price).

Acting as a fiduciary is not always as clear cut as it sounds. For example, assume John was appointed as financial agent for his mother who is now incapacitated and needs full-time care.

He knows his mother wanted to remain in her home until her death, but the cost of home-based care is higher than if she moved into a care facility. What should John do? Clearly, it depends. As agent, John must set aside his own interests as a remainder beneficiary to analyze whether it is appropriate to provide home care for his mother (as she wished) or to move her and, by doing so, extend the period over which benefits can be provided to her (i.e., so she does not run out of money before her death).

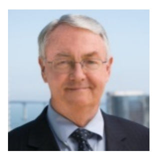
Fifth, the agent is obligated to protect and preserve the assets as well as promptly deliver to the principal all money and assets collected on principal's behalf.

Finally, if the power of attorney allows you signature authority over bank accounts, investment accounts, or a foreign trust, Congress has added an additional duty to this list. Under the federal Bank Secrecy Act, any person with *signature authority over* (not just ownership in) a foreign bank account, brokerage account, mutual fund, trust or other type of foreign financial account (exceeding certain thresholds) may be required to report that account to the IRS each year by filing a Financial Crimes Enforcement Network (FinCEN) 114, Report of Foreign Bank and Financial Accounts (also known as an FBAR report). If you are an agent under a general power of attorney, you should confirm on an annual basis if the principal has such foreign accounts. Failure to file the FBAR can result in significant financial penalties. However, certain changes to a power of attorney may be included to limit the duties of the agent and avoid triggering the FBAR reporting obligation.

You also have rights as an agent. You cannot be required to act for another person without your consent. Your appointment as agent does not necessarily mean you must act on behalf of the principal. Your consent, however, may be implied if you take any actions using the powers. If you disagree with what the principal wants you to do or you are unable (or do not want) to act as agent, you can decline to serve or, if serving, you may resign. Generally, a written declination to a serve or a written resignation is required so that the next named agent under the power of attorney may act.

The principal also owes certain duties of care toward you. The principal should compensate you (if this is your agreement) and should indemnify you, as the agent, against all claims, liabilities, and expenses you incur while acting on behalf of the principal and within the scope of your authority. For example, if the agent is sued for selling a car with a cracked engine block and the principal knew about this issue without disclosing it to the agent, indemnification is appropriate. However, if the agent knew of the problem and actively disguised it from the buyer, indemnification is not appropriate.

If you have been appointed to act as agent under a power of attorney or you have appointed someone else to act on your behalf and have questions about your duties and rights under this arrangement, we recommend you contact a qualified attorney to discuss them.



IRAs AND THE PROHIBITED TRANSACTION RULES

by Bradford N. Dewan, J.D., MBA

A recent Tax Court case, Thiessen v. Comm'r [1] is the latest in a series of recent Tax Court cases that highlight and focus on how an IRA can lose its tax-favored status if the IRA owner engages in certain actions related to the IRA that are later determined to be prohibited transactions under IRC section 4975. The consequences are very significant and adverse to the IRA owner. The following is a brief description of the Thiessen case and the components of the prohibited transaction rules that were applied to essentially terminate the IRA and result in a deemed taxable distribution to the IRA owner.

Summary. James and Judith Thiessen wanted to acquire the assets of a metal fabrication business. To facilitate that purchase of a

[i] 146 T.C. No. 7 (March 29, 2016)

business involved in metal fabrication, they each rolled over their tax-deferred retirement funds into newly created Individual Retirement Accounts ("IRAs"). They directed the IRA custodian to use the IRA funds to purchase the stock of a newly formed "C" corporation, Elsara Enterprises, Inc. ("Elsara"). Once capitalized, Elsara then purchased the assets of Ancona Job Shop ("Ancona"), an unincorporated business that specialized in the design, fabrication, and installation of metal products. In conjunction with the purchase of the assets, James and Judith personally guaranteed the promissory note that Elsara issued to Ancona as part of the purchase price.

After an audit, the IRS asserted that the personal guaranties by the Thiessens constituted prohibited transactions that resulted in deemed distributions of 100% of the assets held in their IRAs (that had purchased the shares of Elsara).

Because the Thiessens had not indicated on their tax returns that they had each personally guaranteed the loan, they were liable for $180,129 deficiency attributable primarily to unreported IRA taxable distributions.

The Tax Court held:

1. The Thiessens' guaranty of the loan constituted prohibited transactions since the guaranties caused the couple to be treated as providing indirect extensions of credit to their IRAs.
2. As a result of the guaranties being treated as prohibited transactions, each IRA lost its status as an IRA.
3. The loss of IRA status caused the assets in their respective IRAs to be deemed to have been distributed to each of them in a taxable distribution as of January 1 of 2003, the year the guaranties were executed.
4. The Thiessens were liable for the 10% early withdrawal penalty tax since neither of them had reached the age of 59 ½ in the year of the deemed distributions; and
5. The Thiessens' failure to report gross income in excess of 25% of the amount of gross income actually reported on their joint return resulted in extending the statute of limitations on assessments to six years (not just three years).

<u>Discussion</u>. In June 2003, James and Judith Thiessen left their jobs at Dillon Cos. Inc., a wholly-owned subsidiary of Kroger Co. where they each had participated in Kroger's retirement plans. Upon retiring they took the following steps:

1. Each of them rolled over the funds from the retirement plans into newly formed individual retirement accounts (IRAs).
2. Each directed the IRA custodian that the funds in the IRAs be used to purchase the stock of a newly formed C corporation, Elsara Enterprises, Inc. (Elsara).
3. As the sole members of the Board of Directors of Elsara, they authorized and directed the purchase by Elsara of the assets of Ancona Job Shop, an unincorporated business that specialized in the design, fabrication, and installation of metal products.
4. To purchase the assets, Elsara paid part of the purchase price in cash and paid the balance with a promissory note.
5. Each of the Thiessens personally guaranteed the payment of the promissory note issued as part of the payment of the purchase price.

The Thiessens reported on their 2003 tax return that the rollover of the funds from the Kroger retirement plans into the IRAs was nontaxable. However, they did not mention that they had guaranteed the payments under the promissory note described above.

The owner of Ancona was Polk Investments, Inc. and had made the decision to sell the business. The Thiessens were told by Jay Hoyal, a broker at the brokerage firm A.J. Hoyal & Co., Inc. (AJH), that they could use the funds in the retirement accounts to purchase Ancona. Specifically, he stated that they could roll over the funds from their retirement plan accounts into IRAs, cause the IRAs to acquire the initial stock of a newly formed C corporation, and cause the C corporation to acquire Ancona ("IRA funding structure"). The Thiessens were also advised that AJH typically recommended that an acquisition of an existing business be structured to include a loan from the seller so that the seller would have an interest in helping the buyer in the future.

Mr. Thiessen discussed this IRA funding structure with a friend who had recently used that structure to acquire a business. The friend referred Mr. Thiessen to Christian Blees, a certified public accountant. The Thiessens discussed the IRA funding structure with Mr. Blees and later asked him to help them implement the IRA funding structure to acquire Ancona. The Thiessens also retained Thomas James, an attorney with no prior ties to Mr. Blees or A.J. Hoyal & Co., Inc, to help them with the terms of the sale contract as well as the terms of a financing arrangement that they would implement to effect the purchase of Ancona. Mr. Blees was not involved in drafting the sale contract or in structuring the financing arrangement.

Mr. Blees and his firm helped the Thiessens establish Elsara as a C corporation. The Thiessens were named as Elsara's officers and directors and they (and no one else) have served in those positions since that point.

The Thiessens each established an IRA in their respective name as a "self-directed" IRA with each of them retaining all discretionary authority and control concerning investments to be made by his or her IRA. Mr. Thiessen transferred $384,855.80 to his IRA from the Kroger retirement plan account, and Mrs. Thiessen transferred $47,220.61 to her IRA from her Kroger retirement plan account. They formally transferred these funds as tax-free rollovers and the IRA custodian reported to the IRS on 2003 Forms 5498, IRA Contribution Information, that the funds deposited into the IRAs were "rollover contributions."

On June 9, 2003, Mr. Thiessen directed the custodian to use the funds in his IRA to purchase 8,911 shares of Elsara stock. Mrs. Thiessen directed the custodian to use the funds in her IRA to purchase 1,089 shares of Elsara stock. The total amount paid by the two IRAs for all of the stock was $431,500. These shares of stock were the only ones that Elsara issued during the relevant years.

Around June 18, 2003, Elsara purchased the assets of Ancona from Polk for $601,977.50. The purchase price included Elsara's promissory note to the seller with the principal amount of $200,000.

The promissory note stated that Elsara would pay $200,000 (plus interest accruing at 7% per annum) to Polk through 60 monthly payments and that repayment was secured by "[a]ll items of value used in the operation of the business known as Ancona Job Shop". The promissory note further stated that the Thiessens personally guaranteed repayment and it included the Thiessens' signed statement to that effect.

Analysis. The IRS claimed the prohibited transactions occurred under IRC section 4975(c)(1)(B) when the Thiessens personally guaranteed the payments under the promissory note and that those prohibited transactions caused a deemed distribution of all of the assets in the two IRAs to them in a taxable distribution.

Prohibited Transaction: Key Elements

1. An IRA ceases to be an IRA if the individual for whose benefit the IRA is established, or his or her beneficiary, engages in a prohibited transaction with respect to the IRA.[2]
2. A "prohibited transaction" generally includes "any direct or indirect . . . lending of money or other extension of credit between a plan and a disqualified person."[3]
3. A "plan" includes an IRA described in IRC sec. 408(a).[4]
4. A "disqualified person" includes a "fiduciary."[5]

[2] IRC sec. 408(e)(2)(A)
[3] IRC sec. 4975(c)(1)(B)
[4] IRC sec. 4975(e)(1)(B)
[5] IRC sec. 4975(e)(2)(A)

5. A “fiduciary” includes any person who “exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets.”[6]
6. If a prohibited transaction has occurred, the IRA ceases to be an IRA as of the first day of the taxable year of the IRA owner in which the prohibited transaction occurred.[7]
7. If a prohibited transaction has occurred, the IRA owner is deemed to have received a distribution on the first day of that taxable year of an amount equal to the FMV on such first day of all assets in the IRA on such first day.[8]
8. The deemed distribution is generally included in the IRA owner’s gross income in accordance with the provisions of IRC sec. 72.[9]
9. An IRA owner will be subject to an additional 10% tax on the “deemed distributions” described above if the IRA owner was not yet 59 ½ years old on the date of the distribution and no other exceptions to the 10% penalty tax applies.

Tax Court and IRS Rationale. The IRS had determined that the Thiessens had received taxable distributions from IRAs in 2003. The basis for this determination was that the promissory note guaranties by the Thiessens constituted prohibited transactions, because the guaranties were, in effect, their respective indirect extensions of credit to their IRAs. The result of the prohibited transaction was that their IRAs lost their status as IRAs which caused deemed taxable distributions of the entire amounts held in the IRAs and the termination of the IRAs.

The IRS and the Tax Court looked to Peek v. Commissioner[10] where the same CPA, Mr. Blees, had promoted the IRA funding structure to two unrelated taxpayers who, pursuant to that promotion, rolled over funds in their retirement plans into self-directed IRAs. They then formed a new corporation into which the funds from their IRAs were invested with the purchase of the stock of the corporations. The taxpayers, as the Directors and Officers of the corporation, then had the corporation use the invested funds to purchase (through the same brokerage firm as the Thiessens) the assets of a business by, in part, receiving a loan from the seller for part of the purchase price. After this, the taxpayers personally guaranteed the loans.

In Peek, the Tax Court held that the taxpayers were “disqualified persons” and ruled that the taxpayers’ guarantees of the loan were prohibited transactions, because the guarantees constituted indirect extensions of credit between the taxpayers, who were disqualified persons, and the IRAs. The Tax Court held that the taxpayers’ participation in the prohibited transactions caused the IRAs to cease to qualify as IRAs within the meaning of IRC section 408(a) in the year in which the guarantees were made.

The court in the Thiessens’ case reasoned that, for purposes of the prohibited transaction rules, the Thiessens’ IRAs were “plans” and the Thiessens were “disqualified persons,” because they exercised discretionary authority or discretionary control over the management of their IRAs (as well as over the management and disposition of the assets held in the IRAs). Therefore, as was true for the taxpayers in Peek, the Thiessens’ guaranties of the loan from Polk were prohibited transactions which resulted in the Thiessens’ IRAs ceasing to qualify as IRAs as a result of the guaranties.

The Thiessens participation in the prohibited transactions caused their IRAs to cease to be IRAs as of the first day of the taxable year in which the prohibited transactions occurred. As a result, they were deemed to have received taxable distributions on that first day of amounts equal to the fair market values (on the first day) of the assets in their IRAs.

[6] IRC sec. 4975(e)(3)(A)
[7] IRC sec. 408(e)(2)(A)
[8] IRC sec 408(e)(2)(B)
[9] IRC sec. 408(d)(1)
[10] 140 T.C. 216

Finally, because the unreported gross income from the deemed distributions from the IRAs exceeded 25% of the gross income the Thiessens actually reported for tax year 2003, the 3-year statute of limitations of assessment and collections was extended by statute to 6 years. The Tax Court determined that the Thiessens' return disclosure of their respective rollovers as tax-free was not sufficient to put the IRS on notice that the Thiessens had engaged in the prohibited transactions.

Conclusion. The Thiessen case, the Peek case, and another recent Tax Court case, Ellis v. Comm'r[11] underscore the importance for IRA owners and their advisors to recognize the existence of and the application of the prohibited transaction rules under IRC section 4975. While IRA owners are subject to very few limitations as to the types of investments that may be made with IRA funds, an IRA owner's involvement with any such investment acquired with IRA funds is very broadly circumscribed, if not actually prohibited.

FEDERAL TAX NEWS

by DeEtte L. Loeffler, J.D., LL.M. Taxation

Vanishing Financial Privacy? In February of 2016, bills entitled Incorporation Transparency and Law Enforcement Assistance Act (HR 4450 and SB 2489) were introduced in the House and Senate to require disclosure of information on the beneficial ownership of U.S. corporations and limited liability companies for use by law enforcement. Similar bills have been proposed each year since 2008 and the current bills are not expected to be adopted. However, in Europe, information is now collected on the beneficial ownership of companies, trusts, and foundations. In April, thirty (30) European nations agreed to the automatic exchange of such information. Among the parties to this agreement are the United Kingdom, France, Germany, Italy, Spain, and Ireland.

113 Countries Now Participate in FATCA Disclosure. The Socialist Republic of Viet Nam is the most recent country to sign an Intergovernmental Agreement with the United States to implement FATCA reporting. Financial institutions in 113 countries now report information on U.S. taxpayers with accounts in those countries.

Business Tax Proposals Analyzed. On April 22, 2016, the Joint Committee on Taxation (JCT) released a report discussing various business tax reform proposals. The report was presented at a meeting of the Senate Committee on Finance on April 26, 2016. According to Thomas Barthold, Chief of Staff of the JCT, the largest corporate tax expenditure is for the deferral of active income of controlled foreign corporations. This deferral accounts for \$563.6 billion (compared to \$57.4 billion for deferral in like-kind exchanges). Effective federal tax rates range from 63.21% for ordinary income distributed to taxpayers from a corporation down to 39.6% for active income from S corporations. The speaker emphasized the need for corporate tax reform to "integrate" corporate and individual tax rates.

STATE TAX NEWS

by DeEtte L. Loeffler, J.D., LL.M. Taxation

Tax Conformity. SB 907 would cause California to conform to the Federal Tax Increase Prevention Act of 2014 and extend tax relief on mortgage forgiveness debt. Under current California law, taxpayers who experience a short sale are taxable on the amount of the debt forgiven by the bank. In contrast, under federal law, they are not taxed on the relief of such debt. Between 2007 and 2013, California conformed to federal law and did not tax such debt forgiveness.

Sugar Tax Stalls. AB 2782, the Healthy California Fund (which would have imposed a 2 cent per ounce tax on sugary beverages) lost momentum and further hearings were cancelled in April. The tax money would have been held in a separate fund and used for education and treatment of diabetes and childhood obesity.

[11] T. C. Memo. 2013-245 (2013)

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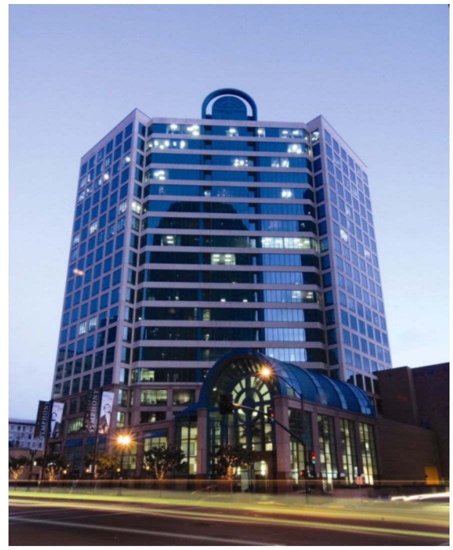

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