Building Prohibited Transaction Chinese Walls for Retirement Plan Investment Structures

David Randall Jenkins
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for Retirement Plan Investment Structures

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an IRS Approved Continuing Education Provider

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Chicago
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The Section 4975(e)(2)(G) disqualified person entity criterion concomitantly establishes its complement. Since three complement units are necessary to comprise 100%, there must be three capital equity interests in each plan investment entity. Moreover, decision-making must manifest a majority of at least any two out of three capital equity interests or greater diversification.
Prohibited transactions proscribe self-dealing activities.
A self-dealing activity requires two elements: plan assets and disqualified persons:

![Diagram of self-dealing activity]

**Figure 1**
The Self-Dealing Activity (Plan Asset, Disqualified Person) Nexus
The self-dealing activity (plan asset, disqualified person) nexus remains confounded until one element is defined.
Congress chose to unconfuse the self-dealing activity (plan asset, disqualified person) nexus by defining the latter element by and through the Section 4975(e)(2)(G) fifty percent or greater disqualified person entity criterion.
What is the complement of fifty percent or more?
The disqualified person criterion, accordingly, defines its complement as “less than fifty percent.”
The disqualified person complement impounds Congress’s management risk diversification policy.
How many disqualified person complement units are in 100%?
Three disqualified person complement units are necessary to comprise 100%.
It can be said, therefore, Congress’s management risk diversification policy’s first requirement is that there must be at least three capital equity interest holders in any plan entity investment.
This is not the totality of Congress’s Section 4975 impounded management risk diversification policy.
In furtherance of Congress’s policy to protect plan assets for their ordained purpose, discretionary authority or control over plan assets is policy disfavored.
Therefore, Congress’s management risk diversification policy’s second requirement is also a compliance necessary condition.
Congress’s management risk diversification policies also require plan investment entity decision-making manifest a majority of at least any two out of three capital equity interest combinations or greater diversification.
The plan asset complement is presumptively derived from the disqualified person complement.
As a result, all plan asset investments, respectively, should be less than fifty percent of plan assets (except for an Employee Stock Ownership Plan).
### The Minimum Diversification Policy Compliant Scenario

<table>
<thead>
<tr>
<th>Investment Risk Diversification (Weighted-Avg. %)</th>
<th>IE₁</th>
<th>IE₂</th>
<th>IE₃</th>
<th>Total Plan Assets Invested</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>49%</td>
<td>49%</td>
<td>2%</td>
<td>(100%, Pₙ)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Management Risk Diversification (Acquired CEI %)</th>
<th>49%</th>
<th>P₁</th>
<th>49%</th>
<th>P₂</th>
<th>49%</th>
<th>P₃</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>49%</td>
<td>P₂</td>
<td>49%</td>
<td>P₃</td>
<td>49%</td>
<td>P₁</td>
</tr>
<tr>
<td></td>
<td>2%</td>
<td>P₃</td>
<td>2%</td>
<td>P₁</td>
<td>2%</td>
<td>P₂</td>
</tr>
</tbody>
</table>

| Total CEI %                                      | 100%| 100%| 100%|

### Management Risk Diversification Policy Compliance Analysis The Planₙ Set

<table>
<thead>
<tr>
<th>IEₙ</th>
<th>Combination</th>
<th>Combination Majority Test</th>
<th>Majority</th>
</tr>
</thead>
<tbody>
<tr>
<td>IE₁</td>
<td>P₁, P₂</td>
<td>49% + 49% = 98%; 98% &gt; 50%</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>P₁, P₃</td>
<td>49% + 2% = 51%; 51% &gt; 50%</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>P₂, P₃</td>
<td>49% + 2% = 51%; 51% &gt; 50%</td>
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<td>P₂, P₃</td>
<td>49% + 2% = 51%; 51% &gt; 50%</td>
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<tr>
<td></td>
<td>P₃, P₂</td>
<td>49% + 2% = 51%; 51% &gt; 50%</td>
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<tr>
<td>IE₃</td>
<td>P₁, P₁</td>
<td>49% + 49% = 98%; 98% &gt; 50%</td>
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<td></td>
<td>P₁, P₂</td>
<td>49% + 2% = 51%; 51% &gt; 50%</td>
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<tr>
<td></td>
<td>P₂, P₃</td>
<td>49% + 2% = 51%; 51% &gt; 50%</td>
<td>Yes</td>
</tr>
</tbody>
</table>
**The Minimum Diversification Policy Compliant Scenario**

Plan, Investment Risk Diversification Policy Compliance Analysis

<table>
<thead>
<tr>
<th>Combination</th>
<th>Combination Majority Test</th>
<th>Majority</th>
</tr>
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<tbody>
<tr>
<td>(IE$_1$, IE$_2$)</td>
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<td>Yes</td>
</tr>
<tr>
<td>(IE$_1$, IE$_3$)</td>
<td>49% + 2% = 51%; 51% &gt; 50%</td>
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</tr>
<tr>
<td>(IE$_2$, IE$_3$)</td>
<td>49% + 2% = 51%; 51% &gt; 50%</td>
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Building Prohibited Transaction Chinese Walls for Retirement Plan Investment Structures


Retirement plan management and investment risk diversification policy compliance transcends generally proscribed self-dealing activities into incidental benefits. Specifically proscribed activities incrementally require properly invoking a plan asset rule exception. The resulting Prohibited Transaction Chinese Wall transcends specific proscriptions into incidental benefits.
The realization of a Prohibited Transaction Chinese Wall was derived from considering three tax decisions: The Tax Court’s 2013 *Peek* and *Ellis* decisions compared to the Utah U. S. District Court’s 2011 decision in *Middleton v. Stephenson*.

*Peek v. Commissioner*
The *Peek* Tax Court decision issued May 2013.
Peek and Fleck invested their self-directed IRA funds, approximately $309,000 each, in consideration for acquiring a fifty percent capital equity interest each in a newly formed Colorado corporation, FP Company, Inc.
FP then acquired the assets of a fire extinguisher sales business.
Peek and Fleck, individually gave their respective personal guaranties on FP’s promissory note executed in favor of the seller, to wit:
In substance, the *Peek* Tax Court held that since each IRA invested in the Section 4975(e)(2)(G) disqualified person entity criterion FP was a disqualified person entity with respect to each IRA.
In substance, the Tax Court held investment in the disqualified person criterion preempts targeted benefits like the plan asset rule operating company exception and, as a result, FP’s underlying assets were deemed to be plan assets.
As a result, the Tax Court concluded a Section 4975(c)(1)(B) prohibited transaction had occurred when Peek and Fleck personally guarantied FP’s promissory note executed in favor of the seller.
The Peek and Fleck SDIRA acquisitions of fifty percent each of FP’s capital equity interests was management risk diversification policy noncompliant:

<table>
<thead>
<tr>
<th>IE&lt;sub&gt;n&lt;/sub&gt;</th>
<th>Combination</th>
<th>Combination Majority Test</th>
<th>Majority</th>
</tr>
</thead>
<tbody>
<tr>
<td>FP Corp</td>
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</tr>
<tr>
<td>FP Corp</td>
<td>Peek, P&lt;sub&gt;3&lt;/sub&gt;</td>
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<tr>
<td>FP Corp</td>
<td>Fleck, P&lt;sub&gt;3&lt;/sub&gt;</td>
<td>50% + 0% = 50%; 50% ≠ 50%</td>
<td>No</td>
</tr>
</tbody>
</table>

As a result, it can be said that management risk
diversification policy noncompliance results in the denial of targeted benefits like the benefits derived from the plan asset rule operating company exception.
Ellis v. Commissioner

The *Ellis* Tax Court decision issued in October 2013 and involved a SDIRA investment in a used car sales business in Harrisonville, Missouri.
Terry Ellis’ SDIRA invested $319,500 in CST Investments LLC in consideration for 98% of the entity’s capital equity interests:
Again, the Tax Court substantively held the SDIRA’s disqualified person criterion entity investment caused the operating company to be a disqualified person entity.
Such status caused the plan asset rule operating company exception to be preempted, and the operating company’s underlying assets to be plan assets.
The *Ellis* Tax Court concluded Terry Ellis’s receipt of compensation from the operating company amounted to a generally proscribed prohibited transaction under Section 4975(c)(1)(D) or (E).
The *Ellis* transaction structure was management risk diversification policy noncompliant:

<table>
<thead>
<tr>
<th>IEₙ</th>
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</thead>
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<tr>
<td>FP Corp</td>
<td>Ellis, 3rd Party</td>
<td>98% + 2% = 100%; 100% &gt; 50%</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Ellis, P₃</td>
<td>98% + 0% = 98%; 98% &gt; 50%</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>3rd Party, P₃</td>
<td>2% + 0% = 2%; 2% ≱ 0%</td>
<td>No</td>
</tr>
</tbody>
</table>
The *Peek* Tax Court concluded a specifically proscribed prohibited transaction under Section 4975(c)(1)(B).
The *Ellis* Tax Court concluded a generally proscribed prohibited transaction under Section 4975(c)(1)(D) or (E).
The (Peek, Ellis) difference signals the Tax Court’s teaching management and investment risk diversification policy noncompliance results in generally proscribed prohibited transaction determinations.
At the same time, the Tax Court is also teaching a specifically proscribed prohibited transaction is caused by failing to properly invoke a plan asset rule exception notwithstanding management risk diversification policy compliance.
Middleton v. Stephenson

The *Stephenson* Utah District Court decision is the first reported decision implicating the nature of a Prohibited Transaction Chinese Wall.
Hoyt Stephenson formed NFSM, an operating company in the health fitness industry.
All NFSM stock was owned by an Employee Stock Ownership Plan in which Stephenson was a trustee.
NFSM’s revenues were principally derived by providing services to two other operating companies owned by Stephenson.
Stephenson sold the operating companies to NFSM for cash and a promissory note.
Subsequently, NFSM entered into a default agreement with Stephenson, returning the two operating companies’ ownership to Stephenson, who later sold them to an unrelated third party.
Middleton, an NFSM employee and ESOP beneficiary, brought suit against Stephenson alleging a breach of fiduciary duty premised on Stephenson’s self-dealing activities.
Stephenson Conclusions

NFSM was an operating company within the meaning of the plan asset rule.
The ESOP’s 100% NFSM ownership did not preempt the plan asset rule operating company exception.
Stephenson Conclusions

NFNM’s underlying assets were therefore not plan assets.
**Stephenson Conclusions**

Transactions between NFSM and Stephenson could not amount to self-dealing activities because the essential plan asset element was missing from the self-dealing activity (plan asset, disqualified person) nexus.
The Stephenson
Prohibited Transaction
Chinese Wall

No Plan Assets; No Feasible Prohibited Transactions

Plan Assets; Prohibited Transactions are Feasible

NFSM

Exogenous Side

Endogenous Side

100%

NFSM ESOP

Prohibited Transaction Chinese Wall
Restructuring *Peek* (49, 49, 2)

The Restructured Peek
Management Risk Diversification Policy Compliance Analysis

<table>
<thead>
<tr>
<th>Combination</th>
<th>Combination Majority Test</th>
<th>Majority</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>49% + 49% = 98%; 98% &gt; 50%</td>
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</tr>
<tr>
<td>2</td>
<td>49% + 2% = 51%; 51% &gt; 50%</td>
<td>Yes</td>
</tr>
<tr>
<td>3</td>
<td>49% + 2% = 51%; 51% &gt; 50%</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Investment Risk Diversification

The plan asset rule, without more, excepts defining public securities and public securities portfolio undivided interests in entity underlying assets as plan assets.
Investment Risk Diversification

Public securities portfolio investment risk is, *prima facie*, more diversified than the investment risk diversification of a single public security.
Investment Risk Diversification

Properly invoking a nonpublic investment interest plan asset rule exception equates such investment risk diversification to be on a par with public securities portfolio investment risk diversification.
Investment Risk Diversification

Properly invoking a plan asset rule exception creates a conclusive presumption investment risk diversification is Section 4975 impounded investment risk diversification policy compliant.
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