Real Estate Entrepreneur Pays Obscene Taxes After Typical "Checkbook LLC" Arrangement Blows Up

By CPA & Seasoned IRA Tax Attorney

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Quick Synopsis

An engineer from Phoenix made a living doing "Phase I" and similar types of environmental impact reports for purchasers of commercial properties. When the 2008 crash came, his business declined. He started flipping properties and did quite well with it in very short order.

Pursuant to the "advice" of a Check Book LLC promotor, the promotor set up an IRA-owned LLC for the Engineer. The "advice" and "customization" were typical, or, in a word, somewhere between "awful" to "non-existent". The operating agreement was almost certainly a template with no customization to meet the client's specific needs. The Engineer was the sole manager of the LLC. Worse yet, Engineer received no effective advice on how to property use the LLC without destroying his IRA (which is quite common). Consequently, he entered into deals between himself and his IRA that were clearly prohibited. As a result, his $230,000 IRA was destroyed, the funds distributed, and heavy taxes & penalties levied as a result.

Lessons: Avoid Checkbook LLC promotors. If you think an LLC for your IRA or 401k might make sense, contact a *qualified* tax attorney. When consulting with counsel, be sure to accomplish three tasks:

1. Determine whether you really need an IRA-owned LLC;
2. IF the answer to #1 is yes, customize the LLC to your particular circumstances & strategy – this is not the time to "cheap out" with a mere template, which is what the vast majority of checkbook LLC promotors sell; and
3. Learn the rules that apply to self-directing an IRA, especially the Prohibited Transaction rules. Make sure to analyze those rules in the context of the *specific* types of transactions you intend to complete with your IRA or IRA-owned LLC.

Other implications of the case:

- Engineer made about $126k off of 9 real property flips – nice way to start! He reported the flips as short-term capital gains, which are exempt from social security/self-employment taxes. This means that the IRS did not try to argue that 9 flips in a year made Engineer a "dealer". Had the IRS made & won such an argument, the income would have been subject to self-employment taxes on top of regular income taxes.

- Engineer could not deduct travel expenses because he failed to document the business purpose of each trip.

- Engineer was not able to deduct attorney's fees spent investigating the purchase of a portfolio of notes. The court implied that he missed a subtle way to get those fees deducted, probably due to not being represented by a tax lawyer in court. Any decent tax attorney would have caught this issue.

- Home office expenses need to be deducted on Schedule C, they cannot be added to the cost of investment properties. Note: His home office expense was rent paid to his girlfriend, the IRS evidently did not object to that.

- Engineer was penalized for taking improper deductions for his 2009 self-prepared tax return. A CPA completed Engineer's return for 2010 and no penalties were levied for the deductions disallowed in that year. Having a good CPA often pays.

Detailed Discussion

Engineer Niemann from Phoenix made a living doing economic impact surveys for commercial real estate (e.g. – Phase I reports). The RE crash caused his business to drop dramatically, so he started flipping RE. He did 9 deals his second year (2009), 8 of which made a profit, for net income of $126,000.

Niemann represented himself in court. Such cases tend to go poorly for the taxpayer and often set poor precedents for the rest of us. It's hard to tell how the case would have gone had good counsel been involved, maybe it would have helped, maybe not. The trend is that tax counsel makes a difference, including settling bad cases before they get to court.

Niemann had 3 entities, which the Tax Court referred to as a "tangle".

<u>Dependable Project Services, LLC</u>

Founded for Niemann's services business in 2003, later used to hold mineral rights

2008 and 2009 are years at issue, claimed some of this LLC's deductions on Schedule C.

<u>Real Estate Rabbit, LLC (The "Checkbook" LLC)</u>

- A "check book IRA" LLC
- Niemann's IRA was the sole member of the LLC
- Neiman was the LLC's manager
- The LLC was used mainly for flipping real estate, also held mineral rights and loans
- The Court's language in re checkbook LLC's is worth quoting at length. I submit that as the Tax Court starts to address "checkbook LLC's" with greater frequency, we shall see more such language & that the court shall have developed a distaste for them, or at least for the poorly drafted & misused ones.

"**His reporting went most awry after he attended seminars advertising the use of a self-directed "checkbook LLC."** [Niemann] explained that what that meant to him was simply the process of writing checks inside of an LLC that is inside of a tax-advantaged IRA. This information was sold to anyone who attended these seminars."

"Niemann, **who we found to be a very smart man** though not trained in law, realized as trial neared that Magic was not actually a multimember LLC. **This led him to then concede that he had engaged in numerous "prohibited transactions" with his IRA."**

> "For example, Niemann **arranged for Rabbit the entity that he had tucked into his IRA to transfer one property to himself and another to Magic, which he wholly owned**.

> This meant that Niemann had terminated his IRA. And **this termination is with extreme prejudice** – the IRA's assets are deemed distributed. See secs. 72(t), 408(e)(2)(B). **And what "deemed distributed" means to Niemann is actually "added to his taxable income" about $230,000 in extra income** according to the notice of deficiency for the 2009 tax year." (bold mine)

This sort of result is absolutely typical with most "checkbook" LLC promotors. They often have no idea what they are doing and charge quite a bit to structure a tax disaster, see my comments under "Quick Synopsis" on page 1 for some key pointers in dealing with IRA-owned LLC's. They can be very useful – *if* done right.

Magic, LLC

- Was supposed to be a multi-member LLC
- Vendor never made it a "multi-member" LLC – typical slop from promotors, seminars, and especially LLC pushers out of Nevada and Utah. I doubt that making this LLC multi-member would have solved any of the problems addressed by this case – but the fact that the promotor botched it and Niemann did not catch the error are unsurprising.
- The court found that Niemann was the sole owner and manager of the LLC.

Issues

- Travel Expenses. The IRS attacked travel expenses to the properties of $8,000 in 2009 and $16,000 in 2010. Those expenses apparently included meals & entertainment as well, though the case was not completely clear in this regard. These sorts of expenses require more documentation than normal expenses.
  - The fact that the expenses were round numbers screams "I made them up" and likely attracted the IRS auditor's attention.
  - While Niemann had a decent log, it was not good enough. Meals, entertainment and travel need to be documented with time, place, amount, and business purpose for each transaction. Niemann's records failed to describe the *business purpose* of each trip. Niemann evidently did not attempt to reconstruct his records or add the business purpose for each transaction. As such, the travel expenses were all disallowed.
    - Write the business purpose for the meeting on the receipt (if any) and pay one of your kids or an admin assistant to scan the receipts. Save the scan on multiple drives by date and ignore them thereafter, if & until the IRS shows up for an audit.
- Attorneys' Fees. One of the LLC's paid $8,000 to an attorney to evaluate the collectability of a large portfolio of student loans that was for sale for $2M with a face value of $3M. The attorney ultimately advised against acquisition. The IRS successfully argued that the fees were nondeductible. ○ To deduct legal fees as an expense under Code Section 162, Niemann needed to have enough activity to qualify as a "trade or business". He did not have sufficient "continuity" or "regularity" to have a "trade or business" of buying distressed notes. He made 2 loans to realtors, and had not bought or held any other notes. He was not even close to having a "trade or business", at least as far as buying notes was concerned.
  - The *Douglas* case. An important citation was *Douglas v. Commissioner*, T.C. Memo, 1998-165, aff'd, 181 F.3d 87 (4th Cir. 1999). In *Douglas*, the taxpayer bought eleven residential properties from 1982 to 1989, renovated seven in the same years, and had sold two, but had no sales during the years at issue. Most of the properties were rented, at least one was sold on installment contract, with the contract being a second mortgage. When the property was foreclosed by the first, taxpayers incurred legal fees.

There are two ways to deduct such fees: Either as "trade or business" expenses under IRC Section 162, or as expenses incurred in the "production of income" under Code Section 212. Deducting expenses as arising from a "trade or business" is generally more favorable than deducting them as part of "the production of income". As such, the taxpayer argued that he was in a "real estate rental buying & selling business". The *Douglas* court held that the taxpayer did not have activity that was sufficiently "continuous" or "regular" in 1992 & 1993 to constitute a "trade or business" of property development. The court focused in particular on the lack of sales for the years in question. The taxpayer could therefore not deduct the expenses in question as "trade or business" expenses. The expenses were permitted under IRC Section 212, albeit on Schedule A of the taxpayers' personal returns, which is a very unfavorable place to put expenses. In all likelihood, some or all of the expenses ended up as being non-deductible.

    - Our case was poorly argued by the taxpayer, who of course represented himself in court. There is case law holding that a rental operation, on its own, can be a "trade or business". The taxpayers in *Douglas* essentially tried to argue that they had a flipping business and lost. They should have argued that they had a *rental* trade or business. Based on my recollection of case law, their activity appeared to have been sufficient for such an argument to have prevailed. Had the taxpayers retained an attorney familiar with both real estate investing and some of the case law surrounding it, they might have won.

  - The Court noted that Niemann did not try to argue that the legal fees could be deducted as expenses associated with the production of income (Code Section 212, instead of Section 162). Niemann either did not know he could get a deduction in this manner (which is a common sort of error for those who represent themselves in court) or the expense would not have done him any good on Schedule A of Form 1040 because he made "too much" to take a deduction there.

- <u>Short-Term Capital Gains on Flips</u>. Niemann reported $126,000 of short-term capital gains in 2009 based on the profits from his flipping activities – not bad for his second year in the business, and his first year selling!
  - <u>This is a good point for REI</u>. The IRS apparently did not attempt to argue that buying/selling nine properties in one year constituted a "dealer" activity. Therefore, the $126k was not subject to social security/self-employment taxes of around $19,000. This is the upshot of not having enough activity to constitute a "trade or business" – one is less likely to have enough activity to be a "dealer" and can therefore avoid SS/SE taxes on the income by reporting the sales of Schedule D instead of Schedule C of Form 1040.
  - <u>Assignments</u>. In this case, Niemann evidently took title and then sold the properties. Assignments would be a harder type of transaction to report as capital gains, since they very much resemble services, which are taxed as ordinary income and subject to selfemployment/social security taxes.

- <u>Home Office Expenses</u>. $29k of home office expenses were capitalized to the properties.
  - Niemann capitalized these costs (added them to the basis of the properties), probably because a deduction did him no good based on certain limitations on Schedule C of Form 1040.
  - The court held that these amounts were costs of doing business and could not be capitalized, as they were not costs of acquiring property. The Court stated that these costs should have been reported on Schedule C. They were presumably added to Schedule C via court order.
  - Interestingly, the home office costs were pretty aggressive in that they arose from the rent that the taxpayer payed his girlfriend for the space. The IRS evidently did not challenge those costs, which strikes me as a bit unusual. It goes to show that many audits and auditors are limited as to what is targeted. One should take (legal & ethical) advantage of such human/bureaucratic quirks.
  - The home office deductions probably did Niemann no good for the years in question. He likely carried them forward for use in future years. And that is probably why he tried to capitalize them instead of deducting them on Schedule C.

Penalties

- The IRS penalizes disallowed deductions if, taken together, they resulted in under-stating taxes by the greater of:
  - $5,000; or
  - 10% of the taxes that should have been reported
- In this case, the math means that such penalties were imposed. The penalty is 20% of the tax that was under-reported.
- Niemann could have still avoided this penalty if he could have shown that:
  - The errors were "reasonable"; and ○ In good faith. • Niemann prepared the 2009 return on his own and had a CPA amend it.
  - He did not submit evidence that his failure to document travel expenses was "reasonable". In other words, he asserted that his lack of documentation was "reasonable", and doubtless provided an explanation. But that was not enough to constitute credible evidence.
  - While the court viewed Niemann as a credible witness overall, it did not find that his capitalization (vs. deduction of) home office expenses was reasonable because the court did not view this area of the law as at all grey or unclear.
    - Implicitly, this tells us that Niemann was not able to take the home office expense deduction on Schedule C due to other limitations. The limitation in question was almost certainly due to the fact that no income was shown on Schedule C, and home office expenses cannot drive the profit on the Schedule C below zero. Niemann would be able to carry the home office deductions he could not take in 2009 forward to a future year when it could offset positive income on the same Schedule C, if & when such income should occur.
- Niemann's 2010 return was prepared by a CPA.
  - Relying on a professional avoids the "substantial understatement" penalty only if the reliance was "reasonable". The reliance was reasonable if:
    - The advisor was a competent professional with sufficient expertise to justify reliance;
- This advisor was a CPA at a reputable firm and came highly recommended
    - The taxpayer provided necessary and accurate information to the advisor;
- Niemann testified that he provided the CPA with everything he asked for, including Quicken printouts. The court also found that the CPA had the necessary information to report the IRA transactions, and did in fact report them.
    - The taxpayer actually relied on the advisor's judgment in good faith.
- The court found that Niemann relied on the CPA in good faith. The transactions were complex, involved three businesses, and also involved complicated facts.
    - As such, the "substantial understatement" penalties were waived.
    - In short – using a good CPA makes a difference when compared to doing one's own returns.

John Hyre is an attorney, accountant and real estate investor based out of Columbus, Ohio. He advises clients nationwide on to avoid tax trouble when structuring their self-directed IRA's, 401(k)'s, HSA's and CESA's. John has also successfully defended SDIRA's from IRS attack in audits and in Tax Court. John Hyre will speak at UpstateCREIA on April 17 and come back for a full 2 day workshop on May 20 & 21, 2017. UpstateCREIA.com for details.