

## Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter Archive Message #676

Date:21-Jun-17

Subject: [Mary Vandenack on DNA Pro Ventures - IRS's Disqualification of ESOP Upheld by Tax Court and 8<sup>th</sup> Circuit](#)

*"In the DNA case, the IRS issued a non-qualification letter with respect to an ESOP established by DNA. The ESOP was established in 2008. In that year, stock was allocated to the account of Dr. Prohaska in an amount that exceeded his compensation from DNA for that year by one hundred percent. As a result, the IRS determined that the ESOP was disqualified for 2008 and all later years. The Tax Court and the Eighth Circuit Court of Appeals agreed."*

**Mary Vandenack** provides members with commentary on [DNA Pro Ventures, Inc. v. Comm'r](#) dealing with the disqualification of an ESOP.

**Mary E. Vandenack** is founding and managing member of **Vandenack Weaver LLC** in Omaha, Nebraska. Mary is a highly regarded practitioner in the areas of tax, benefits, high net worth estate planning, asset protection planning, executive compensation, business succession planning, tax dispute resolution, international tax, state and local tax, and tax-exempt entities. Mary's practice serves businesses and business owners, executives, real estate developers and investors, health care providers and tax exempt organizations. Mary is a member of the American Bar Association Real Property Trust and Estate Section where she serves as Co-Chair of the Futures Task Force and of the American Bar Association Law Practice Division where she serves on the TechShow Board, the Executive Council, and the Law Practice Magazine Board. Mary is also a member of the American Bar Association Sections on Taxation and Business. Mary is a frequent writer and speaker on tax, benefits, asset protection planning, and estate planning topics as well as on law practice related topics including improving the delivery of legal services, technology in the practice of law, building sustainable law firms, and alternative fee structures.

Now, here is Mary's commentary:

## **EXECUTIVE SUMMARY:**

In the DNA case, the IRS issued a non-qualification letter with respect to an ESOP established by DNA. The ESOP was established in 2008. In that year, stock was allocated to the account of Dr. Prohaska in an amount that exceeded his compensation from DNA for that year by one hundred percent. As a result, the IRS determined that the ESOP was disqualified for 2008 and all later years. The Tax Court and the Eighth Circuit Court of Appeals agreed.

## **FACTS:**

Daniel J. Prohaska is a physician specializing in orthopaedic surgery. During 2008 to 2010, Dr. Prohaska worked with Advanced Orthopaedic Associates, P.A. ("Advanced Orthopaedics"). Advanced Orthopaedics sponsored a 401(k) retirement plan and during 2008 to 2010, Dr. Prohaska deferred the maximum income allowable to such 401(k) plan.

In 2008, Dr. Prohaska was involved in DNA Pro Ventures, Inc. ("DNA"). DNA was incorporated in Kansas in 2008. DNA initially issued fifty shares of Class A common stock with a par value of \$10.00 per share to Dr. Prohaska and fifty such shares to Dr. Prohaska's wife. Each contributed \$500.00 in cash in exchange for the shares.

When DNA was formed, DNA established an employee stock ownership plan ("ESOP") for the benefit of its employees. Ryan Eldridge was the initial trustee but the plan was amended to name Dr. Prohaska as trustee. On December 31, 2008, DNA issued 1,150 shares of class B common stock to the trust. Such shares had a par value of \$10 per share. The shares were allocated to Dr. Prohaska's ESOP account in 2008.

During 2008, no salaries, wages or other compensation was paid by DNA.

In September of 2011, the Internal Revenue Service ("IRS") notified DNA that the ESOP plan would be reviewed to determine whether the ESOP had satisfied the qualification requirements for tax exempt status.

In June of 2014, the IRS issued a final non-qualification letter. The basis for disqualification included (1) failure to comply with the terms of the plan documents in not obtaining appraisals, and (2) failure to comply with IRS §415 by making contributions to the plan in excess of compensation to the participants.

The ESOP challenged the non-qualification letter by filing a declaratory judgment action in the Tax Court. The Tax Court ruled in favor of the IRS stating that the IRS had not abused its discretion in determining that the trust established in conjunction with the ESOP failed to be a qualified trust. As a result, the ESOP was disqualified for all tax years. The Tax Court noted that a qualification failure is a continuing failure. Allowing a plan to “re-qualify in subsequent years would be to allow a plan ‘to rise phoenix-like from the ashes of such disqualification and become qualified for that year.’”

The ESOP appealed the Tax Court decision to the Eighth Circuit. The Eighth Circuit Court affirmed the decision of the Tax Court. In doing so, the Eighth Circuit Court noted that either of the grounds cited by the Tax Court as the basis for its decision would have been sufficient to uphold the IRS disqualification determination; however, the Eighth Circuit limited its review to the IRC §415 issue. The Eighth Circuit Court noted that because Dr. Prohaska had received no compensation in 2008, the allocation of DNA stock to his ESOP account violated the IRC §415 contribution limit.

## **COMMENT:**

IRC §401(a) outlines the requirements for a trust created as part of an employee stock ownership plan to constitute a qualified trust. A qualified plan must meet all of such requirements to be exempt from taxation under IRC §501(a).

IRC §401(a)(16) states that a trust shall not constitute a qualified trust if the plan of which such trust is a part provides for benefits or contributions which exceed the limitations of §415.

IRC §415(c)(1) provides that contributions cannot exceed the lesser of a specific dollar amount or 100 percent of the participant’s compensation. A

failure under §415 is a continuing failure and a plan continues to be disqualified in future years.<sup>1</sup>

The standard of review by the Eighth Circuit of the Tax Court is legal conclusion *de novo* and factual findings for clear error. In arguing to the Eighth Circuit, the ESOP sought to argue that the initial shares had been purchased with a loan. In making the argument, the ESOP referred to documents that had not been made part of the record in Tax Court. As a result, the Eighth Circuit did not consider the documents and concluded based on the stipulated record. Practitioners need to be sure to introduce sufficient evidence at the Tax Court level to ensure that all relevant facts will be considered in the event of an appeal.

The Eighth Circuit noted that when a plan is disqualified under §415, the disqualification continues until remedial action is taken but noted that no evidence of corrective action had been presented.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!**

*Mary Vandenack*

**CITE AS:**

**LISI** Employee Benefits & Retirement Planning Newsletter #676 (June 21, 2017) at <http://www.leimbergservices.com>, Copyright 2017 Leimberg Information Services, Inc. (**LISI**). Reproduction in Any Form or Forwarding to Any Person Prohibited - Without Express Permission.

**CITES:**

[DNA Pro Ventures, Inc. v. Comm’r, No. 16-1168 \(8<sup>th</sup> Cir. 2017\).](#)

## **CITATIONS:**

---

<sup>i</sup> Martin Fireproofing Profit-Sharing Plan & Tr. V. Commissioner, 92 TC at 1184-1185.