Roll-Over Business Startup Legal Position Paper

This article is directed to the growing number of entrepreneurs who are financing new businesses using their own retirement funds, a funding mechanism called a Roll-Over Business Start-up (ROBS). Opinions about the legal validity of the ROBS strategy range from blatantly illegal, to so complex that it needs to be avoided, to so easy an entrepreneur just needs pay a particular company and sign a few forms. There is no specific, single rule that delineates a ROBS approach and no rule that prohibits it. Rather, the strategy uses regulations from several sources which, when pieced together in the right framework, allows individuals to invest their own retirement funds into a corporation that employs them.

This paper does not analyze any particular ROBS promoter's product. Rather, my position is that the ROBS strategy is a viable funding strategy if the entrepreneur follows all of the legal requirements for establishing and operating 401(k) plans and for offering Qualified Employer Securities to employees. I believe that *some* ROBS promoters over-simplify a client's duties. This product is not for everyone.

This paper points out numerous issues involved in using a ROBS structure. I do not, however, point out how to address the issues. That I leave to your attorney, your CPA, or the ROBS promoter you select. IF you want me to be your ROBS attorney, just let me know.

Constraints of using a ROBS

- This strategy forces the use of a C corporation, which has its own federal and state reporting and filing requirements which are the responsibility of the entrepreneur.
- The Corporation sponsors a 401(k) Plan for the benefit of ALL its employees, not just the entrepreneur. All employees of the corporation (or its subsidiaries or control group) must be extended their rights under the Plan.
- The Plan has numerous filing requirements. ROBS promoters typically set up the Plan with the entrepreneur as the Trustee and Administrator even if the entrepreneur has no clue what this means. A third-party administrator is usually hired to facilitate the Plan's filing requirements, which creates an additional expense for the new business.
- Any entrepreneur investing qualified funds into the Corporation first must be an employee of the Corporation (or a subsidiary or control group).
- The corporation needs at least one shareholder other than the Plan who needs to own more than a "de minimus" level of equity, typically the entrepreneur.
- The entrepreneur (or delegate) plays several roles in this process. Each have various federal and state rights and responsibilities which need to be upheld:
    - Shareholder
    - Board of Directors
    - Officer of the Corporation (President, Secretary, Treasurer)
    - Employee
    - Plan Trustee
    - Plan Administrator
    - Plan participant

- Corporate stock is typically restricted unless otherwise registered. As long as the Plan is a shareholder, the entrepreneur has a duty to ensure that any equity transactions for the corporation meet an "adequate consideration" rule (see below).

A Proper ROBS Structure

A properly structured and administered ROBS arrangement can satisfy both the requirements and spirit of the tax laws and serve legitimate tax and business planning purposes. It is critical, however, that entrepreneurs who fund their businesses through ROBS arrangements understand the possible legal pitfalls and take seriously their ongoing responsibilities as fiduciaries of their companies' retirement plans.

ROBS arrangements typically involve the following sequential steps:

1. establish a new corporation;
2. the corporation hires the entrepreneur as an employee;
3. the corporation adopts a 401(k) plan that specifically permits plan participants to direct the investment of their plan accounts into a selection of investment options, including employer stock;
4. the entrepreneur as employee initiates a direct rollover or trustee-to-trustee transfer of retirement funds from another qualified retirement plan into the newly established plan;
5. the entrepreneur as employee then directs the investment of his or her 401(k) plan account to purchase the corporation's stock at par value;
6. the entrepreneur personally acquires corporate stock in exchange for direct investments into the corporation, assets transferred to the corporation or as reimbursement for start-up costs; and
7. the company utilizes the proceeds from the sale of stock to purchase an existing business or to begin a new venture.

A wise entrepreneur will understand what the promoter is doing for them versus what they still need to do for themselves. In general, a ROBS promoter creates the corporation, registers the Plan, and provides documentation to their clients that cover the adoption of the Plan by the company and issuance of the stock to the entrepreneur and the Plan.

Operating Company Requirement

In order to have a valid ROBS arrangement, the entrepreneur must intend to use the funds for legitimate business operations. Likewise, the entrepreneur must intend to permanently form and administer a pension plan and must reasonably believe that the plan's acquisition of corporate securities is an appropriate investment of plan assets. If an individual engages in a ROBS arrangement and does not actually establish an operating business, then the entire plan could be disregarded for tax purposes. Individuals cannot avoid paying tax on early distributions from qualified plans by simply funneling the distribution through a phony plan or a corporate shell. Similarly, individuals cannot use retirement assets to support hobbies or personal activities without risking the possibility that the entire arrangement will be disregarded for tax purposes.

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Deferred compensation

Contributions to the plan are not federally taxable to the employee when they are made. Instead, the participant is generally taxed when he or she receives benefits from the plan. If a plan is not qualified (or later disqualified), then the plan will be subject to tax on any investment gains and the participants will be subject to tax on vested contributions to the plan. A CPA or accountant can be a great asset for how to create the transactions on the books of the corporation and the Plan so that all of the reports to the IRS match. For example, the W-2 to the employee should show how much compensation was contributed which should match the Plan's report for that employee.

When employees become eligible to defer compensation into the Plan varies but will not exceed a requirement to work 1,000 hours in a 12 month period of time. When employees qualify to defer compensation, the employer must notify them of their rights and allow them to defer compensation if they chose.

The right to defer compensation is different than the right to transfer qualified funds into the Plan. The transfer right typically starts the day someone becomes an employee of the company and last continuously until through their employment. The right to defer compensation (and receive matching contributions or tax-deferred profit sharing) begins when the eligibility period is met. As the individual responsible for extending these rights to employees an entrepreneur must be aware of how the adopted Plan handles these two issues.

Investment Options

Entrepreneurs are not allowed to create one set of investment options for themselves and another for the employees. In a typical ROBS structure each participant receives an individual "account" to which the employer's (if any) and participant's periodic contributions are allocated. The employee's account bears the risks and pays the trading costs. Some ROBS promoters have contractual arrangements for accounts already set, others allow the entrepreneur to place the accounts with whatever brokerage they desire.

The purchase of corporate stock is an investment option that is a Benefit, Right or Feature of a Plan. As such, the availability of the stock does not have to correlate to the availability of other investment options. The length of time corporate stock is available as an investment option is a key issue entrepreneurs need to know about the Plan they adopt.

Company contributions

Traditional 401(k) plans used by ROBS promoters allow, but do not require, company matches of employee contributions. They also allow, but do not require, tax-deferred bonuses or profit-sharing. The plans may have a top-heavy limit that can impact how much the entrepreneur can contribute personally or may include a choice of safe-harbor approaches. The entrepreneur should know whether the third party administrator is monitoring the employee and employer contributions for potential limit violations.

The employer has discretion to choose the amount of its matching contribution. For example "We will match 100% of the first 3% and 50% of the next 2% of your deferral". Tax-deferred bonuses are not necessarily based on the actual "profit" of the company. Plans may contain a formula that dictate how the bonuses are paid leaving it up to the company to just determine how much money, if any, it wants to devote to these bonuses.

Plans also may contain vesting schedules. Employees are always 100% vested in their own money (rollovers, salary deferral). Company contributions paid directly into the employees' accounts must follow the vesting schedule.

Rules Governing the ROBS Plan's Investment in Employer Securities

ERISA Section 408(e) provides that the prohibited transaction rules will not apply to a plan's acquisition (or sale) of qualifying employer securities if:

- the acquisition or sale is for *adequate consideration*,
- no commission is charged, and
- the plan is an eligible individual account plan.

The type of stock used in ROBS arrangements is common stock, which should qualify as "qualifying employer securities". The critical requirement here, discussed in detail below, is that the plan's acquisition of employer securities must be for adequate consideration. There are no further requirements to this broad exception.

Adequate Consideration: Initial Investment

In all ROBS arrangements, an entrepreneur creates capital stock for the purpose of exchanging it for tax-deferred accumulation assets. The value of the stock is often set as the value of the available assets. Some promoters believe that the business plan should be appraised to come up with a value of the business. While I strongly believe that every entrepreneur should be able to substantiate why this business represents a reasonable expectation of return for the investment, I find that an appraisal for a new business is often so speculative that the appraisals do not help me help my client determine how many shares to issue to the Plan and we are left with the value of available assets.

The number of shares issued to the Plan must meet the adequate consideration requirement of ERISA Section 408(e). Adequate consideration in the case of a marketable obligation means a price not less favorable to the plan than the price determined under ERISA Section 407(e)(1). In cases where there is no generally recognized market, which will almost always be the case in a ROBS arrangement, ERISA provides that adequate consideration is "the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary."

The bottom line is that any entrepreneur using a ROBS strategy must reach the point of making a good faith effort determination of fair market value for the initial stock offering.

Adequate Consideration: Appraisals

IRC and Treasury regulations prescribe numerous requirements for ESOPs, including the requirement that the plan obtain an appraisal from independent appraisers whenever it acquires employer securities and again at the end of each plan year. There is no corresponding rule that requires 401(k) profit sharing plans to obtain an appraisal of employer securities. Still, it may be advisable to obtain one in certain circumstances. ROBS promoters handle this issue differently, suggesting or requiring appraisals of corporate stock at various junctures.

In my opinion, unless a plan is specifically structured as an ESOP, the regulations governing ESOPs, including the requirement for an annual appraisal of the employer securities by independent appraisers, do not apply. There is little risk that the ESOP rules could properly be applied to a ROBS plan absent a specific intent to have the plan designed as an ESOP. The IRS should not treat the plan as an ESOP unless it meets certain requirements.

Qualifying Employer Securities

ROBS promoters create within the 401(k) Plan an investment option called a “Qualifying employer security” (QES). This investment option is made available to ALL employees of the corporation who have funds in the Plan during a timeframe determined by the Corporation (essentially the entrepreneur). I discourage my clients from creating this investment option to only benefit themselves, as that could trigger a discrimination whether the client is an NHCE or HCE. The term “Qualifying employer security” comes from ERISA Section 407(d)(5) and in its simplest sense means the stock in the company.

Regulatory Oversight

ROBS arrangements are governed by the Employee Retirement Income Security Act of 1974 (ERISA). Under ERISA, the Internal Revenue Service (IRS) and the United States Department of Labor (DOL) have joint enforcement and oversight responsibility for employee pension plans. Although there is some overlap in jurisdiction, DOL is primarily responsible for regulating fiduciary conduct. This responsibility includes interpreting the prohibited transaction rules. The IRS has responsibility for interpreting and enforcing tax issues, including funding and vesting standards.

The IRS specifically addressed ROBS arrangements in a 2008 IRS memorandum entitled *Guidelines Regarding Rollovers as Business Start-ups* (“IRS ROBS Memo”). If a violation of the tax laws is identified during an examination of a ROBS arrangement, there are a number of possible outcomes depending upon the nature and severity of the violation. The IRS could propose adjustments to plan documents and operations, impose taxes and penalties, or, in the most egregious cases, retroactively revoke the plan’s status as a qualified (tax exempt) trust under Internal Revenue Code (IRC) Section 401(a).

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IRS Issues

The IRS examiner's primary objective is to determine whether the form and operations of the plan are in accordance with the qualification rules set forth in IRC and the terms of the plan documents. IRS examiners will assess whether the plan has engaged in any prohibited transactions and whether the plan's books and records are being properly maintained.

Examiners are instructed to consider:

- whether the form of the plan complies with the qualification rules;
- whether eligible employees are covered by and benefiting under the plan in accordance with the standards set forth in code Section 410;
- whether the minimum vesting standards of code Section 411 are satisfied;
- whether the contributions and accruals are calculated correctly in accordance with the plan provisions and code Section 411;
- whether the plan complies with IRC's discrimination rules under code Section 401(a)(4), including the rules regarding nondiscrimination of allocations and/or accrual of benefits and benefits rights and features;
- whether the plan is "top-heavy" and, if so, whether it is operating in accordance with plan provisions and code Section 416;
- whether family members are participants in the plan and are actually working for the employer;
- whether any employees, including family members, received impermissibly favored eligibility, benefits, or vesting as compared to other participants;
- whether, with respect to 401(k) plans, the plan passes the average contribution percentage (ACP) and actual deferral percentage (ADP) tests;
- whether the annual addition restrictions of code Section 415 are satisfied;
- whether the employer's deductions for plan contributions are within the limits set by code Section 404;
- whether code Section 412 are satisfied to the extent applicable;
- whether the plan assets are held in trust and are properly titled;
- whether the plan assets, income, and loss are being properly accounted for; and
- whether the plan engaged in any prohibited transactions under code Section 4975(c).

Examiners may also focus on the following additional issues:

- the initial and subsequent valuations of employer stock;
- whether the business was actually formed and operated;
- whether employees were offered the opportunity to participate in the Plan;
- whether the Plan was operated in accordance with the Plan documents; and
- whether the substance of the ROBS arrangement was consistent with its form.

According to the IRS ROBS Memo, the two primary issues are:

- violations of nondiscrimination requirements, in that benefits may not satisfy the benefits, rights and features test of Treas. Reg. section 1.401(a)(4)-4, and
- prohibited transactions, including deficient valuations of stock.

Discrimination Testing: General

There are two sets of nondiscrimination rules: coverage rules and contribution and benefits rules. The IRC's nondiscrimination rules are designed to ensure that HCEs are not disproportionately benefited by a plan. If there are no HCEs covered by the plan, there should not be any discrimination issues. In cases where all employees of the company are HCEs, and thus only HCEs are covered by the plan, the nondiscrimination rules will be automatically satisfied as long as the plan documents are not defective.

Some ROBS promoters automatically consider the entrepreneur as an HCE, others taken a stricter rules based approach that look at each situation according to the Plan rules. Considering the entrepreneur an HCE even if not specifically required is a safe approach that can be adopted, although this approach might unnecessarily restrict the entrepreneur's own contributions. It is not necessary to have the entrepreneur considered as an HCE unless that individual meets the definition outlined in the Plan documents. If the entrepreneur is not an HCE then the discrimination testing is less of an issue.

Discrimination Testing: Coverage

Plans are required to satisfy either the ratio percentage test or both the nondiscriminatory classification test and the average benefits percentage test. In general, the coverage tests are designed to ensure plans satisfy minimum standards for covering NHCEs. A properly structured and administered ROBS plan should satisfy these requirements. Plans that fail to satisfy these requirements or properly correct failures risk disqualification. Therefore, it is critical for plan administrators to regularly consult with competent advisers who have experience applying the coverage rules.

There are no coverage issues that are unique to plans with ROBS features. Coverage issues should not arise because either there are no other employees (i.e., the plan covers a single employee-owner) or there are no HCEs (i.e., the plan owns more than 95 percent of the corporate stock and all of the employees are paid less than the prescribed limits).

Discrimination Testing: Benefits

The Treasury regulations further require plans to "test" annually whether the plan's benefits, rights and features (BRFs) are made available to participants in a nondiscriminatory manner. In addition, administrators are required to ensure that any plan amendments do not discriminate in favor of HCEs.

BRFs include optional forms of benefit distribution (e.g., the choice between a lump sum or installment payments), ancillary benefits (e.g., Social Security supplements or ancillary life insurance benefits), or any other right or feature under a plan that can be expected to have a meaningful value (e.g., a particular form of investment such as the parent company stock). BRFs must be both currently and effectively available on a nondiscriminatory basis.

The IRS correctly points out in the ROBS Memo that a specific provision of a benefit that is limited to highly compensated employees risks violates the nondiscrimination provisions of IRC, which could result in plan disqualification: "the issue of discrimination arises because the plan is designed in a manner that the BRF will never be available to any NHCEs." Therefore, IRS agents are instructed that ROBS cases should be developed for discrimination issues whenever a given plan covers both HCEs and NHCEs and no extension of the stock investment option is afforded to NHCEs. So long as the initial offering and any subsequent offerings are effectively available to NHCEs in a nondiscriminatory manner, the plan should not run afoul of this requirement.

Use of Plan Assets to Compensate Plan Participants

The concern here is that business owners will attempt to skirt the rules applicable to qualified pension plans that generally prohibit a distribution of benefits prior to termination of employment by adopting a plan with ROBS features in order to "pay themselves a salary" out of their retirement plan assets.

In my opinion, this view is inconsistent with the broad language of ERISA Section 407(b)(1), which was intended to permit plan participant investment in employer securities within an individual account plan. As long as the plan does not pay more than fair market value for the employer securities, the requirements of ERISA Section 408(e) should be satisfied.

From an economic perspective, it makes no sense to pay employment taxes (at a 15.3 percent tax rate) plus income taxes in lieu of an early distribution penalty (at a 10 percent rate) plus income taxes). If an entrepreneur believes he will need to tap his retirement funds for personal use while starting up the business, he is better off simply taking a distribution directly from the plan and paying the tax and distribution penalties.

Plan Annual Valuations

The ROBS Memo points out that a plan's failure to obtain an annual valuation raises plan qualification issues. ERISA Sections 103(a)(1)(A) and 104(b) require most employee plans to file an annual report, on Form 5500, with the secretary of labor, and to furnish a summary of that report to plan participants. ERISA Section 103(b) provides that the report must include a financial statement that details the "current value" of the plan's assets. ERISA specifically requires that the financial statement report "the fair value as determined in good faith by a trustee or a named fiduciary."

The purpose of this valuation is to satisfy IRC's requirement that profit sharing plans allocate and distribute the funds accumulated under the plan pursuant to a definite predetermined formula that ensures that the plan's benefits are based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants that may be allocated to such participant's account. Although the valuation method must be consistently followed and uniformly applied, the valuation of trust

assets may be less formal in years where there are no allocations or distributions of assets accumulated under the plan.

Factors that are relevant to the valuation of stock of closely held corporations, including:
- the nature of the business and the history of the enterprise from its inception;
- the economic outlook in general,
- the condition and outlook of the specific industry in particular;
- the book value of the stock and the financial condition of the business;
- the earning capacity of the company; s the dividend-paying capacity;
- whether or not the enterprise has goodwill or other intangible value;
- sales of the stock and the size of the block of stock to be valued; and
- the market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

Most of these factors will not be relevant in cases involving start-ups where the business has a limited financial history, earnings, dividend-paying capacity, goodwill, or intangible value. In the case of a start-up, the critical factor is likely to be the book value of the stock and the general financial condition of the business. If the business has limited operations, the value of the business will generally remain equal to the amount of paid-in capital. On the other hand, in cases where the financial condition of the business changes rapidly, the earning capacity of the company should be taken into account and a more detailed analysis should be performed by the plan administrator or trustee.

The absolute key here is that the plan administrator exercise good faith, common sense, informed judgment, and reasonableness under the circumstances.

Communications to Employees

In order to satisfy the qualified plan requirements, the business must inform its employees that they have the opportunity to participate in the plan. Quite simply, a company cannot have a secret 401(k) plan. Likewise, businesses should not discourage employee participation in their retirement plans. Businesses should not have trouble complying with these simple requirements. In industries with high employee turnover, it can be difficult to establish during an IRS examination several years after the fact that employees were informed about a plan. In order to demonstrate compliance, businesses should maintain sufficient written records to demonstrate that employees were offered the opportunity to participate in the plan and declined. For example, the business should consider obtaining a signed acknowledgement from its employees upon receipt of the plan's summary plan description and keep this with the plan's records.

Other Recordkeeping Issues

Despite the IRS's efforts to simplify reporting and recordkeeping requirements for pension plans, these requirements can be daunting to new business owners who are not accustomed to complying with a complex regulatory regime. In general, entrepreneurs who are considering

funding their businesses through a ROBS arrangement should take time to understand and comply with their ongoing responsibilities. They should strongly consider engaging professional advisers to assist them with complying with their reporting and recordkeeping obligations. It is more economical for an entrepreneur to engage professional return preparers and recordkeepers than to pay an attorney to fix errors during an IRS examination.

Permanency versus Plan Termination

ROBS plans must satisfy the permanency requirement described in Treas. Reg. Section 1.401-1(b)(2). This requirement provides that "although the employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general." Thus, the decision to terminate a plan for reasons other than business necessity should not be undertaken lightly.

There are many reported stories about entrepreneurs who have created successful businesses through ROBS arrangements. It is also an unfortunate reality that some businesses fail. There is no question that entrepreneurs should consider the potential risks before investing their retirement savings in a start-up business. It is equally important for entrepreneurs to be mindful of their obligations under the tax laws once they make a decision to wind up business operations. A plan administrator cannot simply walk away from a pension plan without incurring potential tax liability. In many cases, plan administrators will need to engage professionals to assist them with this process. Plan administrators should ensure that they have reserved sufficient assets to properly unwind the ROBS arrangement and roll over or distribute any remaining plan assets.

Conclusion

ROBS arrangements are not tax shelters or loopholes. From a tax perspective, there is nothing fundamentally unusual or improper about rolling over existing retirement plan assets to fund a new business. In fact, ERISA's statutory framework expressly permits it. Nevertheless, there are several potential operational defects in some ROBS plans that entrepreneurs should be aware of and take steps to avoid.

Entrepreneurs should:

- ensure that their plan documents meet the requirements of a qualified plan (either by using a prototype plan document or by timely obtaining a determination letter for the plan);
- ensure that, if the plan covers HCEs, it does not provide benefits in a manner that impermissibly discriminates against NHCEs;
- ensure that the plan's acquisition of employer securities satisfies the requirements of ERISA Section 408(e); and most importantly,
- take seriously their ongoing responsibilities as administrators and fiduciaries of their companies' retirement plans.