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ALERT

ROLLOVERS FOR BUSINESS STARTUP: PROFESSIONAL GUIDANCE IS CRITICAL

By Susan Foreman Jordan

Over the last few years, a strategy has been utilized whereby accumulations in 401(k) plans and/or IRAs are used as the source of financing business acquisition and startup, taking advantage of existing law which permits profit sharing plans to invest up to 100 percent of their assets in employer stock. The strategy, which has been dubbed by the IRS as Rollovers for Business Startups (ROBS, for short), has been made widely available to individuals seeking to acquire franchise interests, but recent announcements by the IRS and Department of Labor have raised concerns that certain abuses may invalidate the otherwise available tax benefits.

How It Works

The individual forms a new corporation; that corporation immediately implements a profit sharing or 401(k) plan. The individual then rolls into that new plan his accumulated account balance (either from an existing IRA or from the qualified retirement plan of his prior employer) and directs the investment of those rollover monies in stock of the new corporation. The corporation, in turn, uses the proceeds of the stock sale to fund the acquisition of the franchise and/or cover business startup costs. As the business begins to generate cash flow, the corporation may repurchase shares of stock from the plan, enabling the plan to diversify its investments; however, because the shares are “participant-directed investments” in the account of the participant who made the rollover, diversification is not required. In the right circumstances, this strategy can be used quite effectively. For many who

have seen their mid- or upper-level management positions eliminated and seek to re-establish themselves in business, accumulated retirement benefits are the most readily available source of financing.

Governmental Attacks

Because the strategy legitimately enables highly paid individuals to avoid payment of taxes on what otherwise would be taxable distributions, and because some individuals have not followed the rules, the government now is scrutinizing these transactions. In late May, both the Department of Labor and the IRS announced they are developing new guidance addressing ROBS; since then, the IRS has initiated a compliance project whereby questionnaires will be sent to selected plan sponsors seeking verification that the plan complied with all requirements for establishing and maintaining a ROBS plan. Earlier IRS scrutiny resulted in the issuance, on October 1, 2008, of a formal memorandum directed to its reviewing agents. While the IRS acknowledged, at that time, that properly structured ROBS transactions are legal and effective, the agents examining them were directed to apply specific guidelines focusing on potential discrimination in operation and violation of the prohibited transaction rules.

Discrimination

The IRS has argued that ROBS are discriminatory in that they are designed to take advantage of a one-time-only stock offering, making it unlikely that employees, other than the original investor, will have an opportunity

to acquire employer stock. This means the employer stock feature is one that will not be "effectively available" to all plan participants, as required by law. A properly designed ROBS transaction however, permits all rollover accounts to be self-directed and, when appropriate, allows for additional investments in employer securities.

Prohibited Transaction Issues

The prohibited transaction rules restrict various transactions between a qualified retirement plan and certain interested parties, including the employer and plan participants. An exemption from the prohibited transaction rules is available for acquisitions or sales of qualifying employer securities, provided that the acquisition or sale is for adequate consideration. To avoid allegations of self-dealing, a bona fide appraisal of the new company, which supports the transaction, is crucial, and legitimate ROBS transactions obtain such appraisals. This can be problematic, as some experts will not issue valuation reports based upon proposed investments or will value the company based only upon its initial cash on hand. The cost of such an appraisal can be considerable, but such valuations are essential, particularly when shares are purchased, or redeemed.

Another one of the prohibited transaction rules forbids a plan fiduciary from dealing with the assets of the plan in his own interest or for his own account. The IRS notes that in many cases in which the plan invests in employer stock, the employer immediately pays the professional fees due to the promoter from the proceeds of the sale. If the promoter is deemed to be a fiduciary, the payment may result in a prohibited transaction, but this pitfall is avoided easily by paying the professional fee from another source.

Prohibited transactions are subject to excise taxes, which continue to compound and can escalate to 100 percent, unless and until unwound. If prohibited transactions continue unchecked, they can result in disqualification of the retirement plan and the loss of all

tax deferral. Thus, it is important to avoid committing prohibited transactions.

General Qualification Concerns

The IRS also raised concerns that some plans created under ROBS arrangements do not satisfy the "permanence" requirement imposed by the Internal Revenue Code; that is, the plan sponsor must intend that the plan will remain in existence for an indefinite period of time, with "substantial and recurring" contributions. Arguably, if the only contribution made to the retirement plan is the initial rollover, the permanency requirement has not been satisfied. However, given its history of liberal interpretations of the permanency standard, even the IRS admits that its position on this issue is weak. Nevertheless, reputable ROBS consultants recommend that the plan be made available and communicated to all employees and that significant employer contributions be made to the plan. Egregious violators risk loss of plan qualification and immediate taxation of their rollovers. Obviously, care should be taken to assure that the plan documents and administration conform, in all respects, to the requirements of law and that all of the formalities of corporate structure are observed.

The Future of ROBS

Thus far, the IRS has conceded that properly structured ROBS transactions are legal, and neither the IRS nor the Department of Labor has given any indication that they will be barred completely. However it is likely that the rules will be tightened to minimize the number of non-conforming transactions. Professional guidance remains essential to determine when it is appropriate and advisable to employ the strategy and how to do so in a manner most likely to withstand IRS scrutiny and avoid unintended tax consequences.

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