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CORPORATE
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CASE STUDY:

The Pitfalls of "Rollovers as Business Startups" Transactions

Versions of qualified plans, sometimes referred to as "Rollovers as Business Startups" or simply "ROBS,"are marketed with increasing frequency to would-be business owners as a way to access tax-deferred retirement funds without paying distribution taxes, in order to cover new business start-up or acquisition costs. The promoters of ROBS products, often soup-to-nuts service providers working for a fee, market the ROBS concept as a safe alternative to traditional financing options.

Many market ROBS transactions by heralding generic archetypes which have been pre-approved by the Internal Revenue Service (IRS) as proof positive of the safety of the ROBS concept. However, while the IRS has indeed issued favorable determination letters to many providers, prospective business owners should be cognizant of the many operational pitfalls that follow the use of the ROBS concept, many of which are fact intensive to each specific transaction, as well as many common hurdles the ROBs concept present to consummating business acquisitions.

HOW DOES THE ROBS CONCEPT WORK?

The IRS generically describes a ROBS transaction as essentially this: following engagement by a would-be business owner, promoters providing for-fee services create a C-corporation for the would-be business owner. Corporate shares are authorized but are not issued at the time of formation. The promoter then establishes a qualified profit sharing plan, sponsored by the corporate entity. The plan documents are generally "pre-approved" but are usually supplemented by amendment to permit the plan to invest plan assets attributable to rollover accounts up to 100% in employer securities.

The individual then executes either a rollover or direct trustee-to-trustee transfer of the proceeds from the available tax-deferred investment account into this newly created plan. At this point, the prior account is usually liquidated; all proceeds are parked in a rollover account held in trust under the shell corporation's plan. The amendment provision is then acted on immediately, and the individual directs the corporation to issue and then exchange all of its capital stock into its qualified plan in exchange for the proceeds held in the rollover account. The corporate shares, now held as plan assets, are valued and booked equal to the value of available account proceeds.

WHAT ARE SOME OF THE ISSUES WITH THE ROBS CONCEPT?

1. General Perception as a Mere Tax-Avoidance Measure. As a general matter, the IRS has deemed ROBS transactions questionable from the standpoint that they often serve solely to enable individuals to exchange tax-deferred assets for currently available funds (typically through the use of a qualified plan and subsequent investment in employer stock) while circumventing the payment of distribution taxes. It is because the ROBS concept is used for tax-avoidance that it is often flagged for IRS scrutiny.

2. Prospective Violations of Nondiscrimination Requirements. Many ROBS transactions fail because the created plan is designed in a manner such that the benefits and rights associated with the plan will never be available to any other employees of the corporation, other than the individual initiating the ROBS transaction. IRC § 401(a)(4) provides that, under a qualified retirement plan, plan benefits and contributions cannot favor highly compensated employees over other categories within a corporation. Because ROBS transactions generally benefit only the individual initiating the ROBS transaction and setting up the corporation, many qualified retirement plans created pursuant to ROBS transactions violate the anti-discrimination provisions of the Internal Revenue Code.

3. Deficient Value of Stock. In virtually all ROBS arrangements, a prospective business owner creates stock for the purpose of exchanging it for tax-deferred assets. The value of the stock is more often than not set as the value of the available assets. Many times an appraisal is created to support the appraised value, but the appraisal is, in reality, devoid of any substantiation, in which case the ROBS transaction fails in achieving its objectives and is considered a prohibited transaction by the IRS.

4. Permanency. Permanency is generally a requirement for all retirement plans. Because ROBS benefits are by design, to be used only once, the IRS often questions whether plans created in these transactions meet this requirement.

In light of the many issues that come along with the use of a ROBS concept to finance a business acquisition or to start a new business, it is imperative that prospective business owners consult with legal counsel to best insulate themselves and their business from IRS scrutiny.

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