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IRS News

IRS Compliance Project Scrutinizes Potentially Abusive ROBS Retirement Plan Arrangements (01/24/2011)

**Pension and Benefits Week,**

## **IRS Compliance Project Scrutinizes Potentially Abusive ROBS Retirement Plan Arrangements**

IRS discussed the compliance project that scrutinizes potentially abusive Rollovers as Business Start-Ups (ROBS) arrangements, which are designed to allow individuals to convert their existing retirement accounts into seed money for funding new businesses without first paying taxes on the distributions. While conceding that ROBS are not considered abusive tax avoidance transactions, IRS has branded such arrangements as "questionable." (*"Rollovers as Business Start-Ups Compliance Project," Retirement News for Employers, Fall 2010*)

**IRS's concern.** Promoters have been aggressively marketing ROBS arrangements to business owners. A ROBS plan is an arrangement in which business owners use their retirement funds to pay for new business start-up costs. ROBS plans, while not considered abusive tax avoidance transactions, are questionable because they may solely benefit one individual—the individual who rolls over his existing retirement funds to the ROBS plan in a tax-free transaction. The ROBS plan then uses the rollover assets to purchase the stock of the new business.



**RIA illustration :** Under a typical ROBS plan, a new business owner first creates a shell C corporation, with created—but not issued—stock. After incorporation, the newly created shell corporation adopts a retirement plan (typically a pre-approved specimen plan), with a provision allowing 100% of the plan assets attributable to rollovers to be invested in employer stock. Next, the business owner either rolls over or executes a direct transfer of the proceeds from an existing tax-deferred account, such as a 401(k) plan account with a former employer, to the newly created ROBS plan. Once the rollover or direct transfer is complete, the business owner directs the shell corporation to issue all of its capital stock, and then transfer the stock to the ROBS plan in exchange for the proceeds held in the rollover account. After the transfer, the shell corporation has adequate capital to pursue business opportunities and the ROBS plan has capital stock in the corporation equal in value to the amount of the funds transferred. And, because all of the shell corporation's stock has been allocated to the business owner's ROBS plan account, any future employees or beneficiaries will not be able to invest in employer stock, barring a recapitalization (see [Pension and Benefits Week ¶ 1 11/17/2008](#)).


Thus, the business owner has used rollover proceeds to indirectly start up or acquire a business while avoiding taxes (income and penalties, if any) on the transaction.

A company will often apply to IRS for a favorable determination letter to assure their clients that IRS approves the ROBS arrangement. However, IRS notes that even a favorable determination letter—based on the plan's terms meeting Code requirements—does not give plan sponsors protection from incorrectly applying the plan's terms or from operating the plan in a discriminatory manner. When a plan sponsor administers a plan in a way that results in prohibited discrimination or engages in prohibited transactions, it can result in plan disqualification and adverse tax consequences to the plan's sponsor and its participants.

Many ROBS sponsors do not understand that a qualified plan is a separate entity with its own set of requirements. Some promoters incorrectly advised sponsors that they don't have to file an annual return because of an exception in the Form 5500-EZ instructions. IRS notes that the exception applies where plan assets are less than a specified dollar amount and the plan covers only an individual, or an individual and his spouse, who wholly own a trade or business, whether incorporated or unincorporated. However, in a ROBS arrangement the plan, through its company stock investments, rather than the individual, owns the trade or business. Accordingly, this filing exception doesn't apply to a ROBS plan and the annual Form 5500 or 5500-EZ (5500-SF for filing electronically) is still required.


There are also specific problems that may arise with ROBS arrangements:

... After the ROBS plan sponsor purchases the new company's employer stock with the rollover funds, he amends the plan to prevent other participants from purchasing stock;


 **RIA observation:** ROBS plans are designed to benefit only the person involved in setting up the business, and so may violate the "current availability" or "effective availability" requirements of [Reg. § 1.401\(a\)\(4\)-4\(b\)](#) and [Reg. § 1.401\(a\)\(4\)-4\(c\)](#) .

... If the sponsor amends the plan to prevent other employees from participating after the determination letter is issued, this may violate the Code qualification requirements. These types of amendments tend to result in problems with coverage, discrimination and potentially result in violations of benefits, rights and features requirements.

... Promoter fees;

 **RIA observation:** Where the fees paid to the promoter of the ROBS plan are made using the transferred plan assets, a prohibited transaction may arise.

... Valuation of assets;

 **RIA observation:** Setting the value of the corporation's stock at the value of the transferred plan assets may be a prohibited transaction, especially where the stock value was set without an adequately supported appraisal of the stock's value.


... Failure to issue a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., when the assets are rolled over into the ROBS plan.

**IRS's response.** Last year, IRS's Employee Plans initiated a ROBS project to: (1) define traits of compliant versus noncompliant ROBS plans; (2) identify ROBS plans that are noncompliant and take action to correct them; and (3) use results to design compliance strategies focusing on identified issues and trends (for example, Employee Plans Compliance Resolution System, Fix-It Guides, Web-based information, newsletters, and speeches). IRS initially focused on companies that sponsored a plan and received a determination letter but didn't file a Form 5500, Annual Return/Report of Employee Benefit Plan, or Form 5500-EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan, and/or Form 1120, U.S. Corporation Income Tax Return.

IRS's contact letter to plan sponsors asks questions about the ROBS plan's recordkeeping and information reporting requirements, including:

- ... the plan's current status;
- ... the plan's contribution history;
- ... information on the rollover or direct transfer of the assets into the ROBS plan;
- ... participant information;
- ... stock valuation and stock purchases;
- ... general information about the business itself; and
- ... why no Form 5500 or 5500-EZ and/or Form 1120 was filed.

IRS noted that preliminary results from the ROBS Project indicate that most, though not all, ROBS businesses either failed or were on the road to failure with high rates of bankruptcy (business and personal), liens (business and personal), and corporate dissolutions by individual Secretaries of State. Some of the individuals who started ROBS plans lost not only the retirement assets they accumulated over many years, but also their dream of owning a business.

 **RIA recommendation:** Practitioners should counsel clients that ROBS plans pose tax hazards and warn them of the grave risk that retirement funds may be completely lost if the business venture funded through the ROBS plan fails.