

# Using Retirement Plan Assets to Fund a Start-up Company

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By Adam Zuwerink

## Introduction

After working for a manufacturing company for the past 20 years, a client approaches you who has recently been let go and is looking forward to starting the next phase of life by purchasing a local restaurant franchise. Your client has a substantial 401(k) account with the manufacturing company that could be used as seed capital to purchase the franchise and obtain bank financing. But your client is younger than 59½ and is not excited about the prospect of paying income tax on the distribution, plus a 10 percent excise tax to the Internal Revenue Service (IRS) for the early distribution of his 401(k) funds.<sup>1</sup>

Your client recently attended a franchising seminar at which a company gave a presentation about using the 401(k) account funds to purchase stock in a newly formed operating company for the franchise business without paying income tax or the early distribution excise tax. Your client insists that the company has assured him such a transaction has been approved by the IRS, but you still think it sounds too good to be true.

The purpose of this article is to highlight the concerns and potential pitfalls of utilizing this “roll-over as business start-up” (ROBS) transaction.<sup>2</sup> The first section outlines the basic steps in completing a ROBS transaction, followed by a discussion of a memorandum from the IRS’ Director of Employee Plans outlining the IRS’ concern with ROBS, and concluding with a discussion of how the United States Department of Labor (DOL) may view ROBS as a prohibited transaction subject to additional excise taxes.

## Roll-overs as Business Start-ups

The first step in completing the ROBS transaction is to set up a C corporation with a number of authorized, but unissued, shares of stock.<sup>3</sup> Once incorporation is complete, the next step is to set up a tax-qualified retirement plan, with the shell C corporation as the employer-sponsor of the plan. The plan document must allow for plan participants to roll-over funds from a previous employer’s qualified plan, and for participants to invest

100% of their plan accounts in the employer-sponsor’s stock, both of which are allowable provisions in a qualified retirement plan.

After the plan has been properly set up, the individual rolls over the previous 401(k) account to the new plan tax-free and directs the corporation to issue capital stock in exchange for the rollover funds in the plan. The stock is held as a plan asset with a value equal to the account proceeds received by the corporation from the plan.

At the end of the day, the corporation now has cash available to purchase the franchise and pay for start-up costs, and the plan participant owns employer stock as a retirement plan investment. Because the stock is viewed as having the same value as the cash proceeds and is still an asset of the plan, no distribution has been made and the presumption is that no income or excise tax is due under Internal Revenue Code (IRC) 72.

Often the plan is then amended to no longer allow for the investment of employer stock by plan participants, effectively grandfathering the investment already made, but cutting off the right of future plan participants to also become owners of the company.

While each piece of the above transaction is technically allowed by the IRS, a number of red flags are raised by the transaction as a whole. The most important of these is that it is prohibited for a participant to directly use retirement plan funds in a business owned by the participant, which is discussed further below.

## Internal Revenue Service Memorandum

After becoming aware of a number of promoters pushing the ROBS transactions at franchise seminars, Michael Julianelle, Director of Employee Plans for the IRS, issued a memo on October 1, 2008<sup>4</sup> outlining a number of concerns the IRS had after reviewing the plans of nine ROBS transaction promoters.

### *Nondiscrimination Requirements*

A ROBS transaction is often set up so that only the persons involved with setting up the business are allowed to purchase the employer's stock, and the right to purchase the stock is taken away before other employees are hired. One of the cardinal rules of the IRC's retirement plan rules is Section 401(a)(4), which states that a plan may not discriminate in favor of highly compensated employees, defined generally as either a 5 percent owner, or employee who had more than \$110,000 in income during 2009 or 2010.<sup>5</sup> The regulations under IRC 401(a)(4) state that the benefits, rights, and features of a plan must be nondiscriminatory,<sup>6</sup> and the timing of plan amendments taking away rights and benefits of participants is subject to a facts and circumstances discrimination test.<sup>7</sup> The Julianelle Memo raises the concern that a plan amendment taking away the right to an employer stock offering could be a discriminatory practice designed to benefit only the initial owners of the company.<sup>8</sup>

### *Valuation of Stock*

Valuation rules are an often overlooked aspect of modern 401(k) retirement plans that allow for individual plan participants to have their own investment account full of publicly traded mutual funds and stocks that are valued on a daily basis. But IRS rules require that all assets in a plan be valued on a regular basis, no less than annually.<sup>9</sup> As discussed further below, failure to properly document that the employer securities were exchanged for their fair market value is automatically a prohibited transaction subject to excise tax.<sup>10</sup>

The Julianelle Memo calls into question the validity of many start-up business valuations that it reviewed, often being given a single sheet of paper simply stating the valuation of the company equals the value of the available proceeds from the retirement plan account.<sup>11</sup> At the very least, a company engaging in a ROBS transaction must actually start operations and have an expert provide a true enterprise value for the company every year.

### *Promoter Fees*

ROBS transactions are being promoted by some investment companies that receive their fees from a portion of the stock purchase proceeds, but the IRC prohibits a retirement plan fiduciary from dealing with the assets

of a plan in the fiduciary's own interest.<sup>12</sup> A plan fiduciary is defined as including anyone who renders investment advice for a fee on a regular basis.<sup>13</sup> The Julianelle Memo raises the concern that if an investment advisor takes a portion of the stock purchase proceeds as a fee for implementing the ROBS transaction, and the advisor continues to provide advice to the plan on a regular basis, that person becomes a plan fiduciary who is in violation of the prohibited transaction rules.<sup>14</sup>

### *Permanency*

One of the requirements of implementing a qualified retirement plan is that it "must be created primarily for the purposes of providing systematic retirement benefits for employees."<sup>15</sup> While the IRS has not historically challenged permanency issues when a plan is terminated, the Julianelle Memo indicates this is a factor the IRS will review if a plan is terminated shortly after the purpose of the ROBS transaction is ended.<sup>16</sup>

### *Exclusive Benefit*

The Internal Revenue Code requires that in order for a retirement plan to be qualified as tax exempt, no part of the plan's assets can be used for purposes other than the exclusive benefit of employees or their beneficiaries.<sup>17</sup> The Julianelle Memo states that so long as the person rolling over the assets is a plan participant and the funds obtained in exchange for the stock are actually used for business start-up costs, the plan is not in violation of the exclusive benefit rules.<sup>18</sup> But the Julianelle Memo does state that some of the ROBS transactions the IRS reviewed were used to set up a business for someone other than the initial account owner, or the stock proceeds were used to buy personal assets, such as a Mercedes or RV.<sup>19</sup> This violation would subject the retirement plan assets to immediate income taxation as a non-qualified plan.

### *Plan Not Communicated to Employees*

A qualified retirement plan carries a continuing administrative burden in that the terms of the plan must be communicated to all newly hired employees, or the plan risks losing its qualified status and all assets becoming immediately taxable.<sup>20</sup> One of the communication requirements is that all participants in a 401(k) plan must be given the opportunity to defer a portion of their salary to the plan.<sup>21</sup> The Julianelle Memo identified that, in some cases, the retirement plan was simply put on the shelf and forgotten about after the ROBS

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transaction was complete and the stock assets received.<sup>22</sup>

It must be communicated clearly to the client early on that, to pass muster under the Julianelle Memo analysis, the ROBS transaction must be part of a retirement plan that is intended to be a permanent benefit available to all employees while the company is operating. It cannot simply be a vehicle to obtain tax-free funds to start a business with no thought of actually operating a retirement plan.

### **Additional Considerations**

In addition to the concerns outlined in the Julianelle Memo, your client must be aware of a number of administrative costs and burdens of owning employer stock within a start-up company's retirement plan.

#### *Tax Considerations*

While a ROBS transaction may appear to be tax advantageous through the initial avoidance of income taxation, a thorough examination of on-going tax considerations must be considered. Taxes will be paid on the corporate and individual level because the ROBS transaction must be completed through a C corporation. But it must also be remembered that the actual owner of the company is the retirement plan and all dividends must be paid to the plan, not the individual, thereby negating a potential lower dividend tax rate for corporate distributions to individual owners.

Also, the ROBS transaction is only seeking to delay income taxation on the retirement account funds, not avoid it. At some point, the funds will still be subject to income taxation when distributed from the retirement plan. The only real potential tax avoidance is the 10 percent excise tax on early distributions.

#### *Administrative Costs*

The Julianelle Memo makes clear that the IRS will scrutinize a ROBS transaction very closely and make sure that every "i" is dotted and "t" crossed in the retirement plan. This means that on top of the administrative costs to set up the individualized retirement plan itself, an annual valuation of the stock must be completed by a qualified business valuation expert, annual tax returns must be prepared and filed, someone must take the time to administer the plan on an on-going basis, etc. These costs can easily range from \$5,000-\$10,000 or more in the first year or two alone, which automatically negates the 10 percent

excise tax savings for any ROBS transaction less than \$100,000.

### **Sale of Employer Stock**

The focus of the Julianelle Memo was the initial transaction of using plan assets to purchase the employer stock, but it fails to discuss the endgame of getting the stock back out of the plan. As discussed below, having the plan participant simply purchase the stock from the plan likely runs afoul of the DOL's prohibited transaction regulations. And if the stock is sold to an unrelated third party, the plan participant will be required to pay income tax on the entire stock purchase price when it is distributed from the plan.

It is very important that anyone contemplating a ROBS transaction be thoroughly advised of the on-going tax and administrative costs associated with the plan. The analysis will be different for each client, and the benefits do not always outweigh the costs, especially as the size of the roll-over account decreases.

### **Department of Labor Restrictions**

Many ROBS promoters took the Julianelle Memo as the government sanction they were looking for and began touting the plans as "approved by the IRS."<sup>23</sup> But as ESPN college football analyst Lee Corso likes to say, "Not so fast, my friend."<sup>24</sup>

#### *Executive Order: Reorganization Plan No. 4 of 1978*

The Julianelle Memo includes the cryptic paragraph: "We have also coordinated our consideration of ROBS plans with the Department of Labor (DOL). As will be noted later, the transfer of enterprise stock within a ROBS arrangement could raise ERISA Title I prohibited transaction issues. Although our coordination efforts are not yet finalized, they remain ongoing."<sup>25</sup>

Essentially, this means that even if the ROBS transaction complies with every single procedural requirement outlined in the Julianelle Memo, the IRS is not actually the federal governmental department authorized with making the final determination on whether a ROBS plan is a prohibited transaction subject to a potential 115 percent excise tax.<sup>26</sup>

When ERISA was enacted in 1974, it contained its own fiduciary duty rules,<sup>27</sup> but it also added similar prohibited transaction rules to the Internal Revenue Code. With oversight of

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ERISA placed with the Department of Labor, President Carter signed an executive order in 1978 that transferred oversight and interpretation of the prohibited transaction rules in the Internal Revenue Code from the Department of Treasury to the DOL. That order provides:

All authority of the Secretary of the Treasury to issue the following described documents pursuant to the statutes hereinafter specified is hereby transferred to the Secretary of Labor: (a) regulations, rulings, opinions, and exemptions under section 4975 of the Code.<sup>28</sup>

### *Internal Revenue Code Section 4975*

IRC 4975 imposes a 15 percent excise tax on a “disqualified person” who engages in a retirement plan “prohibited transaction.” An additional 100 percent excise tax is imposed during the taxable period after the prohibited transaction occurs.<sup>29</sup>

For purposes of IRC 4975 and a typical ROBS transaction, the term “prohibited transaction” means any direct or indirect: (a) sale or exchange, or leasing, of any property between a plan and a disqualified person; (b) lending of money or other extension of credit between a plan and a disqualified person; (c) furnishing of goods, services, or facilities between a plan and a disqualified person; (d) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan; (e) act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interests or for his own account; or (f) receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

And for purposes of IRC 4975 and a typical ROBS transaction, the term “disqualified person” includes a person related to the retirement plan who is: (a) a fiduciary; (b) a person providing services to the plan; (c) an employer any of whose employees are covered by the plan; (d) an owner, direct or indirect, of 50 percent or more of a company which is the plan sponsor employer; (e) a member of the family of any individual described in the preceding classes; (f) an officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10 percent or more shareholder,

or a highly compensated employee of the employer sponsor.

Based solely on the above definitions, a ROBS transaction would appear to be a prohibited transaction because the principal in control of the plan’s employer sponsor is directing the plan to purchase company stock on that person’s behalf to invest in the disqualified company. In fact, ERISA Section 406(a)(1)(E) specifically provides it is a prohibited transaction for a plan to acquire employer securities or real property.<sup>30</sup> But like any good federal statute, there is an exception to the rule that all but negates it.

Where many ROBS promoters hang their hat is ERISA Section 408(e), which exempts from the prohibited transaction rules the acquisition or sale of employer securities by a retirement plan so long as: (1) the acquisition or sale is for adequate consideration, and (2) no commission is charged in connection with the transaction.<sup>31</sup>

In light of the fact that authority rests with the Department of Labor to rule on prohibited transactions, the taxpayer has the burden to prove to the DOL that it falls under an exception to the general rule that a plan may not purchase employer securities. It becomes obvious that the Julianelle Memo does not in fact answer the question whether a ROBS transaction is a prohibited transaction because the IRS does not have the authority to make such a determination.

### *DOL Advisory Opinion 2006-01A*

The question then becomes, how will the Department of Labor view such a transaction? Unfortunately, we still do not have a direct answer from the DOL. While the Julianelle Memo was a preemptive pronouncement of how the IRS views ROBS, the DOL will only answer the question through an advisory opinion if someone asks them. And as of now, no one has asked them.

What evidence we can gather from prior advisory opinions shows it is likely the DOL will not look kindly on ROBS transactions. While first recognizing the fact DOL regulations acknowledge a disqualified person can transact business with a company in which a plan has invested, DOL Advisory Opinion 2006-01A states:

Regulation section 2509.75-2(c) and Department opinions interpreting it have made clear that a prohibited transaction occurs when a plan invests in a corporation as part of

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an arrangement or understanding under which it is expected that the corporation will engage in a transaction with a party in interest (or disqualified person).<sup>32</sup>

A broad reading of this statement calls into question the entire validity of ROBS transactions, as the fundamental purpose of the scheme is for a disqualified person to provide funds to the company that it controls. Even a narrow reading of the DOL opinions place severe restrictions on how the retirement plan funds can be used as the money must not be used directly for a transaction involving the disqualified person. For example, the money should be used only for payment of a franchise fee or to purchase equipment, and should not be used to pay a disqualified person's salary or make rent payments to a company owned by a disqualified person.

### Conclusion

It has been reported that as many as 30 percent of recent franchisees have chosen to use 401(k) roll-over money to help fund the franchise start-up,<sup>33</sup> which means it is only a matter of time before more concrete guidance and regulations will be provided by the IRS and DOL. If a client approaches you about using retirement plan monies to fund a business start-up, alarm bells should ring on both a legal and practical level. From a practical perspective, the IRS and DOL rules and regulations are set up with the intended purpose of making sure people save for their retirement years, and the inherent risks of mortgaging the future to pay for the present must be made with a full understanding of the potential costs if the business does not survive. From a legal perspective, your client must be fully informed of the legal requirements outlined in the Julianelle Memo regarding setting up and maintaining the retirement plan and the prohibited transaction excise tax risks due to the uncertain status of the transaction scheme with the DOL. Remember, if it sounds too good to be true, it probably is.

### NOTES

1. See Internal Revenue Code (IRC) Section 72(q).
2. The phrase "Rollovers as Business Startups" was coined by Michael D. Julianelle, Director of Employee Plans for the IRS, and the general consensus is that the acronym "ROBS" was purposefully chosen because of the IRS' skepticism towards these transactions.
3. The entity must be a C corporation, rather than an S corporation or limited liability company, because of the prohibited transaction rules of IRC 4975(f)(6).
4. Julianelle, *Guidelines Regarding Rollovers as Business Start-ups*, IRS Employee Plans Director Memorandum, October 1, 2008, located at: [http://www.irs.gov/pub/irs-tege/rollover\\_guidelines.pdf](http://www.irs.gov/pub/irs-tege/rollover_guidelines.pdf) (hereafter, "Julianelle Memo").
5. IRC 414(q)(1).
6. Treas. Reg. 1.401(a)(4)-4(e)(3).
7. Treas. Reg. 1.401(a)(4)-5.
8. Julianelle Memo, 7.
9. Rev. Rul. 80-155, 1980-1 C.B. 84.
10. See ERISA 406; ERISA 408(e).
11. Julianelle Memo 9.
12. IRC 4975(c)(1)(E).
13. IRC 4975(e)(3).
14. Julianelle Memo 10.
15. Julianelle Memo 11, *citing* Treas. Reg. 1.401-1(b).
16. *Id.*
17. IRC 401(a)(2).
18. Julianelle Memo 12
19. *Id.*
20. Treas. Reg. 1.401-1(a)(2).
21. IRC 401(k)(2).
22. Julianelle Memo 12-13.
23. See, e.g., SDCooper Company ERSOP® Plans, located at <http://ersop.com/ersop-faq.html>; DRDA, P.C.'s White Paper on Rollovers as Business Startups, located at [http://www.borsaplan.com/DRDAWhitePaper\\_ROBS.pdf](http://www.borsaplan.com/DRDAWhitePaper_ROBS.pdf).
24. [http://www.espnmediazone.com/bios/Talent/Corso\\_Lee.htm](http://www.espnmediazone.com/bios/Talent/Corso_Lee.htm)
25. Julianelle Memo 4.
26. See IRC 4975.
27. ERISA 406, 408. For purposes of this article, the terminology of IRC 4975 is used and the DOL often uses the terms located in ERISA and the IRC at the same time (e.g. "party in interest" under ERISA and "disqualified person" under the IRC)
28. Executive Order: Reorganization Plan No. 4 of 1978, Section 102, located at [http://www.dol.gov/ebsa/regs/exec\\_order\\_no4.html](http://www.dol.gov/ebsa/regs/exec_order_no4.html).
29. The taxable period for imposition of the 100% excise tax is defined in IRC 4975(f)(2) as beginning on the date the prohibited transaction occurs and ending on the earliest of the date the prohibited transaction is corrected, the date the excise tax is assessed, or the date of mailing of notice of deficiency.
30. 29 USC 1106(a)(1)(E).
31. 29 USC 1108(e).
32. DOL Advisory Opinion No. 2006-01A (Jan. 6, 2006), located at <http://www.dol.gov/ebsa/regs/aos/ao2006-01a.html>, *citing* 29 CFR 2509-75-2(c); DOL Advisory Opinion No. 75-103 (Oct. 22, 1975); 1978 WL 170764 (June 13, 1978).
33. Dugas, *Entrepreneurs turn to 401(k)s to fund start-up businesses*, USA Today, February 19, 2010.



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