DRDA, PLLC's White Paper on Rollovers as Business Startups (ROBS)

DRDA, PLLC's White Paper on the Memorandum from Michael D. Julianelle, Director, Employee Plans, Internal Revenue Service on the subject of Guidelines Regarding Rollovers as Business Startups dated October 1, 2008

Summary

The purpose of this white paper is to present our interpretation of the recent IRS memorandum on the qualified plan structures that allow participants to invest in business startups.

The IRS Memorandum states these plans are qualifiable and as such can receive a favorable determination letter. However, the IRS points out that it has seen operational issues that would violate basic plan qualification rules. The IRS has seen some egregious plans that:

1. allow a one-time stock purchase and then amend the feature out of the plan,
2. are not communicated to the participants,
3. involve the purchase of personal assets with plan funds,
4. have no transactions other than the stock transaction.

Anyone utilizing this structure must realize that it is a qualified retirement plan that:

1. is subject to all applicable rules and regulations,
2. allows for self direction, and
3. authorizes the investment in employer securities as an eligible investment option.

Entrepreneurs would be well advised to realize that the complexity and value of this planning technique and structure not only requires the establishment of the plan in a compliant manner, but also operating it in a compliant manner going forward to ensure that unexpected and undesired tax consequences are not encountered.

DRDA, PLLC (DRDA) is a CPA Firm. We design and create a Rollover as Business Startups (ROBS) qualified plan called the BORSA™ plan. The BORSA™ plan helps entrepreneurs invest in their own small businesses with retirement funds they currently hold in traditional qualified plans. Our focus is on assisting entrepreneurs establish, operate, and sell businesses in a profitable and compliant manner. The purchase and operation of the closely held business is generally the largest financial transaction and asset in the entrepreneur's estate. We understand the importance of this business to the entrepreneur, his/her family, and the employees that work there. We will work with you to help assure your business and plan are operated in a compliant manner, assuming that you comply with the operational requirements outlined below.

Background

The purpose of Mr. Julianelle's document is to provide technical advice to the Internal Revenue Service (IRS) field agents in regard to qualified plan rollovers that are involved in business start-ups. When an IRS agent encounters a transaction, structure, or issue that is new to them they will often request guidance from the central office/authority on what to look for and how to handle the issue. It is such activity that has been the impetus for this IRS Memorandum.

The Memorandum finds that the structure is compliant with the law; however, they cite several issues that concern them in how the plans are being operated or administered. The purpose of this discussion paper is to identify what we believe Treasury is saying and what needs to be done to remain compliant at inception as well as operationally thereafter.

Structure is Compliant with the Law

The following sentences are paraphrases or extracts from the IRS Memorandum:

Treasury does not believe that the form of all of these transactions may be challenged as non-compliant per se. They go on to state that there is no inherent violation in the form of a plan containing a ROBS arrangement that would otherwise prevent a favorable determination letter ruling. The issues described in the Memorandum regarding ROBS are inherently operational, and beyond the scope of a determination letter ruling. Accordingly, determination letter applications for plans with ROBS features can be reviewed by Treasury and approved as appropriate.

Issues Raised

Benefits, Rights & Features

One of the underlying premises of a qualified retirement plan is that all participants are treated fairly and without discrimination. Under a qualified plan, contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees (HCE's). Under the law a person is considered a HCE if they own 5% or more of the plan sponsor (i.e. the company) or received compensation in excess of $110,000 in the preceding plan year. (Note that this amount may change annually based on cost of living.) An employee not meeting one of these two criteria is by default a non-highly compensated employee (NHCE).

In testing the Benefits, Rights & Features (BRF) elements of a plan the IRS looks at it from two perspectives. Are the BRF's currently available and effectively available? In the Memorandum the IRS states that in many cases there are no other employees in the initial year of the transaction or for some number of future years thereafter. Therefore, as no finding regarding discrimination can be made in absence of NHCE's in the transaction year, the current availability testing standard for plan BRF's is satisfied. This does not; however signify that the effective availability standard is similarly resolved.

Effective availability testing requires a facts and circumstances determination regarding whether a plan feature benefits NHCE's and not just HCE's. This determination requires consideration of factors or conditions that must be satisfied in order to accrue a benefit, including timing elements and whether the transaction was structured to intentionally avoid BRF testing issues.

Treasury's concern seems to be that the plan design may only allow an HCE to invest in employer stock, a right that is not generally available to the plan universe, or NHCE's. This has generally been the case since stock in privately held companies is generally only available at the inception of the company. In order to meet the effective availability test, employer securities must be available for the plan participants to purchase should they desire. The purchase price would be determined as a result of the annual valuation discussed below. While there is no requirement for NHCE participants to actually purchase employer securities, the investment feature must be made available to them. This investment option is disclosed in the Summary Plan Description. Furthermore, we recommend that this investment option be acknowledged by the employee via the enrollment form where they document their choice to participate in the plan or not.

Stock Valuation in Regards to Prohibited Transaction Classification

The value of assets held in a qualified plan, both as to purchase and distribution, can have tax implications. Treasury seems to be taking this standard and applying it strictly in plans containing non- marketable assets (i.e. stock in a privately held business).

The Internal Revenue Code provides an exemption from prohibited transaction penalties for purchases of qualifying employer securities provided such purchases meet the criteria of ERISA section 408(e).[1] One of the criteria of ERISA section 408(e) is that purchases or sale of employer securities must be for adequate consideration.[2] Except in the case of marketable securities, adequate consideration for this purpose means a price not less favorable than the price determined under ERISA section 3(18).

There are multiple sources that provide guidance on how adequate consideration is determined. Adequate consideration for assets other than securities for which there is a generally recognized market is fair market value as determined in good faith by the trustee.[3] The courts have ruled that trustees demonstrate good faith in determining the fair market value of real estate by relying on a professional appraiser.[4] DOL proposed regulations would treat adequate consideration for a plan asset, other than a security for which there is a generally recognized market value, as the fair market value of the asset as determined in good faith by the trustee.[5] Under the proposed regulation, a fiduciary would be required to

[1] IRC §4975 (d)(13).

[2] ERISA §408(e) and ERISA Regulation § 2550.408(e).

[3] ERISA §3 (18)(B)

[4] Cosgrove v. Circle K Corp., CA-9 (1997), Nos. 96-15164 and 96-16148 (unpublished opinion) , aff'd by CA-9 (1997), Nos. 96-15164 and 96-16148.

[5] ERISA Proposed Reg. §2510. 3-18.

determine the fair market value in good faith, as determined by a prudent investigation of circumstances prevailing at the time of the valuation and the application of sound business principles. The fiduciary would have to either:

1. Be independent of all parties to the transaction, or

2. Rely on the report of an independent appraiser.

Treasury's position is that valuation of the capitalization of the company is a relevant issue because an exchange of company stock between the plan and its employer-sponsor would be a prohibited transaction, unless the requirements of ERISA section 408(e) (i.e., proof of adequate consideration) are met.

For these reasons we believe compliance with this provision will require a valuation of the company stock at startup and annually for as long as the plan holds the stock.

Promoter Fees

Treasury appears to be attempting to tie the payment of fees to the "promoter" (person or organization providing the plan or structure) from plan assets as a potential transaction between a fiduciary and the plan, which is a self-dealing prohibited transaction. In order to make this connection Treasury would need to cast the plan provider as an investment advisor. ERISA regulations state a person is deemed to render investment advice if such person renders advice to the plan as to the value of securities or other property, makes a recommendation as to the advisability of investing in, purchasing, or selling securities or other property, and such person either directly or indirectly has discretionary authority or control, whether or not pursuant to an agreement arrangement or understanding, with respect to purchasing or selling securities or other property for the plan.[6] The advice would have to be rendered on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding, written or otherwise, between such person and the plan or fiduciary with respect to the plan, and that such services will serve as a primary basis for investment decisions with respect to plan assets. If the promoter meets these requirements, his status may rise to that of a plan fiduciary.

In relation to the BORSA™ structure, the three issues that would have to be determined are that DRDA renders advice as to the value of the corporate stock, that DRDA provides investment advice to the plan on an on-going basis, and that money from the sale of stock to the plan would be used to pay for DRDA services.

To specifically address these issues it is DRDA's policy and practice that:

1. An outside accredited valuation firm establish the value of corporate stock at the outset of the plan and each year thereafter.

2. An outside accredited and licensed money manager be appointed and available to render investment advice to the plan participants as needed.

3. The fees for DRDA services in establishing the plan are paid for out of the entrepreneur's personal funds as a part of his personal investment and not reimbursed from the corporation at a later time.

[6] ERISA Regulation 2510-3.21(c)

Permanency

Treasury's concern here is that the plan is being established solely as a funding vehicle rather than as an actual on-going retirement plan. Treasury regulations provide that a qualified plan must be created primarily for the purposes of providing systematic retirement benefits for employees.[7] Additionally, the regulations require that the plan be permanent, as distinguished from a temporary arrangement.[8] Plans which suffer from permanency failures are generally deficient in that they do not receive substantial and recurring contributions.

The BORSA™ plan is first a qualified retirement plan, second a plan that allows for the self directing of investments, and third offers employer securities as an investment option. It is our policy to recommend that the founder/entrepreneur contribute a minimum of 1% of his/her compensation into the plan each year to demonstrate this intention.

Exclusive Benefit

A qualified retirement plan must be for the exclusive benefit of its participants and beneficiaries, and not for other purposes. Treasury states the typical ROBS design does not violate this rule. They do indicate that they are aware of plans that used money to purchase personal assets from the sponsor or for the personal use of the sponsor and not the purchase of a legitimate trade or business.

This issue is addressed by common sense. The purpose of the plan is to accumulate assets that will provide retirement benefits to the participants. The use of money from the plan must be toward this end. You are allowed to invest for the future, not consume for the present.

Plan Not Communicated to Employees

A qualified plan must be communicated to the employees of the plan sponsor. The plan does not exist for the exclusive use of the company founder but rather for the benefit of the employees of the sponsoring company. As such, the existence of the plan must be communicated to the employees. This communication is done in multiple ways.

1. A Summary Plan Description is prepared and distributed to each employee upon hiring.
2. A notice letter is given to each employee 30 days prior to their plan entry date outlining their eligibility to participate in the plan.
3. A plan enrollment/participation form is provided to each employee so they may indicate their desire to participate or not to participate.

These activities and the written acknowledgement of the employee on the enrollment/participation form will provide clear documentation of the fact the plan is communicated to your employees.

Inactivity in Cash or Deferred 401(k) Arrangement

Treasury noted that some plans do not provide participants with the opportunity to make 401(k) contributions. This is a communication and documentation issue as noted above. By providing the Summary Plan Description, pre-enrollment notices and enrollment forms you will be compliant in regard to this issue.

[7] Treasury Regulation 1.401-1(b)

[8] Treasury Regulation 1.401-1(b)(2)

Conclusion

At DRDA, PLLC we specifically address all of the issues raised above with every client. We emphasize the need to maintain strict compliance with the law with every client - from the time we first explore the suitability of the BORSA™ for the clients' particular circumstances, through the course of our initial engagement, and after the BORSA™ has been established and funded.

All tax law compliance requires regular on-going monitoring and reporting. We work diligently with our clients to accomplish these tasks.

The IRS's recent memorandum underscores the fact that there is much more to creating a compliant Rollovers as Business Startups structure than merely drafting the paperwork and rolling over the money. Rather, the issues involved in designing, establishing, and operating a compliant structure are highly technical and complex. The IRS has evidently uncovered many non-compliant plans, and they have clearly expressed their intent to closely examine and monitor all of these structures.

Given the IRS' heightened scrutiny, it is essential to have accredited professionals design, create, and administer your plan.

Contact us today to learn more about how we can help you buy or start a business with a BORSA™.