BNA, INC.

DAILY TAX REPORT

BNA Employee-Owned Since 1947

Reproduced with permission from Daily Tax Report, 54 DTR J-1, 3/21/2011. Copyright © 2011 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Examinations of Rollovers as Business Start-Ups (ROBS) Arrangements: A Guide to Surviving IRS Scrutiny

By Brian C. McManus and Mark Matthews

Introduction

In recent years, thousands of aspiring entrepreneurs have tapped into their existing retirement savings to finance the start-up or acquisition of a new business. Industry experts estimate that since 2005 more than 10,000 start-up businesses have been capitalized through rollover arrangements. One of the most common techniques involves rolling over a prior individual retirement account (IRA), 401(k) account, or employee stock ownership plan (ESOP) account into a newly established 401(k) plan that is sponsored by the start-up business and then investing the rollover funds in the stock of the new corporation.

These complex arrangements, commonly referred to as ''rollovers as business start-ups'' or ROBS, enable aspiring entrepreneurs to capitalize their new business with retirement funds while avoiding taxes and penalties otherwise applicable to early distributions. Although these arrangements are usually intended to serve legitimate business and tax planning purposes, they can also result in substantial tax and penalties for business owners who fail to properly establish or administer their corporate 401(k) plans or who otherwise attempt to convert plan assets for personal use.

Brian McManus is an associate in the tax practice at Morgan, Lewis & Bockius LLP, resident in the Boston office. Mark Matthews is a partner in the firm's litigation and tax practices, resident in Washington, D.C. Matthews previously served as deputy commissioner for services and enforcement of the Internal Revenue Service. They represent several clients that have adopted retirement plans with ROBS features.

The legal requirements for establishing and operating 401(k) plans, which are a specific type of employee benefits plan utilized in ROBS arrangements, are prescribed by the Employee Retirement Income Security Act of 1974 (ERISA).[1] ERISA was originally intended to safeguard plan participants and beneficiaries from bankruptcies and underfunded pension plans. Today, ERISA is a complex statutory and regulatory regime that regulates the design, implementation, and operation of employee benefits plans.

Under ERISA, the Internal Revenue Service (IRS or the service) and the United States Department of Labor (DOL) have joint enforcement and oversight responsibility for employee pension plans. Although there is some overlap in jurisdiction, DOL is primarily responsible for regulating fiduciary conduct. This responsibil-

[1] Title I of ERISA includes the provisions concerning fiduciary obligations, reporting and disclosure requirements, participation and vesting, funding, and plan administration. Title II contains tax provisions that amended the Internal Revenue Code of 1986 (the code). There is some overlap between the Title I and Title II provisions on such matters as participation, vesting, and funding.

ISSN 0092-6884

ity includes interpreting the prohibited transaction rules. IRS has responsibility for interpreting and enforcing tax issues, including funding and vesting standards.

IRS officials have correctly recognized that a properly structured and administered ROBS arrangement can satisfy both the requirements and spirit of the tax laws and serve legitimate tax and business planning purposes.

This article focuses on the service's approach to the tax issues that arise in connection with IRS examinations of ROBS arrangements.

Several commenters have pointed out that the service's ''label'' for these arrangements—''ROBS''—implies that in the eyes of the service ROBS arrangements are improper. In fact, the service has been aware of ROBS arrangements for several years and has historically issued favorable determination letters to retirement plans with ROBS features. ''ROBS'' is simply an unfortunate acronym and does not imply anything further.

The service has fully examined numerous businesses that engaged in ROBS arrangements and, in many cases, declined to propose any adjustments to the plans.

Nevertheless, the service understandably remains on the lookout for businesses that have attempted to abuse the ROBS structure to skirt requirements applicable to pension plans, such as restrictions on early distribution of benefits and provision of benefits that do not impermissibly favor highly compensated employees. The challenge for both the service and businesses coping with an IRS examination is distinguishing legitimate ROBS arrangements from those that do not comply with the tax laws.

The service's current approach to plan examinations involving a retirement plan with ROBS features is to consider the merits of each arrangement on a case-by-case basis. Examiners typically focus on the operations of the plan because, in most cases, there are no inherent violations in the form of the plan itself.[2] Although the service has not provided any formal guidance specifically addressing ROBS arrangements, several potential issues were discussed in a 2008 IRS memorandum entitled *Guidelines Regarding Rollovers as Business Start-ups* (''IRS ROBS Memo'').

If a violation of the tax laws is identified during an examination of a ROBS arrangement, there are a number of possible outcomes depending upon the nature and severity of the violation. The service could propose adjustments to plan documents and operations, impose taxes and penalties, or, in the most egregious cases, retroactively revoke the plan's status as a qualified (tax-exempt) trust under Internal Revenue Code (''the code'') Section 401(a).

ROBS arrangements are not tax shelters or unlawful in any way. Nor are they per se noncompliant with the complex plan qualification rules.

Despite the issues discussed herein, ROBS arrangements are not tax shelters or unlawful in any way. Nor are they per se noncompliant with the complex plan qualification rules. IRS officials have correctly recognized that a properly structured and administered ROBS arrangement can satisfy both the requirements and spirit of the tax laws and serve legitimate tax and business planning purposes. It is critical, however, that aspiring entrepreneurs who fund their businesses through ROBS arrangements understand the possible legal pitfalls and take seriously their ongoing responsibilities as fiduciaries of their companies' retirement plans.

ROBS Arrangements

ROBS arrangements typically involve the following sequential steps:

- an aspiring entrepreneur establishes a new corporation;
- the corporation adopts a prototype 401(k) plan[3] that specifically permits plan participants to direct the investment of their plan accounts into a selection of investment options, including employer stock;
- the entrepreneur elects to participate in the new 401(k) plan and, as permitted by the plan, directs a rollover or trustee-to-trustee transfer of retirement funds from another qualified retirement plan into the newly established corporate plan;
- the entrepreneur then directs the investment of his or her 401(k) plan account to purchase the corporation's newly issued stock at par value (i.e., the amount that the entrepreneur wishes to invest in the new business); and
- finally, the company utilizes the proceeds from the sale of stock to purchase an existing business or to begin a new venture.

In many cases, the entrepreneur will also personally acquire additional corporate stock or receive additional stock outside of the 401(k) plan as reimbursement for start-up costs.

The tax treatment of these complex arrangements is subject to various provisions of the code. These rules are easily confused and misapplied—even by tax experts and IRS examiners. The first critical step in any IRS examination involving an employee benefits plan is to identify the precise type of plan involved and the tax laws that specifically apply to that plan.

[2] Most employers adopt preapproved prototype plans. These plans have been approved by IRS as meeting the qualified pension plan document requirements in accordance with code Section 401(a) et seq.

[3] 401(k) plans are also commonly referred to as cash or deferred arrangements (CODAs). The arrangements allow employees to elect to defer compensation from wages on a pre-tax basis and have an equivalent amount contributed by the employer to their accounts under the 401(k) plan.

There are challenges in some audits to bringing focus to the correct statutory and regulatory provisions because several different ERISA and code provisions permit employee benefits plans to acquire and hold employer securities. It is important to focus an audit on the correct rules so that taxpayers and agents do not waste significant time, effort, and money analyzing irrelevant issues.

ROBS Arrangements Typically Involve 401(k) Profit-Sharing Plans

The primary issue in any IRS employee plan examination is whether the plan is ''qualified'' and entitled to special tax treatment under the code. Code Section 401(a) provides the basic requirements for plan qualification.

If a pension plan satisfies the requirements of code Section 401(a), then the plan, its participants, and the employer are all exempt from tax on any investment gains on plan assets.[4] In addition, the contributions to the plan are not taxable to the employee when they are made.[5] Instead, the participant is generally taxed when he or she receives benefits from the plan. If a plan is not qualified (or later disqualified), then the plan will be subject to tax on any investment gains and the participants will be subject to tax on vested contributions to the plan.

Code Section 401(a) applies to pension, profit-sharing, and stock bonus plans. In general, these plans, which are commonly referred to under Title I of ERISA as ''pension plans,'' provide for the deferral of employment income until termination of employment and beyond.[6] The distinctive feature of 401(k) plans, which are a type of pension plan, is that participants have the option of having their employer contribute a portion of their compensation to their 401(k) accounts in lieu of receiving the same amount as taxable wages.

There are two general categories of qualified pension benefits plans—defined benefits plans and defined contribution plans (also referred to as individual account plans). ROBS arrangements exclusively involve defined contribution plans. In a defined contribution plan, the terms of the plan define the amount of the employer's contributions, rather than the amount of benefits. Each participant receives an individual ''account'' to which the employer's and participant's periodic contributions are allocated. The employee's plan account bears the risks (and benefits) of investment gains and losses. The amount of each participant's benefits depends on the value of the account.

There are several different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit sharing plans, and stock bonus plans (and employee stock ownership plans, which are a subset of stock bonus plans).

A profit sharing plan, which is by far the most common form of defined contribution plan, provides for annual employer contributions that are computed based on a formula set forth in the plan documents. The employer has discretion to choose the amount of its contribution and is not necessarily required to compute its contributions based on the actual ''profit'' of the company. A stock bonus plan is a specific type of defined contribution plan that permits the employer to make contributions in the form of employer stock. ROBS arrangements involve a 401(k) profit sharing plan rather than a stock bonus plan.

ROBS Plan's Investment in Employer Securities Governed by ERISA Section 408(e)

In general, Title I of ERISA prohibits pension plans from engaging in certain ''prohibited transactions'' with ''parties in interest.''[7] Under ERISA, a plan fiduciary that causes the plan to engage in a prohibited transaction can be held liable for a ''fiduciary breach.''[8] A non-fiduciary who participates in a prohibited transaction may also be held liable for equitable relief under ERISA.[9]

The code contains similar, but not identical, rules that impose tax on ''disqualified persons'' that engage in the prohibited transactions listed in code Section 4975(c). Disqualified persons under the code include an employer whose employees are covered by the plan; plan fiduciaries, counsel, and employees of the plan; service providers; and certain officers, directors, shareholders, and employees of the employer who are covered by the plan.[10] There are numerous caveats and exceptions to the general rules that ''prohibit'' and impose tax on these types of disfavored transactions.

Although the acquisition or holding of any employer securities by a pension plan, which is the cornerstone of a ROBS arrangement, is one of the ''prohibited transactions'' described in Title I of ERISA,[11] there are several exemptions set forth in Title I that permit pension plans to invest in employer securities without running afoul of either Title I or the code's prohibited transaction rules. Each exemption has different requirements.

One potential area of confusion in an IRS examination of a ROBS arrangement is how the prohibited transaction rules apply to the plan's acquisition of employer securities. If an issue as to whether the plan's acquisition or sale of employer securities constituted a prohibited transaction arises in the context of a ROBS examination, the relevant exemption is ERISA Section 408(e), which specifically permits the acquisition of ''qualifying'' employer securities by a pension plan under certain circumstances.

[4] Qualified pension plans are required to hold plan assets in trust. The trust associated with a qualified plan is exempt from tax under code Section 501(a).

[5] The employer, however, may deduct the contributions when made. See code Section 404(a)(6).

[6] See ERISA Section 3(1).

[7] Under Section 406(a), a plan is prohibited from acquiring employer securities or engaging in various other transactions with the employer or any other party in interest absent an exemption (and, in the case of employer securities, must also comply with certain rules discussed herein).

[8] ERISA Sections 502(a)(2), 409.

[9] ERISA Section 502(a)(3); *Harris Trust & Savings Bank v. Salomon Smith Barney*, 530 U.S. 238 (2000).

[10] Code Section 4972(e)(2).

[11] ERISA Sections 406(a)(1)(E), 407(a).

ERISA Section 408(e) is a broad exemption that, in combination with the provisions of ERISA Section 407, clearly indicates Congress's belief that investment in employer securities, within limits, is appropriate and permissible for qualified pension plans.

ERISA Section 408(e) is a broad exemption that, in combination with the provisions of ERISA Section 407, clearly indicates Congress's belief that investment in employer securities, within limits, is appropriate and permissible for qualified pension plans.[12] Transactions that are exempt under ERISA Section 408(e) are expressly exempt from the code's prohibited transaction rules under code Section 4975(d)(13), although there is no corresponding provision in the code to the subsections of ERISA Section 406(a) that specifically makes the acquisition or holding of employer securities in itself a prohibited transaction under the tax laws, as opposed to ERISA.

ERISA Section 408(e) provides that the prohibited transaction rules will not apply to a plan's acquisition (or sale) of qualifying employer securities (as defined in ERISA Section 407(d)(5)) if:

- the acquisition or sale is for adequate consideration,
- no commission is charged, and
- the plan is an eligible individual account plan as defined in ERISA Section 407(d)(3) (otherwise a 10 percent limit applies).

The term ''individual account plan'' is defined in Section 407(d)(3)(A) to include ''a profit sharing, stock bonus, thrift or savings plan.'' ROBS plans are typically structured as profit sharing plans, which are a type of ''individual account plan.'' The type of stock used in ROBS arrangements is common stock, which should qualify as ''qualifying employer securities'' under ERISA Section 407(d)(5).

The critical requirement here, discussed in detail below, is that the plan's acquisition of employer securities must be for adequate consideration. There are no further requirements to this broad exception.

During an IRS Examination It Is Important To Distinguish Inapplicable Rules

There have been at least a few examinations where IRS examiners have erroneously attempted to apply rules governing defined benefits plans and ESOPs to ROBS arrangements. Plans with ROBS features are structured as 401(k) profit sharing plans rather than defined benefits plans or ESOPs. Therefore, these rules should not apply. The critical distinctions are discussed below.

The Rules Concerning Defined Benefit Plans Do Not Apply to ROBS Arrangements. The regulations governing defined benefits plans are more complex than those covering defined contribution plans because they are designed to ensure that the plan has sufficient assets to pay the defined benefits. ROBS arrangements involve defined contribution plans. In a plan with ROBS features, the plan documents should define the amount of the employer's annual contribution, rather than the amount of benefits that the participant will receive at retirement.

Each participant should also have an individual account under the plan to which the employer's and participant's periodic contributions are allocated. In contrast, in a defined benefits plan, participants are promised a specific level of retirement income according to a detailed formula set forth by the plan.[13] That is, the benefits each participant receives at retirement are ''defined'' by the plan. The employer is required to contribute sufficient funds to pay the defined benefits. Employers, rather than the individual plan participants, bear the risks (and the benefits) of investment gains and losses.

The Rules Concerning ESOPs Should Not Apply to ROBS Arrangements. An ESOP is a type of stock bonus plan or money purchase plan that is designed to invest primarily in qualifying employer securities.[14] Because such plans are intended to be invested primarily in employer securities, an ESOP must meet specific requirements under the code that relate to the ability of participants to diversify their investment out of qualifying employer securities as they near retirement age and that describe how participants receive distributions when stock is not publicly traded, as well as requirements relating to voting and tender rights for publicly traded stock.

Even though ROBS arrangements involve an investment in employer securities, ROBS plans are rarely structured as ESOPs. The code and Treasury regulations prescribe numerous requirements for ESOPs, including the requirement that the plan obtain an appraisal from independent appraisers whenever it acquires employer securities and again at the end of each plan year.[15] Although all qualified pension plans, including all defined contribution plans, are required to value the plan's assets at least once annually,[16] there is no corresponding rule that requires 401(k) profit sharing plans to obtain an appraisal of employer securities.

[12] Under ERISA Section 407(b)(2), defined benefit plans may invest only 10 percent of plan assets in employer securities. Defined contribution individual account plans are not subject to such a percentage of assets limitation. See ERISA Section 407(b)(1). On ERISA's general policy of encouraging employee ownership of employers through its ESOP provisions, see *Chao v. Hall Holding Co.*, 285 F.3d 415 (6th Cir. 2002); *Kuper v. Iovenko*, 66 F.3d 1447, 1458 (6th Cir. 1995).

[13] ERISA Section 3(35).

[14] *Steinman v. Hicks*, 352 F.3d 1101, 1103 (7th Cir. 2003).

[15] Code Section 401(a)(28)(C) requires ESOPs to obtain an annual valuation of closely held stock of an employer by an independent appraiser. The service requires that the appraisal be prepared by an individual who holds himself or herself out to be an appraiser, or performs appraisals on a regular basis, and is qualified to make appraisals of the type of property being valued. In order to satisfy the ''independence'' requirement, the appraiser cannot have a financial interest in the company or have a relationship with any party to the transaction with respect to which the valuation is being made. Treas. Reg. Section 54.4975-11(d)(5).

[16] See Revenue Ruling 80-155, 1980-1 C.B. 84.

As discussed below, however, it may be advisable to obtain one in certain circumstances.

Unless a plan is specifically structured as an ESOP, the regulations governing ESOPs, including the requirement for an annual appraisal of the employer securities by independent appraisers, do not apply. There is little risk that the ESOP rules could properly be applied to a ROBS plan absent a specific intent to have the plan designed as an ESOP.

There is little risk that the ESOP rules could properly be applied to a ROBS plan absent a specific intent to have the plan designed as an ESOP.

The service cannot treat the plan as an ESOP ''unless it meets the requirements of section 409(h), section 409(o), and, if applicable, section 409(n), section 409(p), and section 664(g) and, if the employer has a registration-type class of securities (as defined in section 409(e)(4)), it meets the requirements of section 409(e).''[17] In addition, Treasury Regulations Section 54.4975-11(a)(2) expressly requires that the plan document must specifically designate the plan as an ESOP.

The 'Qualifying Employer Security' Rules Under ERISA Section 407(d)(5) Are Applicable to ROBS Arrangements. Another potential area for confusion is with the term ''qualifying employer security.'' The term is defined in ERISA Section 407(d)(5).[18] Separately, in the context of an ESOP, code Section 4975(e)(8) provides that the term ''qualifying employer security'' means any employer security within the meaning of code Section 409(l).[19]

The definition for ''employer security'' set forth in code Section 409(l) is significantly different than the definition provided in ERISA Section 407(d)(5). So which definition applies in the context of the ERISA Section 408(e)/code Section 4975(d)(13) exemption? The service has clarified that, for purposes of meeting the exemption under code Section 4975(d)(13), the definition of ''qualifying employer securities'' in ERISA Section 407(d)(5) controls.[20] Therefore, the qualification requirements set forth in code Section 409(l) should not be at issue in an IRS examination of a ROBS arrangement either.

IRS's Examination Procedures For Employee Plans

The IRS Examination Process of a Plan With ROBS Features Should Be Similar To a Routine Employee Plan Examination

The IRS examiner's primary objective is to determine whether the form and operations of the plan are in accordance with:

- the qualification rules set forth in the code, and
- the terms of the plan documents.[21]

In addition, IRS examiners will consider whether the plan has engaged in any prohibited transactions and whether the plan's books and records are being properly maintained. IRS examiners are concerned with protecting the government's interests as well as the interests of the plan's participants.

Examinations of pension plans are typically more complex than individual income tax examinations. Examiners are instructed to consider, inter alia, the following potential issues:

- whether the form of the plan complies with the qualification rules;
- whether eligible employees are covered by and benefiting under the plan in accordance with the standards set forth in code Section 410;
- whether the minimum vesting standards of code Section 411 are satisfied;
- whether the contributions and accruals are calculated correctly in accordance with the plan provisions and code Section 411;
- whether the plan complies with the code's discrimination rules under code Section 401(a)(4), including the rules regarding nondiscrimination of allocations and/or accrual of benefits and benefits rights and features;
- whether the plan is ''top-heavy'' and, if so, whether it is operating in accordance with plan provisions and code Section 416;
- whether family members are participants in the plan and are actually working for the employer;
- whether any employees, including family members, received impermissibly favored eligibility, benefits, or vesting as compared to other participants;
- whether, with respect to 401(k) plans, the plan passes the average contribution percentage (ACP) and actual deferral percentage (ADP) tests;
- whether the annual addition restrictions of code Section 415 are satisfied;
- whether the employer's deductions for plan contributions are within the limits set by code Section 404;

[17] Code Section 4975(e)(7)(b).

[18] The term ''qualifying employer security'' means an employer security that is (A) stock, (B) a marketable obligation (as defined in subsection (e) of this section), or (C) an interest in a publicly traded partnership (as defined in Section 7704(b) of Title 26), but only if such partnership is an existing partnership as defined in Section 10211(c)(2)(A) of the Revenue Act of 1987 (Pub. L. No. 100-203). ERISA Section 407(d)(5).

[19] For purposes of code Section 409(l), ''employer securities'' is generally defined as common stock issued by the employer (or by a corporation that is a member of the same controlled group) that is readily tradable on an established securities market. Where there is no readily tradable common stock that meets the requirements previously described, the term ''employer securities'' means common stock issued by the employer (or by a corporation that is a member of the same controlled group) having a combination of voting power and dividend rights equal to or in excess of (A) that class of common stock of the employer (or of any other such corporation) having the greatest voting power, and (B) that class of common stock of the employer (or of any other such corporation) having the greatest dividend rights. Preferred stock may also qualify as ''employer securities'' for purposes of code Section 409(l) in certain circumstances.

[20] CCA 200109010.

[21] Internal Revenue Manual Section 4.71.1.3

- whether the minimum funding standards set forth in code Section 412 are satisfied to the extent applicable;
- whether the plan assets are held in trust and are properly titled;
- whether the plan assets, income, and loss are being properly accounted for; and
- whether the plan engaged in any prohibited transactions under code Section 4975(c).

In examinations involving ROBS arrangements, the examiners may focus on the following additional issues:

- the initial and subsequent valuations of employer stock;
- whether the business was actually formed and operated;
- whether employees were offered the opportunity to participate in the plan;
- whether the plan was operated in accordance with the plan documents; and
- whether the substance of the ROBS arrangement was consistent with its form.

These issues are discussed in further detail below.

Typical Issues in an IRS Examination Of a ROBS Arrangement

There is limited published guidance that specifically addresses ROBS arrangements, aside from the previously mentioned 2008 IRS ROBS Memo. The IRS ROBS Memo raised several potential operational issues that examiners were instructed to consider.

Although the ROBS Memo is an internal IRS document and not ''guidance'' that can be relied on by the public, it provides useful insight into IRS's internal thinking on these issues. According to IRS, ''the two primary issues raised by ROBS arrangements are (1) violations of nondiscrimination requirements, in that benefits may not satisfy the benefits, rights and features test of Treas. Reg. section 1.401(a)(4)-4, and (2) prohibited transactions, due to deficient valuations of stock.'' The former issue only applies to plans covering highly compensated employees (HCEs). The latter issue could apply to any ROBS 401(k) plan.

Nondiscrimination Requirements: Benefits, Rights, and Features

The tax laws seek to prevent employers from providing tax-advantaged retirement benefits to limited groups of employees. Congress is especially sensitive to concerns that employers may attempt to discriminate against lower-paid employees by extending preferential coverage, benefits, rights, or features only to higher-paid employees. The code's nondiscrimination rules are designed to ensure that HCEs are not disproportionately benefited by a plan.[22]

Nondiscrimination issues should only arise in cases involving custom plans that were not previously approved by the service or cases involving plans that cover HCEs. If there are no HCEs covered by the plan, there should not be any discrimination issues. In cases where all employees of the company are HCEs, and thus only HCEs are covered by the plan, the nondiscrimination rules will be automatically satisfied as long as the plan documents are not defective.

There are two sets of nondiscrimination rules: coverage rules and contribution and benefits rules (''benefits rules''). These rules are discussed below.

Coverage Rules

Code Section 410 sets forth rules governing the age and service requirements for qualified pension plans, and requires such plans to ''cover'' or benefit a minimum percentage of non-highly compensated employees (NHCEs). Certain employees may be excluded from plan coverage so long as the plan's coverage does not discriminate in favor of HCEs.

The coverage rules require plans to perform various ''coverage tests'' on an annual basis to ensure that the plan complies with the code's minimum coverage standards. Plans are required to satisfy either the ratio percentage test or both the nondiscriminatory classification test and the average benefits percentage test.[23]

The regulations prescribing these requirements are complex and beyond the scope of this article. In general, the coverage tests are designed to ensure plans satisfy minimum standards for covering NHCEs. A properly structured and administered ROBS plan should satisfy these requirements. Plans that fail to satisfy these requirements or properly correct failures risk disqualification. Therefore, it is critical for plan administrators to regularly consult with competent advisers who have experience applying the coverage rules.

There are no coverage issues that are unique to plans with ROBS features. In most IRS examinations involving ROBS arrangements, coverage issues should not arise because either there are no other employees (i.e., the plan covers a single employee-owner) or there are no HCEs (i.e., the plan owns more than 95 percent of the corporate stock and all of the employees are paid less than the limits prescribed by code Section 414(q)(1)(B)).

Benefits Rules

In addition to the coverage rules, qualified plans are also prohibited from discriminating in contributions or benefits under code Section 401(a)(4). The Treasury regulations contain three basic requirements for determining whether a plan discriminates in favor of HCEs:

- contributions or benefits must be nondiscriminatory in amount;
- the plan's benefits, rights, and features (BRFs) must be made available to participants in a nondiscriminatory manner; and
- the timing of plan amendments and terminations must be nondiscriminatory.

In terms of satisfying the nondiscriminatory amount requirement, defined contribution plans may be structured as ''safe harbor plans,'' which automatically satisfy the regulatory requirements by allocating contributions and forfeitures based on percentages of compen-

[22] The term ''highly compensated employee'' or ''HCE'' is defined in code Section 414(q)(1) as an employee who was a 5 percent owner in that year or the preceding one, or who in the preceding year received compensation in excess of an amount indexed for inflation and, if the employer elects, was in the top paid group of employees for that year. An employee who earned $110,000 in 2010 is an HCE for 2011. See also IRS Notice 2010-78.

[23] See code Section 410(b); Treas. Reg. Section 410(b)-3.

sation.[24] If it does not satisfy a safe harbor design, the plan must be tested to ensure that it does not impermissibly benefit HCEs. For a 401(k) plan, the testing for nondiscriminatory contributions or benefits is satisfied if the plan meets the ADP and ACP tests.[25]

Treasury regulations require plans to "test" annually whether the plan's BRFs are made available to participants in a nondiscriminatory manner.

The Treasury regulations further require plans to "test" annually whether the plan's BRFs are made available to participants in a nondiscriminatory manner. These tests are discussed immediately below.

In addition, administrators are required to ensure that any plan amendments do not discriminate in favor of HCEs. These rules are described further below. Again, in cases where a company employs only HCEs or only NHCEs are covered by the plan, the benefits rules will also be automatically satisfied, so long as the plan documents are not defective.

BRF Discrimination Tests. BRFs include optional forms of benefit distribution (e.g., the choice between a lump sum or installment payments), ancillary benefits (e.g., Social Security supplements or ancillary life insurance benefits), or any other right or feature under a plan that can be expected to have a meaningful value (e.g., different contribution allocation formulas or a particular form of investment). BRFs must be both currently and effectively available on a nondiscriminatory basis.[26]

There are several annual "tests" for compliance with the BRF current availability nondiscrimination rules. These tests involve preparing various computations in accordance with formulas set forth in the Treasury regulations to determine whether the BRF is currently available to a broad enough group of NHCEs to be considered nondiscriminatory. Utilization of the BRF is not relevant for determining nondiscriminatory availability. Thus, if the BRF is available on a nondiscriminatory basis, the fact that only HCEs utilize the BRF is not relevant.

In addition to being currently available on a nondiscriminatory basis, BRFs must be effectively available on a nondiscriminatory basis. "Effective availability" is a facts-and-circumstances test.[27] The rules for determining whether the BRFs provided under a plan are made effectively available in a nondiscriminatory manner are set forth in Treas. Reg. Section 1.401(a)(4)-4. Where the conditions for availability of a BRF are designed in a way that makes it unavailable to NHCEs, or where the availability of the BRF is not communicated to NHCEs, the BRF may be found to be effectively discriminatory.

The details of nondiscrimination testing are complex and beyond the scope of this article. However, there are no BRF testing issues that are unique to ROBS arrangements. Key here is that plan administrators who lack experience applying these rules regularly seek guidance from experienced advisers to ensure that the annual plan testing is administered and to identify and correct any potential issues or failures.

If timely identified, plans that fail to satisfy the nondiscrimination requirements for BRFs or discriminatory amendments may be retroactively corrected through a "corrective amendment."[28] Once a plan is under examination, counsel should ensure that the annual nondiscrimination testing has been correctly performed and, if necessary, attempt to correct any errors as soon as they are identified.

IRS Examiners Typically Focus on BRF Effective Availability. One of the primary concerns IRS expressed in the 2008 ROBS Memo is that ROBS arrangements may not satisfy the "effectively available" requirement of the BRF nondiscrimination rules. According to the memo, the service "believes that some [ROBS] plans violate the anti-discrimination provisions of the Code and Regulations, on a case-by-case basis."

In most ROBS arrangements there are no individuals who fall within the statutory definition for HCE, so these rules do not apply. Most new business owners' compensation is well below the limits set forth in code Section 414(q)(1)(B). In addition, the employer securities that are held by the plan are considered trust assets and are not attributed to individual participants for purposes of determining whether a participant is an HCE.[29]

Therefore, the first step when an examiner raises nondiscrimination failures for a plan is determining whether the rules are even applicable.

IRS correctly points out in the ROBS Memo that a "specific provision of a benefit that is limited to highly compensated employees risks violates [sic] the nondiscrimination provisions of the Code, which could result in plan disqualification." According to IRS, "the issue of discrimination arises [in ROBS arrangements] because the plan is designed in a manner that the BRF will never be available to any NHCEs."

Therefore, IRS agents are instructed that "ROBS cases should be developed for discrimination issues whenever a given plan covers both HCEs and NHCEs, and no extension of the stock investment option is afforded to NHCEs." Here, the service is acknowledging that nondiscrimination is a non-issue in cases where the plan does not cover HCEs.

Moreover, if, at the time of the ROBS arrangement, the individuals participating in the plan were NHCEs, then it stands to reason that the plan was designed in a manner such that the BRFs could be made available to NHCEs. In other words, in most cases a ROBS arrange-

[24] See Treas. Reg. Section 1.401(a)(4)-2(b)(2); Treas. Reg. Section 1.401(a)(4)-3(a)(1).

[25] See code Sections 401(k) and 401(m) and the Treasury regulations issued thereunder. Under these regulations, the plans must be tested annually, unless structured as "safe harbor plans," which automatically satisfy the regulatory requirements by allocating contributions and forfeitures based on percentages of compensation. In addition, there are various remedial procedures that may be employed to correct failures to comply with the nondiscrimination requirements.

[26] See Treas. Reg. Section 1.401(a)(4)-4.

[27] See Treas. Reg. Section 1.401(a)(4)-4(c).

[28] See Treas. Reg. Section 1.401(a)(4)-11(g).

[29] Code Section 318 is applied to determine ownership. Code Section 318(a)(2)(B)(i) expressly precludes attribution of stock owned by a plan described in Section 401(a) to any participant in the plan for whose benefit the stock is held in trust.

ment cannot possibly violate the discrimination rules. Given these circumstances, the ROBS Memo's generalization that these types of plans are ''designed in a manner that the BRF will never be available to any NHCEs'' is certainly unsupported.

In most cases a ROBS arrangement cannot possibly violate the discrimination rules.

In a ROBS arrangement where amounts have been rolled over or transferred into the plan from other qualified retirement plans and then invested in whole or in part in employer securities, a preliminary issue with respect to a nondiscrimination challenge is whether the right to roll over retirement funds and/or acquire employer securities is a BRF that is currently available on a nondiscriminatory basis. As noted above, the BRFs of a plan include all forms of optional benefits, ancillary benefits, and other rights and features available to any employee under the plan.[30]

The term ''other rights and features'' specifically includes ''the right to a particular form of investment, including, for example, a particular class or type of employer security (taking into account, in determining whether different forms of investment exist, any differences in conversion, dividend, voting, liquidation preference, or other rights conferred under the security).''[31] The right to make rollover contributions and transfers to and from the plan is also specifically included in the regulatory definition.[32] Therefore, the provisions in ROBS plans should be drafted in a nondiscriminatory manner that affords HCEs and NCHEs the same rights to roll over retirement funds and to acquire employer securities. This should satisfy the current availability requirement for these BRFs.

The second, more common, nondiscrimination issue for ROBS plans covering HCEs is whether the right to roll over retirement funds and acquire employer securities is effectively available in a nondiscriminatory manner. As noted above, the determination of whether benefits are ''effectively available'' is made on the basis of all facts and circumstances.[33]

The Treasury regulations provide several examples of plans where the group of employees to whom a specific benefit is effectively available substantially favors HCEs.[34] Based on these examples, if the right to purchase employer securities was limited to accredited investors and only HCEs satisfied this requirement, it appears that the service would likely take the position that the group of employees to whom this benefit is effectively available substantially favors HCEs. Likewise, if the opportunity to purchase employer securities in a particular offering was not disclosed to NHCEs, then it appears that that group of employees to whom this benefit is effectively available also substantially favors HCEs.

Therefore, it is important that plan administrators are cognizant of their obligations to ensure that NHCEs are also permitted to roll over retirement funds and acquire employer securities.

There is no basis in the code, the Treasury regulations, or case law for IRS's implied assertion that employers are required to make open-ended stock offerings in order to satisfy the effective availability requirements.

For ROBS plans involving HCEs, there can be a question as to whether the right to acquire employer securities is effectively available in a nondiscriminatory manner if the ''ROBS arrangements are designed to take advantage of a one-time only stock offering.'' According to the ROBS Memo, this ''investment feature generally would not satisfy the effectively available benefit requirement.'' Nevertheless, since the effective availability test is applied by taking into account all facts and circumstances, there would need to be some evidence indicating that only a single stock offering would be made. In reality, most aspiring entrepreneurs intend to make subsequent offerings, perhaps even through an initial public offering.

Notwithstanding, there is no basis in the code, the Treasury regulations, or case law for the implied assertion that employers are required to make open-ended stock offerings in order to satisfy the effective availability requirements. So long as the initial offering and any subsequent offerings are effectively available to NHCEs in a nondiscriminatory manner, the plan should not run afoul of this requirement.

Potentially Discriminatory Amendments. Qualified pension plans are prohibited from timing a plan amendment in a manner that has the effect of discriminating in favor of HCEs. A determination of whether the timing of a plan amendment or series of plan amendments is discriminatory is made by taking into account all of the relevant facts and circumstances, such as the relative number and length of service of HCEs and NHCEs with respect to the provision being amended.[35]

According to the ROBS Memo, ''in some ROBS versions, the provision permitting the stock investment is eliminated immediately after exchange, by means of a second amendment that serves to prospectively redact that provision.'' Such an amendment could be problematic if, based on all the facts and circumstances, the amendment had the effect of discriminating in favor of HCEs.

When an amendment fails to satisfy the nondiscriminatory amendment requirement, the employer may retroactively adopt a corrective amendment, subject to the general rules applicable to corrective amendments, discussed below. Of course, if the plan did not cover HCEs

[30] See Treas. Reg. Section 1.401(a)(4)-4(a).

[31] See Treas. Reg. Section 1.401(a)(4)-4(e)(3)(iii)(C).

[32] See Treas. Reg. Section 1.401(a)(4)-4(e)(3)(iii)(I).

[33] See Treas. Reg. Section 1.401(a)(4)-4(c)(1).

[34] See Treas. Reg. Section 1.401(a)(4)-4(c)(2).

[35] See Treas. Reg. Section 1.401(a)(4)-5.

before or after the plan amendment was adopted, this requirement would not be an issue.[36]

Corrective Amendments. If a plan fails the nondiscrimination requirements, it may be possible for the plan to adopt a corrective amendment that corrects the availability of a benefit, right, or feature.[37]

The Treasury regulations require that an amendment be made by the 15th day of the 10th month after the close of a plan year in order to be taken into account for the preceding plan year.[38] The regulations further require that the amendment not be part of a ''pattern of amendments being used to correct repeated failures with respect to a particular benefit, right, or feature.''[39]

In addition, the corrective amendment must have substance.[40] The Treasury regulations specifically provide that ''a corrective amendment making a benefit, right, or feature available to employees is not taken into account to the extent the benefit, right, or feature is not currently available to any of those employees immediately after the amendment.'' For example, a corrective amendment that permitted NHCEs to roll over funds and purchase employer securities probably would not have substance if there were no employer securities available for purchase.

If the plan administrator is unable to make a corrective amendment, the defect may be cured through a settlement agreement with the service. A plan's failure to comply with these rules should not necessarily result in disqualification.

Prohibited Transactions—Deficient Valuations

Another key issue raised in the ROBS Memo is the employer's valuation of employer stock. According to IRS:

> In all ROBS arrangements, an aspiring entrepreneur creates capital stock for the purpose of exchanging it for tax-deferred accumulation assets. The value of the stock is set as the value of the available assets. An appraisal may be created to substantiate this value, but it is often devoid of supportive analysis. We find this may create a prohibited transaction, depending on the true enterprise value.

Code Section 4975(a) imposes a tax on certain ''prohibited transactions.'' As defined in code Section 4975(c), this is equal to 15 percent of the amount involved in the transaction. If the prohibited transaction is not corrected within a specific period, the amount of tax could increase to 100 percent of the amount involved in the transaction.[41] Consequently, plan fiduciaries and other ''disqualified persons'' who engage in a ''prohibited transaction'' under the code could face substantial tax liabilities.

Title I and Title II of ERISA define the term ''prohibited transaction'' differently. One of the ''prohibited transactions'' described in Title I of ERISA is the acquisition or holding of any employer securities by a pension plan.[42] There is no corresponding provision in the code that specifically makes the acquisition or holding of employer securities a prohibited transaction subject to tax. However, code Section 4975(c)(1)(A) broadly defines a prohibited transaction to include the sale or exchange of property between a plan and a disqualified person.

Code Section 4975(d)(13) provides an exception to the code's ''tax'' on prohibited transactions for transactions that satisfy the requirements of ERISA Section 408(e). Thus, if a valuation issue is raised during an IRS examination of a ROBS arrangement, the issue should be framed as whether the acquisition or sale of employer stock satisfied the relevant requirements of ERISA Section 408(e), which are the following:

- the stock must be a qualifying employer security within the meaning of ERISA Section 407(d)(5);
- the acquisition or sale must be for adequate consideration;
- no commission may be charged; and
- the plan must be an eligible individual account plan as defined in ERISA Section 407(d)(3).

Each of these requirements is discussed in further detail below.

'Qualifying Employer Security.' The term ''qualifying employer security'' specifically includes corporate common stock.[43]

Adequate Consideration. ERISA Section 408(e) provides that adequate consideration in the case of a marketable obligation means a price not less favorable to the plan than the price determined under ERISA Section 407(e)(1). A marketable obligation is a bond, debenture, note, certificate, or other evidence of indebtedness.[44]

In most, if not all, cases involving a ROBS arrangement, the securities at issue will be common stocks, which are not marketable obligations as that term is defined in ERISA Section 407(e). Thus, the general definition for adequate consideration set forth in ERISA Section 3(18) and 29 Code of Federal Regulations Section 2550.408e(d) is applicable. A properly designed ROBS arrangement should satisfy this requirement.

In cases where there is a generally recognized market for the securities, ERISA and DOL regulations define adequate consideration as either the prevailing price on a national securities exchange or the offering price quoted by persons independent of the issuer or any party in interest. In cases where there is no generally recognized market, which will almost always be the case in a ROBS arrangement, ERISA provides that adequate consideration is ''the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary.''[45]

In 1988, the DOL proposed a regulation that defined the term ''fair market value'' for this purpose as the price at which the stock would change hands between a willing, informed buyer and sellers under no compul-

[36] Treas. Reg. Section 1.401(a)(4)-11(d)(3) provides that periods in which employees do not participate in the plan may not be taken into account in determining whether the plan satisfies Section 401(a)(4).

[37] See Treas. Reg. Section 1.401(a)(4)-11(g)(2).

[38] See Treas. Reg. Section 1.401(a)(4)-11(g)(3)(iv)(A).

[39] See Treas. Reg. Section 1.401(a)(4)-11(g)(3)(vi)(A).

[40] See Treas. Reg. Section 1.401(a)(4)-11(g)(4).

[41] See code Section 4975(f).

[42] See ERISA Sections 406(a)(1)(E), 407(a).

[43] See ERISA Section 407(d)(4).

[44] See ERISA Section 407(e).

[45] ERISA Section 3(18).

sion.[46] The proposed regulation further defined ''good faith'' to require a prudent inquiry and a written valuation by an independent person. The proposed regulation was controversial and was never issued in final form. A frequent criticism was that the requirement for written valuations would impose an undue burden on small businesses.

There is no current requirement that fiduciaries obtain appraisals from independent appraisers in order to qualify for an exemption under ERISA Section 408(e).

The proposed regulation was officially withdrawn with little fanfare in 1995.[47] Thus, there is no current requirement that fiduciaries obtain appraisals from independent appraisers in order to qualify for an exemption under ERISA Section 408(e).

There are numerous cases that consider whether a plan's acquisition of employer securities was for adequate consideration.[48] The case law generally provides that adequate consideration has two distinct parts:

- fair market value, and
- a good faith determination by the trustee.[49]

In *Donovan v. Cunningham*,[50] the U.S. Court of Appeals for the Fifth Circuit explained that when determining whether ''adequate consideration'' has been paid:

> the adequate consideration test, like the prudent man rule, is expressly focused upon the *conduct* of the fiduciaries. A court reviewing the adequacy of consideration under Section 3(18) is to ask if the price paid is ''the fair market value of the asset *as determined in good faith by the . . . fiduciary*,'' it is not to redetermine the appropriate amount for itself *de novo*. Contrary to the appellees' contentions, this is not a search for subjective good faith—a pure heart and an empty head are not enough. The statutory reference to good faith in Section 3(18) must be read in light of the overriding duties of Section 404. Doing so, we hold that the ESOP fiduciaries will carry their burden to prove that adequate consideration was paid by showing that they arrived at their determination of fair market value by way of a prudent investigation in the circumstances then prevailing.[51]

In cases where the plan purchases shares from an operating business, the corporation has assumed uncertain liabilities, or other shareholders have contributed tangible or intangible assets in exchange for stock, a prudent investigation in the circumstances then prevailing may require the plan to obtain a formal valuation of the business in order to demonstrate that there has been a good faith determination of fair market value.[52]

In most ROBS arrangements, however, the plan will typically acquire its shares of common stock for ''par value'' during the initial capitalization of the corporation. The shares are usually valued in an amount equal to paid-in capital (or book value). This simple mathematical valuation is certainly reasonable in cases where the corporation does not have other assets or liabilities at the time when the stock is acquired, and every shareholder pays the same amount for the stock.

Although the ROBS Memo states that ''the lack of a bona fide appraisal raises a question as to whether the entire exchange is a prohibited transaction,'' there is no rigid requirement that plans obtain independent appraisals.

For example, assume that a company with no assets or liabilities resolves to issue 100 shares of common stock with $1 par value. If the plan contributes $95 and receive 95 shares and an individual contributes $5 and receives 5 shares, then there can be no question that the plan received adequate consideration for its investment. The plan paid $95 and now owns 95 percent of a company with $100 in assets.

Although the ROBS Memo states that ''the lack of a bona fide appraisal raises a question as to whether the entire exchange is a prohibited transaction,'' there is no rigid requirement that plans obtain independent appraisals.[53] In fact, it would probably be unreasonable for a plan to incur the expense of obtaining an ''appraisal'' of a start-up business whose only asset was cash.

No Commission May Be Charged. In order to satisfy the requirements of ERISA Section 408(e), the plan cannot pay a commission in connection with the acquisition of employer securities. Properly structured ROBS arrangements should not involve the payment of commissions in connection with the acquisition of the employer securities.

'Eligible Individual Account Plan.' The term ''individual account plan,'' as defined in ERISA Section 407(d)(3)(A), includes ''a profit sharing, stock bonus, thrift or savings plan.'' ROBS plans are typically structured as profit sharing plans, which satisfy this requirement.

Use of Plan Assets to Compensate Plan Participants. Some commenters have asserted that an employer cannot use the proceeds from its sale of stock to the plan to compensate plan participants without running afoul of

[46] See Prop. Reg. 29 C.F.R. Section 2510.3-18(b), 53 Fed. Reg. 16732 (May 17, 1988).

[47] See 60 Fed. Reg. 23559 (May 8, 1995).

[48] See *Neil v. Zell Co.*, No. 08 C 6833, 2009 U.S. Dist. LEXIS 117735, (N.D. Ill. 2009); *Pietrangelo v. NUI Corp.*, No. Civ. 04-3223, 2005 U.S. Dist. LEXIS 40832 (D.N.J. 2005).

[49] See 29 U.S.C. Section 1002(18)(B).

[50] 716 F.2d 1455 (5th Cir. 1983).

[51] Id. at 1467-68 (footnotes omitted); see also *Reich v. Valley National Bank of Arizona*, 837 F.Supp. 1259, 1280-81 (S.D.N.Y. 1993).

[52] See *Henry v. Champlain Enterprises*, 445 F.3d 610 (2d Cir. 2006); *Keach v U.S. Trust Co.*, 419 F.3d 626 (7th Cir. 2005); *Donovan*, 716 F.2d 1455 (5th Cir. 1983).

[53] See *Foltz v. U.S. News & World Report Inc.*, 663 F.Supp. 1494 (D.D.C. 1987) (''Neither ERISA nor the documents under which the Plan operated provide any affirmative directive as to how the . . . stock should have been valued.'').

the prohibited transaction rules. It appears that IRS's concern here is that business owners will attempt to skirt the rules applicable to qualified pension plans that generally prohibit a distribution of benefits prior to termination of employment by adopting a plan with ROBS features in order to ''pay themselves a salary'' out of their retirement plan assets.

This view is inconsistent with the broad language of ERISA Section 407(b)(1), which was intended to permit plan participant investment in employer securities within an individual account plan. As long as the plan does not pay more than fair market value for the employer securities, the requirements of ERISA Section 408(e) should be satisfied.

Moreover, this concern overlooks the simple fact that there is no tax benefit to ''paying yourself a salary'' out of retirement funds, due to employment taxes. From an economic perspective, it makes no sense to pay employment taxes (at a 15.3 percent tax rate, plus income taxes) in lieu of an early distribution penalty (at a 10 percent rate, plus income taxes). If an entrepreneur believes he will need to tap his retirement funds for personal use while starting up the business, he is better off simply taking a distribution directly from the plan and paying the tax and distribution penalties.

Annual Valuations of Employer Securities

The ROBS Memo points out that a plan's failure to obtain an annual valuation raises plan qualification issues. ERISA Sections 103(a)(1)(A) and 104(b) require most employee plans to file an annual report, on Form 5500, with the secretary of labor, and to furnish a summary of that report to plan participants. ERISA Section 103(b) provides that the report must include a financial statement that details the ''current value'' of the plan's assets.

''Current value'' under ERISA is defined as ''fair market value where available and otherwise the fair value as determined in good faith by a trustee or a named fiduciary . . . pursuant to the terms of the plan . . . assuming an orderly liquidation at the time of such determination.''[54] There is no requirement under this subsection that the trustee or named fiduciary engage an appraiser or that the valuation be determined by an independent third party. Indeed, ERISA specifically requires that the financial statement report ''the fair value as determined in good faith by a trustee or a named fiduciary.''

Revenue Ruling 80-155 similarly requires a defined contribution plan to prepare an annual valuation of investments held by the trust in accordance with a method consistently followed and uniformly applied. According to the revenue ruling, the fair market value on the inventory date is to be used for this purpose.

The purpose of this valuation is to satisfy the code's requirement that profit sharing plans allocate and distribute the funds accumulated under the plan pursuant to a definite predetermined formula that ensures that the plan's benefits are based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants that may be allocated to such participant's account.[55] Although the valuation method must be consistently followed and uniformly applied, the valuation of trust assets may be less formal in years where there are no allocations or distributions of assets accumulated under the plan.[56] In addition, the valuation may be made by the plan administrator or trustee—there is no requirement in the revenue ruling that the valuation be performed by an independent appraiser.

The revenue ruling does not define ''fair market value'' or provide specific rules for valuing plan assets. Fair market value is generally considered the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.[57] In addition, the hypothetical buyer and seller are assumed to be well informed about the property. The courts have applied these principles to ERISA.[58]

The service recognizes that valuation is not an exact science. According to the service, ''a sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment, and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.''[59]

There is a series of revenue rulings that address the approach, methods, and factors that should be considered in valuing shares of the capital stock of closely held corporations. Although these revenue rulings were originally issued in the context of estate tax and gift tax valuations, the principles have been extended to income tax matters.[60] Revenue Ruling 59-60 provides several of the factors that are relevant to the valuation of stock of closely held corporations, including:

- the nature of the business and the history of the enterprise from its inception;
- the economic outlook in general, and the condition and outlook of the specific industry in particular;
- the book value of the stock and the financial condition of the business;
- the earning capacity of the company;
- the dividend-paying capacity;
- whether or not the enterprise has goodwill or other intangible value;

[54] See ERISA Section 3(26).

[55] See code Section 414(i); Treas. Reg. Section 1.401-1(b)(1)(ii).

[56] The IRM provides that ''the valuation in a single participant plan, a self-directed account, or frozen plan can be less formal in a year in which the plan or self-directed account receives no contribution and makes no distribution or change in investment.'' IRM Section 4.72.8.1.2 (Sept. 1, 2006).

[57] See *United States v. Cartwright*, 411 U.S. 546 (1973) (applying definition of fair market value); *Almota Farmers Elevator & Warehouse Co. v. United States*, 409 U.S. 470 (1973) (applying definition to fair market value in context of takings clause); *Klapmeier v. Telecheck International Inc.*, 482 F.2d 247, 252 (8th Cir. 1973) (determining fair market value in context of securities fraud); *Transwestern Pipeline Co. v. O'Brien*, 418 F.2d 15, 17 (5th Cir. 1969) (determining fair market value in context of takings clause); *Fitts Estate v. Commissioner*, 237 F.2d 729, 731 (8th Cir. 1956).

[58] See *Sommers Drug Stores Co. Employee Profit Sharing Trust v. Corrigan*, 793 F.2d 1456 (5th Cir. 1986) (applying definition of fair value in ERISA breach of fiduciary duty matter).

[59] See Rev. Rul. 59-60.

[60] See Rev. Ruls. 59-60, 70-287, and 80-213; see also Rev. Rul. 68-609 (extending principles to valuations for income tax purposes).

- sales of the stock and the size of the block of stock to be valued; and
- the market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

Most of these factors will not be relevant in cases involving start-ups where the business has a limited financial history, earnings, dividend-paying capacity, goodwill, or intangible value.[61] In the case of a start-up, the critical factor is likely to be the book value of the stock and the general financial condition of the business.

If the business has limited operations, the value of the business will generally remain equal to the amount of paid-in capital. On the other hand, in cases where the financial condition of the business changes rapidly, the earning capacity of the company should be taken into account and a more detailed analysis should be performed by the plan administrator or trustee.

The plan administrator should apply sound business principles of evaluation and conduct a prudent investigation of the relevant circumstances. In cases where there are sales or distributions of plan assets, substantial changes in the business's financial condition, or a substantial number of participants, it may be reasonable to obtain a professional valuation of the business. In other cases, however, it may be unreasonable for the plan or sponsor to incur substantial fees in connection with an annual valuation.

The absolute key here is that the plan administrator exercise good faith, common sense, informed judgment, and reasonableness under the circumstances.[62]

Communication to Employees

In order to satisfy the qualified plan requirements, the business must inform its employees that they have the opportunity to participate in the plan. Quite simply, a company cannot have a secret 401(k) plan. Likewise, businesses should not discourage employee participation in their retirement plans.

Businesses should not have trouble complying with these simple requirements. Nevertheless, in industries with high employee turnover, it can be difficult to establish during an IRS examination several years after the fact that employees were informed about a plan.

In order to demonstrate compliance, businesses should maintain sufficient written records to demonstrate that employees were offered the opportunity to participate in the plan and declined. For example, the business should consider obtaining a signed acknowledgement from its employees upon receipt of the plan's summary plan description and keep this with the plan's records.

Other Potential Examination Issues

Recordkeeping. Despite the service's efforts to simplify reporting and recordkeeping requirements for pension plans, these requirements can be daunting to new business owners who are not accustomed to complying with a complex regulatory regime. ERISA recordkeeping requirements are well beyond the scope of this article.

In general, entrepreneurs who are considering funding their businesses through a ROBS arrangement should take time to understand and comply with their ongoing responsibilities. Plan administrators should strongly consider engaging professional advisers to assist them with complying with their reporting and recordkeeping obligations. It is more economical for an administrator to engage professional return preparers and recordkeepers than to pay an attorney to fix errors during an IRS examination.

Substance-Over-Form Doctrine. A fundamental principle of taxation is that courts ''look to the objective economic realities of a transaction rather than to the particular form the parties employed.''[63] In order to have a valid ROBS arrangement, the entrepreneur must intend to use the funds for legitimate business operations. Likewise, the entrepreneur must intend to permanently form and administer a pension plan and must reasonably believe that the plan's acquisition of corporate securities is an appropriate investment of plan assets.

If an individual engages in a ROBS arrangement and does not actually establish an operating business, then the entire plan could be disregarded for tax purposes. Individuals cannot avoid paying tax on early distributions from qualified plans by simply funneling the distribution through a phony plan or a corporate shell. Similarly, individuals cannot use retirement assets to support hobbies or personal activities without risking the possibility that the entire arrangement will be disregarded for tax purposes.

Individuals who adopt employee benefit plans with the intent of skirting the early distribution rules through artifice or who otherwise fail to meet the qualified plan rules should expect harsh treatment by the service.

Permanency and Plan Termination. ROBS plans must satisfy the permanency requirement described in Treas. Reg. Section 1.401-1(b)(2). This requirement provides that ''although the employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general.''[64] Thus, the decision to terminate a plan for reasons other than business necessity should not be undertaken lightly.

There are many reported stories about entrepreneurs who have created successful businesses through ROBS arrangements. However, it is an unfortunate reality that some businesses fail. There is no question that aspiring entrepreneurs should consider the potential risks before investing their retirement savings in a start-up business. It is equally important for entrepreneurs to be mindful of their obligations under the tax laws once they make a decision to wind up business operations.

[61] See Harold S. Peckron, *How Much Is That Doggie in the Window?—Tax Considerations in Valuing a Business*, 2 Barry L. Rev. 87 (2001) (discussing challenges associated with valuing a small, closely held business).

[62] See Rev. Rul. 59-60, Section 3.01 (identifying three mandatory factors for valuing small businesses as ''common sense, informed judgment and reasonableness'').

[63] *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978) (reviewing general substance-over-form principles).

[64] See Treas. Reg. Section 1.401-1(b)(2).

Termination of a plan within three years of its establishment may draw inquiries from the service, questioning whether the plan was intended to be ''permanent''—if not, the plan could be disqualified. Further, notwithstanding the fact that the plan's employer securities may have lost their value, a plan administrator cannot simply walk away from a pension plan without incurring IRS scrutiny and potential tax liability. In many cases, plan administrators will need to engage (and pay) professionals to assist them with this process.

Plan administrators should ensure that they have reserved sufficient assets to properly unwind the ROBS arrangement and roll over or distribute any remaining plan assets.

Conclusion

Despite some commenters' rhetoric, ROBS arrangements should not be characterized as tax shelters or loopholes. From a tax perspective, there is nothing fundamentally unusual or improper about rolling over existing retirement plan assets to fund a new business. In fact, ERISA's statutory framework expressly permits it.

Nevertheless, there are several potential operational defects in some ROBS plans that entrepreneurs should be aware of and take steps to avoid. Specifically, entrepreneurs should:

- ensure that their plan documents meet the requirements of a qualified plan (either by using a prototype plan document or by timely obtaining a determination letter for the plan);
- ensure that, if the plan covers HCEs, it does not provide benefits in a manner that impermissibly discriminates against NHCEs;
- ensure that the plan's acquisition of employer securities satisfies the requirements of ERISA Section 408(e); and
- most importantly, take seriously their ongoing responsibilities as administrators and fiduciaries of their companies' retirement plans.

Despite the seemingly harsh language in the ROBS Memo, in practice IRS officials recognize that ROBS arrangements may be designed to serve legitimate business and tax planning purposes. But there is also no question that ROBS arrangements, like many tax-advantaged transactions, can present opportunities for abuse. Therefore, it is important that entrepreneurs who engage in ROBS arrangements and IRS agents who examine these plans understand this complex regulatory regime and the facts and circumstances of the arrangements.