

# **Startup Business Finance Using Your Retirement Account**

## **Rollover Business Startups**

Presented by:

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**WARNING: DO NOT  
FINANCE YOUR BUSINESS  
START UP THIS WAY**

# Situation:

- ▶ 40 year old with \$300,000 in her employer's 401(k)
- ▶ She is getting ready to leave to start her own business
- ▶ Needs \$300,000 for down payment on franchise, equipment, space, IP license . . .

# Funding Options

- ▶ She could use other savings
- ▶ She could borrow from friends & family
- ▶ She could attempt to get a business loan
- ▶ She could seek investment from venture capitalists or angel investors
- ▶ However, she may also be tempted to use her 401(k) balance to fund the startup

# Typical US Household Assets at a Glance

- ▶ US household (w/ undergraduate & graduate/doctoral degree):
  - ▶ Has a house with equity equal to \$145,000 (undergrad) or \$192,000 (graduate/doctoral)
  - ▶ has \$3,600 (undergrad) or \$4,200 (graduate/doctoral) in a bank savings account
  - ▶ has \$170,000 (undergrad) or \$270,000 (graduate/doctoral) in a retirement account
- ▶ Much of that wealth is illiquid and cannot be readily called upon for entrepreneurial purposes
- ▶ On average, retirement assets make up about 34% of household financial assets
- ▶ Makes it more tempting to use retirement accounts to fund start-ups
  - ▶ Wealth, Asset Ownership, & Debt of Households Detailed Tables: 2011, US Census (2011), available at <https://www.census.gov/data/tables/2011/demo/wealth/wealth-asset-ownership.html>;  
See also [https://www.ici.org/research/stats/retirement/ret\\_16\\_q3](https://www.ici.org/research/stats/retirement/ret_16_q3)

# US Retirement Market Snapshot

- ▶ ~\$25 trillion invested by retirement plans as of Q3 2016, compared to total US capital markets ~\$63 trillion
  - ▶ Retirement plans make up just shy of 40% of US capital market
- ▶ ~21% of the total market is held by: IRA ~\$7 trillion; 401(k) ~\$4.8 trillion; 403(b) and 457 plans together ~\$1.5 trillion
  - ▶ Sources: Investment Company Institute, *citing* Federal Reserve Board, Department of Labor, National Association of Government Defined Contribution Administrators, American Council of Life Insurers, and Internal Revenue Service Statistics of Income Division; available at [https://www.ici.org/research/stats/retirement/ret\\_16\\_q3](https://www.ici.org/research/stats/retirement/ret_16_q3)

# Traditional Approach – Tax Implications

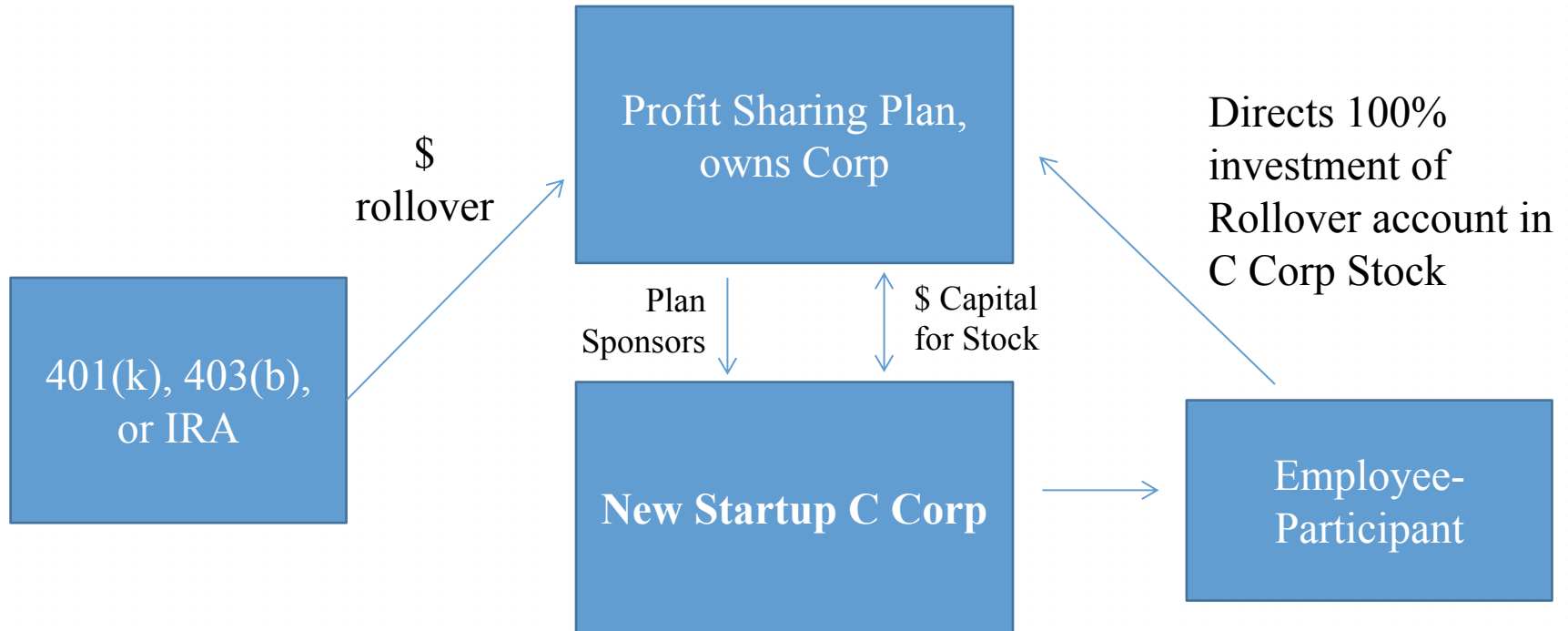
▶ Cash out 401(k)	\$300,000
▶ FIT @ 25%	\$ 75,000
▶ State Inc. Tax	?
▶ 10% Early W/D	<u>\$ 30,000</u>
▶ Funds Available	\$195,000

# Is there a more efficient way to invest in her startup?

- ▶ Rollover Business Startup (or ROBS)
  - ▶ This method is highly technical and is fraught with potential pitfalls and speed bumps
- ▶ IRS absolutely hates this method
  - ▶ There is a strong risk of IRS or DOL scrutiny
- ▶ Think carefully about putting retirement savings, and new business, at serious risk



# Basic ROBS Structure



# Tax Implication Comparison to Traditional Approach

	<u>ROBS</u>	<u>Traditional</u>
▶ Cash out 401(k)	\$300,000	\$300,000
▶ FIT @ 25%	\$ 75,000	\$ 0
▶ State tax	?	?
▶ 10% Early W/D	<u>\$ 30,000</u>	<u>\$ 0</u>
▶ Funds Available	\$195,000	\$300,000

At a cost of a lot of complexity, entrepreneur accessed 50% more cash to invest

# ROBS Technical Requirements - Formation

- ▶ ROBS are possible due to an exception to the prohibited transaction rules
- ▶ “Prohibited Transactions” are transactions between a qualified retirement plan and a “party in interest” that are prohibited by ERISA and the Internal Revenue Code (“Code”), and include a
  - ▶ sale or exchange, or leasing, of any property between the plan and a party in interest;
  - ▶ lending of money or other extension of credit between the plan and a party in interest;
  - ▶ furnishing of goods, services, or facilities between the plan and a party in interest;
  - ▶ transfer to, or use by or for the benefit of a party in interest, of any assets of the plan; or
  - ▶ acquisition, on behalf of the plan, of any employer security or employer real property in violation of ERISA § 407(a)

# ROBS Technical Requirements - Formation

- ▶ A “Party in Interest” includes:
  - ▶ (1) a fiduciary of the plan;
  - ▶ (2) a person providing services to the plan;
  - ▶ (3) an employer, any of whose employees are covered by the plan;
  - ▶ (4) an employee organization, any of whose members are covered by the plan;
  - ▶ (5) any direct or indirect owner of 50% or more of an employer or employee organization described in (3) or (4); or
  - ▶ (6) a member of the family of any individual described in (1), (2), (3), or (4) (i.e., the individual’s spouse, ancestor, lineal descendant, or any spouse of a lineal descendant)
- ▶ Because a ROBS transaction involves the sale of stock to a plan by a party in interest (i.e., the employer of employees covered by the plan), it would be prohibited under these rules unless an exception applies

# ROBS Technical Requirements - Formation

- ▶ ERISA § 408(e) exempts from the definition of prohibited transaction the acquisition or sale by a plan of “qualifying employer securities” (defined in ERISA § 407(d)(5) as stock issued by the employer of employees covered by the plan):
  - ▶ (1) if such acquisition or sale is for “adequate consideration”
  - ▶ (2) if no commission is charged; and
  - ▶ (3) if the plan is an eligible individual account plan
- ▶ An “eligible individual account plan” includes a profit-sharing plan or employee stock ownership plan that explicitly permits investment in qualifying employer securities, but specifically excludes an individual retirement account (IRA). ERISA § 407(d)(3).
- ▶ “Adequate consideration” for assets without a generally recognized market is “the fair market value of the asset as determined in good faith by a fiduciary or fiduciaries in accordance with regulations prescribed by the Secretary.” ERISA § 3(18).

# ROBS Technical Requirements - Formation

- ▶ Thus, to meet the terms of the exception:
  - ▶ The plan should be a participant-directed profit sharing plan (could also include a 401(k) feature) that expressly permits investment in qualifying employer securities
  - ▶ The business must be structured as a C-Corporation so it can issue stock meeting the definition of “qualifying employer securities”; LLCs, partnerships, or S-Corporations will not work
  - ▶ To satisfy the requirement of “adequate consideration,” the business should be appraised by a qualified independent appraiser – must have a business plan that adequately supports appraisal value determined; and
  - ▶ No commission can be charged directly or indirectly to the plan

# ROBS Technical Requirements - Operations

- ▶ Form 5500 filing – Required annually
  - ▶ While there is an exemption for plans with less than \$250,000 in assets that cover only the business' owner, this does not apply in a ROBS transaction because the plan, not the entrepreneur, owns the business
- ▶ Annual Tax return(s) for the C-Corp
- ▶ Incorporator or Board of Directors
- ▶ Annual state filing requirements
- ▶ Annual independent appraisal

# ROBS Technical Requirements – Operations

- ▶ Non-discrimination as to contributions, benefits, rights, and features under the plan, including right to rollover funds and invest in qualifying employer securities, if available
- ▶ Coverage – Participation in plan must be made available to employees of the ROBS business
- ▶ Eligible Employees – can have waiting period, age requirements, and service period requirements
- ▶ 401(k) Plans
- ▶ Summary Plan Document
- ▶ Summary Annual Reports for Participants
- ▶ Must be a *bona fide* plan with ongoing contributions



# ROBS Business as an Ongoing Operation

- ▶ Employees—proper classification as common law employees or independent contractors is critical
  - ▶ Improper classification could lead to liability for employment taxes, workers compensation requirements, employee benefits (including plan participation), etc.
- ▶ Company finance – line of credit, operating funds
  - ▶ Personal guarantee a prohibited transaction?
- ▶ Observing corporate formalities—acting in the proper role (CEO vs Plan Participant)

# IRS Audit Scenario

- ▶ Bob bought an established business, ABC Corp., through a ROBS transaction in 2013. Bob had the help of a ROBS promoter with years of experience in promoting and helping to structure these transactions.
- ▶ As a lead up to completing the sale of ABC Corp. from its previous owners, ABC Corp. established a qualified profit sharing plan in the fall of 2012.
- ▶ Bob became an employee of ABC Corp. in January of 2013. In February, Bob purchased 100% the stock in ABC Corp. through cash and his rollover account—66% bought in cash in his individual capacity and 33% as participant in the profit-sharing plan (at a slightly discounted rate). The purchases happened simultaneously. All of the ROBS steps were otherwise met.

# IRS Audit Scenario Cont'd

- ▶ When the Form 5500 for the 2012 plan year was filed, it erroneously listed Bob's participation date as October 1, 2012 due to a glitch in the software used to prepare the Form 5500.
- ▶ In 2015, the IRS conducted an audit of ABC Corp. and noticed the erroneous participation date. Although this was a reporting error, the IRS began attempts to find the entire ROBS transaction was a "prohibited transaction" under the Internal Revenue Code.
- ▶ Only after months of negotiations with the IRS, and tens of thousands of dollars in legal fees, was Bob able to prevent the unwinding the entire ROBS transaction (and substantial adverse tax consequences) and enter into a "closing agreement" to pay a relatively small fee to correct what was ultimately agreed to be, if anything at all, an insignificant operational error which led to the erroneous reporting on the Form 5500.
- ▶ Without counsel, Bob could have lost much more.

# Possible Consequences If ROBS Requirements Not Met

- ▶ Liability for excise taxes on prohibited transaction
  - ▶ 15% excise tax on the amount involved in the transaction, paid by party in interest
  - ▶ 100% excise tax on the amount involved if transaction is not corrected within the applicable taxable period
- ▶ Disqualification of Profit Sharing Plan
  - ▶ Plan loses tax-exempt status and becomes a taxable trust
  - ▶ Vested account balances may become immediately taxable to participants
  - ▶ Employer deductions for contributions may be disallowed
  - ▶ Plan owes income taxes on Trust earnings
- ▶ Correction through Audit Cap
  - ▶ To avoid disqualification, Plan may be corrected through a Closing Agreement with the IRS under its Audit Cap program
  - ▶ Will require payment of a fee, which will be less than the cost of plan disqualification but may be significant

# ROBS Outcomes

<b>FAILURE</b>	<b>SUCCESS</b>
Loss of retirement savings	Gain taxed as ordinary income (no capital gain) unless distributed in-kind under NUA rules
No capital loss deduction	Retirement contributions for rank & file
May still be subject to IRS/DOL audit	Exiting can be tricky due to IRS rules on stock transfers to entrepreneur or family members

# Exiting ROBS – Asset Sale of the Business

- ▶ Initial scenario--\$300,000 invested in C-Corp (“ABC Co.”) through ROBS transaction
- ▶ After appraisal, shareholder (Plan) approval, and all state law requirements are met (notice, meeting, any necessary filings, etc.), substantially all of ABC Co.’s assets are sold to separate, unrelated buyer (NewCo Inc.) at a price that nets \$1,300,000
- ▶ After satisfying or reserving for remaining liabilities, ABC Co. distributes sale proceeds and other assets to shareholder (Plan) and cancels and redeems stock
- ▶ The Plan terminates and distributes the funds to the Employee-ROBS entrepreneur as a termination distribution

# Exiting ROBS – Sale Cont'd

- ▶ Assumed: the Employee-ROBS entrepreneur does not rollover funds received into an IRA or other tax-deferred retirement account and that the company had no outstanding liabilities
- ▶ Tax Implications:
  - ▶ Gain: \$1,000,000
  - ▶ Corporate taxes @ 35%..... \$350,000
  - ▶ Gain after corporate taxes.....\$650,000
  - ▶ Personal taxes @ 39.6% .....\$257,400
  - ▶ Cash left after taxes.....\$392,600
  - ▶ Net Tax Rate = 60.7%
- ▶ Had this not been a ROBS transaction, the personal taxes could have been reduced to \$130,000 (Capital gains tax at 20%) and net cash left over would have been \$520,000 (+\$127,400). Net tax rate would have been 48%.
- ▶ Note: If the sale was of the *stock*, the tax implications for ROBS would be different—ordinary income tax would be paid only upon distribution from the Plan and no corporate taxes would be paid

# Exiting ROBS – Repurchase By Corporation

- ▶ If the business has sufficient cash, Corporation could repurchase the stock for adequate consideration, as determined by an independent qualified appraiser
  - ▶ Stock would return to Corporation as Treasury Stock, and cash would go into Profit Sharing Plan account
  - ▶ Redemption could occur at one time or over period of time
  - ▶ Stock or assets could be sold by Corporation to third party
  - ▶ Cash received for stock would be taxable as ordinary income when distributed
    - ▶ Could be rolled over to IRA or other qualified plan



# Exiting ROBS – In-Kind Distribution

- ▶ If entrepreneur ceases employment or is eligible for an in-service distribution, then stock could be distributed in-kind from Plan to entrepreneur
  - ▶ Generally, the fair market value of stock received would be subject to immediate ordinary income tax, plus an additional 10% tax if under age 59½
  - ▶ However, an individual receiving a lump-sum distribution of her entire plan balance from all of the employer's qualified plans paid after age 59½ or because of the participant's death or termination of employment may take advantage of the net unrealized appreciation (NUA) rules
    - ▶ Under the NUA rules, the basis in the employer securities would be subject to immediate ordinary income tax (and possibly an additional 10% tax for early withdrawal);
    - ▶ The unrealized gain would be subject to long-term capital gains tax when sold; and
    - ▶ Additional gain following the in-kind distribution would be subject to short-term or long-term capital gains tax, depending on when sold

# Reasons Not to Use ROBS

- ▶ Use up (lose) retirement savings
  - ▶ Diversity of investment versus having all your eggs in one basket
- ▶ No capital gains; gains taxed at ordinary rates under most circumstances
  - ▶ This tax implication cannot be avoided when using ROBS except pursuant to NUA rules
- ▶ IRS/DOL hassle
  - ▶ Audits are a strong possibility

# Reasons Not to Use ROBS Continued

- ▶ Cost of appraisal annually
  - ▶ This must be done annually
- ▶ Higher fees for lawyers and accountants, and additional fees for ROBS promoters and administrators
- ▶ Potential loss of equity as employees participate in the Profit Sharing Plan

# Alternatives -- Using Mom's 401(k) or IRA

## ▶ Plan Loan

- ▶ 401(k) plans may, but are not required to, permit loans
  - ▶ Loans are not permitted from an IRA
- ▶ No demonstration of need ordinarily required
- ▶ IRS limit on loans: (1) the greater of \$10,000 or 50% of vested account balance, or (2) \$50,000, whichever is less
- ▶ Loan proceeds not taxed; repay with after-tax funds
- ▶ If a loan is not repaid timely, it will be treated as a distribution and will be taxed as such, including any early distribution penalty

# Using Mom's 401(k) or IRA Cont'd

## ▶ Hardship Distribution

- ▶ 401(k) plans may, but are not required to, permit distributions on account of an immediate and heavy financial need of the employee (or spouse or dependents) if the amount requested is necessary to satisfy the need
  - ▶ Note: Hardship distributions are not permitted from an IRA
- ▶ Fully taxable when distributed, including any early distribution penalty
- ▶ No repayment required
- ▶ Helping a child start a business probably does not qualify as an immediate & heavy financial need

# Using Mom's 401(k) or IRA Continued

## ▶ Distribution

- ▶ From 401(k) plan: at severance of employment, retirement, death, disability, attainment of age 59½, or termination of the plan
- ▶ Generally no limit on when an IRA owner may take a distribution
- ▶ Fully taxable when distributed, including any early distribution penalty

# Alternatives Cont'd: Participant Directed Account

- ▶ Many profit sharing plans allow participants to direct their own investments
- ▶ Generally limited to certain investments – if no limit, mom might invest all or part of her account in child's business
- ▶ Significant risk of prohibited transaction
  - ▶ Transaction between a plan and a party in interest that is prohibited by law
  - ▶ Penalty:
    - ▶ Profit Sharing Plan: Party in interest required to pay excise tax up to 100% of the amount involved
    - ▶ IRA: transaction treated as a taxable distribution as of the first day of the taxable year in which the prohibited transaction occurred

# Other Alternatives

- ▶ Employee Stock Ownership Plan (“ESOP”)
  - ▶ Must be S or C corporation
  - ▶ Company establishes an ESOP which obtains a loan, then purchases shares in the company with the money. The company receives the money in exchange for the shares.
  - ▶ Expensive (substantial legal and valuation fees)
  - ▶ Difficulty finding a lender
- ▶ Qualified Plan Investing in Qualifying Employer Real Estate
  - ▶ Certain qualified defined contribution plans (e.g., 401(k) plans) may purchase real estate and lease it to the employer
  - ▶ Real estate must be “qualifying”
    - ▶ To be qualifying, there must be more than one property, the property must be suitable for more than one use, and the investment must be prudent and in accordance with plan documents
  - ▶ Requires annual valuations
  - ▶ Exempt from prohibited transaction rules



# Additional Information on the Firm

Kennerly Montgomery is a general practice law firm that has provided legal advice to clients for 100 years. KM attorneys practice in a variety of areas, representing private employers, non-profits, and municipal clients, including local governments, agencies and public utilities.

Bill Mason, Kathy Aslinger, and Zack Gardner practice extensively in employment and employee benefits law, which includes advising employers on individual employee issues, employment contracts, employee handbooks, as well as design, documentation, administration, audit, litigation, termination and qualification of employee health and welfare and pension plans for public, tax-exempt and private employers. They represent clients before various agencies regulating employment issues and employee benefits.

# A Little About Your Presenters

Bill Mason received his law degree from Harvard Law School in 1974, and has been practicing more than 40 years, most of that time in employment and employee benefits for employers. He worked for the Tennessee Valley Authority from 1974 – 1986, Wagner Myers & Sanger PC, from 1986 – 1988, and William E. Mason PC from 1988 – 2009. Bill joined Kennerly Montgomery in 2009. He serves on the Board of Directors for the Legacy Park Foundation and the Education Subcommittee for the United Way of Greater Knoxville. He is the past Chair of the Hillcrest Healthcare Board of Directors. In 2016, the US Treasury Department appointed him as the IRS Taxpayer Advocacy Panel (TAP) representative for Tennessee.

As a leader of Kennerly Montgomery's employee benefits practice, Kathy Aslinger focuses on advising fiduciaries for the benefit of participants, assisting both private and governmental clients in the design, implementation and maintenance of their employee benefit plans, including 401(k), pension, cafeteria, and health plans. She commonly assists clients in maneuvering through the complex world of audits, fiduciary liability issues, DOL and IRS compliance, HIPAA, COBRA, ERISA and state law obligations, as well as Affordable Care Act compliance. Kathy has been practicing law for over 18 years and has been with Kennerly Montgomery since January 2010. In addition, Kathy serves on the Board of Directors for Uplands Village, a continuing care retirement community in Pleasant Hill, Tennessee.

Zack Gardner joined Kennerly Montgomery as an associate in July of 2014. He works primarily in the firm's business & corporate law practices. He graduated cum laude from the University of Tennessee with a Concentration in Business Transactions in 2013 and also earned a Bachelor of Arts in Political Science and History, summa cum laude, from the University of Tennessee in 2010. He also serves on the Knox Bar Association's Minorities Opportunities Committee and is Co-Chair of the KBA Barristers Diversity Committee.

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