Recently, personnel in our examination and determination letter functions have identified a retirement plan design that appears to operate primarily to transact in employer stock, resulting in the avoidance of taxes otherwise applicable to distributions from tax-deferred accumulation accounts.

Although we do not believe that the form of all of these transactions may be challenged as non-compliant per se, issues such as those described within this memorandum should be developed on a case-by-case basis. Those cases currently in process or held in suspense should be worked within the context of these guidelines. Please cascade this memorandum to your managers and technical employee staff as appropriate.

EXECUTIVE SUMMARY

A version of a qualified plan is being marketed as a means for prospective business owners to access accumulated tax-deferred retirement funds, without paying applicable distribution taxes, in order to cover new business start-up costs. For purposes of this memorandum, these arrangements are known as Rollovers as Business Startups, or ROBS. While ROBS would otherwise serve legitimate tax and business planning needs, they are questionable in that they may serve solely to enable one individual's exchange of tax-deferred assets for currently available funds, by using a qualified plan and its investment in employer stock as a medium. This may avoid distribution taxes otherwise assessable on this exchange. Although a variety of business activity has been examined, an attribute common to this design is the assignment of newly created enterprise stock into a qualified plan as consideration for these transferred funds, the valuation of which may be questionable.
BACKGROUND

Employee Plans first identified ROBS provisions giving rise to these transactions through our regular compliance processes, including determination letter submissions and later project examination activity. They are proprietary defined contribution plans, generally established in the form of profit sharing plans coupled with a cash or deferred arrangement (CODA). Several different promoters have crafted variations on this design, but the elements of each are sufficiently similar that they can be addressed generally.

Although ROBS arrangements may operate as profit sharing plans, their primary purpose appears to be to provide funding for the establishment of a business or franchise. They are designed to allow a newly created business entity to retrieve available tax-exempt accumulation funds from its principal in exchange for its capital stock, simultaneously avoiding all otherwise imposable distribution income and excise taxes that would ordinarily apply to the transaction.

The typical ROBS customer is an individual seeking to start up a personal business, and having accumulated tax-deferred investment funds, usually in the form of a defined contribution account created under a prior employer’s plan. From our review of open cases, franchises are often the business form of choice, and this design is marketed as a funding method on various internet sites.

After client engagement, the practitioner-promoter apparently advises the individual to create a C-corporation. A number of corporate shares may be created, but they are not issued. After incorporation is complete, the practitioner installs a qualified profit sharing plan, sponsored by the shell corporate entity. The plan document used is generally a “pre-approved” specimen, but is usually supplemented with a single amendment. This amendment generally exists as either a stand-alone amendment or a tack-on addition to a qualified plan adoption agreement, and consists of a one paragraph provision to permit the plan to invest plan assets attributable to rollover accounts up to 100% in employer securities.

The individual then executes either a rollover or direct trustee-to-trustee transfer of the proceeds from the available tax-deferred investment account into this newly created plan. At this point, the prior account is usually liquidated; all proceeds are parked in a rollover account held in trust under the shell corporation’s plan.

The amendment provision is then acted on immediately, and the individual directs the corporation to issue and then exchange all of its capital stock into its qualified plan in exchange for the proceeds held in the rollover account. The corporate shares, now held as plan assets, are valued and booked equal to the value of available account proceeds.

1 At the time the ROBS transaction is executed, some of these amounts may remain as deferred separated accounts held under a prior plan trust, and some appear to have been rolled over into a “conduit IRA”, which was a common utility for individual retirement arrangements prior to the expanded portability provisions enacted by the Economic Growth Tax Relief and Reconciliation Act of 2001.
Usually, after the exchange of stock is complete, no other plan participant will ever receive any ability to invest in employer stock. 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. In all versions, the exchange fully allocates all of the stock to the rollover sub-account created for the benefit of the individual, and no further allocations of stock to future participants are permitted.

A ROBS transaction therefore takes the form of the following sequential steps:

- An individual establishes a shell corporation sponsoring an associated and purportedly qualified retirement plan. At this point, the corporation has no employees, assets or business operations, and may not even have a contribution to capital to create shareholder equity.

- The plan document provides that all participants may invest the entirety of their account balances in employer stock.

- The individual becomes the only employee of the shell corporation and the only participant in the plan. Note that at this point, there is still no ownership or shareholder equity interest.

- The individual then executes a rollover or direct trustee-to-trustee transfer of available funds from a prior qualified plan or personal IRA into the newly created qualified plan. These available funds might be any assets previously accumulated under the individual's prior employer's qualified plan, or under a conduit IRA which itself was created from these amounts. Note that at this point, because assets have been moved from one tax-exempt accumulation vehicle to another, all assessable income or excise taxes otherwise applicable to the distribution have been avoided².

- The sole participant in the plan then directs investment of his or her account balance into a purchase of employer stock. The employer stock is valued to reflect the amount of plan assets that the taxpayer wishes to access.

- The individual then uses the transferred funds to purchase a franchise or begin some other form of business enterprise. Note that all otherwise assessable taxes on a distribution from the prior tax-deferred accumulation account are avoided.

² Distributions from tax-deferred accumulation accounts would generally be taxed under IRC § 72, which specifies treatment for various forms of annuity or non-annuity payments. In general, a single sum distribution would be taxed as ordinary income, at the individual's effective tax rate. Of particular concern here, the distribution would generally also be subject to the 10% "premature distribution" penalty provided by IRC § 72(t), unless the individual was at least 59½ years old on the transaction date, or met one of the other limited statutory exceptions. ROBS transactions effectively avoid all § 72 concerns.
After the business is established, the plan may be amended to prohibit further investments in employer stock. This amendment may be unnecessary, because all stock is fully allocated. As a result, only the original individual benefits from this investment option. Future employees and plan participants will not be entitled to invest in employer stock.

A portion of the proceeds of the stock transaction may be remitted back to the promoter, in the form of a professional fee. This may be either a direct payment from plan to promoter, or an indirect payment, where gross proceeds are transferred to the individual and some amount of his gross wealth is then returned to promoter.

**PROCEDURAL DEVELOPMENT OF CASES**

Employee Plans has received numerous alerts from practitioners regarding the promotion of this scheme in the marketplace. Questions regarding the legitimacy of ROBS-type transactions have been posed to the Service at various employee benefits and practitioner conferences.⁴

We have currently identified 9 promoters of this transaction. Most are actively promoting the use of ROBS at seminars that are held to assist individuals purchase business franchises. A referral to the Lead Development Center (LDC) has already been made and an LDC Investigator has been assigned.

We have also coordinated our consideration of ROBS plans with the Department of Labor (DOL). As will be noted later, the transfer of enterprise stock within a ROBS arrangement could raise ERISA Title I prohibited transaction issues. Although our coordination efforts are not yet finalized, they remain ongoing.

Additionally, SB/SE has reviewed several returns of employers who have engaged in ROBS transactions. Their examinations have largely started with a review of business tax returns, and then moved on to a review of promoter activity.

*Determinations Letter Contacts*

EP Determinations identified numerous determination letter submissions for taxpayer adoptions of these plans. Most are filed by a named representative who is also a pre-approved document platform provider. Since the type of plan used for this promotion is a prototype plan with a minor amendment that permits the investment in employer securities, we have issued some favorable determination letters for these plans. We are also likely to receive many more submissions within the two-year EGTRRA pre-approved adoption window created by Announcement 2008-23, 2008-14 I.R.B. 731.

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⁴ For example, a fact pattern describing a ROBS arrangement was presented at the American Bar Association’s 2003 Joint Committee on Employee Benefits “Q&A”. See [http://www.abanet.org/jceb/2003/qd03irs.pdf](http://www.abanet.org/jceb/2003/qd03irs.pdf), question 9 therein.
A major promoter was first identified through our determination letter program as the sponsor of a pre-approved prototype, or “M&P”, which has been approved by the Service under our pre-approved opinion letter program. This document is then marketed to clients, and is ultimately adopted by employers by the execution of adoption agreements. The base document from which client plans are administered is thus a pre-approved M&P specimen supplied by the provider which was reviewed and approved by the Service with a favorable opinion letter.

Because of the unique rules regarding scope of reliance applicable to M&P adopters, a modification of an M&P generally requires submission for a determination letter application as an individually designed plan. Thus, we are confident that the determination letter database will eventually hold a registry of most, if not all, of this promoter’s clients, once the two-year window closes on April 30, 2010.

Current Examination Contacts

We have examined a number of these plans – having opened a specific examination project on them based off referrals from our determination letter program – and found significant disqualifying operational defects in most. For example, employees in some arrangements have not been notified of the existence of the plan, do not enter the plan or receive contributions or allocable shares of employer stock. Additionally, we have identified that plan assets are either not valued or are valued with threadbare appraisals. Required annual reports for some plans have not been filed. In several situations, we have also found that the business entity created from the ROBS exchange has either not survived, or used the resultant assets on personal, non-business purchases.

Again, considering business activity that occurs, it is likely that many ROBS plans did in fact file returns that are currently in place on RICS. The amount of the asset transfer is likely to exceed the minimum $100,000 that would otherwise eliminate filing of Form 5500EZ, Annual Return/Report of Employee Benefit Plan.4

In those cases, however, where the appropriate Form 5500 or 5500EZ was not filed, issues may arise as to the proper way to correct a failure to file. For example, issues may arise due to DOL’s mandate for electronic filing beginning with the 2009 plan year and the resulting limitations on filing paper returns. It is anticipated that additional guidelines will be issued to address these situations.

4Form 5500 filing is triggered by when the value of trust assets reaches a specified level. See Treas. Reg.§ 301.6058-1(a)(1), et seq. Note that Section 1103(a) of the Pension Protection Act of 2006, Pub. L. 109-280, increased the amount of assets required for filing by one-participant plans from $100,000 to $250,000 effective for plan years beginning after December 31, 2006. Note also that Form 5500EZ will be replaced with Form 5500-SF, beginning with year 2009 filings.
PRIMARY ISSUES RAISED:

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. § 1.401(a)(4)-4, and (2) prohibited transactions, due to deficient valuations of stock.

Benefits, Rights & Features Discrimination

Because ROBS transactions generally benefit only the principal involved with setting up a business, and do not enable rank-and-file employees to acquire employer stock, we believe that some of these plans violate the anti-discrimination provisions of the Code and Regulations, on a case-by-case basis.

IRC § 401(a)(4) provides that, under a qualified retirement plan, contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees (HCEs).

IRC § 414(q)(1)(A) provides that an HCE is defined as either (1) a 5% owner, defined under the attribution rules of § 318, or (2) receives compensation over $80,000 (indexed, and subject to a “top-paid group” election by the employer.)

IRC § 318(a)(2)(B)(i) precludes attribution of stock owned by a plan described in § 401(a) to any participant in the plan for whom the stock is held for the benefit of, in trust.

Treas. Reg. § 1.401(a)(4)-1(b)(2) provides that in order to satisfy § 401(a)(4), either the contributions or the benefits under a plan must be nondiscriminatory in amount.

Treas. Reg. § 1.401(a)(4)-4(e)(3) provides that the plan’s benefits, rights and features (BRFs) are tested to see if they are nondiscriminatory in effect. BRF testing considerations can arise in many forms, including as here, the right to make investments in employer securities.

Treas. Reg. § 1.401(a)(4)-4(b)(1) indicates that whether any given BRF is “currently available” (i.e. nondiscriminatory in result) should be tested under the nondiscriminatory classification test used for coverage testing. Further, Reg. § 1.401(a)(4)-4(c) provides that a BRF must also be “effectively available” to non-highly compensated employees (NHCEs), on the basis of all facts and circumstances.

Treas. Reg. § 1.401(a)(4)-5 provides that whether the timing of a plan amendment or series of plan amendments has the effect of discriminating specifically in favor of HCEs involves a facts and circumstances determination.

In a typical ROBS arrangement, there may not be any individual who meets the statutory HCE definition. At the time when rollover funds are used to purchase...
employer stock, the stock acquires identity as a trust asset and is not attributed to the individual participant. Compensation paid then becomes the determining factor in resolving HCE status questions.⁵

In most of our cases, the amount of compensation being paid to the individual who starts-up the business is ostensibly below the IRC § 414(q)(1)(B) dollar limit, at least for initial years. While this may leave open the question as to whether true compensation being paid to the individual is actually higher than reported compensation, absent a personal tax review of the individual no one may receive compensation at or above the HCE indexed dollar limit.

Even if the ROBS initiator is an HCE, in many of our cases, there are no other employees in the initial year of the transaction or for some number of future years thereafter. Therefore, as no finding regarding discrimination can be made in absence of NHCEs in the transaction year, the current availability testing standard for plan BRFs is satisfied. This does not, however, signify that the effective availability standard is similarly resolved.

Effective availability testing requires a facts and circumstances determination regarding whether a plan feature benefits NHCEs. This determination requires consideration of factors or conditions precedent that must be satisfied in order to accrue a benefit, including timing elements and whether the transaction was structured to intentionally avoid BRF testing issues. Furthermore, Treas. Reg. § 1.401(a)(4)-5 requires consideration as to whether the timing of plan amendments serves to preclude other NHCEs from receiving stock allocations.

Given that ROBS arrangements are designed to take advantage of a one-time only stock offering, the investment feature generally would not satisfy the effectively available benefit requirement. The issue of discrimination arises because the plan is designed in a manner that the BRF will never be available to any NHCEs. For this reason, 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.

Prohibited Transactions – Valuation of Stock

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 true enterprise value.

⁵ In several of our examined cases, the transaction did not exactly follow the sequential series of steps outlined earlier. Instead, the principal received shares of the shell corporation prior to the sale back to the plan. This timing made the principal a 100% owner for a short period of time. In such a case, HCE status is conferred on start-up, perhaps creating an imminent BRF testing issue. This might also raise related prohibited transaction concerns.
IRC § 4975(a) imposes a tax on a prohibited transaction equal to 15% of the amount involved in the transaction. IRC § 4975(b) imposes a tax equal to 100% of the amount involved in any case where a prohibited transaction is not corrected within the taxable period, as defined at § 4975(f).

IRC § 4975(c)(1)(A) defines a prohibited transaction as a sale, exchange or lease of any property between a plan and a disqualified person.

IRC § 4975(e)(1)(F) defines a plan as any trust, plan, account or annuity that is exempt from tax under § 501(a), or was ever determined by the Secretary to be so exempt.

IRC § 4975(e)(2)(C) defines a disqualified person as an employer, any of whose employees are covered by the plan.

IRC § 4975(e)(2)(E)(i) defines a disqualified person as an owner, direct or indirect, of 50% or more of the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation which is an employer described in § 4975(e)(2)(C).

IRC § 4975(d)(13) provides an exemption from prohibited transaction consideration for any transaction which is exempt from ERISA § 406, by reason of ERISA § 408(e), which addresses certain transactions involving employer stock.

IRC § 4975(f)(2) defines the taxable period as the period beginning with the date on which the prohibited transaction occurs and ending on the earlier of the dates on which a) a notice of deficiency with respect to the tax imposed by § 6212(a) is mailed, b) the date on which the tax imposed by § 4975(a) is assessed, or c) the date on which correction of the prohibited transaction is completed.

IRC § 4975(f)(5) defines correction as the undoing of the transaction, to the extent possible, such that the plan is restored to a financial position not worse than it would have been absent the transaction.

ERISA § 408(e), and ERISA Reg. § 2550.408e promulgated thereunder, provides an exemption from ERISA § 406 for acquisitions or sales of qualifying employer securities, subject to a requirement that the acquisition or sale must be for “adequate consideration.” Except in the case of a “marketable obligation”, adequate consideration for this purpose means a price not less favorable than the price determined under ERISA § 3(18).

ERISA § 3(18) provides in relevant part that, in the case of an asset other than a security for which there is no generally recognized market, adequate consideration means 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.

An exchange of company stock between the plan and its employer-sponsor would be a prohibited transaction, unless the requirements of ERISA § 408(e) are met. Therefore, valuation of the capitalization of the new company is a relevant issue. Since the company is new, there could be a question of whether it is indeed worth the value of the
tax-deferred assets for which it was exchanged. If the transaction has not been for adequate consideration, it would have to be corrected, for example, by the corporation’s redemption of the stock from the plan and replacing it with cash equal to its fair market value, plus an additional interest factor for lost plan earnings.

A valuation-related prohibited transaction issue may arise where the start-up enterprise does not actually “start-up.” Here, the start-up entity might record “cash” as its only asset, without any real attempt to secure, for example, a franchise license, property, plant and equipment or other assets necessary to start a bona fide business. The valuation ostensibly legitimizing the exchange is unsupported.

Many examiners have been provided with a single sheet of paper, signed by a purported valuation specialist. This appraisal “certifies” that the value of the enterprise stock is a sum certain, the amount of which approximates the amount of available proceeds from the individual’s tax deferred retirement account.

These appraisals are questionable. Because the valuation usually approximates available funds, consideration needs to be given to whether inherent value in the plan-acquired entity actually exists. The lack of a bona fide appraisal raises a question as to whether the entire exchange is a prohibited transaction.

**Prohibited Transactions – Promoter Fees**

In the case where the plan purchases the stock of the employer, and the employer immediately pays professional fees to the promoter out of the proceeds, prohibited transactions may occur.

IRC § 4975(c)(1)(E) prohibits a fiduciary from dealing with the assets of the plan in his own interest or his own account.

IRC § 4975(e)(3) defines a fiduciary as any person who exercises any discretionary authority or control, renders investment advice for a fee, or has any discretionary authority or responsibility in the administration of the plan.

Treas. Reg. § 54.4975-9(c) defines when a person would be providing investment advice as defined in § 4975(e)(3)(B).

ERISA Reg. § 2510-3.21(c) further clarifies the meaning of the term "investment advice." Under that regulation, a person is deemed to render investment advice if such person renders advice to the plan as to the value of securities or other property, or makes a recommendation as to the advisability of investing in, purchasing, or selling securities or other property and such person either directly or indirectly has discretionary authority or control, whether or not pursuant to an agreement, arrangement or understanding, with respect to purchasing or selling securities or other property for the plan. The advice would have to be rendered on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding, written or

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6 We note that deficient valuations can also raise qualification issues. See e.g. Rev. Rul. 80-155, 1980-1 CB 84.
otherwise, between such person and the plan or a fiduciary with respect to the plan, that such services will serve as a primary basis for investment decisions with respect to plan assets, and that such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of plan investments.7

If the promoter meets these requirements, his status may rise to that of plan fiduciary. Where a fiduciary directly receives a remit-back from the plan of a portion of tax-deferred accumulation assets, this payment may be a violation of IRC § 4975(c)(1)(E). Essentially, plan assets are being transferred in exchange for services and investment advice. Specialists will need to ascertain whether this is discernable from the facts presented on their examination, and whether the requirements of Treas. Reg. § 54.4975-9(c) have been met.

Note that IRC § 4975(f)(1) provides that where more than one person is liable for prohibited transaction excise taxes, all persons are jointly and severally liable for any deficiency. Therefore, assessments against promoters for direct receipt of plan assets may be made even where assessments are proposed against the corporation or individual for invalid appraisal of the underlying stock.8

OTHER ISSUES:

Permanency

Because ROBS benefits are designed to be used only once, we have considered whether they are truly a “permanent” retirement program. Permanency is a qualification requirement for all retirement plans.

IRC § 401(a)(1) provides that a trust is established for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan.

Treas. Reg. § 1.401-1(b)(1)(ii) provides that a profit sharing plan is established to enable employees or their beneficiaries to participate in the profits of the employer’s trade or business, or in the profits of an affiliated employer who is entitled to deduct his contributions to the plan under IRC § 404(a)(3)(B), pursuant to a definite formula for allocating the contributions and for distributing the funds accumulated under the plan.

7 DOL has taken the position that this definition of fiduciary also applies to investment advice provided to a participant or beneficiary in an individual account plan that allows participants or beneficiaries to direct the investment of their accounts. See ERISA Reg. § 2509.96-1(c).

8 In an attempt to “insulate” client adopters against prohibited transaction issues, one promoter has apparently created a multiple employer plan within the meaning of IRC § 413(c), with each client adopting-in as a participating employer. Notwithstanding this attempt, the analysis supplied by this memorandum should be applied to these cases.
Treas. Reg. § 1.401-1(b) provides that a qualified plan must be created primarily for the purposes of providing systematic retirement benefits for employees. Treas. Reg. § 1.401-1(b)(2) requires that the plan be a permanent, as distinguished from temporary, arrangement, and provides a general rule that if a plan is discontinued within a few years after its adoption, there is a presumption that it was not intended as a permanent program from its inception, unless business necessity required the discontinuance, termination or partial termination.

Rev. Rul. 69-25, 1969-1 C.B. 113, provides that for purposes of invoking this “business necessity” exception, the necessity must have been unforeseeable when the plan was adopted, and cannot be within the control of the employer.

Consider that business reasons – tax motivated or otherwise – are generally the only reasons why a retirement arrangement is installed. Similarly, they are likely to be the only reason why they are terminated as well. For this reason, permanency is not an area where the Service has aggressively challenged plan terminations or design considerations. Additionally, Regulations address permanency within the context of an entire plan arrangement, not necessarily to a feature within a plan.

Therefore, a plan containing a ROBS arrangement would have to be shown to be non-permanent in its entirety. Many of the ROBS arrangements we have examined also contain a CODA feature. Plans which suffer from permanency failures are generally deficient in that they do not receive substantial and recurring contributions. Because CODA features receive contributions only if participants make contributions, the issue of permanence is resolvable in favor of the employer.

Under the specific facts presented by the cases we have examined, we are unable to find that all ROBS arrangements violate the permanency rule. However, facts of particular cases should be considered on a case-by-case basis.

**Exclusive Benefit**

As noted earlier, ROBS arrangements typically involve direction of some amount of plan assets to the promoter in payment of professional fees for setting up the transaction. In some cases, the newly created business purchased assets that were essentially personal assets for the benefit of the individual. We considered whether this violates the “exclusive benefit” requirements of the Code.

IRC § 401(a)(2) provides, in relevant part, that a plan is not qualified unless it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, for any part of the corpus or income to be used for or diverted to purposes other than for the exclusive benefit of employees or their beneficiaries.

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9 In fact, as will be noted later, some plans appear to have been established with CODAs that do not receive contributions and may not have been adequately communicated to employees. These plans would not be insulated against permanency issues.
Treas. Reg. § 1.401-1 (a)(3)(iv) provides that it must be impossible "under the trust instrument at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries.

Treas. Reg. § 1.401-2 outlines the specific provisions that a plan must follow to meet the exclusive benefit rule for purposes of Title II of ERISA. Other applicable exclusive benefit issues are contained in corresponding Title I provisions.

We have reviewed ROBS arrangements to determine whether they are truly for the exclusive benefit of employees. The facts unique to each of our ROBS cases are disparate as to the eventual disposition of tax deferred accumulation assets. In a few cases, these assets wound up purchasing personal assets, like recreational vehicles. But in many, if not most of the transactions, the assets were in fact used to purchase legitimate business or franchises, plus attendant start-up costs. Courts have generally held that whether a Title II exclusive benefit violation has occurred largely depends on whether benefits to third parties are not merely an incidental side effect of an investment of trust assets, but are instead a major purpose of the investment.

Therefore, we believe that the typical ROBS design does not violate the exclusive benefit requirement in form. However, examiners will need to develop specific operational issues, such as where trust assets were used to pay purely non-business expenses prior to pursuing exclusive benefit violations.

Plan not communicated to employees

In some cases, we have found that the existence of the plan is not communicated to people hired after the newly created business is up and running. "Participants", as identified on employee census information provided to our examiners, are not even aware that they merit this classification. If this can be established, the plan may be in violation of Treas. Reg. § 1.401-1(a)(2), requiring that it be a definite, written program communicated to employees. In some cases, employees may not reach participation status into the plan on their required entry dates, causing the plan to fail IRC § 410(a) requirements.

Inactivity in cash or deferred arrangement

A large number of reviewed plans contain election provisions in the adoption agreement to utilize a CODA. Often, low number of participants actually chose to make salary reduction contributions. However, many of our examiners found this issue and raised it, and usually received a response that the CODA was "inactive." In fact, many of these

10 However, we are aware of arrangements in which the individual transferring tax-deferred assets into the plan is not an employee, participant or owner, such as where the arrangement is used to set up a business for a spouse. Such a transfer might be one where the exclusive benefit issue is properly raised.

11 As a reminder, exclusive benefit revocation cases must be submitted for technical advice consideration under established procedures within each business unit.
plans have provisions describing a CODA feature, including applicable elections in the employer’s signed adoption agreement. There being no such thing as an “inactive” CODA, examiners should consider whether all the procedures for allowing employees to participate in the CODA were followed, whether new employees just chose not to defer, or whether employees were not even offered salary reduction elections. If it is established that employees were not permitted to make elective deferrals, the plan would violate IRC § 401(k)(2)(D) in that it did not permit eligible employees to elect salary deferral contributions.  

**COMPLETION AND MOVEMENT OF CASES**

**Determination Letter Contacts**

We have specifically considered whether the form of the plan, as presented, is entitled to a favorable determination letter ruling. There is no inherent violation in the form of a plan containing a ROBS arrangement that would otherwise prevent a favorable ruling. The issues described herein are inherently operational, and beyond the scope of a determination letter ruling. Accordingly, determination letter applications for plans with ROBS features can be reviewed and approved as appropriate. However, we will monitor the volume of approval letters issued to these plans in a manner similar to those issued to IRC § 412(i) arrangements. Current procedures for these notifications, including review by EP Determinations Quality Assurance, are to be followed for ROBS determination letter submissions.

**Open Examination Cases**

Open examination cases should be worked within the context of these guidelines. Cases presenting prohibited transaction issues should be worked under existing procedures for processing delinquent returns in agreed cases, and under unagreed procedures for all other circumstances, including appropriate referral to and coordination with DOL. Cases in which BRF discrimination is an issue should be processed first under the appropriate Employee Plans Compliance Resolution System (EPCRS) correction program. If EPCRS is not appropriate or available, then unagreed qualification procedures should be followed.

**Statute of Limitation Concerns**

For BRF discrimination and other disqualification cases, normal control procedures for protection of applicable statutes of limitation on trust and related taxable returns should be followed. This may involve converting non-calendar year plans, and annualizing income in accordance with IRC § 645(a). Related returns should be protected, generally for the individual and employer sponsor only.

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12 Also, to the extent that a CODA supports the permanency of a plan, that support expires if in fact the CODA is not in fact communicated to employees.
Similar procedures are also applicable for prohibited transaction cases, however, specialists are cautioned that one other consideration may block pursuing deficiency determinations for these cases.

IRC § 6501(a) provides that the amount of any tax, including those imposed by Chapter 43 (such as IRC § 4975) may be assessed within three years after the “return” was filed.

IRC § 6501(l) further provides that, for this purpose, the term “return” means the annual Form 5500 series return required to be filed by plan/trust for the year in which the act occurred. Therefore, in most instances, the statute of limitation to make a prohibited transaction assessment on a ROBS transaction begins with the filing of Form 5500 for the year in which the stock transaction is executed.

IRC § 6501(e)(3) provides, however, that if this information return does not adequately disclose the existence of this transaction, the ordinary limitation period on assessment is extended to six years. Adequacy of disclosure is largely a facts and circumstances determination, developed through judicial interpretation.13

Prohibited transactions are classifiable into either “discrete” one-time transactions, or “continuous” recurring transactions.14 ROBS arrangements fall into the former. In a discrete transaction, a taxable event occurs in the initial or “source” year when the prohibited exchange of stock occurs, and is deemed to be carried forward into later taxable periods until corrected.15

The Service’s position with respect to administering the limitation period on assessment applicable to discrete transactions is that the source year must be open in order to make any assessment in the source or any later year. If this source year is barred by elapse of the relevant limitation statute, no excise tax deficiency may be assessed. Given the length of time that has elapsed since many of these transactions first were created and the time involved moving these cases through our determination letter and audit cycle processes, it is likely that the three-year limitation period has either elapsed or is imminent for most of these transactions.

Therefore, ROBS prohibited transaction cases are likely to require a determination as to whether a six-year statute is open, under a failure to make adequate disclosure of the existence of the transaction in the source year. For this purpose, coordination with Area Counsel will be required.16 Specialists are reminded that statutes are to be protected, and assessments perfected, against the correct parties. Where the 3-year limitation period is open, it should be protected in lieu of relying on a 6-year period.

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13 See e.g. Janpol v. Commissioner, 102 T.C. 499 (1994)
14 Note that these terms are not derived from statute or regulation, but are administrative creations.
15 Unlike a continuous transaction, in which the taxable amount involved accumulates with a future interest factor in the manner known as “pyramiding”, a discrete transaction’s taxable amount is simply replicated forward in later years.
16 Peter Gavagan, of Northeast Area Counsel, will coordinate application of 6-year statutes of limitation to open ROBS examination cases.
CONCLUSION

ROBS transactions may violate law in several regards. First, this scheme might create a prohibited transaction between the plan and its sponsor. At the time of the exchange between plan assets and newly-minted employer stock, the value of the capitalization of the entity is equivalent to the value of all plan assets, when in reality, the entity may be valueless and asset-less for an indefinite period of time. Additionally, this scheme may not satisfy the benefits, rights and features requirement of the Regulations. The primary utility of the arrangement may only be available the business’s principal individual.

Specific facts will need to be evaluated on a case by case basis in order to make a proper determination as to whether these plans operationally comply with established law and guidance. Technical advice requests may be submitted after consultation with group managers. For this reason, employee plans specialists are directed to resolve open ROBS cases as described herein.¹⁷

¹⁷ As additional reference material, see IRM § 4.72.8, Valuation of Assets, and § 4.72. , Prohibited Transactions.