

Dangers in using IRAs for business startups

The IRS is continuing its scrutiny of "Robs" arrangements, so advisers should warn clients away

By Ed Slott

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When the Internal Revenue Service names a transaction "Robs," that can't be good. The acronym tells us how unfavorably the IRS views these "rollover as business startup" transactions, especially if they appear to be designed to sidestep the tax on individual retirement account distributions.

Some background: On Aug. 27, the IRS held a telephone forum dealing with tax avoidance transactions and employer plan compliance issues that may threaten retirement security. During the call, Monika Templeman, director of employer plan examinations, and Colleen Patton, an area manager for the Pacific Coast, addressed a number of areas that present growing concerns to the IRS.

Robs were one major area of concern. Before we get to the agency's concerns, let's look at these transactions.

At the heart of a Robs transaction is the premise of using one's own retirement assets to start a business — without paying taxes on the money. Here are the basic steps:

A new business owner has available funds in a retirement account (an IRA, for example). While this isn't an action step, it is a critical part of any Robs transaction — no retirement account, no Robs.

A new company and a new plan are established. The entrepreneur creates a new business, which then adopts a qualified plan, such as a 401(k). The plan's provisions are drafted so that they allow both the purchase of shares of the new company's stock and the ability to roll in money from existing retirement accounts.

The rollover is completed. The business owner takes his or her existing IRA (or other rollover-eligible account) and rolls it into the newly established plan at the new company.

The business owner uses the assets in the new plan to purchase shares of company stock. The IRA funds that were rolled into the plan end up in the company's checking account and not in the qualified plan (because of the exchange for stock), with no tax due on the transfer. The money is now available to pay business expenses or even the business owner's personal expenses (which definitely is not allowed), with no tax.

In addition, the shares of the newly established company's stock are frequently made available only to the entrepreneur, which could lead to violations of the non-discrimination requirements that plans must meet in order to keep their tax-favored, qualified status.

Although Ms. Templeman indicated that a Robs arrangement isn't being labeled "an abuse per se," it was clear from the tone of the call that the IRS is scrutinizing these transactions closely.

When asked by one of the callers why the IRS is showing “hostility” toward these types of transactions, she said that Robs plans are looked at on a case-by-case basis to determine whether they are compliant.

Ms. Patton added: “Theoretically, there could be a Robs that is completely compliant operationally. However, in the field, we are finding that does not happen often.”

The word “theoretically” should alert you to be on your guard if a client is considering this. Clients need to know in advance that the IRS will be scrutinizing these transactions very carefully.

The IRS also identified significant non-compliance in the valuation of company stock being purchased by the plan on behalf of the entrepreneur.

This arbitrary transfer of value could be considered a prohibited transaction, which can have disastrous tax consequences. If the IRS determines a prohibited transaction has occurred and discovers the transaction before it is corrected, it can impose a 100% tax on the funds involved.

Whether or not you agree with the IRS, it is clear that the agency is taking a tough stance when it comes to Robs arrangements. At a minimum, it seems, a client who makes such a transaction stands to draw added attention from IRS and could be committing a prohibited transaction, effectively wiping out his or her retirement funds.

Neither is an attractive proposition.

Ed Slott, a certified public accountant, created the IRA Leadership Program and Ed Slott's Elite IRA Advisor Group to help financial advisers and insurance companies