RETIREMENT

Don’t Let ROBS Steal Your Retirement

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Retirees are more vibrant today than they have been at any other time. They’re more active in their communities. They travel more than ever (at least, those that want to travel). They are even starting businesses at a faster rate today than in previous eras.

One of the more significant challenges of starting a new business is accumulating the capital to fund that business initially. One intriguing option is to access your existing 401(k) funds. This can be done without withdrawing the funds and therefore avoiding any interest or penalty payments.

"Purchasing or starting a new business can be very expensive and risky," says Megan Slatter, Wealth Advisor at Crewe Advisors in Salt Lake City. "Rollovers as Business Startups ("ROBS") can be a powerful solution for someone with a great business idea but may otherwise not have access to start-up capital. It allows them to use retirement assets saved in a 401(k) or IRA towards their business and avoid paying income taxes or the early 10% withdrawal penalty. Since you are not repaying the money back to your retirement plan, it is not considered a loan."

There are specific rules to qualify for a ROBS. In addition, the IRS issued guidelines for ROBS that outlined several issues.

There is a real possibility that using a ROBS can present significant risks. Because of this, it's not surprising to find financial professionals who steer clear of them.

"I would never recommend them," says Dick Billings, Senior Document and Compliance Specialist at PCS Retirement, LLC in Philadelphia. "If a person is considering a ROBS plan and does not have a good enough credit rating to get a loan directly from a bank or the SBA, they should not be risking their protected retirement plan benefits on a new business."

The downside can be quite dramatic. New businesses always have some chance of failure. In the case of ROBS, losing your business also means losing a piece of your retirement.

“There are several disadvantages, but the main risk is that if the small business goes under, then stock certificates become worthless,” says Jason Grantz, Managing Director at Integrated Pension Services in Highland Park, New Jersey. “It basically puts not only current income at risk but the retirement assets all in the same risk basket.”

Beyond business failure, using ROBS presents other obstacles that you must consider.

“The first disadvantage is the C-Corporation requirement, as this structure provides the highest likely taxation rates,” says Ryan Shuchman, Investment Advisor Representative and Partner at Cornerstone Financial Services in Southfield, Michigan. “The next biggest disadvantage is that all profits must go back into the retirement plan, not to the business owner. The owner simply takes a market rate salary as compensation.”

ROBS also places you in an environment that adds additional pressure on the business owner, both in terms of cash flow and compliance.

“The companies facilitating these transactions tend to charge high fees, it is easy to get in trouble with the IRS in these transactions, and you are essentially laying your retirement money on the line,” says Josh St. Laurent, Founder & CEO of Wealth In Yourself, in South Lake Tahoe, California.

The compliance issue is a most severe disincentive to utilizing a ROBS. Since it's a complicated transaction involving both tax law and ERISA law, you shouldn't take a casual approach with a ROBS strategy. It's best to get advice from a competent attorney to reduce the chances of making a major mistake.

"The IRS instituted a ROBS project in 2009 which indicated that, although there were some successes, most businesses failed," says Marcia S. Wagner, Managing Member of The Wagner Law Group in Boston. "Some individuals who started ROBS not only lost their retirement assets but also lost their businesses. Additionally, there may be prohibited transactions involved in such a transaction. For example, to the extent that the rolled over assets are used to purchase 100 percent of the stock of the new corporation, it may be difficult to convince the IRS that the plan did not overpay for the shares of the newly established corporation. Also, since generally no other employees will be able to purchase employer stock, if the corporation at some point hires non-highly compensated employees, the IRS could allege a violation of the benefits, rights, and features portion of the Code Section 401(a)(4) regulations."

From the perspective of your retirement portfolio, a ROBS appears to violate one of the most fundamental investing rules.

"There is an old saying in wealth management: Concentration makes you rich, diversification keeps you rich," says Herman (Tommy) Thompson, Jr., a Financial Planner at Innovative Financial Group in Atlanta. "The whole idea behind a retirement plan is to take wealth earned from primary employment (concentration) and invest it for retirement in other assets (diversification). ROBS are quite literally taking all of your eggs and putting them in one basket. I understand the concept of wanting to 'bet on yourself,' but that is not what retirement funds are for."

The worst-case investment scenario leads to a potential worst-case tax scenario.

“Assume the business goes broke,” says Billings. “All the ROBS stock purchases are worthless and said loss cannot be deducted on the owner’s tax return. But assume the business is very successful. At some point, that closely held stock must be taken from the Plan. All distributions from the ROBS Plan, whether in cash or in-kind, are subject to ordinary income tax. If the sale of the stock was made with personal after-tax funds, only capital gains would apply.”

Does this mean you should never take advantage of a ROBS? Consider the fact that the failure of a leveraged new business (i.e., one financed by borrowing) will have ramifications regardless of the source of the funding.

“It is true that there is a possibility that the retirement money invested in a ROBS-funded enterprise would be lost,” says Shad Elia, CEO of New England Home Buyers in Haverhill, Massachusetts. “This is arguably the biggest disadvantage of using ROBS, but regardless of how a firm is financed, it always runs the danger of doing so. Instead of using your property as security, as is the case with many bank loans, ROBS allows you to leverage your retirement money. While both methods carry some risk, ROBS may provide you more time to rebuild your retirement savings, while utilizing your home as collateral may have more immediate repercussions. Additionally, you have a choice over how much or how little of your retirement savings you invest in your company.”

Before you risk even a portion of your retirement savings, you’ll want to calculate the downside risk and what it means to you in practical terms.

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