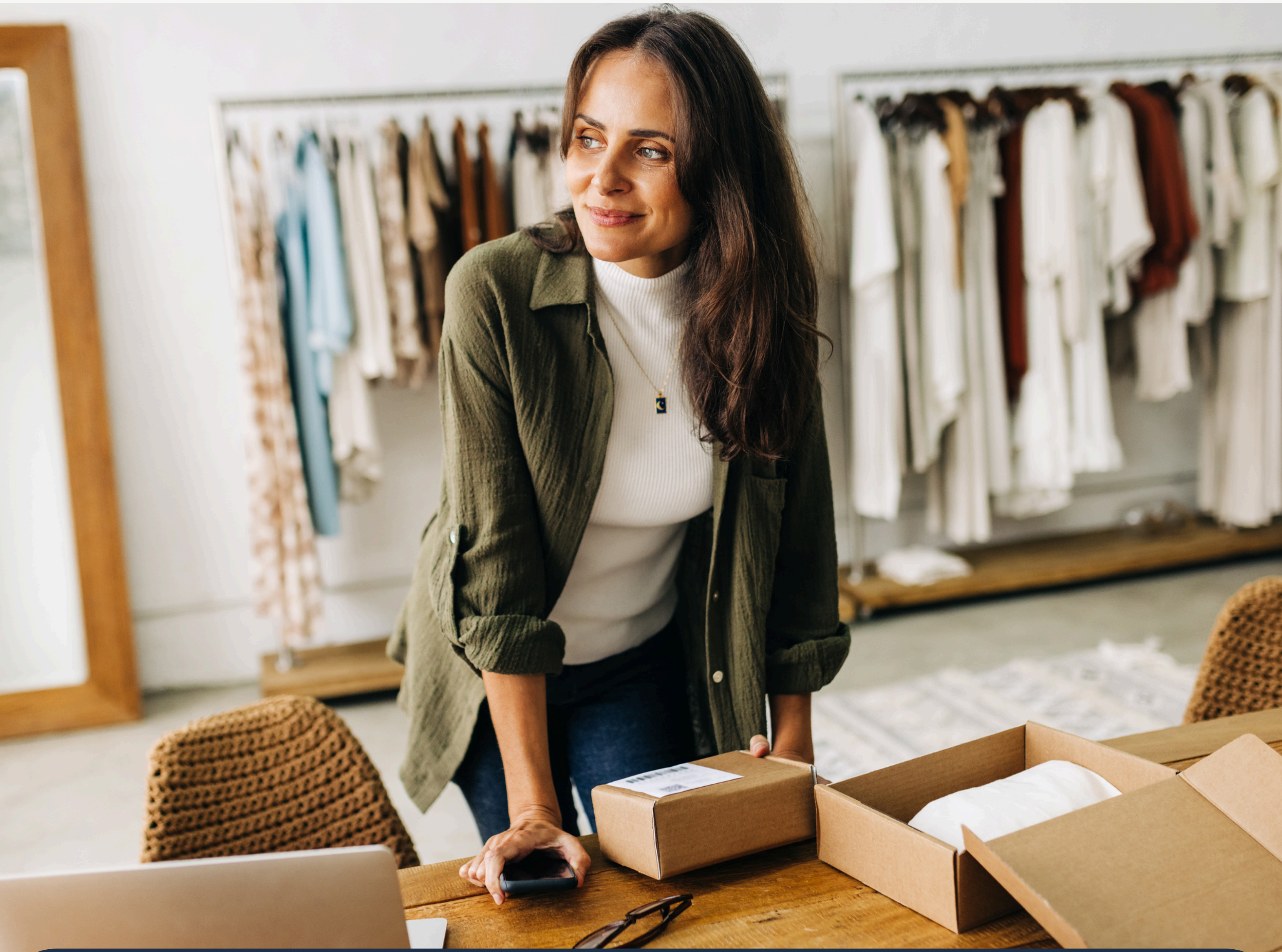
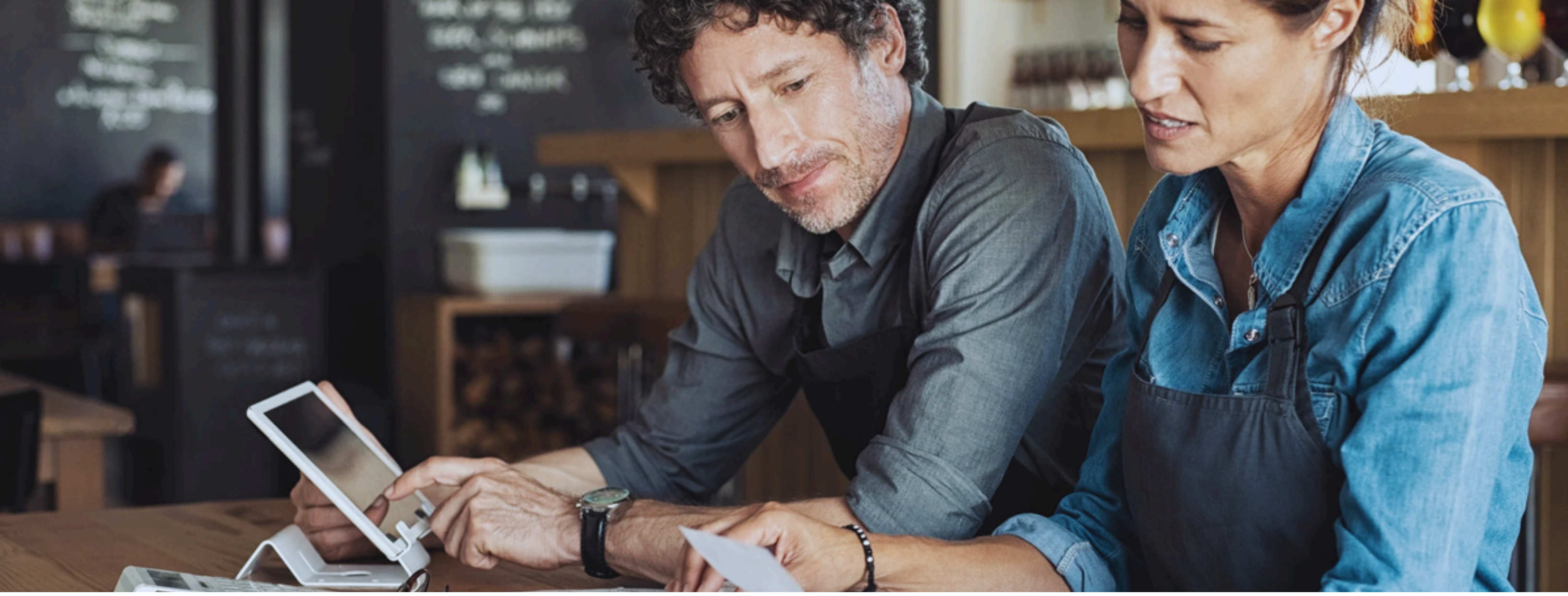


401(k) Business Financing & Your CPA: Keeping Your ROBS Structure in Compliance

Running a small business comes with a lot of details to track and take care of. Thankfully for business owners the world over, Certified Public Accountants (CPAs) exist.

Using 401(k) Business Financing, a.k.a. Rollovers for Business Start-ups or ROBS, to fund your business adds a layer of government regulations and compliance. While some business owners rely on their CPA to take care of these details, not all CPAs are familiar with the nuances of keeping your ROBS structure in compliance.

And as you know, keeping your structure in compliance is critical. Guidant offers accounting and tax services to ensure you're taken care of, but we understand that some business owners want to use a CPA they already have a relationship with. If you are one of those business owners, we've put together a list of things you and your CPA will need to act on to keep your structure in compliance. It's important that you be familiar with these details and communicate them to your CPA. In fact, feel free to send this document their way!



Prohibited Transactions

As part of the ROBS process and structure, the 401(k) plan purchased stock in the corporation and now may be the majority shareholder of the Company. Because of this unique investment situation, the corporation must avoid certain transactions known as “prohibited transactions.”

Prohibited transaction: when income or assets of the retirement plan are used in the sale or lease of property, loans, or providing services of things for the benefit of a disqualified person.

Disqualified party: anyone who owns 50% or more of the company, an officer or director of the company, or a family member (spouse, children, parents, grandparents) of any majority owners.

This rule against prohibited transactions is meant to help you avoid any conflicts of interest between yourself and the 401(k) plan. Because of the role you serve in administering and maintaining the 401(k) plan, it is your responsibility to act in the plan’s best interest – not your own. An example of a prohibited transaction is your business leasing an office building that you personally own. This causes a conflict of interest, as the transaction brings you money personally and may not be the best terms for the business or 401(k) plan.

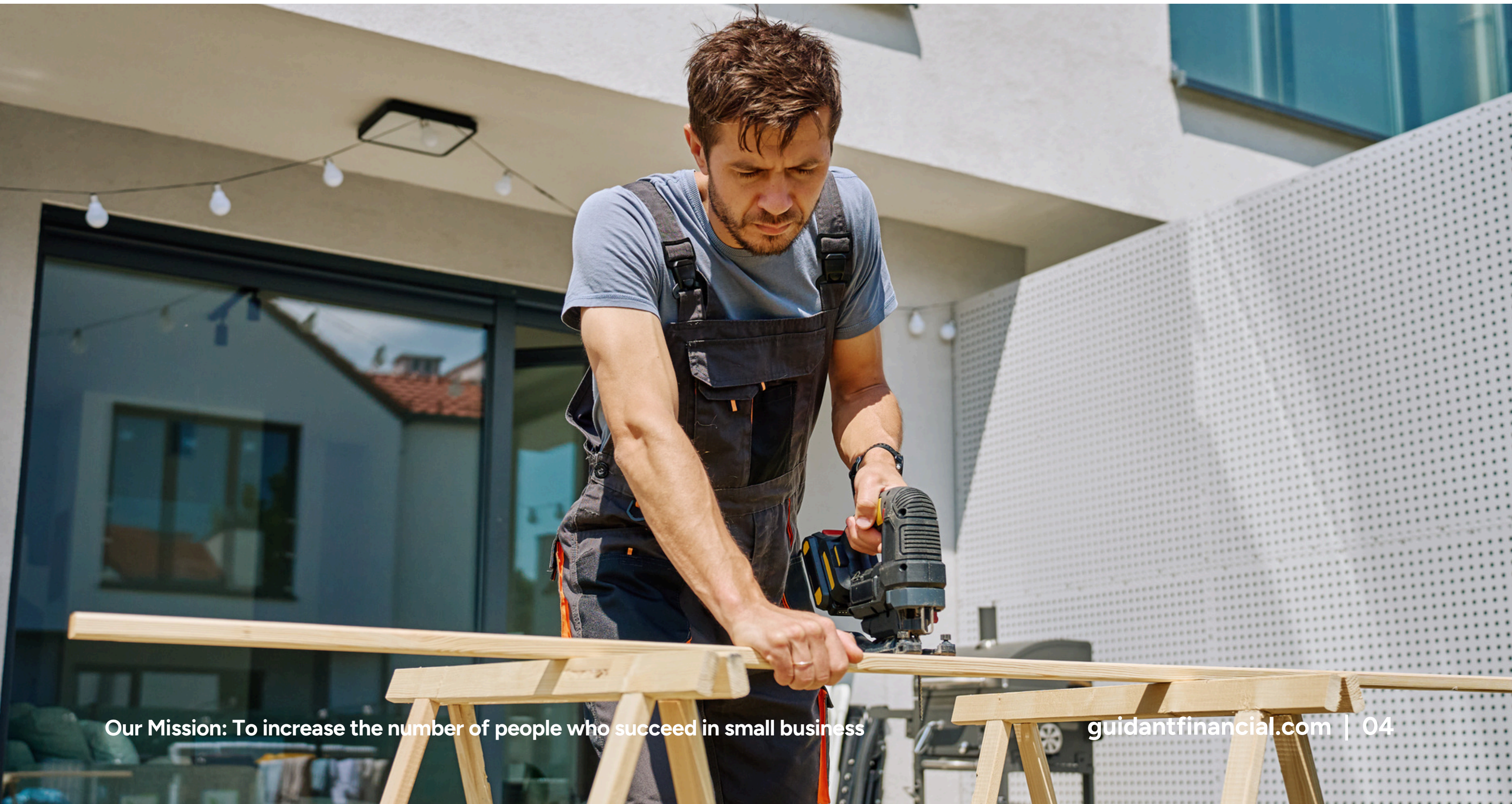
A prohibited transaction can disqualify the tax-deferred nature of your retirement funds, which dismantles the ROBS structure and can result in significant penalties. If your CPA is unfamiliar with prohibited transactions, they can learn more about them from the IRS here.

Owner Compensation

For a business funded by ROBS, the IRS requires that the owner is paid no more than "reasonable compensation." Again, this is to protect the interests of the retirement account. Unfortunately, there is no hard and fast definition of what "reasonable compensation" actually means, but it is essentially a fair rate that others in a similar role would make in a similar market in a similar business.

There are a few ways to determine your compensation: salary surveys, looking at comparable job listings, or speaking with similar business owners in your area. What is most important is that you or your CPA document your research in the (unlikely but possible) event the IRS challenges your decision.

When paying yourself this salary, make sure to draw from the revenue of the business, not the proceeds from the stock transaction. Using money from the stock transaction could be a red flag to the IRS that you may be putting your personal interests ahead of the 401(k)'s. Waiting to draw a salary until after the business is generating revenue will help you avoid those red flags.



Reimbursement of Pre-ROBS Expenses

It's common for new business owners to incur expenses before the ROBS structure is set up. Generally speaking, you can have the corporation use corporate funds to reimburse you for valid business expenses, like a franchise fee or the down payment on a location lease. The expense that is being reimbursed just needs to be clearly incurred on the behalf of the business, not in your own self-interest.

If you're sensing a pattern here, you're correct. As far the IRS is concerned, ROBS is a vehicle to increase your retirement assets by building a business that can contribute to your 401(k) plan and as your business grows and increases in value, the investment of stock by the 401(K) plan increases as well. The point is to benefit your future self, not line your current self's pockets.

Because of this, it's important to be thoughtful about the types of pre-ROBS expenses you reimburse yourself for. Considering the amount, timing, and method of reimbursements can get complicated. Will you use revenue proceeds to pay yourself back over time, or perhaps take a large lump sum? Be sure to talk through these details with your CPA or tax accountant.

Shareholder Distributions/Dividends

Your 401(k) plan is a shareholder in your company – likely the majority shareholder. If you ever complete distributions to your shareholders, these distributions must align with the stock ownership documented in your stock ledger. In other words, you need to ensure your 401(k) plan receives its due. Paying out dividends only to yourself can trigger taxes, penalties, and even the disqualification of your retirement account.

Annual Financial Statement Production

Each year Guidant will estimate the value of your business based on your annual Profit & Loss statement and Balance Sheet. We use this estimated value to calculate the value of the business's stock, which in turn informs the value of your retirement assets. This information is required to complete the Form 5500, which is essentially your 401(k) plan's tax return. The Form 5500 must be filed with the IRS each year to keep your plan in compliance.

The timing of this filing can be tricky, however. Many CPAs are very busy during peak tax periods, which means they'll often defer doing corporate taxes until the second corporate tax filing deadline. Unfortunately, that second deadline is only one month before the extended Form 5500 filing deadline.

This means that ROBS business owners often find themselves scrambling to provide Guidant with financial statements and/or their completed tax return. This puts our clients in jeopardy of missing the 5500 filing deadline, which can carry penalties of $750 or more.

To avoid this, we highly recommend you engage a bookkeeper or ask your CPA to help you finalize your documents well ahead of the deadline.

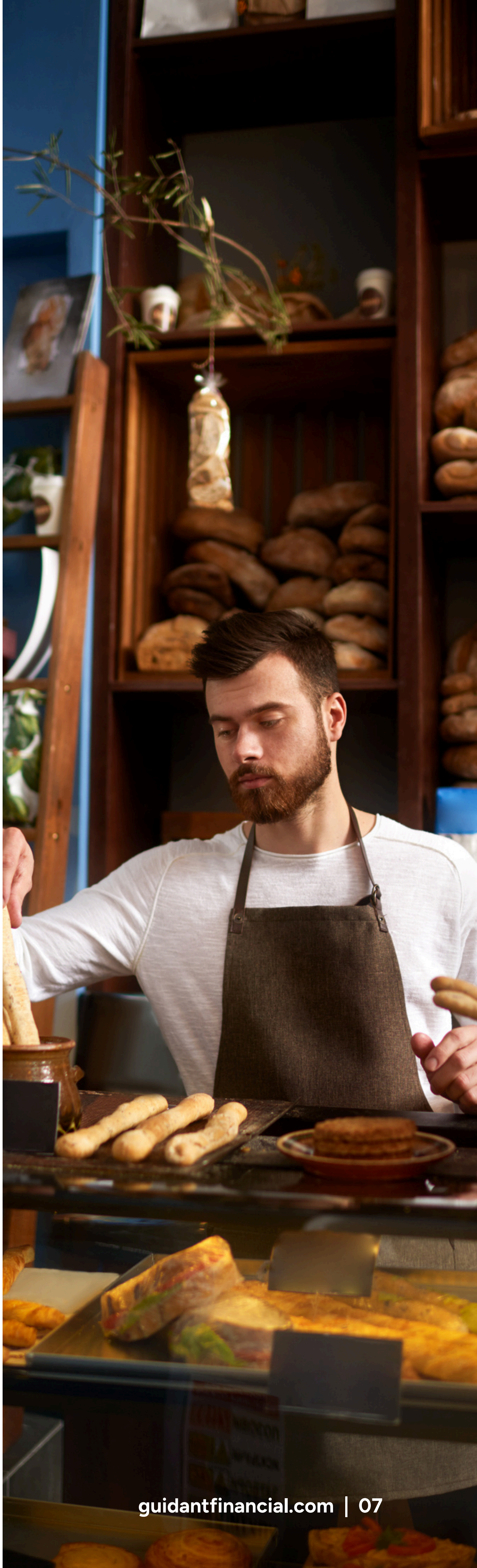
S-Corp Conversions

A business funded through ROBS must be a C-Corporation – no exceptions.

However, most small business CPAs specialize in pass-through tax entities like LLCs and S-Corps. They will often encourage ROBS-financed business owners to convert their C-Corp into an S-Corp because they are unaware of the requirement that the ROBS corporation must be a C-corporation.

A 401(k) plan cannot own stock in an S-Corp, as this nullifies the pass-through nature of the S-Corp. This is one of the reasons a C-Corp is required for the ROBS structure: it also allows for exemptions from certain prohibited transactions, which makes the entire structure possible. If you or your CPA converts your C-Corp to an S-Corp (or other entity), the investment of your 401(k) plan in the business becomes a prohibited transaction. This can cause inaccurate tax returns, significant fees and penalties, more taxes, and a painful amount of accounting clean-up.

Bottom line: your business is set up as a C-Corporation for a reason. Keep it that way.



Exit Strategy Planning: Stock Buy-back

Once their business is up and running, some ROBS-funded owners are eager to buy back the stock from their 401(k) plan as quickly as possible. They want to return the money to their retirement account so they have more flexibility and don't have to be concerned with some of the issues we have raised above. When done properly, a stock buyback of the shares the 401(k) plan owns is pretty straightforward.

First you would get an independent third-party business appraisal to get an accurate value of the stock price. Then the corporation would pay the 401(k) plan the appropriate amount as determined by the appraisal to buy that stock back. (Your CPA can typically help you obtain a third-party appraisal, or you can use our appraisal services at a discounted rate.)

To protect your business, you should plan to engage an attorney to help you with this buyback, as well as getting more support from your CPA if your attorney is not familiar with ROBS.

Personal Use of Corporate Assets

The personal use of corporate assets can be a concern for IRS auditors. Why? You guessed it: the potential for a conflict of interest between you and your 401(k) plan. As we've already touched on multiple times, the IRS is very big on ensuring you're putting your retirement plan before your personal, current gain.

Using corporate assets for personal benefit can be as simple as using your corporate car for personal transportation or trying to deduct your home office expenses and use on your taxes. It's important to ensure your CPA understands the risks that personal use of corporate assets poses to your business and retirement plan, including certain tax deductions.

Corporate Loans To or From Shareholders

While it is possible for a corporation and shareholders to loan money in both directions, these transactions should be done with particular care. As you now know, avoiding a conflict of interest between yourself and the plan is extremely important.

The risk is fairly low when a shareholder lends money to a business at fair market value, as this typically benefits the business and the 401(k) plan, which is also a shareholder. Your CPA can help you with the appropriate paperwork and establishing the interest rate and terms of repayment.

When the money goes the other way, however, it's a different story. The business lending money to the shareholder can appear to be a conflict of interest in the eyes of the IRS. In particular, this transaction is extremely risky if the loan goes into default and/or is never paid back. This can trigger taxes, penalties, or the disqualification of the plan.

Traditional to Roth 401(k) Transition

In a 401(k) plan, most of the funds typically being contributed are not taxed as they are getting contributed (pre-tax dollars). When you distribute the money from your 401(k) account, the withdrawals are taxed at that time. The opposite is true for Roth 401(k) funds: you pay taxes on the money before you put it into the retirement plan, and therefore the earnings in the Roth 401(k) account accumulate tax-free. Within the ROBS structure, it is possible to convert some of the pre-tax retirement funds into Roth funds.

As some signs point to taxes increasing in the future, converting these funds could potentially decrease the amount you pay in taxes by paying them now instead of later. However, it is important to note that pre-tax and Roth 401(k) dollars must be tracked carefully and separately, so you can account specifically for each. Before moving forward, we suggest ensuring your CPA is familiar with both the ROBS structure and this Roth conversation strategy.