



Ask SCORE for Business Advice

Green Bay Press Gazette Thur., March 4, 2010

Using Retirement Funds as Capital by Tina Dettman-Bielefeldt

You might have seen the ads. The headline shouts, “Use 401(k) savings to start a business without getting hit by taxes and early-withdrawal penalties.”

It’s easy to pay attention to something that sounds like such a great option; especially when credit has dried up and entrepreneurs are finding it hard to raise capital. But, is it really possible to borrow money for a business and avoid early withdrawal penalties?

Mark Nicholas, an independent retirement plan fiduciary and De Pere resident, says that it all depends on your Plan documents. Only about half of 401(k) plans have loan provisions and most require you be actively employed to take a loan. There is also an option to use a rollover from a 401(k) to purchase stock in a closely held company, although the IRS is closely scrutinizing these arrangements.

“The IRS is concerned that you have a business that has value,” Nicholas advised. “You usually can’t use your 401(k) rollover to fund a start-up because the new corporation would not have any stock value. As long as the business has a reasonable valuation, and you can certify that it would be appropriate to have company stock as a plan investment, it can be used.”

This means that the best opportunity for using retirement funds would be for purchase of an existing business or franchise. In that case, the buyer would form a new corporation to purchase the business and convert the 401(k) funds to company stock. The IRS will require an independent business valuation to ensure that the Plan does not overpay for its investment.

Since compliance issues can result in penalties, entrepreneurs typically need help from an independent plan fiduciary.

Loans are limited by law to 50% of the vested account balances or \$50,000, whichever is less. Nicholas said that loans typically can’t be for more than five years and must be at a reasonable interest rate. There are some fees for taking out the money and annual administration fees. Loan payments must be made on a regular basis.

Nicholas warned, “If the business goes bad, you still have the loan and a responsibility to pay back that loan. Payments will need to continue. If you stop, the loan could become a deemed distribution and that balance would become taxable to the participants.”

As an example, let’s say that you had an original balance of \$100,000 in your 401(k) and borrowed \$50,000 that could not be repaid. Not only have you reduced the 401(k) balance to \$50,000, you also must pay a 10% early withdrawal penalty and ordinary income taxes on the \$50,000 that was lost. At tax time, you might owe the IRS and State of Wisconsin \$20,000 or more on the \$50,000 that was borrowed.

Despite the risks, Nicholas thinks that it could be a good option in certain instances. Loans from a 401(k) can carry a lower interest rate, and if the business does well, the entrepreneur might realize a much better return on investment. However, since qualified retirement plans are protected from creditors in a bankruptcy, extreme caution is advised.

If you’d like to learn more, contact the Green Bay Chapter of SCORE. Visit www.greenbayscore.org or call Cindy Gokey at 920-496-8930 for information.

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