

Wednesday, July 1, 2015

## Need Funding for Your Business? Can You Use Your 401 (k) or IRA????

Are you considering purchasing a business? Buying a franchise? Need money? There may be a pot of it in your 401 (k) or IRA. Can that be used? I am hearing lots of ads on the radio that promise a way to use your retirement accounts as a source of funding for a start-up or to purchase an existing business. Is it a good idea? What about the taxes and penalties for early withdrawal???

Here is generally the way it works: First, create a state law corporation or LLC that reports its taxes as a Subchapter C corporation. That means that the company will pay taxes as an entity rather than passing all profits/losses through to the owners. Generally used for larger companies and has serious tax implications. Please don't make this election without competent accounting and legal advice. Anyway, once you have the corporation set up, the company adopts a 401 (k) plan. You then join the company as an employee and also join the 401 (k) plan. You then roll-over your existing retirement account into the new plan which promptly buys all of the stock of the new corporation. Now the plan has the stock and the corporation has the funds to buy the franchise or existing business. You have successfully taken money out of your retirement account without incurring the penalties or paying the income tax on the funds held by your IRA or 401 (k). Or have you?

If you think this sounds too good to be true, you are probably right! This plan or something similar is being promoted by franchise companies, brokers and promoters and it is possible that it could work. The IRS has indicated that while it is not *per se* unlawful, they do not like it. If done absolutely correctly- and you will need sophisticated legal and accounting counsel, not just the promoter- this may work but the complications are immense:

1. The first issue is that the overriding rule regarding these retirement plans is that the retiree is not supposed to gain a "benefit" from them until retirement at least 59 1/2 year old. Is there a direct benefit from this plan? Presumably so but maybe it is only an "indirect benefit."
2. The stock in the new company must be fairly priced otherwise this may be a prohibited transaction, not just an investment by the 401 (k). How does one determine a fair price? The best way would be with a qualified business appraisal but that can be expensive and most accountants and appraiser's will tell you that an accurate appraisal of the worth of a start-up is difficult if not impossible.
3. The investment in the stock must be a reasonable investment. If this type of investment was made by the trustee of your current plan, i.e., someone else invested your retirement money in a start-up, would you be pleased? Would you think that was appropriate? Enron anyone???
4. Once the investment has been made, the franchise bought and the company is up and running, all employees must be given the right to participate in the 401 (k) plan and for their account to purchase company stock, other wise the plan is unlawfully discriminating. You could lose control of your own company.
5. Who will vote the shares in the new company? Presumably the Trustee of the 401 (k) plan. Who will that be? If that is you, the entrepreneur, you run the risk of a prohibited transaction. If it is not you, again, you run the risk of losing control of your own company.

6. Tax consequences: A subchapter C Corporation reports its profits and losses directly. Theoretically, profits (after wages, of course) are paid out as dividends to the plan. Taxes on those profits are presumably deferred as with all 401 (k)s. But what about losses? Most new business suffer losses, usually real but sometimes paper losses. These are advantageous to the investors as offsets to other income. Here losses will also go to the 401 (k) not the entrepreneur. In addition, there is the very real possibility of double taxation both on operating profits but also when, and if, you sell the business.

7. This idea creates two distinct entities: the state law corporation and the 401 (k) plan. Each has its own rules and reporting requirements. A 401 (k) plan falls under the federal law known as ERISA (The **Employee Retirement Income Security Act** of 1974 (**ERISA**) (Pub.L. 93-406, 88 Stat. 829, enacted September 2, 1974, codified in part at 29 U.S.C. ch. 18)). This law is very complicated and it takes a lawyer and accountant who concentrates in this area to truly understand it and properly advise you.. Not every lawyer or accountant is competent to offer advice or to provide the reporting necessary. Again, ***please do not lean solely on the broker or promoter for advice- thee have a vested interest.***

8. ***And last but not least, a large number of new business fail. If this new business fails, you will have lost your retirement account and you may then be subject to taxes, fines and penalties from the IRS with no money with which to pay!***

In summary, this kind of financing may work but it is not for the unsophisticated investor nor for the faint of heart. If you are considering such a plan, ***please, please***, seek advice from a competent attorney and accountant. Do not rely solely on the promoter or franchise company!

Posted by Dwight Sowerby at 9:15 AM 1 comment: