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Betting Your Retirement On Your Start-Up

By DAVID S. JOACHIM

WITH small-business loans and second mortgages scarce these days, some middle-age entrepreneurs are starting companies using their retirement savings, a novel financing method that they say avoids loan payments and early withdrawal penalties.

These business owners are effectively treating their start-up ventures as any other stock in their 401(k) portfolio, and in the process they are providing seed capital for their own budding enterprises. In some cases they are even paying themselves a salary as their businesses start generating cash.

It's a risky strategy, one that has business owners essentially betting their retirement on their company. But beyond that, it is a controversial, considering that the same person is serving as financier, chief executive and salaried employee. And because it is all being fueled by pretax retirement dollars, the tax consequences are unclear.

But that has not stopped several advisory firms and hundreds of their clients from promoting it as the ultimate start-up strategy that, during a widespread market crisis, lets you invest in the one thing you have control over: yourself.

With credit tighter than it has been in decades, "a banker friend told me that I'd have more luck robbing a bank than borrowing from one," said George Richards of Providence, R.I., who used the retirement financing tactic to invest the $150,000 he had in his Individual Retirement Account to buy a liquor store near Brown University.

Mr. Richards, 46, turned his back on the corporate world after AT&T cut his engineering job three years ago and he found himself in what he described as a dreadful job as a mortgage broker. He decided to take "an undervalued grungy little college liquor store and make it a fun place."

A financing method that avoids loans and early withdrawal penalties.

Now, he added, "I'm creating an asset I want to be a part of, instead of just stumbling along on a career path at some big company."

John Mickey of Chicago came upon the retirement-financing idea last spring as he sought to become an independent businessman for the first time by buying a franchise after about 20 years working for big companies. He zeroed in on Adventures in Advertising, a company in Neenah, Wis., that makes promotional items like pens, coffee mugs and golf balls imprinted with company logos.

He needed $30,000 to buy the franchise rights, but with no track record as a business owner, he knew he could not get a small-business loan from a bank. A home equity loan was also not an option, because he had not owned his home long enough to build much equity.

So his franchise consultant suggested that he look to his 401(k) retirement accounts, worth about $160,000 combined. That gave him several options. He could simply cash out some of the balance, but at age 46 he would have paid a hefty penalty tax for early withdrawal. Or he could borrow against his holdings, but that would have saddled his young company with the overhead of monthly payments.

"I didn't want to have a loan to pay off, and I didn't want to be taxed up the wazoo for cashing out the 401(k)," he said.

That led him to BeneTrends of North Wales, Pa., one of the leading promoters of 401(k) start-up financing, which walked him through the process.

First he would start a C corporation, a designation that allows a company to issue private shares of stock. Then he would create a profit-sharing retirement plan within his corporation, making it eligible to accept pretax retirement contributions. Finally, he would roll over about half of his retirement savings, roughly $80,000, from his 401(k) into the profit-sharing plan.

As a result, the profit-sharing plan could buy the franchise rights and also provide working capital for his business.

Since July he has landed about eight clients. Adventures in Advertising processes the orders and takes a fee of 6 to 10 per-

cent. He paid BeneTrends about $5,000 for its services.

His company, Burly Bear Promotions, pays him a salary of about $100,000 a year.

The tactic that Mr. Richards and Mr. Mickey used to start their companies is so novel that many business analysts, tax experts and even Internal Revenue Service officials said they had never heard of it.

One such expert, Edgar Adkins, a partner in the national tax office at Grant Thornton who specializes in compensation and benefits, said, "It's an interesting concept."

At first glance, Mr. Adkins said, the trickiest part would be to make sure that the start-up company complies with a federal tax rule governing company-sponsored retirement plans. For such a plan to qualify for tax-deferred contributions and a tax deduction for the company, he said, it must be used for the "exclusive benefit" of employees and not primarily to benefit the company.

He also warned against taking a sizable salary out of the company. "Any tax deductions for corporations, for any expense like a salary, has to be an 'ordinary and reasonable' amount," he said. "When you pay compensation, particularly when it's going to the owner, the I.R.S. looks closely at what's reasonable. The I.R.S. suspicion is that you are paying yourself a disguised dividend."

The difference is that a dividend is subject to a corporate tax and another tax after it is paid to an investor. A salary, by contrast, is taxed as ordinary income, but the company can take a tax deduction, Mr. Adkins said.

The I.R.S. said it could not comment about retirement financing. But a spokesman, Dean Patterson, said in an e-mail message: "We are looking at these types of transactions because they raise complex tax and benefit issues. Before entering into any tax arrangement, the I.R.S. always reminds taxpayers that they should discuss it with a trusted tax professional."

The advisory firms that advocate retirement financing, including BeneTrends, SD Cooper and Guidant Financial, say they can shelter most of the profits from taxes by turning them back into retirement contributions, thus replenishing the initial retirement cash and deferring taxes. They also say that companies started in this way are more likely to survive the tough-going early years, because they are not weighed down by debt.

It is always risky to bet your retirement on one company, big or small. But Mr. Richards, the liquor store owner, said he was comfortable with that risk.

"I would bet on myself and my abilities any day," he said. "I don't know who I'd rather bet on than me."

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