Small Business Alternatives

You Might Already Have the Cash You Need

By David Nilssen

Financing a business correctly is nearly as important as selecting the right business. While identifying, obtaining and maintaining a business are arduous but highly rewarding tasks, the means by which one finances his or her venture will significantly impact the initial and long-term success of the business.

Traditionally, prospective owners have sought a variety of loans, or utilized credit cards or even home equity to finance a business. And they have assumed the pros and cons that come with each of these sources – the biggest "con" being the debt the new business inherits. By using debt-type financing, many people who have bought and eventually built a successful business have experienced the frustrations of "one step forward, two steps back."

For most new business owners, there is another and more rewarding financing option. If you have an IRA, a 401(k) and/or similar retirement plan, you can use that before retirement to purchase a business. And you can tap into those funds without incurring distribution taxes or early withdrawal penalties.

Utilizing your funds

Reinvesting your hard-earned money back into your business instead of toward debt is an excellent way to lower overhead and put you ahead of the start-up business curve.

This is great news for new business owners – and excellent for retirement accounts as well. If you're like many people, your IRA/401(k) probably seems to be growing at a snail's pace, and you feel pretty helpless when it comes to stimulating its growth. Well, here's one way that you can directly impact its value while doing your new business a favor! As your business grows, your retirement account grows too.

IRA monies in this type of plan can purchase the business outright, be used as loan leverage or be combined for multiparty purchases. You are also free to combine your IRA money with the IRA funds of business partners.

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This funding strategy has been available to retirement account holders since the creation of the Employee Retirement Income Security Act (ERISA) of 1974. This act transferred the responsibility of retirement investing from the employer to the employee. ERISA is the same act that allows for accounts known as "self-directed IRAs" – a structure that enables account holders to "self-direct" their retirement funds into any legitimate investment, from the stock market to real estate and, yes, the purchase of a business.

Now that Baby Boomers are taking a much closer look at their retirement accounts and are demanding to know how they can accelerate their growth, these kinds of approaches are gaining a lot of renewed attention.

Though still relatively unknown by many financial professionals, this strategy is rapidly becoming recognized as a mainstream funding vehicle. Whether retirement funds are used or not, there is always the risk of losing money. Should a buyer use a loan to finance their venture and the business should fail, they will still owe money on that loan. However, if their own retirement funds are used and lost (and assuming no debt was secured), one will not have to worry about a creditor trying to seize their assets or damage their credit.

Making it work

There are some operational guidelines one must follow when it comes to this strategy. Under this structure, you are required to work on the business at least 1,000 hours yearly (divided as you choose; many opt for 20 hours per week), pay yourself a salary and offer your employees the option of enrolling in a 401(k) plan. There are a few other requirements as well, with a reliable service provider able to list those for you.

The setup of these types of accounts should be done by a service provider who has a solid history and reputation in the industry. Many of these companies offer free consultations, so take advantage of that opportunity to perform your due diligence.

Determining how you will finance a new business purchase is one of the most critical choices you will face as an entrepreneur. Knowing you can access your own retirement funds to buy your business should go a long way in making that choice a simpler one.

INFORMATION LINK

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