Small Business Loan: Borrowing From Your 401K for Your Business? Beware

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By Carol Tice

Using your retirement account to start a business has been a popular funding method in recent decades. New franchisees in particular often fund that first store with their IRA or 401(k) fund.

The transaction is often done using a method known to the IRS as **ROBS — Rollovers as Business Startups.** About 4,000 of these IRA-rollover transactions took place last year. But that acronym will give you an idea of what the IRS thinks about these transactions. If you're considering funding your business this way, I strongly recommend you study up on this issue. Several experts I've spoken with think the IRS will eventually disallow many or all ROBS setups.

ROBS works like this: You leave Corporate America with a fat 401(k) account. Or maybe you've been socking away money in a personal IRA. What you do is you incorporate your business and set up a brand-new retirement plan for that business. Then, you roll your existing lump of retirement cash into the new plan.

Then, you borrow it out and use it for business expenses, tax free. Or at least that's the theory.

In the past two years, the IRS has sent a series of increasingly loud warnings out about ROBS transactions. It began in 2008, when the IRS issued a guidance letterthat warned many ROBS may violate the law. This year, the agency began tasking its auditors with reviewing ROBS transactions.

At the moment, the initial focus appears to be on new ROBS. Apparently, applying for a ROBS gets you an audit letter from IRS, right off the bat.

What is the problem with ROBS? Essentially, you're not supposed to be able to withdraw money from an untaxed retirement account without paying tax. You're supposed to pay tax on it when you withdraw it in retirement. If you withdraw it early, you are supposed to pay tax and penalties. There is an exception for business startups…but the rules are very complicated.

You are essentially putting yourself in the business of running a retirement plan. It's not a one-time event — you will have annual tax filing responsibilities. Fail to keep up with the paperwork, and boom — you have a noncompliant program.

Also, retirement plans must be offered to all workers. If you have employees but you're the only participant in the plan, that's a no-no.

There are other rules, too. How you spend the money you withdraw from the new retirement plan must be carefully documented so you can demonstrate to IRS that it was spent appropriately. It is specifically prohibited to use the funds as simply a personal piggybank you're drawing down so you can "pay" yourself a salary while the company gets off the ground. But in my experience talking to entrepreneurs, that's exactly what many use if for.

As you can see, you're basically having to become a human-resource professional on the side when you set up a ROBS transaction. It's a lot of headaches.

Finance companies that set up these rollovers for entrepreneurs defend them and say they comply with the law. But that assurance won't protect you if IRS rules against you. If you do contemplate doing a ROBS transaction, get help from a company that will offer you legal defense if IRS comes knocking.

The expert advice I got is if you want to use your retirement funds for your business, either liquidate the account and pay the tax and early-withdrawal penalties now, or borrow it and pay it back — you can do that tax-free in some circumstances.

Or better yet, get a small business loan, or business line of credit, as you'll probably want to use that retirement money to live off of when you retire.

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