

## Funding A Start-Up Business With Retirement Assets

Most entrepreneurs have one problem in common – financing. For example, a bank has agreed to lend the entrepreneur start-up funds but the bank is requiring the entrepreneur to also make a twenty percent investment in the business. The only problem is that the entrepreneur does not have enough liquid assets in his/her bank accounts or investment accounts to satisfy this requirement and the entrepreneur does not have access to friends or family to lend assistance. Aside from bringing in outside investors, the entrepreneur may have an asset that could provide him/her with the necessary funds to satisfy the bank's investment requirement – such as a 401(k), IRA or other similar qualified retirement account (all of these retirement accounts will be referred to in the aggregate as a 401(k)). The entrepreneur rolls over assets from his/her current 401(k) into a qualified retirement account set up in the name of NEWCO (the start-up company). If this



is done properly then the entrepreneur will not have to pay any taxes or early withdrawal penalties on the amount withdrawn. In contrast, if a loan is taken from the 401(k) then the plan documents usually require repayment within a

certain time frame or upon termination of employment.

It must be noted that start-up businesses have a relatively high failure rate. An Internet search will reveal statistics that after two years between twenty-five to thirty-five percent of start-up businesses are no longer in business. After five years approximately fifty-five percent of start-ups are no longer in business. So, an entrepreneur must use extreme caution in using assets from his/her 401(k) as business start-up funds.

If the entrepreneur ultimately feels comfortable withdrawing assets from his/her retirement account as a source of start-up funding then the following steps will need to be followed to minimize the risk of early withdrawal taxes or penalties. The steps are:

1. Research your current retirement plan documents;
2. Incorporate NEWCO as a C corporation;
3. NEWCO then establishes a qualified retirement plan;
4. The value of NEWCO's stock is established; and
5. NEWCO's retirement plan purchases NEWCO's stock and NEWCO is now funded with the entrepreneur's investment.

So, the first thing the entrepreneur needs to do is research his/her 401(k) plan documents to determine the type and amount of withdrawals that are permitted.

The entrepreneur's second task is to incorporate NEWCO as a corporation. NEWCO must be taxed as a C corporation. The reason that NEWCO is not able to be taxed as an S corporation is that the tax regulations require that the shareholders of an S corporation be individuals, estates, certain tax exempt organizations and certain trusts.

*(Continued on page 2)*

### WHV Practice Area Spotlight

#### General Corporate

Our business lawyers are trusted legal advisors to privately held companies. Our corporate attorneys have the experience and the knowledge to counsel and advise clients about their day-to-day legal concerns and issues.

Timely counsel and advice are provided on a wide array of business matters, including the following:

- Business expansions, start-up of new ventures and/or operations.
- Equity and debt financing.
- Securitizations.
- Board of Director representation.
- Strategic business and growth planning.
- Corporate control and takeover concerns.
- Disclosure matters.
- Risk management and assessment.
- Corporate governance.
- Purchasing and vendor concerns.
- Customer relations.
- Employment matters.
- Distributor and sales representative matters.
- Regulatory compliance matters.

Please visit [www.wegmanlaw.com](http://www.wegmanlaw.com) for more information.

(Continued from page 1)

Third, NEWCO establishes a qualified retirement account. This account must be created to comply with the applicable IRS guidelines. Additionally, the roll-over of qualified retirement funds into this account must be performed pursuant to IRS requirements to ensure that no taxes or penalties are paid on this withdrawal. There are a number of companies that specialize in performing these services. The initial qualified retirement plan set-up fees could be as high as \$5,000.00 with monthly fees around \$100.00.

Fourth, a value must be placed on NEWCO's stock. The valuation will typically be the amount of assets being rolled over from the entrepreneurs 401(k) to NEWCO's newly created qualified retirement account.

Fifth, NEWCO's qualified retirement account will purchase NEWCO's stock. This purchase is made possible due to the fact that when NEWCO's qualified retirement plan is established one of the investment choices is NEWCO's stock. With this purchase NEWCO is now funded with the entrepreneur's investment. This results in the entrepreneur satisfying the bank's investment



requirement. Along with this purchase of stock it is now common for NEWCO's qualified retirement plan to be amended to no longer allow employees to invest in NEWCO's stock.

The IRS has issued determination letters validating qualified retirement plans as referenced above. And, many of the companies that market and establish these business funding scenarios will obtain a determination letter from the IRS indicating that NEWCO's qualified retirement account is approved by the IRS. However, the IRS has never issued a determination letter validating this entire funding process. One reason for this is that amending the plan documents to prohibit any other employees from investing in NEWCO's stock could be considered discrimination.

The IRS will also view the following as red flags: if Form 1099-R is not filed at the time of the rollover to NEWCO's qualified retirement plan, if a company fails to file Form 5500 or 5500EZ, if the company amends its plan documents to prevent employees from investing in the company stock after the initial purchase has taken place and if third-party fees in establishing NEWCO's qualified retirement plan are paid out of the funds rolled over from the 401(k).

An entrepreneur must use caution in considering the use of one's retirement assets to fund a start-up business. The risks and benefits have to be considered as they relate to the present and the future. Further, as noted, the IRS has yet to issue a determination letter as to the entire process involved in establishing and running such a qualified retirement plan.

*This article is not providing legal advice or creating an attorney-client relationship. If you have any questions or would like to learn more about this topic or if you have other legal questions, do not hesitate to contact Chris Corpus, Esq. at [cacorpus@wegmanlaw.com](mailto:cacorpus@wegmanlaw.com).*

## WHV Notable News and Events

*Christopher A. Holecek and Angela M. Lavin successfully preserved a summary judgment and substantial jury verdict in an action seeking an injunction and money damages on behalf of a corporate client in an unfair competition lawsuit tried in federal court in Miami. The trial had lasted 10 days. The opposing party had appealed the favorable outcomes and, after full briefing and oral argument, the 11th Circuit Court of Appeals affirmed the rulings and findings in their entirety, including an award of attorneys' fees.*

*Peter A. Hessler was successful in causing an opposing counsel in a previously settled malpractice and deceptive advertising case to remove unflattering remarks and accusations about the firm's client on the opposing law firm's website. In settling the multi-count action, Hessler insisted on non-disparagement and non-disclosure provisions, with a monetary penalty for violating the same. When he learned of the website and its content, designed to solicit clients who may assert claims against the firm's client, Hessler successfully negotiated the removal of the offensive content on the strength of the provisions of the settlement agreement.*

*Christopher A. Holecek has been named to the Ohio Super Lawyers list as one of the top attorneys in Ohio for 2012. No more than 5 percent of the lawyers in the state are selected by Super Lawyers.*

*Angela M. Lavin and Scott J. Robinson have been named to the Ohio Rising Stars list as being among the top attorneys in Ohio for 2012. No more than 2.5 percent of the lawyers in the state are selected to the list.*

*Wegman, Hessler & Vanderburg welcomes our newest staff member, Nicole M. Churchill. Nicole recently joined the firm as a paralegal in the firm's Probate Department.*

**Disclaimer:** The information contained in this newsletter has been prepared by Wegman, Hessler & Vanderburg and is provided for general information purposes only, and should not be construed as legal advice on any specific matter. The receipt of information contained in this newsletter does not constitute or create an attorney-client relationship between the recipient and the firm. Readers should not act upon, either positively or negatively, any information found herein without seeking professional legal counsel addressing the specific legal need and factual situation.