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IS THE JOBS PANIC JUSTIFIED?

From 401(k) Nest Egg To Seed Money

With credit tight, firms such as BeneTrends help entrepreneurs fund startups with retirement savings

By Brian Burnsed

Michael Amstein decided to strike out on his own last year, leaving behind his job as an executive at an ambulance company. The 43-year-old Denver native carefully weighed the pros and cons of various franchise options and eventually decided to open a Nestlé Toll House Café at a local mall. But when he applied for loans, Amstein couldn't come up with enough collateral and was rejected. Undaunted, he turned to BeneTrends, a firm that helps entrepreneurs tap into their 401(k)s without incurring a tax penalty. After paying $4,500, Amstein unlocked $100,000 from his account and bought the cookie shop. "I was nervous about starting something," says Amstein. "But I took a leap of faith, and it has worked out."

With banks tightening lending, small businesses, which can't borrow from the bond market like larger corporations, have lost one of their best sources of funding. To fill the void, a cottage industry, made up of a few small companies and a bevy of independent contractors, has sprung up to help entrepreneurs turn their 401(k)s and other tax-deferred accounts into capital. The firms, which generally charge $4,500 to $7,500 for their services, are taking advantage of an unpublicized tax law that allows individuals to invest their retirement funds in a company.

Here's how it works. An entrepreneur, aided by the outside adviser, creates a corporation. The newly formed entity starts a 401(k) plan, and an individual rolls over existing retirement funds into the account. Under 401(k) rules, the plan can purchase shares in the corporation—money that can be plowed into a small business that sells a product or service. Those deals are considered investments, which is the key. By investing the money rather than withdrawing it, entrepreneurs avoid triggering a penalty that amounts to 10% of the assets.

The funding method has been around for years. But the credit crisis has turned this once sleepy niche into a booming business. Industry leaders BeneTrends in North Wales, Pa., and Guidant Financial Group in Bellevue, Wash., say customer volume is up 30% to 35% over the past year. By comparison, small-business loans from traditional lenders fell 30%. "There's not any kind of underwriting requirement," says David Nilssen, CEO of Guidant, which has helped customers unlock $1.5 billion in 401(k) funds since its start in 2003. "You either have the capital or you don't."

Such strategies can make the difference between a small business getting off the ground or not. But they come with a big risk. If the company goes belly up, the nest egg will be wiped out. And the possibility of failure is great. A study at Case Western Reserve University found that more than half of startups fold within five years. "I know small business owners are in tough situations," says Alice Bredin, a small-business consultant who works with American Express. But utilizing retirement funds "is a really bad idea."

Tim and Terry Madden considered taking out a traditional loan to buy three franchises of Assisting Hands, which provides in-home help to the elderly and disabled. They qualified, but the Fountain Hills (Ariz.) couple didn't want to rack up huge piles of debt in a turbulent economy. Instead, the Maddens used $175,000 of their retirement assets, paying Guidant $5,000 to steer them through the process. "Everybody worries about taking money out of an account you've grown over the years," says Terry Madden, whose franchises are slated to open in January. "But we felt it was a calculated risk. We sleep at night." |BW|

55%

The percentage of small businesses that fail within the first five years

Data: Case Western Reserve University

Amstein unlocked $100,000 from his 401(k) to start a cookie shop

JAMIE KRIPKE