Protecting Yourself When You Are Self-Employed

A new study conducted by the nonprofit Institute for the Future reports that more of us will turn to self-employment in the future.

I can't say I was too surprised by this (especially considering that the project was sponsored by small-business software maker Intuit). Given that job security is so last-century, it makes sense that more people would want to -- or be forced to -- strike out on their own.

Taking Blind Risks

What I found interesting in the study is that baby boomers are currently the fastest growing demographic to go into business for themselves, and that's expected to accelerate over the next decade.

For some boomers, the entrepreneurial itch is a necessity: When you still have a mortgage to pay, college tuition to handle, and another 30 or 40 years to live, being downsized or gently pushed out from a corporate job doesn't mean your need to work has disappeared. For others, it's a desire to break out of the corporate world without switching to golf 24/7.

But my antennae started buzzing when I read this in the report: "They [boomers] have better access to capital, either from their own savings or through their work and personal networks."

This worries me. Whether it's living off of an emergency cash fund while launching a business, raiding retirement funds, or tapping home equity, far too many entrepreneurial wannabes empty their piggybanks without really thinking through the potential risks they're taking.

Planning for Entrepreneurship

If you hope to join the ranks of the successfully self-employed, you need to do a lot of advance financial planning.

Here are the proper steps to take:

- **Figure out the replacement cost of lost benefits.**

If you leave a corporate job, you probably leave behind plenty of benefits, too, including health insurance, life insurance, flexible spending accounts, and company matching of your contributions to a 401(k). Exactly how do you expect to pick up the slack and cover those costs yourself?

If you have a big financial cushion, then you're sitting pretty. But most people quit their jobs and give themselves six months to get their new venture up and running, and it isn't until after they quit that they sit down and tally up the cost of all the bills they're now 100 percent responsible for.

The result is that they run through their emergency cash fund at about double the speed they anticipated. Pretty soon they have no savings left, yet their new business is still far from breaking even.

In addition, it's almost a given that in the first two or three years of being self-employed, people give themselves a retirement break: they tell themselves its OK that they aren't setting aside any money while they concentrate on getting their business off the ground.

That's a costly gamble. If you were contributing $10,000 a year to your 401(k) and receiving a $1,500 company match, that's $40,000 or so over three years that won't be compounding for you. This is fine if you're incredibly successful (and diligent) and manage to catch up with big retirement contributions once your business becomes solvent, but there's no guarantee it will become solvent at all.

• Don't access retirement savings.

Your 401(k) is not a business-financing tool. Even those who are at least 55 and thus can make penalty-free withdrawals after leaving a job are reckless to touch their retirement savings.

Let's say you use $50,000 to live on in the first year of your new business, and plan to "replace" the money once the business takes off. What if it doesn't take off? You've just siphoned off a serious chunk of your retirement security. Consider that if the $50,000 had stayed invested for another 10 years and grew at an annualized 8 percent, it would be worth nearly $108,000. That could cover a lot of retirement expenses.

The no-raid policy is just as important for those in their 30s and 40s. Not only will they be hit with the 10 percent early-withdrawal penalty (as well as the regular income tax everyone pays on 401(k) distributions regardless of age), they're throwing away precious compounding time.

Leaving $50,000 untouched for another 30 years would result in it growing to more than $500,000, assuming an 8 percent average annual return. Withdrawing it at age 35, however, means you'd be lucky to have $30,000 left after paying the penalty and tax.

• Keep the home-equity tap turned off.

It's the height of financial lunacy to tap your home equity to finance a startup. Even if it's relatively safe to assume that your business is going to be successful, you're still converting what was an asset (your home equity) to a debt.

Can your new cash flow cover the extra cost of that home equity line? If not, you could lose your house. And who's truly prepared for the cost of the home equity line of credit to go up every time there's an uptick in short-term interest rates? Based on what I've observed over the past year, very few homeowners anticipate their interest rate going up two, three, or four percentage points, and many are now experiencing extreme mortgage stress.

• Don't rely on credit.

Even if you get a great low-introductory rate on a credit card, it's going to be incredibly hard to keep that rate low for very long. Many introductory rates adjust after six months to a year, and in the meantime the credit card company is scrutinizing your every financial move to see if it can come up with an excuse to boost the rate even sooner.

If you insist on financing some of your startup on your credit card, please give yourself a set-in-stone conservative limit you will not exceed. Remember, you can pull the plug on your business, but if you have $20,000 or $30,000 of credit card debt you're going to be paying for that for years to come.

Don't expect to just walk away from it: It's never been harder to qualify for bankruptcy, and besides, if you go that route your credit is going to be awful for at least 7 to 10 years.

The Responsible Route

So how can you responsibly afford to venture out on your own?

Start planning for it today. Set aside separate savings that will cover your family's finances for at least a year if you decide to become an entrepreneur. If you can't imagine where to come up with the money, it's time to get back to basics: Scour your spending and make sacrifices so you can build up your entrepreneurial financial cushion.

You might also consider taking a part-time job while you're launching your own business. I realize you want to devote all your time to your own business, but keeping some money coming in will go a long way toward giving you and your family financial breathing room.

Credit – Suze Orman