Business Owner Retirement Planning

Starting and running a successful business takes drive, energy, and a lot of hard work. But at some point, every entrepreneur begins to think about exiting the business and moving on to retirement or other pursuits. And a key part of the exit strategy usually includes selling the business and living comfortably on the proceeds.

Realizing that dream, however, can be even more difficult than starting the business in the first place. While many business owners know how to profitably run a business, few seem to know the ins and outs of successfully selling a business when the time comes.

Always Be Ready for a Sale

Frequently, a homeowner will "spruce up" a home just before putting it on the market. Many business owners follow a similar strategy, waiting until the last minute to prepare the business for sale. However, unexpected events such as an economic downturn, health problems, death, or divorce can force a sale before the business is ready to be sold. The end result can be no sale, a "fire sale" liquidation of assets, or, in a worst-case scenario, simply closing the doors.

Another approach is to run the business as if it were constantly for sale. Consider steps like:

- **Make yourself unnecessary:** Can the business prosper without you? Is a large part of the business value built on your professional skills and/or personal relationships? Install an independent management team and create formal operating procedures such that you can be easily replaced.
- **A clear track record:** Potential buyers like to see a clear, solid record of income and expenses. Recording every sale, and paying taxes when they're due, is a good way to build this record.
- **Look at yourself in the mirror:** Like an annual health checkup, at least once a year look at your business as if you were a potential buyer. Are there any hidden problems that a buyer might uncover when doing the necessary due diligence? What is a realistic market value for the business?

Diversify Your Retirement Planning

For many business owners, much of their net worth is tied up in the value of the business. If the business loses value, so does the owner's net worth. A more diversified approach could include income from:

- **Employer-sponsored qualified retirement plans:** Consider an employer-sponsored qualified retirement plan as an employee benefit.
- **Individual retirement plans:** Individual retirement plans such as a traditional IRA or Roth IRA can be a useful supplement to an employer-sponsored qualified retirement plan.
- **Other employee benefits:** Executive bonus plans, non-qualified deferred compensation arrangements and stock option plans are benefits that can be very useful in achieving retirement income goals.
- **Personal savings and investment:** A diversified, personal investment portfolio, separate and apart from the business.
- **Social Security:** Regardless of how a business is structured, a business owner pays Social Security taxes on his or her earned income. Consider including Social Security retirement benefits as a part of the retirement plan.

Employer-Sponsored Qualified Retirement Plans

Employer-sponsored qualified retirement plans can generally be classified as either defined benefit or defined contribution. Under federal income tax law, a number of restrictions and limitations apply to both types of plans.[1]

Defined benefit plans specify the benefit amount a participant will receive at retirement; an actuary calculates how much must be contributed each year to fund the anticipated benefit.

Defined contribution plans typically put a percentage of current salaries into a plan each year. The final retirement benefit depends on the amount contributed, the investment return, and the number of years until a participant retires. A number of different defined contribution plans are available:

- **Traditional Money Purchase Plan:** The employer contributes a defined or fixed percentage of each participating employee's compensation.
- **Traditional Profit Sharing Plan:** Employer contributions need not be a specific percentage of compensation, but must be "substantial and recurring."

[1] The discussion here concerns federal income tax law. State or local law may vary widely from federal law.

- **SIMPLE Retirement Plan:** Applicable to businesses with 100 or fewer employees. Either an IRA version or a 401(k) version can be used.
- **Simplified Employee Pension (SEP):** A SEP provides an employer with a simplified way to contribute to an employee's individual retirement account or individual retirement annuity.
- **IRC Sec. 401(k) Plan:** A type of defined contribution plan to which both the employer and the employee may contribute.
- **"Solo" 401(k):** A type of 401(k) plan that covers only the business owner or the business owner and spouse. In such a plan, the business owner makes contributions as both an owner and an employee.

The decision to install an employer-sponsored qualified retirement plan, and the best type of plan for a particular business, should only be made after consultation with a qualified pension plan administrator. Key considerations include the owner's retirement goals, his or her individual tax bracket, and the owner's need for additional retirement savings. Other characteristics, such as the age of a business, its stability and financial condition, the number of employees, their ages and salaries, and the need to compete for and retain employees, should also be taken into consideration.

Individual Retirement Plans[1]

A business owner may want to consider an "individual" retirement plan, in place of, or as a supplement to, an employer-sponsored qualified retirement plan.

- **Traditional IRA:** Contributions may be deductible from current income, growth inside an account is tax-deferred, and distributions are generally taxable.
- **Roth IRA:** Contributions are never deductible, growth inside an account is tax-deferred, and distributions (assuming certain requirements are met) are tax-free.

Other Employee Benefits

Some employee benefits, such as group health or employer-provided life insurance, help meet retirement goals indirectly by using business dollars to provided essential benefits that would otherwise have to be paid for with personal funds. The freed-up dollars can be then re-directed toward retirement savings.

[1] The discussion here concerns federal income tax law. State or local law may vary widely from federal law.

Other employee benefits help more directly in reaching the retirement goal, including:

- **Nonqualified deferred compensation arrangements:** Allow selected employees (the employer can pick and choose) to defer receipt of a portion of their compensation until a later date. These plans do not meet federal income tax requirements to be considered "qualified" plans.
- **Stock option plans:** For larger, publicly-held firms, federal income tax law allows for several different types of stock option plans. If certain requirements are met, these plans allow employees to purchase stock in the employing firm at advantageous prices and also enjoy preferential income tax treatment of any gains.

Personal Savings and Investment

As cash flow allows, a business owner can develop an investment portfolio separate and apart from the business itself. For example, stocks, bonds, savings accounts, real estate, and precious metals could all be part of such a diversified portfolio. Ultimately, the business may come to be regarded as simply one more asset in the owner's overall investment portfolio.

Social Security Retirement Benefits

Whether a business is a sole-proprietorship, partnership, C Corp, S Corp, or LLC, the business owner will have paid Social Security taxes on his or her earned income over the whole of a working lifetime. Social Security retirement benefits are generally available to qualifying individuals beginning at age 62 and can provide a stable, life-long monthly retirement income, to both the owner and his or her spouse.

Begin Early and Seek Professional Guidance

Developing a successful retirement plan involves carefully considering a wide range of issues and potential problems. Finding solutions to these questions often requires both personal education and the guidance of knowledgeable individuals, from many professional disciplines. Beginning the planning as early as possible is a key step.