As a business owner, do you have a retirement contingency plan?

Insights on retirement for small-business owners

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Fluctuating profitability and general economic market timing affects business valuations and the funds available to support the retirement lifestyle of business owners.

A few years ago, Frank's factory had more manufacturing orders coming in than it could fulfil.[1] All three of his adult children were employed in the business and both cash flow and profits had never been better. He had 80 well-paid employees split between two shifts. The future of the business was promising, and Frank was feeling comfortable about his impending retirement.

Things started to change when one of his largest clients asked him to reduce his prices. Even though they had a long-term relationship, the client was considering a new competitor that offered similar product at over 20% less than Frank's current price. Frank had no choice but to renegotiate the contract at a lower price.

Soon after, other clients started asking for lower prices. Frank's margins kept getting squeezed until he could no longer meet these requests. He lost one contract, and then others, some with major clients. Sales had fallen off a cliff, and suddenly the future of the business was in jeopardy. Frank needed to refocus on his business plan to ensure the continuity of his business.

At the age of 60, Frank wasn't ready to make the dramatic adjustments necessary to revive the business. Just when he thought he was in a good position to exit his business in an orderly fashion, he would have to make major changes to his retirement plans.

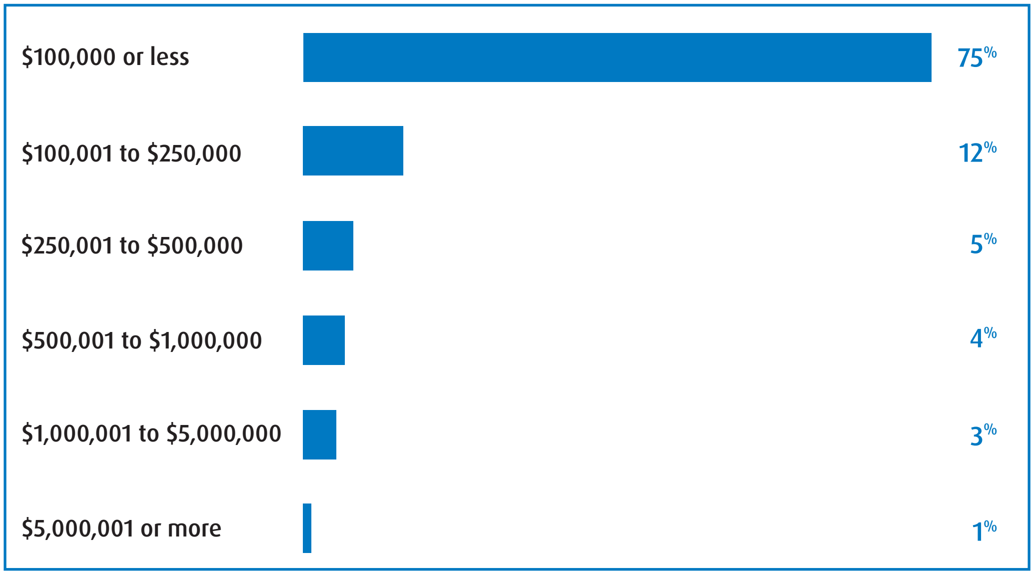
Retirement options for business owners

Retiring from your own business can be difficult after having invested the better part of your working years to achieve success. For many business owners, a retirement date is not always within their control, and the funds available for retirement can vary, especially if the owner was depending on either selling their business or continuing to draw income from the operating business.

BMO Wealth Management commissioned a survey of American private business owners to learn more about their retirement goals and how they were planning to fund their retirement.[2] Overall, the survey found a number of very interesting results; most notably, that the majority of business owners are not financially prepared for the retirement they envision. When asked how much they had saved toward their retirement, three quarters (75%) indicated that they had saved less than $100,000, and only 8% indicated that they had saved more than $500,000.

The majority of business owners are not financially prepared for the retirement they envision.

Savings allocated for retirement



Source: BMO Wealth Management survey by ValidateIt Technologies Inc., July 2016.

Even among business owners aged 45 to 64, many of whom could be nearing retirement, a significant percentage (68%) indicated that they had retirement savings of less than $100,000. Only 11% of respondents in this age range had saved more than $500,000.

Savings of less than $100,000 for retirement, by age of business owner

Source: BMO Wealth Management survey by ValidateIt Technologies Inc., July 2016.

The amount of savings required for a comfortable retirement depends on a wide variety of factors:

- Expected annual spending in retirement
- How much can be saved each year leading up to retirement
- Current age and expected retirement age
- Expected lifespan
- Inflation and investment returns
- Funds available from other sources, such as Social Security, and other pensions and inheritances
- Future health and health-care costs
- Taxes, that are especially, impacted by the use of retirement accounts, such as IRAs and 401(k)s, to support retirement spending

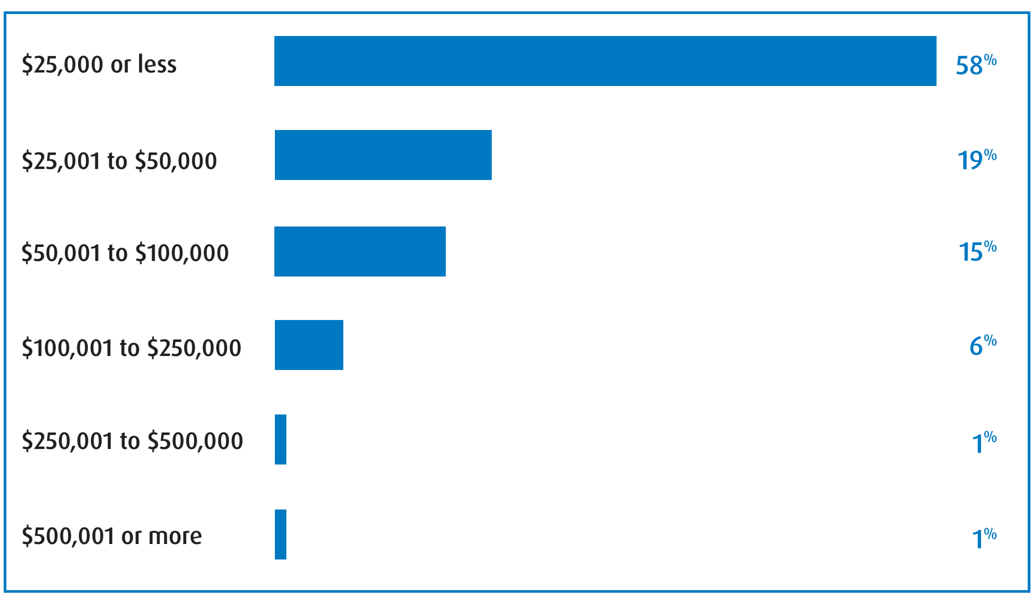
A personal financial plan can help to put all of these individual factors together to determine the right amount of savings to meet your retirement goals.

A financial plan can help to determine the right amount of savings to meet retirement goals.

Is $500,000 in retirement savings enough?

There is no simple or easy answer to the question of how much to save for retirement. Every business owner has his or her own set of unique circumstances and requirements. The survey asked business owners how much income they are currently taking from their businesses to support their regular personal expenses. Just over three-quarters (77%) indicated that they drew out less than $50,000 annually. Only 8% of business owners indicated that they were able to withdraw more than $100,000 per year. Business owners should also consider certain business costs, such as their cell phones or entertainment expenses that would have to be paid for personally once they retire from their business.

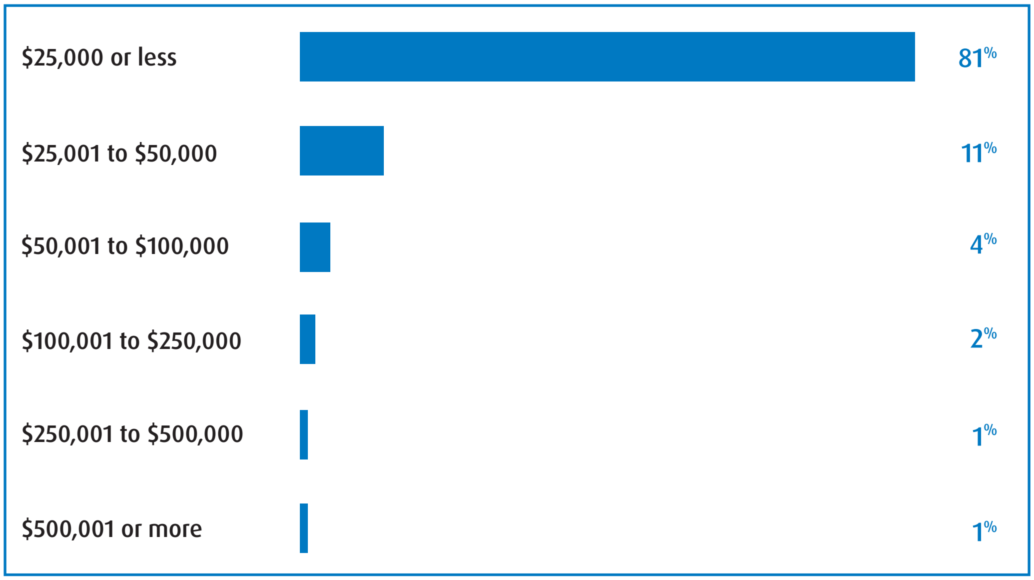
Income withdrawn annually to meet regular personal expenses



Source: BMO Wealth Management survey by ValidateIt Technologies Inc., July 2016.

The survey also asked business owners about the amount of income their businesses generated over and above what they used to meet personal expenses. These are funds that could be saved toward their retirement goals. While the amounts varied greatly, more than four out of every five (81%) of the respondents indicated that they could save $25,000 or less for their retirement on an annual basis.

How much do business owners set aside annually for retirement?

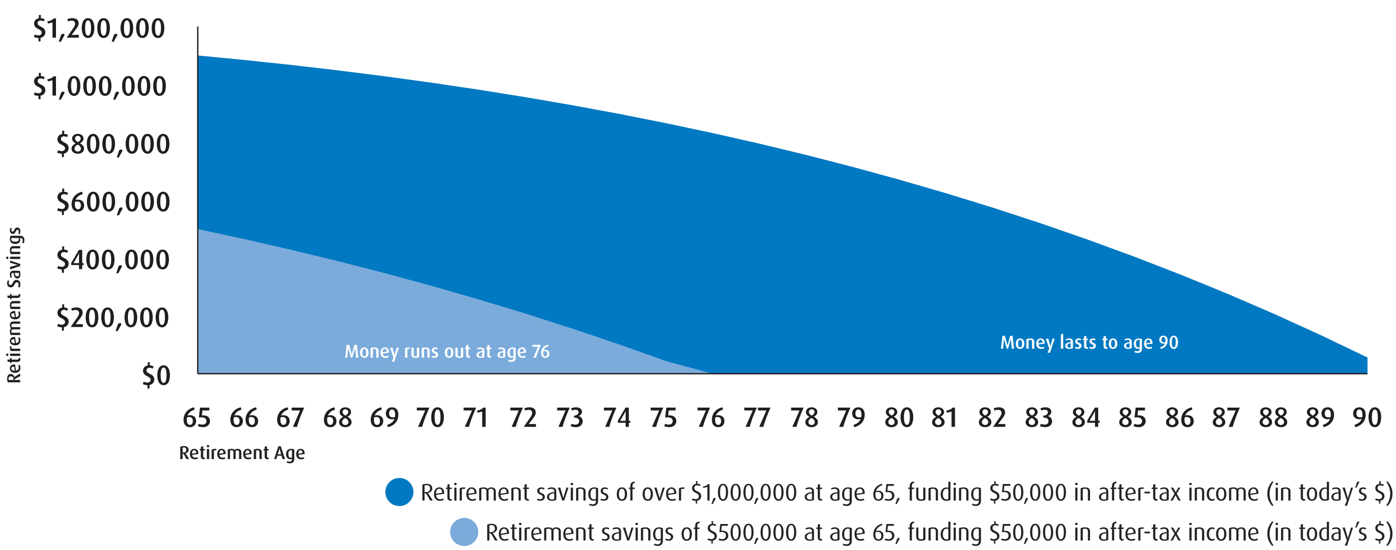


Source: BMO Wealth Management survey by ValidateIt Technologies Inc., July 2016.

As for when to retire, business owners typically work well beyond the typical retirement age, with an expected retirement age of 72.6 years for self-employed individuals.[3]

With this in mind, a preliminary financial plan can be created to show the shortfall in a business owner's retirement fund based on how much is being saved each year. The following chart shows that, like Frank, many business owners will probably have to rely on the value of their business to help fund their future retirement.

Is $500,000 in retirement savings enough?



Assumptions: The savings are accumulated in a non-taxable investment account with a rate of return of 4% from interest income, taxed at a blended tax rate of 20%. The withdrawals of $50,000 in after-tax income in retirement are indexed for inflation at 2%. The following calculations do not take into consideration any additional sources of income such as Social Security, corporate pensions, retirement accounts, or corporate accounts.

Withdrawing at a rate of $50,000 per year can cause a $500,000 pool of retirement savings to be depleted in about 12 years as shown above. For this level of retirement income to be sustainable during a retirement that lasts between ages 65 and 90, it will take more than double the initial amount of savings, or almost $1,100,000. This sizable difference highlights the importance of being able to depend on the value of your business for your retirement.

Turning a business into a retirement asset

Two questions have to be considered when trying to convert an operating business into liquid funds that can be used to help meet specific retirement funding goals:

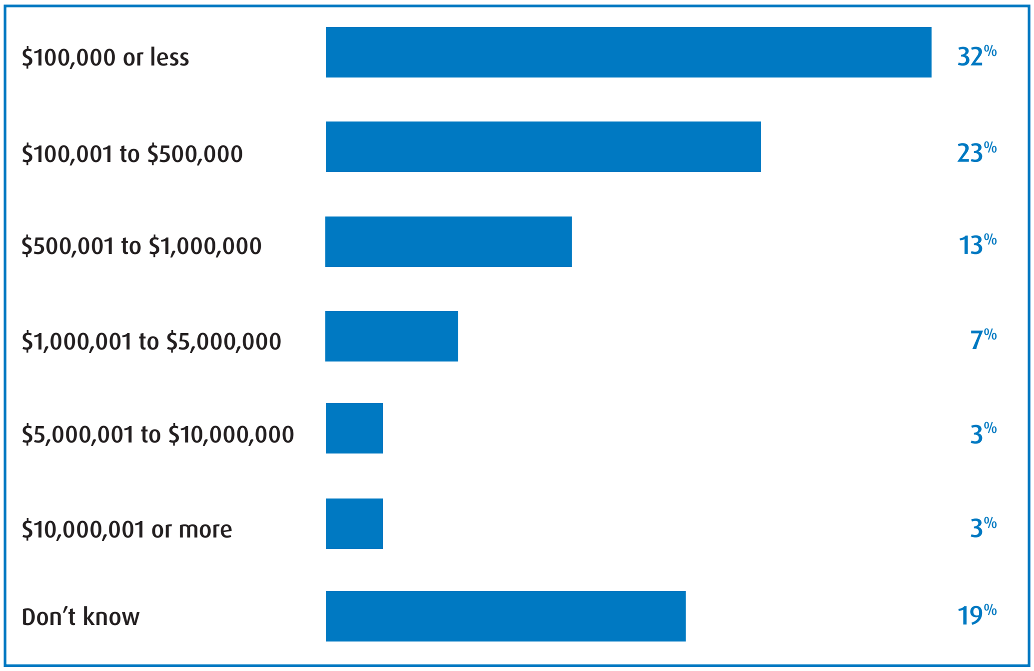
- **How much is the business worth?**
- **What methods are available to convert a business into retirement capital?**

Unfortunately, a third question has to be asked as well: Is it even possible to find a buyer for the business, or to convert the business into retirement funds in any way? In many cases, it may not be possible. A high percentage of participants in the survey (31%) cited heavy reliance on the active involvement of the business owner as a barrier to succession planning and the conversion of a business into retirement capital.

Valuing a private business

Assessing a reasonable value for a private business is no easy task, and often, there is a limited amount of information available to benchmark a business. When business owners were asked the value of their business should it be sold today, a majority of those surveyed (55%) estimated that it was worth less than $500,000. Only 13% believed their business was worth more than $1,000,000.

Valuations of businesses by their owner



Source: BMO Wealth Management survey by ValidateIt Technologies Inc., July 2016.

When private business owners require a formal valuation of their business, a professional business appraiser can be consulted. Often, the result of a formal business valuation is lower than the business owner expected, as the only true value of a business is the amount that a willing and informed buyer will pay.[4] Private businesses can be valued by a number of methods[5]:

Income approach Applying an appropriate multiple to the value of future cash flows or income

Market approach Based on the prices obtained from the sales of similar companies

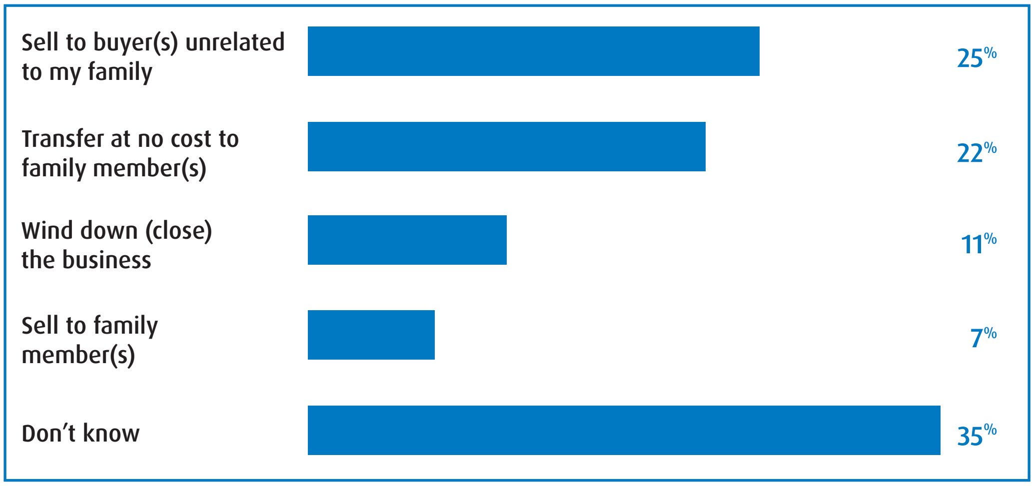
Asset-based approach The value of assets in the business, less any liabilities

Determining the value of a private business is often very complex; the business' income has to be recalculated to be forward looking without any involvement or expenses of the business owner, comparable transactions are scarce, and it can be challenging to make objective valuations of the assets of a business.

Exit options for business owners

Private business owners have a number of exit options, some of which will provide additional funds to help meet gaps in their retirement funding needs. Survey respondents indicated that they would prefer to sell their business to an unrelated person (25%), transfer to a family member for no consideration (22%), wind down and close the business (11%), or sell the business to a family member (7%). A sizeable minority (35%) did not know which of these options they would choose. Business owners considering a transfer or sale within the family must also determine if there is even interest from family members in assuming ownership responsibilities. A lack of interest may require additional flexibility when considering exit options.

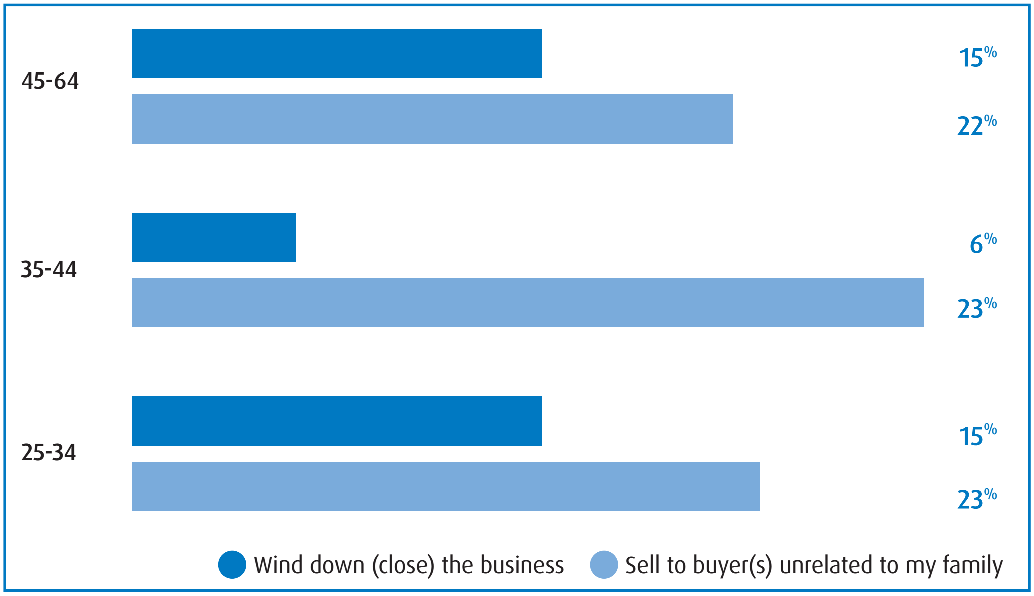
How would owners choose to exit their business?



Source: BMO Wealth Management survey by ValidateIt Technologies Inc., July 2016.

It is worth noting that business owners between the ages of 45 and 64 were more likely to consider winding down their business and less likely to try selling to an unrelated person than all of the business owners surveyed. The views of this group are significant because more than half of all business owners are age 50 or older.[6] These owners also had a lower expectation that they would be able to find anyone outside their family to buy the business.

Business exit strategies by age of owner

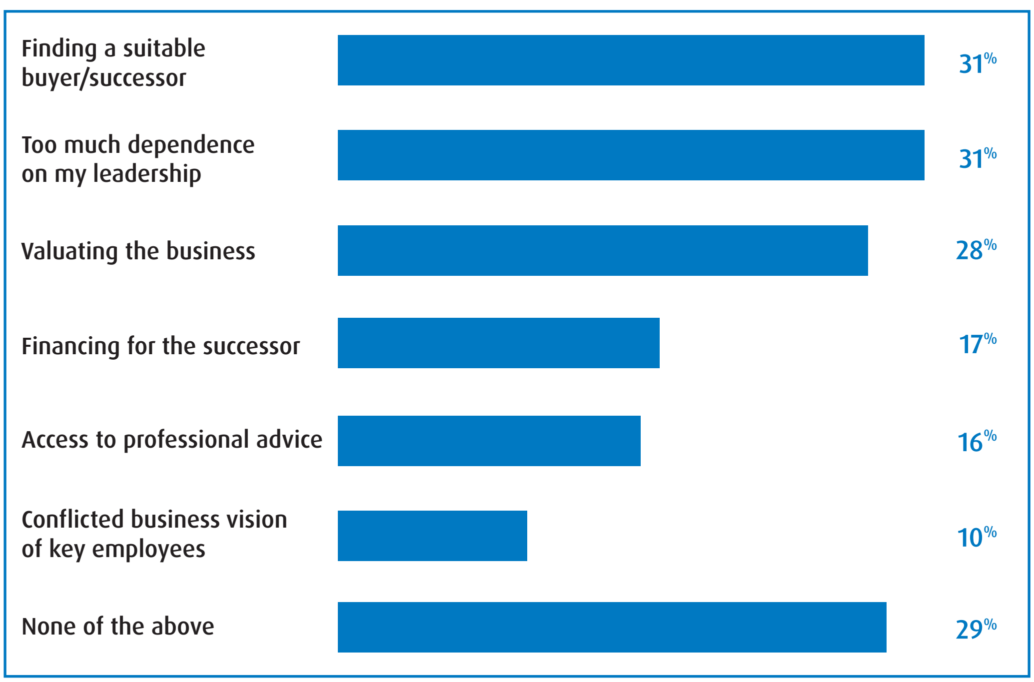


Source: BMO Wealth Management survey by ValidateIt Technologies Inc., July 2016.

This lowered expectation is explained in part by the many barriers to succession planning that business owners surveyed have experienced. Finding a suitable buyer was a barrier for 31% of respondents. Additional barriers are listed in the following table, where, according to business owners, overdependence on the owner's leadership (31%) and determining the value of the business (28%) are standout factors.

Seeking counsel from financial professionals, can help overcome these barriers.

Barriers to succession planning for business owners



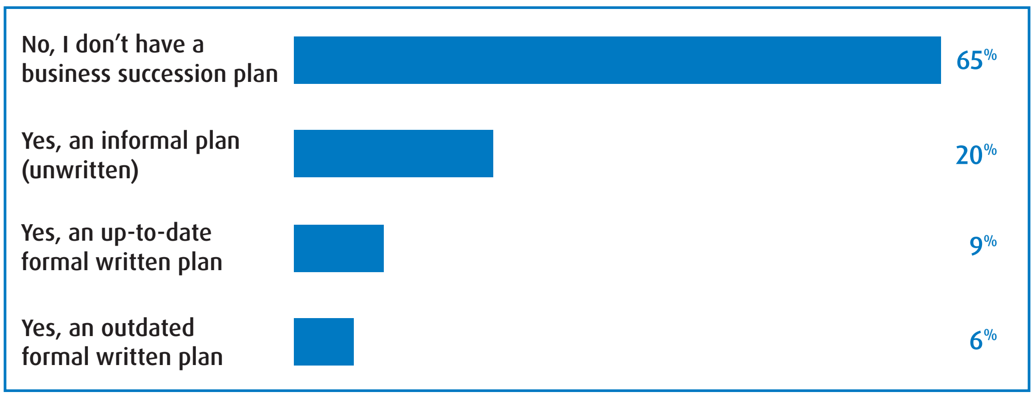
Source: BMO Wealth Management survey by ValidateIt Technologies Inc., July 2016.

Planning for the future

Retirement planning for private business owners can be complex, as it is necessary to have a business succession plan and a personal financial plan focused on retirement that work together. Both of these plans require a personal commitment in order to create an overall retirement plan that can be successfully achieved.

Participants in the survey were asked if they have a business succession plan in place to help sell, transfer or wind down their business in the future. Almost two-thirds (65%) indicated that they did not have a business succession plan. More concerning was the finding that only 9% of business owners surveyed had an up-to-date, formal written plan. Even for owners aged 45 to 64, who could be considered to be approaching retirement, this figure only rose to 10%. Only one-fifth (20%) of all respondents indicated that they only had an informal, unwritten business succession plan.

Do business owners have a succession plan?



Source: BMO Wealth Management survey by ValidateIt Technologies Inc., July 2016.

A formal, written business succession plan has many components and its development considers many options. Its purpose is to set an overall plan for how the business should be managed once you are no longer active in the business. It should also detail the steps to transfer the management of your business, its core values, culture and traditions.[7] Most importantly, it includes both technical concerns, such as legal, accounting and tax matters, and softer interpersonal issues that are of the utmost importance for family members, key employees and other business stakeholders. The most successful business succession plans take a number of years to implement and cover both the technical and soft interpersonal issues.

The purpose of a succession plan is to set an overall process and a time schedule for the business owner's planned withdrawal from the business.

Challenges to withdrawing from your business

In the BMO survey, three in five (60%) of the business owners surveyed planned to sell their business to an unrelated third party, or had no preferred option for withdrawing from their business. The many barriers to exiting a business cited by business owners make it crucial to formulate a contingency plan for retirement that includes the enhancement of non-business savings.

Certain situations can also put your retirement plans at risk:

Business in decline Putting personal funds back into a business going through a downturn might help bridge your business to better times. In the example above, Frank's manufacturing business needed dramatic changes and further investment to return to viability in the face of new competition. Ongoing personal funding of current operations without a long-term revitalization plan could lead to a situation in which such investment might never be recovered.

Selling with vendor financing Often, a purchaser of a private business does not have the capital, or the ability to borrow sufficient funds, to pay outright for it. For a sale to key employees or non-family management team members this is often the case. To facilitate a sale, business owners often provide financing, expecting repayment over a number of years. If the business does not succeed under new ownership, or the new owners do not honour their financial commitments, you may be left receiving only a portion of the negotiated sales price.

Failure of a family business Many business owners planning to pass on their business to the next generation put ownership structures in place to allow for continued cash flow, often in the form of dividends, to help provide for their own retirement funding needs. Unfortunately, only 30% of family businesses survive into a second generation,[8] so you may not receive the ongoing retirement income you expect.

Inflexible business structures Sometimes, the availability of suitable cash flow from the withdrawal from a business is restricted by previous planning, such as estate freezes that pass on growth in the business to other owners.

Any of these situations could have a negative impact on your ability to fund your plans for retirement.

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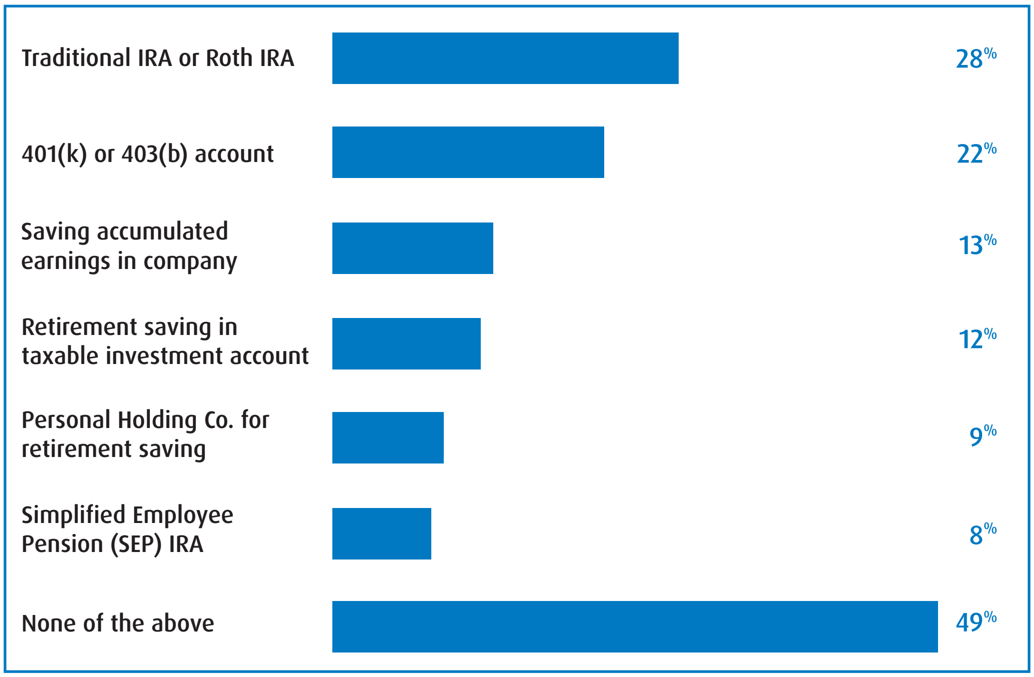
Putting an effective retirement plan in place

If you are intending to sell your business as part of your retirement plan, there are a number of steps that can be taken in advance, under the guidance of your tax professional, to minimize the amount of taxes owed. As a result of the sale of the business, there may be capital gains incurred, at least the tax rate applicable to capital gains is often lower than would otherwise be payable on regular income. Additional long-term tax advantages may also be achieved by the use of insurance policies or pension plans put in place prior to the sale.

An effective retirement contingency plan includes savings outside of the assets of the business that can be used to help fund your retirement needs. When asked about the diversification of their retirement assets, 28% of private business owners taking part in the BMO survey reported that they had invested funds in their Traditional IRAs or Roth IRAs and 22% had a 401(k) or 403(b) account for retirement. Almost half (49%) had not diversified their pool of retirement capital. Business owners closer to retirement had accumulated greater savings outside their businesses, with 39% having investments in Traditional IRAs or Roth IRAs, and 29% saving in 401(k) or 403(b) accounts for their retirement.

Diversification of retirement savings



Source: BMO Wealth Management survey by ValidateIt Technologies Inc., July 2016.

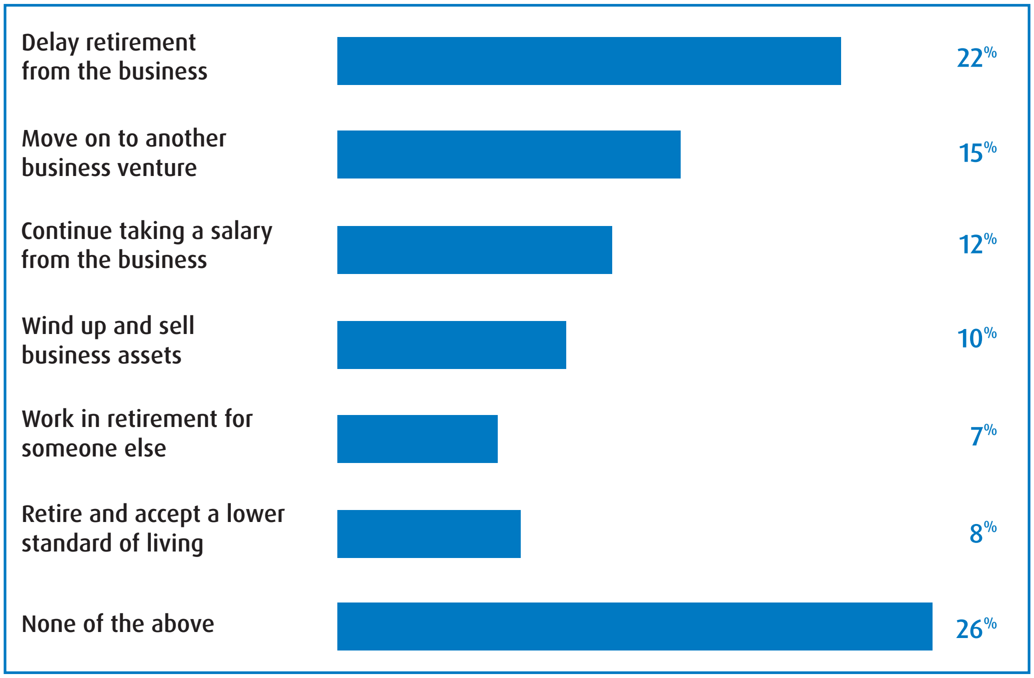
It is important to establish diversified retirement savings personally and outside of business, given the risks and challenges in converting business assets into funds for retirement.

The importance of owning diversified retirement savings personally and outside of your business cannot be emphasized enough, given the risks and challenges in converting business assets into funds that can be used for your retirement.

When retirement assets are not available

When private business owners who took part in the survey were asked what contingency plans they had in place in the event that their business could not be sold, or that the sale proceeds were not sufficient for their retirement purposes, they reported a range of solutions. These included delaying retirement (22%), moving on to another business venture (15%), continuing to draw a salary from the business (12%) and winding up their business (10%).

What would owners do if the sale of their business could not support their planned retirement?



Source: BMO Wealth Management survey by ValidateIt Technologies Inc., July 2016.

For business owners aged 45 to 64 and closer to retirement, the two most frequently cited solutions were delaying retirement (28%) and retiring and winding up and selling the business (13%). These results are consistent with the finding that a large proportion of business owners have not yet diversified their retirement assets beyond their business holdings.

One additional option may be available for business owners that have buildings, land or other valuable assets as part of their business. Even if the operating business cannot be sold and converted into necessary retirement funds, such assets are more liquid and often are quite valuable. For example, Frank could fund his retirement from the proceeds of the sale of his business' equipment, building and land. However, the tax implications of the sale of any business assets must be carefully considered.

Conclusion

Tom Deans noted in his book **Every Family's Business** that in order to maximize shareholder value, the owners of a family business should be ready to sell at any time if the right price came along.[9] While it is important to have a contingency plan in place for your retirement, sometimes the opportunity to help make your business succession and retirement plans a reality will arise.

Working together with BMO financial professionals who understand the needs and challenges of private business owners can help you make the plans necessary both for your business and your personal situation in order to achieve a financially stronger retirement.

Footnotes

[1] The example of Frank is a fictional character and is based on a composite of a number of observed situations. Any resemblance to any person or business situation is merely coincidental.

[2] BMO Wealth Management survey conducted by ValidateIt Technologies Inc. between the dates of June 27 and July 5, 2016. The online sample size was 403 American small business owners between the ages of 18 and 64 with at least two employees. The survey has a confidence interval of +-4.83% at the 95% confidence level.

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