The retirement trap

Failing to properly plan for your later years could keep you from selling your business.

There are two story lines here. The first involves a successful business owner. We all know one. We admire them, envy them, and maybe we are them. I'm calling mine Phil. He started his business long ago, when his needs were simple and ideas unrestrained. Anything was better than getting a job, so he jumped in at a time when clearing $1,000 per month left plenty of room for fun. Advance the clock 30 years, and Phil is getting close to age 60. For Phil, the business worked out and life is pretty good. He has a great family, beautiful home, a place at the beach and nice cars. He's a member of the golf club and gives generously to the fundraisers. Phil's got it made. He estimates the business is worth about $5 million and complains about all the taxes he pays from his $500,000 of profits each year.

Here's the second, seemingly unrelated story line. From a 2015 article in *Barron's* titled, "Retirement Rules: Rethinking a 4% Withdrawal Rate", Reshma Kapadia writes that the 4% rule was first introduced in 1994 by financial advisor Bill Bengen and soon became conventional wisdom. Some readers may even remember the 1980s, when 5%, 6% and even 7% were discussed as reasonable withdrawal rates. Kapadia quotes Wade Pfau, professor of retirement income at the American College of Financial Services: "The rule suggests that if retirees withdraw 4% of their portfolio in their first year of retirement, and adjust that initial amount for inflation in subsequent years, they'll have a low risk of depleting their portfolios in 30 years." Pfau goes on to say that today, 3% is a better starting point for inflation-adjusted spending and this is *not* expected to cover the cost of medical and long-term care costs, which need to be handled separately.

Let's go back to Phil, who luckily found a buyer for his business and got his asking price of $5 million. Phil has a good CPA, who keeps the tax burden on the sale to $1 million, so he nets $4 million. Phil is now quite proud of his big, fat investment account holding all this money. He's set, right?

Here's where the two story lines collide. Now retired and with time on his hands, Phil begins to design his retirement lifestyle by doing his reading and meeting with with a certified financial planner, and he does not like what he's learning. His business intuition was fantastic, but unfortunately, his financial planning intuitions had not kept up because he was thinking that the 10% yield he got from his business must certainly be something he could replicate from a well-managed portfolio. But his readings were directing him toward a 4% rule, and his planner was suggesting a 3% rule. Even the 4% rule applied to his $4 million portfolio yields $160,000 of annual retirement income. If he anticipates social security adding about $40,000 annually, his total income will be $200,000. And that's a 60% pay *cut*. The U.S. Small Business Administration Office of Advocacy reports that there are 28.8 million small businesses — those with less than 50 employees — in the U.S. There are many owners like Phil out there. And, frankly, I've painted the above picture about as rosy as possible. Yes, you might say he should have seen it coming, but let's be honest, it's hard to gain experience in something you might only do once in your life – selling your business.

Let's look at some possible ways that Phil could have better prepared for retirement.

1) Develop a plan for generating income in retirement.
   a) Perhaps Phil could have owned some real estate connected with his business and held onto it after the sale as a source of rental income.
   b) He could have built retirement assets outside of his business. He was making $500,000 per year. The rule of thumb of saving 20% for your future applies to everyone. It doesn't matter how you generate your income, you must be a good saver. For Phil, that's $100,000 per year.
   c) And, there are the traditional methods for creating income in retirement by owning income annuities and harvesting cash value from life insurance policies as a supplemental retirement resource.
2) Perhaps Phil should not sell his business. Is it possible to hire professional management to run the business and continue to receive some level of profits from the business? This becomes a serious concentration of risk issue, but maybe Phil wants to see family members run the business someday or perhaps there are key employees ready to step up to the challenge.
3) Once a realistic retirement income picture begins to take shape, work diligently to adjust lifestyle spending to your future retirement levels. Is that big house really where you get your enjoyment, or would you rather spend more time traveling than on home maintenance? Downsizing and paying off debts, etc., could take a few years to smoothly accomplish, so starting early on your retirement income projections is important.

The feeling of financial security is derived from income, not assets. Yet by saving, we generally mean accumulating assets. Even though we might be successful at accumulating assets, anxiety remains common because we're not sure how to efficiently turn those assets back into income. The 20% savings rule and the 3% or 4% distribution rule are not rules at all. They represent conventional wisdom and must be tailored to an individual's circumstances. Start early and find a fee-based certified financial planner and develop your own personal roadmap for retirement and determine how transitioning your business fits into the overall plan. Don't get trapped.

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