Will Your Business Fund Your Retirement?

Many business owners look at their business as their nest egg which, when sold, will give them enough money to live on comfortably in retirement.

But this isn't necessarily the case, and it's worthwhile checking the figures to work out whether the business will provide sufficient capital to fund the desired retirement lifestyle, or whether there is a 'business capital gap'.

The business capital gap is the shortfall between the value of the business today and what the owner needs from it to fund retirement. This shortfall can be significant. It can greatly affect standard of living, or potentially mean that business owners can't afford to retire.

Business owners typically earn a fair compensation for the work they do plus a share of the profits each year. The funding of lifestyle assets such as cars, houses and holidays may have taken priority to the detriment of accumulating wealth-producing investments that are independent of the business.

This can frequently mean that when the business is sold, owners are disappointed by their reduction in income. When these circumstances arise, it clearly shows that not enough thought has been given to retirement planning and business succession.

The situation is increasingly likely to occur because the number of Australian businesses for sale is expected to increase as the baby boomer generation retires. Potential buyers such as managers in the business or family members may be heavily mortgaged, limiting their ability to fund business purchases.

Younger family members also may prefer to remain independent and be unwilling to take over the business from the retiring generation. These factors can all translate to a buyer's market.

On the other hand, pre-planning and having a succession plan in place can maximise the value an owner gets from the business.

The examples below demonstrate the potential impact of a business sale on retirement income. Careful planning in advance of sale, including prudent tax management and structuring, holding investment assets outside the business, a transition to retirement strategy, succession planning, and keeping aware of business sale opportunities and cycles in valuations is needed.

Having a business plan and going through a business planning process can increase the earning rate of the business and thus its sale value thereby improving the owners' exit position.

Example 1 – small business

Alice Smith runs a small retail business with annual sales of $2.5 million. She is the sole owner and takes an income of $150,000. The business's net cash flow is $250,000 a year.

The business has been independently valued at four times cash flow, giving it a value of $1 million. Tax on the proceeds takes $250,000 (unless Alice has set up business ownership in a way that takes advantage of the CGT small business concessions) meaning Alice receives a net $750,000 from the sale.

She contributes the funds to her superannuation account where they earn a modest but reasonable five percent per annum meaning she only receives $37,500 income a year. This is a 75 percent reduction on her previous income and unless she has other retirement savings will not provide for a comfortable retirement.

Example 2 – larger business

Michael Jones and David Williams each own 50 percent of a property development business with annual sales of $7.5 million. They earn $250,000 each from the business, and its net cash flow is $500,000 per annum.

They decide to sell the business to an individual who will run it on her own (meaning one of the existing owner's salaries can be added back to the cash flow for valuation purposes, bringing this up to $750,000).

The business is valued at five times cash flow giving it a value of $3.75 million. After tax at 25 percent (assuming full CGT is paid on the sale), Michael and David each receive just over $1.4 million.

They each contribute the funds to their superannuation accounts and earn five percent, their new annual income is now $70,000 each, a reduction of 72 percent. Again, this may not be enough to support the retirement lifestyle that they and their spouses were hoping for.