Helping a Client Get Off the Fence
Bank Investment Consultant / November 2006

ADVISOR CHALLENGE by howard j. stock

Helping a Client Get

Two advisors tackle the same hypothetical small-business client

THE CLIENT: Bob Weiderman, 52, is married with three grown children (26, 28 and 31 years old—all college grads). He lives in Akron, Ohio, where he owns a $3 million fencing business and employs 20 workers. He earns $150,000 per year and holds a term life insurance policy. He's used to taking moderate risk as a business owner. His assets are tied up in his house, which he has almost paid off, and his business.

Bob is thinking about his retirement, but hasn't done anything about it. His insurance

DONALD W. PATRICK
Managing Director
Integrated Financial Group
Atlanta

WE NEED TO MAKE A NUMBER OF ASSUMPTIONS TO give the proper advice. Assume that Bob wants to retire at age 62. His life expectancy is 90, and his wife 95 (this would follow a discussion of family longevity and their current health status).

Let's also assume that Bob's business will grow at 4% per year until retirement. If he sells the business outright (easier said than done), he would net $2,370,000 after 15% federal capital gains tax and 6% state tax. Using Monte Carlo simulation, and assuming a "60/40" portfolio (60% equities and 40% cash and bonds) at retirement, he has close to a 100% probability of success if he enjoys a lifestyle of $120,000 per year. Every five years, we assume he gets a 20% increase for inflation. We suspect there is enough surplus to buy his boat (not to exceed $200k) to sail around the world. If Bob were to die today and the heirs could liquidate the business, his spouse would have sufficient capital, thus there's no need for additional life insurance.

SUCCESSION PLAN

If Bob were to sell the business to an outsider, we would recommend "grooming" it five years prior to selling. This means ensuring it can run without the owner, implementing repeatable systems (E-Myth is a great resource), ensuring that the books are kept properly and verifying that the business is worth $3 million (business owners often inflate the true value).

Bob may want to turn the business over to his children, one or all three of whom may have an interest in it and bring different skill sets. However, only one sibling should have a controlling interest because you cannot run a business by committee. Funding the purchase of the business by the kids could be a problem. If Bob is only able to take $150,000 per year out of the business, there may not be enough profitability to pay a salary and do a buyout over, say, 10 years. We would need to examine the income statement and the balance sheet.

Bob could establish an Employee Stock Ownership Plan (ESOP), which would allow him to exit the business in a tax-efficient manner and turn ownership over to his employees. He would need to groom a manager to fill his roll. If there's sufficient cash flow, he should explore some pension options, either in conjunction with an ESOP or separately. However, with 20 employees, this strategy probably will not work. It might be possible to implement a defined benefit pension plan, which would let Bob pull money out of the business in a tax-favorable manner. If the employees are older and/or have higher salaries, the cost of funding the plan may neutralize any benefit for Bob.

ESTATE PLAN

Bob could explore a revocable living trust. He and his wife need Powers of Attorney for health care and finances. To manage his estate taxes, he might put the home in his wife's name and establish a limited liability corporation to own the business. He could then gift shares to his wife to equalize ownership of assets for estate tax purposes. He could also gift shares to his children if his financial independence needs are met. This could also help reduce the value of the business for estate tax purposes.

PLANNING ISSUES

- Ensure Bob has $2 million in umbrella liability coverage. Review homeowners and auto insurance for proper liability; they should have high deductibles.
- Structure the transition of the business so that he gets a small consulting fee in order to qualify for group medical until he and his wife are eligible for Medicare.
- Consider a group long-term care program, which would be less expensive for the employees, who would pay the premiums.