Inc.

PERSONAL CAPITAL

Selling Your Business Won't Fund Your Retirement. This Overlooked Strategy Will

Strategic retirement planning for entrepreneurs involves this little-known technique.

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Don't let retirement planning take you by surprise. Photo courtesy of Getty Images.

A fellow entrepreneur once told me that owning a business was like having a job you can sell. It's a wonderful thought, but I don't know that it's accurate, and it's definitely not the best way to plan for retirement.

Small-business sales rose sharply in 2017 with 9,919 small businesses sold, an increase from 7,842 in 2016. The Small Business Administration estimates there are 29.6 million small firms in the U.S. According to the Bureau of Labor Statistics, only 56 percent of businesses survive after five years. This tells us two things:

1. Three out of 10,000 businesses get sold each year, on average.
2. Only a bit more than half of businesses survive the first five years, so you may not have a business to sell in the future.

I raise these points not to convey doom and gloom or to scare you away from starting a business, but to ensure that your business helps you succeed now and in the future. To that end, I strongly recommend that you take advantage of the tax-deferred and bankruptcy-protected savings vehicles that the Internal Revenue Service has available for small-business owners.

Specifically, you should look into a Simplified Employee Pension (SEP) or a 401(k) plan. Here's a breakdown of how they work, and the differences that matter for you as an entrepreneur.

How SEPs Work for Small Businesses

An SEP is better for small businesses with a lot of cash and few to no employees besides yourself. This is because it allows the business to save the lesser of $55,000 or 25 percent of your salary in 2018, but the same contribution percentage is applied across all qualified employees.

The business funds an SEP-Individual Retirement Account (IRA) for each employee, which is similar to a traditional IRA, and the individual can then choose how to invest the money. You don't need to decide how much to contribute until you are filing your business tax return, but you do need to include all eligible employees.

They all get the same percentage of salary contributed, hence why this is a good option for one-person companies. As an example, if you are able to contribute the maximum for 20 years at eight percent, you're looking at a nice nest egg of $2.5 million.

Advantages of an SEP Over a 401(k)

A 401(k) is a bit different, as it allows the individual to reduce their taxable salary and put the money into a retirement investment account. It lets the company match part of an employee's salary--say, three percent. The matching and the costs of the 401(k) plan are both business expenses for the company.

In 2018, individuals can contribute up to $18,500, and if you are over 50 years old, you can contribute an additional $6,000. If you earn $75,000 and are able to contribute the full $18,500 per year with a company match of three percent, then after 20 years, assuming an annual rate of return of eight percent, you would have a nest egg of approximately $950,000.

When you consider that in 2017, the average small business sold for $229,000, the importance of saving via cash flow rather than relying on a "big exit" is even clearer. Of course, stock market returns are not guaranteed--but neither is the ability to sell your business.

If you aren't sure how to set up a plan or invest your funds, take a look at Betterment, Wealthfront, and Vanguard for low-cost diversified portfolios. After all, given the choice, it's better to save as you go. And if you can sell your business in the future, it's all upside!

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