Special Considerations for the Self-employed

Business succession or retirement planning means building a bridge between your life today and your future. By weighing alternative courses of action, you can design your individual plan.

To do this, think about where you want to live and what you want to do during your post-business years. To explore these topics further, refer to Picture Your Future, PM 1817, in this series.

As you paint your retirement picture, where does the business fit? This is a major question for the self-employed, whether you have earned your living from farming, a main street business, manufacturing, a trade, profession, or other business. A major concern is the future of the business. Do you have an operating heir? Will the business be sold? Leased? Closed?

These are tough questions. Because a business often is a large part of a retirement fund, the income it will generate always is a major concern. How much money will you need from the business to live the lifestyle you are picturing?

What Are Your Spouse’s Goals?

Have you talked with your spouse about his or her retirement picture? Two spouses may see quite different retirement pictures. Consider:

- When do you each plan to retire?
- Will retirement be phased in over time?
- Where will you live—part-time in the home community and part-time somewhere else?
- If one spouse is still employed, will it be possible to be gone for extended periods?
- If one spouse is older, will the younger spouse wish to retire at the same time?
- How will early retirement affect the younger spouse’s retirement benefits?

NOTE: Several ISU Extension and Outreach publications are referenced throughout this piece. Search by title for a copy of these free resources at our Online Store, store.extension.iastate.edu.
Business Contact or Friend?
Many self-employed people have spent most of their lives building the business. Often business and personal lives intertwine, making it hard to separate them. Will you miss seeing your regular clients or customers? Will you miss the activity?

Do You Have Other Interests?
Outside interests provide a base for retirement activities. Do you have a hobby such as woodworking, china-painting, stamp collecting? Do you enjoy fishing, hunting, gardening, bowling, golfing, or another activity? Do you belong to civic organizations? Do you volunteer within your community, church, school, or other places of interest to you?

How Much Will It Cost to Live?
Consider how expenses may change in retirement. Write down everything that you spend, and then think about which expenses may be higher or lower in retirement. For help estimating your retirement expenses, refer to PM 1818B, Estimating Your Retirement Expenses.

Did you receive a benefit from your business that defrayed family expenses? If you had meat, fresh fruit, or vegetables from the operation, you may find that your grocery bill will be higher. If you owned a clothing store, will you now be paying full price for clothing? Were there shared expenses between the business and household? Will tax deductions change for things like shared electricity, heat, phone, or transportation?

The Medicare enrollment window is 3 months before and after your 65th birthday. Contact Social Security to enroll. Many retirees also purchase a Medicare Supplement Insurance policy and/or a Prescription Drug (Part D) policy to help reduce their out-of-pocket costs. Once enrolled in Medicare you have a short grace period in which you can automatically enroll in a supplemental plan regardless of health history, so explore your options early.

Contact the Senior Health Insurance Information Program or SHIIP for free planning resources. SHIIP is a service of the Iowa Insurance Division. Call 800-351-4664 or visit the Web at www.shiip.state.ia.us for additional information.

To consider further how much retirement income you may need, refer to PM 1818A, Retirement Income: How Much Do You Need? No one knows what future costs will be. How will inflation affect what you will need? PM 1819, Money Math, can help you put projected numbers together. Think about how business cycles might affect your numbers. Consider contingencies for the “best case” and “worst case” possibilities. Economic cycles may affect the worth of your business.

Investing for Retirement
Many nonbusiness retirement investment opportunities are available for the self-employed.

Learn more about Individual Retirement Accounts, Keogh plans, Roth IRA’s and other retirement vehicles in PM 1822, Retirement Investment Options. See the special section for the self-employed.

Business Issues
If you are self-employed, the decision to retire will involve much more than cleaning out an office or giving up the daily commute to work. A business involves a collection of physical assets, such as inventories of goods, equipment, buildings, or livestock and land. Do you plan to: transfer the business, develop a “multiperson” structure, sell or lease the business, give it as a gift—or close the business? Will you want to maintain a role in the business after retirement? The method used will depend on your financial condition, future plans, and objectives of those involved.

Disposal
If you contemplate a disposal of the business, the most important consideration may be how to sell or rent the assets for the highest return. Consider how tax liability may affect the net sale. An auction or dispersal sale is quick and final. Such a sale may require a considerable amount of preparation and publicity, but many professional auction companies can provide assistance. Selling everything at once will attract a large number of buyers, but bad
weather or other unforeseen events may keep people away. Market risk also may be a concern. An alternative is to sell items privately, through newspaper and magazine ads, Internet services, or a professional broker. This process is slower, but usually allows a choice of offers.

**Transfer**
The real value of a business, however, may lie in the intangible assets such as a customer base, a product name and reputation, or the genetic pool built up in a herd of livestock. An intact transfer of the business will preserve these intangible assets, and pass on their value to the next operator or owner. Transferring an entire business will usually require more time, effort, and planning. Financial and emotional rewards, however, will likely be greater.

**Sale**
Selling a business or its individual assets outright relieves you of any future responsibility. If the sale is for cash, the immediate problem is how and where to invest the proceeds to provide the desired mix of cash income, growth, and security. The sale of assets and resulting tax liability may result in significant costs, resulting in fewer funds available to invest for retirement after the tax obligations have been paid. If an installment contract is selected, the proceeds will become available over a longer period of time. The terms of the contract should match your expected income needs. Pay attention to provisions that address late payment or nonpayment by the purchaser.

When a business is sold to a family member, the interest rates may be set below market values, but not below the Applicable Federal Rate, to assist the next generation in taking over the business. Be sure that adequate income will be available to meet your retirement needs. Helping establish children in business should not come at the expense of your own financial security. Also, consider how other members of the family will perceive the transfer process. Working out terms that are acceptable to everyone may require some professional advice.

Whenever assets are sold, income tax consequences are triggered, even with contract sales. Inventory items such as retail goods, grain, or livestock may create a considerable tax bill. Likewise, selling depreciable assets may result in a recapture of depreciation, which also is taxed as ordinary income. Finally, assets that are sold for more than their original cost or tax basis will create capital gains income. Land and buildings will likely fall in this category. You should consult a tax planner before making plans to sell taxable assets. It is usually not possible to avoid or substantially reduce taxes resulting from the liquidation of a business. At best, the tax bill can be delayed or spread out over a longer period of time. Certain assets passing through an estate receive a new basis which may eliminate tax liability built up over time. The only exception is that real estate assets passed on through inheritance receive a new tax basis, which essentially eliminates the capital gains that have been built up over time.

**Leasing**
If you would rather receive a regular income from your business assets than a lump sum payment, you may prefer to lease rather than sell. Leasing also allows you to retain some control over use of assets and business operation. Along with that, however, comes the responsibility to maintain and replace property, the need to deal personally with the tenant, and the risk that rental payments may not be made on time. Many of these duties can be shifted to a professional property manager or farm manager, in exchange for a portion of the income generated.

Farm property is typically leased under either a cash lease or a crop-share lease. A cash lease provides a fixed income with little involvement in the business operation. The most important decision is setting an appropriate rent for a specific property. Extension publication FM 1851, Cash Rental Rates for Iowa, summarizes the results of an annual survey of farm lease terms. Some farm landowners have a flexible lease agreement, which gives a formula for setting yearly rent, based on actual farm yields and prices.

A crop-share lease provides the opportunity (and responsibility) to share in decision-making about cropping programs and practices, and in the marketing of grain. You also will share in the risks and rewards of the farming operation. With a share
lease the level of your involvement will determine if you are considered to be “material participants” in the business, which means the income you receive is taxed as earned income rather than investment or rental income. Whether this is desirable or not depends on your ages, your objectives relative to Social Security taxes and income, and your estate plan. See FM 1564, Improving Your Farm Lease Agreement, for more details.

**Family-Owned Business Considerations**

When asked, many families talk about their goals for the future of the business. However, few have developed a written plan to transfer the ownership of the family business when they retire or die. Have you discussed how the transfer of your business may affect family members? Do you have a written plan in place?

There are many issues to consider when thinking about transferring ownership. Considerations important to some families include: treat all children equally; start one or more children in the family business; provide financial security for themselves or their survivors and/or keep the business within the family. What is important to you?

How do children who are not currently part of the family-owned business fit into the picture?

As you plan for retirement, are you also estate planning? Should the “sweat equity” of the child who has worked in the business be considered? If you or your spouse dies, will the remaining spouse have enough money available to live?

Each situation is unique, so what works for someone else may not work for you. Also, the complex legal issues make this a good time to consult an attorney who specializes in property transfer, income, gift, and estate taxes.

**When Business and Home Share an Address**

Do your residence and business share an address? Will you plan to continue living at that location after retirement? If you continue to live there, how will you feel when someone else is making the operating decisions? How much involvement will you have in the business after retirement? If moving is part of your retirement plan, will you miss landscape plantings such as rhubarb, strawberries, apple trees, or special flowers? Will you be glad to give up the responsibility? These questions and others are important parts of the retirement decision.

**Less than one third of family businesses survive the transition from first to second generation ownership. Of those that do, about half do not survive the transition from second to third generation ownership. The primary cause of failure is the lack of planning (from Transferring Management in the Family Owned Business, by Small Business Administration).**

**RESOURCES**

- **ISU Extension and Outreach**
  - Ag Decision Maker: Whole Farm – Transition and Estate Planning—[www.extension.iastate.edu/agdm/wdbusiness.html](http://www.extension.iastate.edu/agdm/wdbusiness.html)
  - Family Finance—[www.extension.iastate.edu/humansciences/family-finance-families](http://www.extension.iastate.edu/humansciences/family-finance-families)
  - Ready, Set, Retire Series
    - Farming with an Operating Heir—[store.extension.iastate.edu/Product/PM1167F](http://store.extension.iastate.edu/Product/PM1167F)
    - Farming without an Operating Heir—[store.extension.iastate.edu/Product/PM1167G](http://store.extension.iastate.edu/Product/PM1167G)
- **eXtension**
  - Financial Security; Retirement Planning—[www.extension.org/pages/8633](http://www.extension.org/pages/8633)
- **Iowa Small Business Development Centers (SBDC)**
  - 515-294-2030, [www.iowasbdc.org](http://www.iowasbdc.org)

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