Sentinel

Personal Financial Management Ideas

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Maximizing Value For Retiring Owners

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Planning for retirement can be complicated for anyone, but business owners have even more to consider.

Most retirement planning articles for business owners focus on their retirement plan options, which are essential components to maximizing the tax-efficiency of savings and deserve substantial attention on their own. Yet for business owners, another major consideration is important. Your retirement often means ending your income stream at the same time that you are selling potentially your largest asset: the business. Taking steps to make the company more desirable before a sale can help you start retirement in the best position possible.

When developing an exit strategy from the business, first you should identify and prioritize your objectives. While it will not maximize the company's value, you may want to wind up operations completely if you don't wish the company to extend beyond your involvement. Alternatively, you might choose to transfer the business to key employees, family members, or someone else you know. In this case, you may sacrifice some monetary value in pursuit of other goals for your business's future. Discussing these issues with a financial planner can help crystalize the impact of these decisions on your post-retirement lifestyle and may also help uncover hidden value in your business.

Like most financial questions, the right answer to how to maximize your business's value will depend on your specific situation. Yet certain universal principles can lead you down the right track. At the most basic level, if you want to sell your business, create a desirable company that can exist without your involvement.

Make The Owner Obsolete

The first, and arguably most important, step in maximizing your business's value to a potential buyer is to plan to make yourself obsolete. Many businesses rely on the skills, relationships and expertise of their founder. But a business that can thrive after he or she departs requires a path forward without those intangible assets.

You should establish thorough processes and routines that will allow the business to function smoothly without you. Then test those processes. A well-constructed system will ensure that clients, vendors and employees have a consistent experience, regardless of how much or little you contribute to the relationship.

While some owners feel that they need to be the company's focal point, potential buyers prefer to see a well-balanced team. Your exit plan should involve determining who will take over key tasks and when they will do so. Also consider whether you might better outsource or automate some of your current responsibilities. A strong team with a demonstrated track record of success will not only help your business grow in the short term, but a new owner will value a business more highly if he or she can rely on the existing management team. Because retaining key employees benefits your business, you should also be able to show potential buyers that you have taken steps to encourage those staff members to stay on after your departure.

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France's Terri Schiavo Tragedy

Larry M. Elkin, CPA, CFP®

The tragic case of Vincent Lambert will be achingly familiar to many Americans, who have already seen too many similar controversies.

Lambert, a 42-year-old Frenchman, is lying in a persistent vegetative state at a hospital in his homeland as I write this article. After a 2008 motorcycle accident, Lambert can breathe without assistance but remains in a quadriplegic state of paralysis with minimal if any consciousness. In 2013, Lambert's wife and his medical team came to the conclusion that care should end. Rachel Lambert says her husband verbally expressed that he would not want to linger indefinitely in a vegetative state. Lambert's parents and two of his siblings, however, have vehemently opposed removing life support, setting off a protracted legal battle.

On May 20, doctors began removing life support for Lambert, in accordance with a ruling from the European Court of Human Rights. This took the form of withdrawing nutrition and hydration, as well as applying sedatives. That same day, however, the Court of Appeal of Paris intervened and ordered support restored. It was, 12 hours after it had ceased. The order was based on a May 3 request from the U.N. Committee on the Rights of Persons with Disabilities to the French government, demanding that the government ensure Lambert remain alive until an investigation into his condition took place. After 11 years, there is no immediate end in sight for Lambert and his family.

Lambert's fate might have been easily and privately resolved if he had signed an advance medical directive, the document that many Americans refer to as a "living will." But Europe is startlingly far behind the United States in this area. France did not even have a law establishing advance directives until 2005. Germany passed its legislation in 2009. Italy's version did not take effect until just last year.

In the U.S., all 50 states have legislation on their books authorizing advance directives. California passed the first such statute in 1976, just as the litigation over a young woman named Karen Ann Quinlan was emerging as a major national story. Most other states followed shortly after.

Quinlan lost consciousness at a party in 1975 after combining alcohol and Valium. The 21-year-old lapsed into a coma, and then into a vegetative state. Quinlan's parents eventually decided to disconnect her ventilator. (They, like Lambert's parents, describe themselves as devout Catholics; the couple consulted their priest in making the decision.) Quinlan's medical team, however, faced threats of prosecution and refused to comply with the parents' request. The Quinlans went to court, and in 1976, the New Jersey Supreme Court unanimously ruled that they had a right to remove their daughter's respirator. Karen Ann Quinlan lived nine more years in a nursing home, during which time her parents did not seek to remove her feeding tube.

While Karen Ann Quinlan got national attention, legally her case went no farther than New Jersey. Nancy Cruzan's case made it to the U.S. Supreme Court in 1990. When Cruzan was 25 years old, a serious car accident left her without any vital signs. Paramedics resuscitated her, but Cruzan never regained consciousness. A few weeks later, doctors declared she was in a persistent vegetative state and inserted a feeding tube. Five years after the accident, Cruzan's parents asked that the tube be removed; doctors refused to do so without a court order, setting off another protracted legal battle. The Missouri Supreme Court ruled that no one may refuse treatment for another person in the absence of a living will or other compelling evidence of the patient's wishes. In a 5-4 decision, the U.S. Supreme Court upheld this ruling.

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INVESTMENT FOCUS

Can You Sue A Robot?

ReKeithen Miller, CFP®, EA

Isaac Asimov's first law of robotics, introduced in a 1942 short story, states that a robot cannot injure a human. However, if a robot injures a human financially, could that human take it to court?

The question is no longer confined to science fiction. Samathur Li Kin-kan, a prominent Hong Kong investor, will test the legal limits of liability. He invested in a hedge fund run by a supercomputer that suffered substantial losses, including more than $20 million in a single day. According to Bloomberg, since Li cannot sue the artificial intelligence directly, he is trying the next best thing: suing the company running the fund. Li seems to harbor specific animus for the fund's founder, who personally convinced him to trust the AI-driven fund with his money. Raffaele Costa, an Italian hedge fund manager known to some of his peers as "Captain Magic," sold Li on the merits of Tyndaris Investments' AI-managed fund. The question remains: Is Costa's firm liable for Li's losses?

He invested in a hedge fund run by a supercomputer that suffered substantial losses, including more than $20 million in a single day.

According to court filings, Costa showed Li simulations projecting double-digit returns for the AI-run fund. The two men now dispute the thoroughness of this backtesting. Li's suit against Tyndaris claims that Costa overplayed the AI's abilities. Tyndaris has countered that no one guaranteed Li that he would make money. In an industry that routinely reminds investors that "past performance is no guarantee of future results," I would be shocked if anyone had made such a promise, regardless of the technology involved. Tyndaris is also suing Li for unpaid investment management fees.

Humans have a long history of distrusting automation. When automatic elevators first began to displace human elevator operators around 1900, riders were terrified. The very idea of stepping into an elevator without a human operator seemed unthinkable. It took until the mid-1940s, when New York operators went on strike, for widespread automation to take hold. Building owners pushed for a campaign to convince people to use the new technology. Today, while elevator accidents do happen, they are exceedingly rare. Most of us don't think twice about riding elevators without operators, sometimes many times per day.

Some observers have drawn a parallel between early operatorless elevators and today's driverless cars. If nothing else, a similar wariness from the public lingers. Self-driving cars have been on the way for years now, but the death of a pedestrian in Arizona last year fed existing fears about their dangers. Federal investigators cleared Uber of criminal liability but encouraged local police to investigate the car's backup driver. People want to know who will bear legal responsibility if an AI-driven car causes an accident. The answer is not yet apparent.

Ironically, people seemingly struggle with a tendency to trust artificial intelligence too much when it comes to investing their money. "People tend to assume that algorithms are faster and better decision-makers than human traders," Mark Lemley, a law professor at Stanford University who directs the university's Law, Science and Technology program, told Bloomberg. "That may often be true, but when it's not, or when they quickly go astray, investors want someone to blame." The truth is that technology is only as good as the human beings who design and build it. The financial industry has steadily incorporated artificial intelligence in various ways. Humans build all of these tools, directly or indirectly.

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...Robot

Computers designed to identify and execute trades are already popular. A system like the one Tyndaris marketed is rarer; it automatically learns and improves from its own experience. Machine learning, in which computers train themselves rather than simply following detailed programs, offers many new opportunities, including financial applications. However, it is not a system free from human biases or failings. Algorithms build on training and test data selected by humans. The “black box” nature of this type of AI means it can be hard for observers to determine the rationale when the machine draws inaccurate conclusions. This can lead to problems in everything from gender bias in language translation to racial bias in deciding who is granted parole. Google announced in May that it is working on a technology that will make it easier to identify and combat biases arising in self-teaching AI. However, it is obvious by now that machine learning alone does not make AI infallible.

> Self-driving cars have been on the way for years now, but the death of a pedestrian in Arizona last year fed existing fears about their dangers.

Backtesting was also a central point of contention in Li’s lawsuit. While we don’t know what sort of due diligence Li performed, it is important for any potential investor to ask what assumptions served as the basis for a given model. Backtesting uses historical data to project how a particular investing strategy might have performed. Knowing what historical data the tester chose, and why, can offer key insights into how much weight to grant to the results. This is all the more crucial when the projected results seem too good to be true. As with machine learning, inputs matter.

Not everyone has the opportunity to invest in a fully AI-run hedge fund, for better or worse. Yet artificial intelligence is making a major mark on finance through automated financial advisers, often called robo-advisors. These services build and manage individual investment portfolios with little to no direct human input, although many firms offer supplemental human advisers for customers who want to ask particular questions. Automated services have gained popularity because of their economical nature and low barriers to entry.

While these tools can benefit certain investors, they too are vulnerable to errors. For instance, automated advisers programmed to engage in tax-loss harvesting can create problems because of wash sale rules. An investor can’t buy the same or substantially identical investment within 30 days after selling it. In a period of volatility, these restrictions can create problems. For example, TD Ameritrade’s SRI portfolio harvested losses three times in the fourth quarter of 2018. Because of wash sales rules, 35% of the portfolio was allocated to cash between Dec. 24 and the end of the year. This meant returns were less than they otherwise could have been.

The Securities and Exchange Commission has subjected automated advisers to additional scrutiny lately. That scrutiny has largely focused on marketing and social media. Regulators want to make sure that advisers, human or AI, meet strict standards of documentation and transparency. The SEC charged Wealthfront Advisers with falsely stating that it monitored all client accounts to avoid transactions that might trigger a wash sale. The firm was censured and agreed to pay a fine.

In finance – as in transportation, health care and many other fields – we want to know who is responsible when artificial intelligence accidentally harms someone. The answer isn’t yet clear. Li’s legal battle with Tyndaris and Costa is the first known instance of litigation over investment losses triggered by autonomous trading. Given the increasing convergence of technology and finance, it certainly will not be the last.

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...Schiavo

When an advance directive is in place and respected, cases like those of Quinlan, Cruzan and Lambert are almost always avoidable. As a result, advance directives have become standard estate planning instruments in this country. In 2017, Reuters reported on a University of Pennsylvania researcher's conclusion that more than one-third of adult Americans have such directives in place. This is impressive when you consider that a survey conducted the same year found that fewer than half of U.S. adults had written wills. In contrast, advance directives are still reported to be uncommon in Europe. This is likely to be particularly true for young and healthy adults like Vincent Lambert.

While state laws on advanced directives vary, it is more often a directive's absence that causes serious problems. When conflict arises, it is usually because an individual has failed to clearly express and document his or her desires about treatment in extreme situations. This opens the door to someone, usually another close relative, credibly challenging a legal representative's conclusions on the subject. There is no standard template for these end-of-life controversies, except that every case represents a family in agony. The rest of us would do well to remember this.

Compassion and simple human decency demand that we leave these terrible situations in the hands of those closest to the patient, those who are best-informed about the facts, and those in the best position to discern the patient's prospects and wishes. This includes close family, medical professionals and, when necessary, the courts. It does not include politicians, prosecutors, editorial writers or commentators.

Rachel Lambert, who is her husband's legal guardian, said it succinctly in an interview with RTL radio: "Everyone can have their own opinion and convictions ... but above all, can we now have our privacy." For a family in pain, outside judgment and speculation can only make things worse.

In the Quinlan and Cruzan cases, the patients' parents sought to withdraw treatments because they believed there was no hope and no purpose in continuing them. Hospital officials and the government opposed these choices. In the Lambert case, as in its closest widely known American parallel, the Terri Schiavo case, parents wanted to maintain life support while the patient's spouse sought to end it, consistent with what the spouse asserted were the patient's privately expressed desires.

The Schiavo case ended in Florida in the mid-2000s following a 15-year legal battle. After Schiavo unexpectedly went into cardiac arrest at age 26, lack of oxygen to her brain caused catastrophic brain damage. Like many people in their mid-20s, Schiavo did not have a living will or other advance directive. The court named her husband, Michael Schiavo, her legal guardian. For the first few years of Schiavo's care, her husband and her parents worked together to aggressively pursue possible treatments. But eventually Michael Schiavo sought to withdraw life support, as medical professionals admitted no chance for recovery. This set off the years-long legal battle over Schiavo's fate.

While the courts tried to assess Schiavo's medical situation and her wishes to the extent they were knowable, politicians sought both moral and political advantage in joining the fray. The Florida Legislature, then-Gov. Jeb Bush and his brother President George W. Bush all sought to intervene in the case through legislation and the courts. An aide to then-Sen. Mel Martinez, a Florida Republican, was fired after admitting that he authored a memo to fellow GOP senators asserting that the case would put Democrats in a bad position and that "the pro-life base will be excited" that Congress was taking up the Schiavo controversy.

That crass exploitation of a family's grief was reprehensible, if not necessarily representative. Many who opposed Michael Schiavo's effort to end his wife's life support were no doubt motivated by sincere beliefs about what they considered to be euthanasia and the sanctity of life. That likely includes the Bush brothers and other politicians on the political right. But 50 states from across the political spectrum have concluded that people have a right to express how they wish to be treated when life is at an end, and that their wishes ought to be respected when life as they have known it is irretrievably lost. Outsiders have no place in determining when this has occurred.

Thankfully, we have a system to deal with the great majority of these situations. It is incumbent on each of us as capable adults to take advantage of it. The suffering we spare is not only, and probably not even primarily, our own. It is an act of kindness toward the people we love the most. If you haven't documented your wishes about how to be treated when you cannot speak for yourself, right now would be an excellent time to do so.

...Owners

Understand The Owner's Value

Many small business owners have a skewed sense of their business's value because they don't understand how a buyer thinks. A buyer will not pay for things you are taking with you when you leave. This includes the services you provide to the business, whether you compensate yourself for them or not. Therefore, you should take compensation for those services before you leave.

Say a boutique earns $100,000 per year in profit but the owner takes no salary. The company could be virtually worthless if the buyer would need to pay someone close to that amount to provide the functions the current owner fulfills. Conversely, if the business owner pays herself an above-market rate salary, buyers should recognize that they can make additional profit by buying the business and hiring a less-expensive employee.

> A strong team with a demonstrated track record of success will not only help your business grow in the short term, but a new owner will value a business more highly if he or she can rely on the existing management team.

Depending on the business, buyers might price a company based on the "seller's discretionary compensation," which is all the income that an owner receives. Or potential buyers may adjust the financial statements, and their pricing, to reflect a fair market salary for the owner's services.

With this in mind, you should feel comfortable paying yourself any amount that leaves the business with enough cash to operate. Any paid compensation shouldn't have a material impact on the value of the company. Stay mindful, however, that the amount of unpaid work you do might cause buyers to lower their purchase price.

Tidy Your Books

Potential buyers need to have confidence in their analysis when buying a business. Providing them with as organized, complete and accurate a picture of the company's finances as possible will help. All your financial data should be easy for a potential buyer to review. Sloppy financial reporting often serves as a red flag for buyers. Inaccurate or incomplete records can hurt the company's value, since buyers will view it as a more risky acquisition. Buyers compensate for higher risks by lowering their offered price. Paying an outside firm to review – or better yet, audit – your financial statements will help increase your company's value.

Many owner-run companies aren't designed to maximize reported profit, because maximizing reported profit means higher taxes. When preparing for a sale, it is important to remove any personal expenses from the business and cut unnecessary spending. Trying to minimize taxes in the short term can result in material reductions in your business's market value.

Understand your books and be sure that they tell the story you want a potential buyer to see. If your business recently experienced one-time expenses or changes in revenue that might distort its value, be ready to explain the circumstances.

Identify And Improve Key Metrics

The value of any business is what someone else is willing to pay for it. Buyers determine what they are willing to pay in several ways, but a common technique is to look at comparable transactions involving similar companies. Buyers may evaluate key metrics from similar companies at the time they sold and extrapolate a value for your business by comparison. They may price the company based on multiples of assets, revenue, net income, and earnings before interest, taxes, depreciation and amortization (EBITDA). The relevant multiples change by industry and get more esoteric for companies that are not making a profit. Once you identify the key metrics for your particular industry, you can focus on optimizing these numbers for your business.

Buyers also pay more for companies that are trending in the right direction. Even incremental improvements can serve as a sign of business health. Although buyers largely dismiss an owner's specific projections, you still should

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have a formal long-term growth strategy. That strategy can help you to justify the target value for your exit by illustrating the business's overall momentum.

Diversify

A company demonstrates more value when it can boast both a diversified customer base and a diversified revenue stream. Buyers will want to see that no single client accounts for too much of total sales – generally, no more than 10%. Otherwise, if one or two major customers abandon the company after you leave, it could cripple the business. Losing major clients right before a sale is also a problem, especially if those clients represent a disproportionate level of revenue. Instead, your customer base should be balanced and, ideally, growing.

One way to reach new customers, as well as secure the return business of existing customers, is to explore new products or services. Your revenue stream should demonstrate that it is sustainable and should come with a backlog that the new owners can rely on. This is why recurring revenue sources are especially important. You can exhibit more potential value, too, if it is clear why your product or service stands out from competitors.

Identifying and strengthening what makes your business unique will also help you to make your business more marketable. Market research can help you to answer the question of what sets your offerings apart, as well as identifying any potential barriers to competitive entry. In other words, how easy is it for new competitors to get off the ground and create a similar business? The harder it is, the more valuable your business will be to a buyer.

Structure The Business To Be Scalable

When you try to maximize a business's value, you should work to ensure it can grow. A scalable business is one in which profit margins increase even as revenues increase. This is easier in some industries than others. Developing an app costs the same amount whether you sell hundreds of thousands of copies or only a few dozen. A law firm can only offer clients so many billable hours without hiring more lawyers. But within these limits, business owners can take steps that will make it easier for a company to scale. Make sure your technology is up-to-date and works well for its intended purposes. Ensure a clear path for expanding existing processes and work flow.

Plan For After The Sale

It is a good idea to approach a sale with a clear sense of your ideal exit path. Will you stay on as a consultant or in a diminished capacity for some transition period following the sale? If so, when do you plan to leave for good? Including an agreement not to compete with the business after you sell can increase its value, and may be of no cost to you if you plan to retire. Or you might maximize your total proceeds from the company sale by agreeing to an earn-out of future revenue. As with each choice in this process, the right decision will depend on your specific circumstances and risk tolerance.

> When preparing for a sale, it is important to remove any personal expenses from the business and cut unnecessary spending.

Finally, don't forget to consider the tax consequences of a deal's terms. Sometimes you can structure a deal to treat more of the sale proceeds as long-term capital gains, rather than ordinary income. Or you can spread the proceeds over multiple tax years. Both strategies can increase the deal's net proceeds. You should work with your accountant to make sure that you prepare all necessary filings and structure the sale in a way that works for you.

Stay Realistic

Throughout all the work to maximize your company's value, it is important to stay realistic. Like homeowners, business owners sometimes overvalue their own offering because of a personal emotional attachment. This why it's important to seriously consider a third-party valuation before a sale. A valuation expert can give you an objective, independent sense of what your business is worth. This can help you to set a realistic asking price and to make sound retirement planning choices.

Spending time on maximizing your business's value ahead of a sale may mean a longer exit path. But you will have many years to enjoy the benefits of getting the best price you can in exchange for your hard work.

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No Mystery Here: Publishers Pay Writers For More Than Words. When it comes to self-employment taxes, crime may not pay, but authors of crime novels must settle up. Top-selling crime writer Karin Slaughter ran afoul of the tax authorities when her accountants took the position that only a portion of her publishing royalties were attributable to her writing business. The rest, which the accountants contended were due to her personal existence as a "brand" that brought prestige to her publishing house, were omitted in the calculation of those taxes. The Internal Revenue Service slapped a $266,000 collar on the writer for her 2010 and 2011 tax years, and sought to impose additional penalties for negligence. The Tax Court reached a split verdict: Slaughter must pay the back taxes but need not pay penalties, because she provided her professional tax preparers with complete information and was justified in relying on their advice. *K. Slaughter v. Commissioner of Internal Revenue,* T.C. Memo 2019-65.

Connecticut Gift Tax Creates An Estate Tax Wrinkle. Connecticut is the only state that currently imposes a gift tax, and that leads to a complication for some executors when calculating federal estate taxes. The federal government allows a deduction for estate taxes paid to the states, but that deduction does not extend to state gift taxes. Connecticut's estate tax includes a provision that adds back gift taxes paid to the state within three years of death, subjecting those taxes to a higher marginal estate tax rate. In a technical advice memorandum, the IRS Chief Counsel office concluded that the federal deduction for state death taxes must be reduced by the amount of Connecticut tax attributable to this gift tax addback. *Program Manager Technical Advice 2019-03.*

A Legal And Accounting Double-Fault Costs $33 Million Charitable Deduction. Federal courts are not inclined to be lenient when dealing with taxpayers they believe are overly aggressive about valuing and claiming charitable deductions. The owners of a company that contributed a remainder interest in real estate to the University of Michigan discovered this the hard way. First, the Tax Court went beyond even what the IRS requested when it completely disallowed a claimed $33 million deduction for failure to provide a figure for the property's cost basis on a tax return. Then the D.C. Circuit Court of Appeals excused the IRS for failing to raise the issue, while it said the taxpayer forfeited the right to challenge the Tax Court's conclusion because it did not seek Tax Court reconsideration or raise a due process issue on appeal. The appeals court upheld the disallowance and the IRS imposition of 40% penalties for a gross valuation misstatement. *Blau v. Commissioner of Internal Revenue,* No. 17-1266.

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