Diversifying Outside of the Business:
Strategies for Small-Business Owners

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Here are some tax-smart ways to turn a part of your stake in a business into a liquid asset.

Small-business owners are especially vulnerable to a dangerous investment practice: under-diversification. For many, their business represents the lion's share of their net worth. With fortunes riding largely on the success or failure of a single business in a single industry, business owners are exposed to heightened levels of investment risk. Recognizing that risk and understanding a business's place in an overall portfolio is the first step toward building a more stable investment outlook.

Taking money out of the business is one way to fund other investment objectives; however, determining the best means of accessing cash requires serious consideration of a number of factors, beginning with the type of business entity it is. For example, a sole proprietorship, partnership, limited liability company (LLC), or corporation all may carry different tax implications.

Business owners also need to assess their short-term and long-term priorities for the extracted assets. If, for instance, your goal is to create a steady income stream, your approach will be very different than if your goal is to fund your retirement.

Liquidity Options

Here are some simple, tax-efficient methods to help business owners turn part of their stake in a business into a liquid asset.

- Compensation -- Putting yourself on the payroll provides you with a steady stream of income without incurring double taxation -- corporate and personal -- provided the IRS finds your salary reasonable in relation to the services you render.

- Loan repayment -- If you have loaned money to the business, set up a schedule for repayment. To avoid tax problems, the debt must be properly documented and contain terms that affirm that the sum is truly debt, not equity.
- Borrow -- You may withdraw cash from the business in the form of a loan. Again, be sure that the transaction is properly documented and includes a repayment schedule. In addition, the loan must bear interest at a rate not less than the current applicable federal rate. Otherwise, the interest income may be treated as a dividend or as compensation.
- Benefits -- Life insurance, disability insurance, certain medical benefits, dependent care, etc., can be viewed as cash equivalents that are deductible to the business and not taxable to you. Consider setting up a salary reduction or cafeteria plan that would allow you and your employees to take a portion of compensation as nontaxable benefits rather than as taxable income. Similarly, consider establishing a qualified retirement plan. Retirement plans can be effective vehicles for building morale and for helping owners diversify their assets in a tax-advantaged manner.

Outright Liquidation

If you decide to sell the business outright, there will be much planning and decision-making do to. Do you want to sell the business to an interested third party or keep it in the family? What are the financial and tax consequences of transacting the deal in cash versus stock? What type of transaction are you hoping to negotiate? An installment sale? A private annuity sale? A transfer of assets via a family limited partnership (FLP)?

Regardless of the approach, your best, and first, strategy should be to partner with the appropriate planning professionals who can evaluate the business from a cash flow and net worth standpoint on a regular basis. This guidance may be the most critical determinant of when is the best time to take cash out of the business.