



Ruminations on Financial Planning for Small Business Owners

While many of the financial planning issues that small business owners face are the same as everyone else's, there are some differences – primarily in the area of risk management.

- Many small business owners have a large portion of their net worth tied up in their business and thus are not properly diversified.
- The owner generally works in the business also which means his or her wage income is extremely correlated with their investment in the business.
- Frequently the spouse and other family members work in the business as well, further exacerbating the risk to the family as a whole.
- A number of psychological biases cause the owner to dramatically underestimate the risk he or she is taking:
 - **Illusion of control** is the tendency for people to overestimate the amount of control they have over situations – even when those situations are completely random and they have no control whatsoever. For example, many people have a marked preference for picking their own lottery numbers (and stocks for that matter).
 - **Illusory superiority**, also known as the Lake Wobegon effect, is the tendency for people to overestimate their abilities relative to others. For example, over 80% of people believe they are above average drivers, will finish in the top half of their class in school, or that they are better looking than average.
 - **Optimism bias** causes people to believe there is a smaller chance that something bad will happen to them compared to other people. For example, in one study 81% of new business owners thought their business had at least a 70% chance of success, but only 39% thought a business like theirs would be likely to succeed.

While a comprehensive list of financial planning issues is impossible, following is a good sample:

- Business continuity – there should be a buy/sell agreement in place, a well-thought-out plan to transfer the business to the next generation or next owner, etc.
- Key person risk – in the case where there is one individual upon which the business is unduly dependent, frequently the owner, the risk of that individual leaving (voluntarily or not perhaps due to premature death, illness, etc.) should be been planned for with insurance products, non-solicitation or non-compete agreements, etc.
- Retirement – a retirement plan should be established (and *funded*) for the owner and the employees (if appropriate).
- Disability – disability insurance should be in place for the owner and available to employees (if appropriate).
- Liability – this risk can be mitigated by prudent choice of entity type (C-Corp, S-Corp, LLC, etc.) and appropriate property & casualty insurance. In addition owners should be cautious in personally guaranteeing business loans and may want to structure their lives so as to shield a spouse in the event of catastrophe (having the personal residence only in the spouse's name for example).
- Estate taxes – successful small business owners may find their net worth has become large enough to create a significant potential estate tax liability. Not only are the common estate tax mitigation strategies available, but business owners also have opportunities specifically for them such as special tax treatment available under IRC §§ 6166, 303, and 2032a. In addition, having an existing business makes the utilization of strategies such as discounts on valuations of gifts easier not only to do, but to defend to the IRS.

- Income taxes – in addition to typical income tax planning, business owners also have some discretion over the form in which they recognize income (wages vs. salary while working and capital gains vs. interest upon disposition) and can frequently take advantage of fringe benefits including health insurance, business travel and entertainment, employer-provided cell phone or car, etc. In addition, since the business owner frequently has more erratic income than an employee, there may be opportunities to shift income and expenses between tax years to the taxpayer's benefit.
- Liquidity – many businesses have erratic cash flow and all of them have the possibility of facing tough times, thus it is of vital importance to have adequate sources of liquidity (credit lines, etc.) set up *before* they are needed.
- Leverage – both financial leverage (debt vs. equity) and operational leverage (variable vs. fixed costs) increase the risks (and potential returns) and must be evaluated carefully. Frequently an increase in one would make a decrease in the other prudent.
- Complexity – frequently business owners have very complicated financial and legal situations with a variety of contracts, agreements, guarantees, business entities, etc. in place, many of which may simply be legacy items that could be eliminated. Simplification may be appropriate to enable better management now, but also would likely aid heirs in the future.
- Other risks – small business owners also frequently neglect to adequately secure their intellectual property, use employment contracts, conduct background checks, drug tests, credit checks, etc.

Notes:

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