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Focus on Financial Planning

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Even Small Businesses Need to See the Big Picture

Twenty million small business owners are candidates for holistic financial planning advice. These individuals can be your most demanding and rewarding clients. While they work hard to make their businesses successful, they may ignore the financial-planning essentials needed to meet their long-term personal objectives.

For a professional advisor, this is both a challenge and an opportunity. If you want to work with small business owners, be prepared to provide help and advice in six key areas.

There were approximately 15.7 million small businesses with no employees in the U.S. in 2002, and another 5.7 million businesses with fewer than 500 employees, according to government sources. These 20 million-plus small business owners work hard to make their businesses successful, but often ignore the essential things they need to do to meet their long-term personal objectives. In your advisory role, you will want to address a number of issues related to their business and personal finances; many of their issues will be intertwined.

Be prepared to provide help and advice in the following six key areas:

Tax Planning

Tax planning to minimize overall business and personal taxes is a top priority for the small business owner. Strategies for the owner's financial plan depend on the form of his or her business. For example, principals of C corporations will want to utilize tax-advantaged benefits such as health

insurance and flexible spending accounts (or FSAs). If the business is a sole proprietorship, partnership, LLC, or S corporation, there are limitations on the deductibility of benefits.

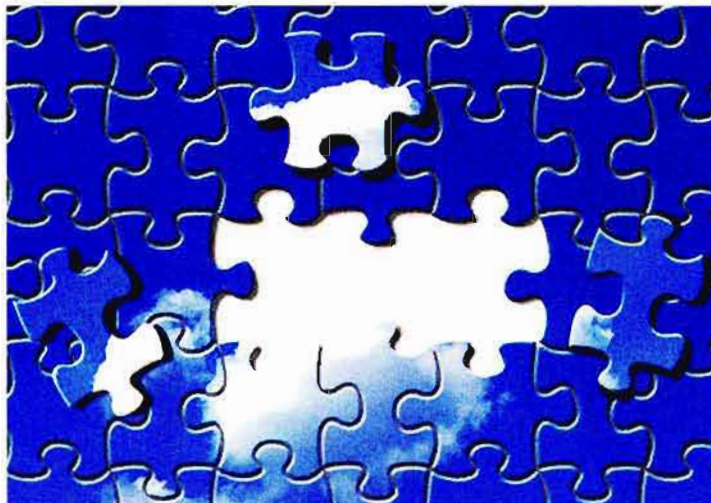
The numerous issues on properly deducting business expenses, such as travel and auto expenses, are generally handled by the firm's CPA or accountant. However, you can add value by ensuring that the next five planning areas optimize the owner's tax situation.

Risk Management

It is particularly important to review the small business owner's risk protection. Business operations may expose the owner to higher risks than a non-owner. In addition, protection for their business and personal lives is often intertwined, where a weakness

on one side can seriously impact the other. For example, a personal loss may impact the owner's ability to continue investing in the business, just as a business liability can impact personal assets.

Business owners should start by obtaining both property and casualty and liability coverage for their operations. They may also need insurance for automobiles or real estate



owned by the business.

Depending upon their specific occupation, another important coverage is professional liability insurance, also known as "malpractice," "errors and omissions" or "professional" insurance. Asset protection strategies are another important part of protecting the client from business liability claims. For example, physicians may

THE TOP REASONS

Top Reasons to Pursue Small Business Owners

1. The 22.9 million small businesses in the United States are located in virtually every neighborhood.
2. More than 500,000 small businesses with employees are launched each year.
3. Four years after they start up, half of all small businesses with employees remain open.
4. Small businesses make up more than 50 percent of the non-farm private U.S. economy and generate about 70 percent of net new jobs.

Source: Small Business Administration (SBA)

be able to protect certain personal assets with an asset protection trust, or by owning real estate investments in an LLC. Some of these strategies can get quite complex, so you would be wise to work with an attorney who specializes in these areas.

As with any client, life insurance and disability protection is critical; however, disability protection may be more complex, depending on the nature of the business. For instance, if the operation can continue on through a protracted disability of the owner (for instance, with family members or other employees stepping in), business overhead insurance may be the most appropriate form of coverage; it protects against the loss of profits resulting from the owner's disability.

On the other hand, if the business is dependent on the owner for its continued operation, a personal disability policy may be the best choice. Since these policies are typically more diffi-

cult to obtain for self-employed individuals (especially for those with higher incomes), it is advantageous to work with an independent insurance specialist to ensure the best approach.

Retirement Planning

Retirement planning is a major focus for all clients, and small business owners are no exception. There are new, attractive options for the self-employed owner with no employees.

The relatively new Individual 401(k) plans are an exciting option for self-employed business owners with no employees (except for a spouse). In 2005, these plans provide the opportunity to defer up to \$42,000 per year (plus an annual \$4,000 catch-up contribution if

the owner is 55 years or older); future annual contributions are flexible (not defined or required).

Another option for older owners who want to maximize deferral for their retirement is the Individual Defined Benefit plan. These plans can allow much larger deferrals if the owner has high income and is close to retirement age, with a target retirement income up to \$170,000 or 100 percent of income based on 2005 tax limits. These plans are offered by some brokerage firms and other financial

institutions, and can be an excellent vehicle for the older owner's retirement security.

For small businesses with employees, recommending the best retirement plan is a more complex process. There is typically a trade-off between the owner's personal objectives and the funding requirements for other eligible employees. There are a number of simplified small business plans, such as SEP-IRAs and SIMPLE IRAs, which are relatively easy to set up and administer. Many brokerage firms offer standard plans. However, if a qualified plan such as a 401(k) or defined benefit plan is appropriate, there will be more complexity to set up and administer these plans. It is important to involve a plan administration firm to assist with these more complex plan issues.

Benefits

Benefits are a significant part of the business owner's financial security. The optimum implementation for a C corporation is often different than for other business forms. C corporations — even if only one-person shops — are allowed to deduct the cost of many employee benefit programs. On the other hand, sole proprietors, partners, S corporation and LLC owners have a more limited menu of deductible benefit opportunities.

Here are some ideas for these more limited business forms:

Health insurance and long-term

HOW SMALL BUSINESSES FARE

Starts and Closures of Employer Firms, 1995–2003

	1995	2000	2001	2002	2003
New firms	594,369	574,300	585,140	589,700e	572,900e
Firm closures	497,246	542,831	553,291	569,000	554,800e
Bankruptcies	51,959	35,472	40,099	38,500	35,037

= Estimate

Source: U.S. Government

care insurance are now 100 percent deductible for many self-employed people. In order to obtain the deduction, the business must have adequate profit to cover the insurance costs, and insurance must not be available from another employer (for instance, from the spouse's employer or another work relationship). If a sole proprietor hires her spouse, she gets extra value; not only can she deduct the insurance costs from business income but she reduces self-employment tax as well.

To go even further, a medical reimbursement plan may be provided for the owner's spouse; in this instance, they can receive a tax deduction for reimbursed medical costs for the entire family.

One approach to helping pay for children's college costs is to hire them as employees (for legitimate work and pay, of course). Their wages are a deductible business expense for the owner and will be taxed at the child's lower income tax rate. The owner may even set up an educational assistance plan and provide reimbursement of up to \$5,250 per year for college expenses.

Investments

Advisors must pay special attention to asset allocation in devising the business owner's portfolio. Since the value of the business may be a large portion of his or her net worth, it is important to diversify away from the business. In planning, consider how the business may perform vs. the various asset classes the client holds. For example, if the business is a small technology company dependent on a growing economy, portfolio allocations should be made in other more defensive or counter-cyclical asset classes.

Succession and Estate Planning

One of the most challenging areas for

THE BOTTOM LINE

- ✓ Business owners need the assistance of an advisor who can look at the big picture and devise a comprehensive plan.
- ✓ Advisors should have a pool of legal, insurance and plan administration specialists to fine-tune their clients' specific plans.
- ✓ With a holistic approach and a bench of outside experts, you can become a trusted advisor to business-owning clients and garner referrals to other business owners and company heirs.

small business owners is succession and estate planning. Often, the first challenge is to help the owner develop a plan to transfer control to others, when time or circumstances dictate. Since small business owners invest a significant part of their lives controlling and building the business, this may be easier said than done. You can help them understand that concrete plans must be put in place to ensure that the value of the business can be successfully passed to others in the event of disability, retirement or death.

One option is to bring family members into the business. This requires long-term planning to be successful. History shows that only 30 percent of first-generation and 15 percent of second-generation family transfers are successful. The transition may involve bringing in family member(s) over a long period, with gradually increasing responsibilities, and planning ownership transfers such as stock gifts, installment sales or private annuities.

Another option may be selling the business over time or in the future to employees, partners, competitors or outside parties.

A different approach involves setting up an ESOP to transition the business to current employees. If a solid

transition plan is in place, it may also be possible to use "earnout" provisions, consulting agreements or non-qualified pension plans to pay out the business value during retirement with tax-deferral benefits.

A buy-sell agreement with partners or competitors may be a solid planning approach to capitalizing on the value of an individual's business in the event of disability, death or retirement. Life insurance contracts are often used to fund these buy-sell agreements.

Finally, additional estate planning issues may arise if the business is to remain in the owner's estate. A key issue is planning for adequate liquidity, especially if estate taxes are anticipated; if there are not enough liquid assets, life insurance may be the best solution. There are benefits in the tax code for corporate stock redemptions to pay estate taxes, special use valuation of real property used in the business and extended payments if the business represents a significant percentage of the adjusted gross estate. The services of an estate-planning attorney can be invaluable in planning for and transitioning business value to the beneficiaries. 121

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