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PRACTICE MANAGEMENT

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Small Business Owners Face Realization and Retirement Risks

By Peter Klein

Recognize the risks and evaluate the options for a secure retirement.

ACCORDING TO THE SMALL Business Administration (SBA), in the U.S. economy, small businesses account for nearly half of all private sector employees, and pay 43% of total U.S. private payroll. Over the past 17 years, they have generated 65% of net new jobs, and have created more than half of nonfarm private GDP. Overall, they are responsible for hiring 43% of high tech workers (scientists, engineers, computer programmers, and others). These statistics came from the Federal Government SBA office.

Alternatively, for many small businesses, the days of slow moving changes and long-term business niches are over. Even fortune 500 hundred companies are looking over their shoulders. Imagine being a large public retailer such as Macy's or Target, and in the unenviable position of competing against a high tech retailer, such as Amazon, with no bricks and mortar, whose stock is trading at an all-time high and yet has never made a profit. This means that reliance of small business owners on selling their business to achieve an exit and some sort of a windfall and thereby recover their investment is becoming increasingly an unreliable realization event.

WHAT DO YOU THINK IS THE MOST IMPORTANT PROBLEM FACING SMALL-BUSINESS OWNERS LIKE YOU TODAY? [OPEN-ENDED]

Complying with government regulations	22%
Consumer confidence	15%
Lack of consumer demand	12%
Lack of credit availability	10%
Poor leadership/Government/President	9%
Cash flow	7%
New healthcare policy	5%
Competition from big business and overseas	4%
Lack of jobs	4%

Wells Fargo/Gallup Small Business Index, Oct. 3-5, 2011

Gallup Polls Survey of Small Business Owners

A Gallup survey of small business owners was taken in the fall of 2011 some two years after the collapse of the economy. Gallup defines a "small business" as a business with less than $20 million in annual sales or fewer than 200 full-time employees. It asked business owners to list and prioritize their challenges. At the top of their list was government regulations; 22% of small-business owners in the United States list complying with government regulations as their most important problem, followed by consumer confidence in the economy (15%) and lack of consumer demand (12%). Correspondingly, 2014 Index of Economic Freedom report reveals that the United States has dropped out of the top 10 freest economies in the world. In 2008, the U.S. ranked 6th. Now it ranks 12th.

Approximately one in three small-business owners say they are very or moderately worried about going out of business. About the same number are worried about not being able to compete with large or global competitors, not being able to hire the number of employees they need, and not being able to pay their employees. Thirty percent worry they will have to reduce their number of employees. On a personal basis, 67% of small-business owners are worried about not being able to put enough money away for retirement while 49% are concerned about not being able to spend enough time with family or pursuing personal interests.

When asked what they need to see their business thrive, the nation's small-business owners want a better economy 15% said growth in sales, 14% job creation, and 12% said fewer government regulations (12%). Small business owners' sentiment or outlook continues to be weak; it is down substantially from prior years prior 2008-2009. Outlook sentiment collapsed in 2009 and has yet to fully recover from those lows.

Bank Credit

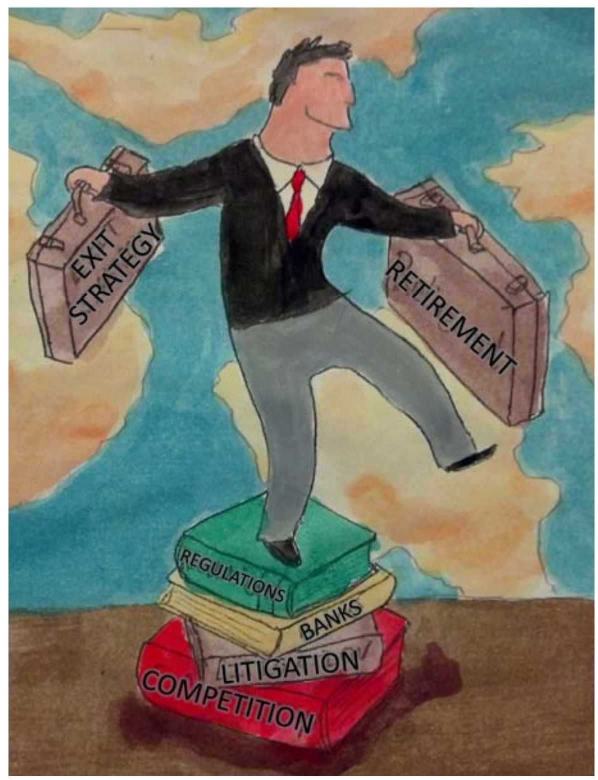
Compounding their situation is tight bank credit. Prior to 2007, credit was available to fund small businesses, but getting access to credit to purchase a small business is now a far greater challenge. Most small business are too small to attract the attention of private equity players while roll-ups (service sector consolidation of small businesses to form a national footprint) that were fashionable in the mid 1990 to early 2000's, have lost their luster and proven to be largely unworkable. The remaining option of selling to the individual buyer is problematic, since they tend to be under-capitalized, requiring bank credit to complete the purchase. Banks are simply not lending to under-capitalized players. Small business owners face a realization and future liquidity crises.

Operating in a highly competitive economy places great demands on the business owner. Continued weakness in the economy has amplified competitiveness. In fact, more than 170,000 small businesses have closed between 2008 and 2010, according to an analysis by the Business Journals of U.S. Census Bureau data. Competition forces an all in commitment on the part of the business owner. Whether its personal capital, personal guarantees, or allocation of time, competitive pressures will impose a total commitment on the part of the owner/operator. Small business owners face the ongoing challenge of a sole proprietorship. They have to provide the bulk of the seed capital but given the small size of the private business and the illiquidity factor, they cannot sell an interest in their business to get more cash as needed. If they decide to co-mingle business and personal assets, they effectively risk more of their worth on the business, with no guaranteed rewards.

Asymmetrical and Evolving Risks

Business owners face six major asymmetrical or evolving risks:

- The risk of litigation is always present, but there is no way to anticipate how your assets will be exposed to potential court judgment. Business litigation can easily take on a life of its own and ultimately become a personal liability. Consequently, you don't risk just the money and assets invested in the business. If anything goes wrong and sued, you are the sole person responsible for damages. Purchasing appropriate general liability insurance and industry-specific coverage can limit some exposure.



- The risk of unwittingly failing to satisfy a federal, state, county or municipal regulation is omni-present, while the breadth of state regulations alone can be challenging, ranging from licensing and registration requirements, employee labor regulations, safety, insurance requirements, vehicle transport rules, product handling, taxation, environmental, building codes, and waste disposal. Federal and state agencies have enormous latitude in assessing penalties and fees for failure to comply not to mention the legal fees incurred in defending the business from federal and state agencies.

- The risk of bank covenant violation increases with a poor economy. Many banks now require personal guarantees to back up a business loan. Some fifteen years ago, a bank requiring a personal guarantee on a commercial loan was the exception. Consequently, there can be significant personal exposure to business credit risks.
- The risk of business failure is always in the background, but many owners fail to appreciate the risk of not setting aside funds for retirement. Most small businesses are profoundly impacted by economic cycles that can result in long periods of negative carry, with the owner unable to take a salary. For example, a current challenge for most small businesses is rising input cost with limited ability to pass on cost increases in a deflationary environment.
- Disability risk for a 25 year old shows that there is a 30% to 50% chance (depending on which source you believe) of experiencing a disability before age 65 that will keep you out of work for 90 days or more. Most entrepreneurs have the perspective that almost anyone can do what they do, but they make the fatal assumption that their innate knowledge of the business and market are widely known or easily transferable, which is not the case. Given a small business typically limited capitalization, the loss of an active owner operator will likely result in its collapse.
- The exit strategy for a small business owner has become problematic in the last four years. As discussed earlier, the option to sell a business today is limited. Furthermore, transitioning from running your own business to getting a job with a large corporation can be a daunting challenge.

On the surface, one would think that someone that has business ownership experience wouldn't have much trouble in finding a position with a large corporation but in actuality most large companies are loath to hire entrepreneurs deeming them not to be team players but rather as outliers that wouldn't fit in a corporate hierarchy. Why are Professional Liabilities so Troubling?

Small business owners such as a doctor or lawyer are personally liable for professional liabilities. State laws usually shield an owner from a company's liabilities but typically do not apply in these situations.

These liabilities can be especially severe as the professional may have conducted him or herself beyond reproach and if sued in the wrong county with the wrong judge or jury, the professional may be unable to prevail. Many times the professional will be forced into an unfair settlement due to the danger of a jury trial.

How Can Small Business Owners Protect Themselves from These Risks?

Property Casualty insurance can only provide protection to a limited extent to business risk but typically can't do much in addressing these asymmetrical risks including protecting your retirement savings.

Accessing a defined benefit plan or defined contribution plan can allow for tax deferred buildup of retirement savings. The problem is that the tax code requires that tax qualification retirement plans be designed to treat the business owners and employees the same. In the context of profit-sharing and 401 (k) plans, the code prohibits contributions that discriminate in favor of highly compensated participants. Given the cash flow restraints of most small businesses, the sharing requirement of these qualified programs can be insurmountable.

The other problem with conventional retirement accounts such as IRA's, 401k and qualified annuities is that once you reach your required withdrawal date, you must withdraw a minimum amount from these accounts, known as requirement minimum distribution or RMD. Distribution amounts can be determined by varying methods including annuity method, and life expectancy method. Alternatively, when the owner dies, the income tax liability is passed on to the beneficiaries of a 401 (k) or IRA. The beneficiaries must pay income tax as they receive the payments. This is known as income in respect of decedent (IRD). The recipient (beneficiary) must declare the money as income in respect of a decedent (IRD) for any year in which income is received.

> "Small business owners should evaluate whether an alternative tax-advantaged plan will allow them greater tax deductions than can be achieved with just a 401(k)/profit-sharing plan or SEP."

Alternatively, business owners and self-employed individuals can have access to tax deferred saving opportunities typically not available to employees who do not have an ownership stake. Specifically, owner-employees and self-employed can adopt and fund retirement plans that, in many cases, offer additional opportunities to put money into deferred retirement accounts over and above what is possible under a 401 (k) plan or simplified employee pension plan, such as a simplified employee pension (SEP).

Alternative tax advantaged programs utilizing a life insurance inside the retirement plan itself. The life insurance inside the plan can be funded with before-tax dollars, which simply means that funds used to acquire the life insurance come from tax-deductible contributions. A business owner plan participant who acquires life insurance inside his/her plan frees up personal cash flow by the amount of the premium less a very modest income tax amount.

Small business owners or self-employed should evaluate whether an alternative tax advantaged plan will allow them greater tax deductions than can be achieved with just a 401 (k)/profit-sharing plan or SEP. A qualified advisor familiar with these plan designs can guide the small business owner. The advantages of life insurance imbedded plan is that the policy and cash value are in a bankruptcy remote entity protected from court judgment and court seizure. The policy can still provide income replacement protection in the event of death, and provide funding of the business for succession planning purposes. As a retirement tool, the policy can be moved out of the plan in a transfer in kind transaction with some exposure to taxes and later fund retirement by borrowing against the policy's cash value tax free.