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Estate Planning for the Entrepreneur and Business Owner: Planning Early and Often

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Estate planning tends to be one of those "to-do" items that everyone knows that they have to complete, but the actual implementation of a plan is usually pushed aside for another day. Business owners and entrepreneurs are especially susceptible to estate planning procrastination because they tend to be focused on building and running their business and then preparing it for a sale. Early and often planning for business owners and entrepreneurs can save them time, expense, and taxes in the future, and position them for extraordinary success during both the highs and lows of the business cycle.

Individual retirement accounts (IRAs) are not taxed for income tax purposes until assets are distributed from the IRA. As a result, an owner (or plan participant) is generally required to take a required minimum distribution (RMD) from an IRA by Dec. 31 of each calendar year, starting on April 1 in the year after the plan participant turned 72 years (referred to as the "required beginning date" or RBD). Upon the death of the plan participant, a named beneficiary is required to take distributions or RMDs from the inherited IRA depending upon whether the deceased plan participant had reached the RBD and the identity of the beneficiary.

Planning Early

- Start-Ups

When business owners are first starting their business, estate planning is usually far from their top priority. Instead, they may focus on business efficiencies, minimizing costs, or raising funds to sustain the healthy growth of their business. Itis precisely at the time of the creation of their business, however, when they should be focusing on their estate plans. Business owners should focus on the type of business entity that should be used to maximize flexibility and minimize tax consequences, the structure most appealable to a future investor, the best jurisdiction in which to create their business, and the most tax-efficient jurisdiction in which they should live when their business generates income. By planning at the outset, business owners can save significant time and expense that would be necessary to change a business structure later in the business life cycle.

Business owners should also be thinking at the outset about how they plan to own their business. Too often, startup owners own their business in their individual names. They have not thought about structuring their ownership or considered asset protection, income-tax planning, estate-tax minimization or business-succession strategies. By planning for the protection of their business interests at the outset, they may protect their business interests from future creditors, minimize future income, gift, and estate tax consequences, and create a framework that will enable their business to thrive in the event of their own incapacities or deaths.

- Pre-Liquidation Event Planning

Even if business owners do not engage in estate planning at the creation of their business, it is still not too late to start planning. Whether a business owner intends to sell a business or keep it for the next generation, at some point after creation, an owner's future intentions will begin to crystalize and take shape. It is at that moment when business owners should be considering their planning options—well before they have begun to explore a possible sale and well before they are looking toward their exit from the business.

One of the greatest benefits to early planning before exploring a possible sale or liquidity event is the utilization of a favorable valuation of a company. The goal of estate tax planning is to leverage one's gift tax exemption by transferring assets out of one's estate while asset levels are low and discountable. By transferring interests out of one's estate before starting down the path to a sale, a business owner will be able to take advantage of lower valuations and transfer wealth more efficiently. Once the business goes to market, however, the planning options diminish. It is therefore critical that business owners start the planning process well before any potential liquidity event is in sight.

- Post-Liquidity Event Planning

Even if a business owner has already started down the road to a liquidity event or even if the liquidity event has already occurred, it is still not too late to embark on planning. Quite frequently, business owners and entrepreneurs use the funds from their first business to start or invest in their next business. By planning at the outset of the new investment, entrepreneurs can protect their new investment from creditors, potentially protect the future appreciation on the new investment from estate tax, and create a structure to minimize future income tax.

Planning Often

Revisiting and reviewing an estate plan is important for everyone, but it is especially important for business owners and entrepreneurs. As a general rule, individuals should be reviewing their estate plan whenever there is a significant event in a person's life—births, deaths, changes in marital status, medical issues, an influx of assets or a deflux of assets. And, at a minimum, everyone should review their plan every five years.

Business owners and entrepreneurs need to be reviewing their estate plans more often than the typical individual because circumstances are always changing that will impact their business. In any given year, a business may be impacted by law changes, increased regulations, new tax policies and rates, employee disputes, supply shortages, increased litigation for the business, or claims of creditors against the company. At any given time, a business may be facing disputes among owners, changing interest rates that impact the business' borrowing power, changing business valuations, economic slowdowns, or concerns over the declining health of key employees. These are just some of the issues facing a business each year, and each issue could warrant a pivot in a previously established plan.

- Changes in Valuations

One of the best times to engage in estate planning with business interests is when the value of the business interest is suppressed. The value could be low because the business is in the start-up phase and simply has no positive value, or the value of an established business could be temporarily and artificially depressed due to an economic slowdown or other market conditions. These are the moments when business owners are best positioned to leverage their gift and estate exemption to transfer business interests out of their estates so that the future appreciation and growth of their business will be removed from their estates.

- Changing Interest Rates

As interest rates change, so does the cost of a business' borrowing capacity. Higher-interest rate environments will increase the cost of borrowing and decrease the borrowing capacity for many businesses that rely on borrowing to survive. Conversely, lower-interest rate environments will decrease the cost of borrowing and increase borrowing capacity.

The potential success of many estate-planning techniques relies heavily upon interest rates. Some techniques are best used in low-interest rate environments, and others are most successful in high-interest rate environments. Therefore, as interest rates change, business planning and business-succession strategies that rely upon interest rates should be reevaluated to determine if changes should be incorporated into a new, updated plan.

- Changes in Tax Laws

Tax laws and tax policies seem to change in every political cycle, well beyond the control of any business owner or entrepreneur. But even slight changes in the tax laws could have a significant impact on business planning. For example, the federal estate tax exemption in 2022 is $12.06 million, and in 2023, the exemption is set to be $12.92million—a jump of $860,000. The increase is significant, but what is even more significant is the ways in which business owners may leverage the additional $860,000 of exemption to potentially fund dynastic trusts that could be protected from estate and generation skipping transfer tax for generations.

- Business Succession

Many business owners and entrepreneurs are so focused on building their business that they do not (and cannot) fathom the possibility that they or a key employee may not be around forever to run their business. Whether their future absence or the absence of a key employee is the result of death or incapacity, the risk to the survival and the value of the business can be significant if no, or insufficient, steps are taken to implement a business-succession strategy. For the rare business owners who think and worry about business succession, even fewer put the time and energy into planning for a catastrophic event. Business-succession planning is vital to the long-term health of a business, and implementing and updating a flexible succession strategy will save a company considerable time, headache, and value in the event of the catastrophic event.

- Asset Protection

Business owners and entrepreneurs often pledge their own assets, at least at the outset, in order to grow their business. This can place individuals at a significant financial risk if they do not take the proper steps to safeguard their assets. As the success of their business grows and much of the risk can be shifted from the business owner to the business, steps should still be taken to protect the wealth accumulated by the business owner in the event that the unexpected creditor (either as a result of a liability to the business or a liability completely unrelated to the business) arises that could jeopardize the business owner's finances. Implementing an asset protection plan before creditors arise is crucial to safeguarding a business owner's individual assets.

Early and often estate planning is essential for business owners and entrepreneurs. With proper planning, business owners and entrepreneurs can save themselves time and expense in the future, and position themselves for extraordinary success as their business grows.

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