Business Planning

Basic benefits of an entity's structure should play a role in business planning.

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Most owners of closely held businesses understand the personal asset protection benefits of an entity structure for their operations; however, far fewer realize or utilize some of the other benefits that a formal business structure can provide. As a result, latent opportunities exist that may add value, lower risks, and enhance the owner's personal estate, business, and tax planning opportunities. The following discussion describes business structure basics and briefly explores a few of their potential uses.

Limited liability

First, as mentioned above, an entity structure provides personal asset protection benefits to its owners. The business venture is given life and formally recognized by some state or foreign government. From that point forward, the owner of the fledgling business has limited his or her personal liability for the actions arising from the business to the investment placed into that venture. Of course, there are exceptions to this rule; however, as long as the owner respects and maintains the distinct separateness of the organization from his or her personal affairs and operates in earnest, most courts will prohibit the pursuit of the owner's personal assets in the event of business-generated loss, bankruptcy, or other adverse incident. This protection can be waived by the business owner by providing a personal guarantee for the entity; extreme caution should be exercised by the owner when doing so.

Divisibility

A business structure provides ease of divisibility of interests. The owner may create and modify his or her own corporate currency structure—almost like a sovereign country does with its currency. If the owner wishes to own 5,000,000 shares or units of his or her own stock, or just 10, so be it. The business can issue its currency as a bonus or as salary or sell it (some hurdles apply to this option though). One area where divisibility may help is property ownership, such as real estate.

Real estate that is owned personally typically passes upon death to heirs or devisees in undivided interests based upon the number of loved ones existing at the time. For example, a large parcel, such as a farm or ranch, passes to the decedent's three children, who each have three children. At the death of the last child, the property is now owned by nine people who may or may not get along. With each successive generation, the property's ownership becomes more fractionalized with each person owning an undivided interest to the property as a whole. Additionally, the likelihood that all nine will continue to use and be willing to maintain the property also becomes more remote. In contrast, a business entity, which owns the parcel of real estate, can pass at each successive generation with an orderly structure of self-governance over the property and a far simpler and cleaner chain-of-title. If desired, the corporate documents can be structured to reacquire an interest at any owner's death and actively prevent dilution of ownership.

Control

Business structures can be used to separate ownership from control. Even with a restrictive business structure, such as an S corporation that permits only one class of share, voting and non-voting shares are allowed. By creating voting and non-voting interests, the ability exists to provide ownership benefits in the venture without providing a voice in governance. Estate planning provides a fertile field for separating ownership from control. It is possible to transfer a large portion of an entity's ownership and value to children or other loved ones, which removes the value from the donor's estate, while maintaining control and the ability to direct cash flows through salaries, bonuses, and distributions.

Parents often joke that they work for their children, and this arrangement makes it a reality with a mitigated estate tax bill as an incentive.

Valuation

An additional bonus that comes with separating ownership from control in a business is the ability to discount the interest's value. A controlling interest in a business is naturally worth more than a non-controlling interest. As a result, a differential in value exists between the two interest types that can be used to discount the non-controlling interest. An additional discount may be obtained for a lack of marketability provided no readily available market exists or restrictions are placed upon the sale of the transferred interests. Either or both discounts may exist for a transferred business interest, which may provide additional value elasticity for asset transfers.

Capacity

Business entities have owners and may have directors, officers, and employees. A single person can serve in each of these capacities concurrently, in only one, or in any combination of them. For example, an owner may work for the business entity as an employee or not. An employee may own an interest in the business or not; same for an officer or director. Each capacity has different rights and duties in relation to the business entity. Understanding and using these relationships, it is possible to structure roles, entities, cash flows, and transactions in a manner to limit risks, reduce tax liabilities, and allocate value to achieve different results depending on the objective. To simply illustrate the concept, it is possible to have an owner—with a single controlling interest share—receive a comfortable salary (as an employee), and have the business retain its earnings, increasing the business's value for the benefit of the non-voting shareholders (via irrevocable trusts benefiting his or her children). The power and flexibility possible in creating and determining optimal cash flow and structuring characterizations are almost limitless.

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Conclusion

Entrepreneurs with small businesses sometimes overlook business planning opportunities that are possible with proper structuring. A healthy understanding of business structure basics along with some time spent contemplating business objectives and how to reach them can provide many benefits in the long run. Discussing business planning opportunities based on the business structure with a trusted advisor could help discover a potentially optimal solution for the owner's objectives.