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Don't Lose Your Family Business to Estate Taxes

Imagine the sorrow of family members after the death of a beloved patriarch or matriarch — the leader who nurtured the family business along with the family itself. Now imagine that sadness compounded by horror when it becomes clear that the only way to pay the estate tax is by liquidating the family business.

Federal estate taxes are due nine months after death. If the heirs do not have enough cash to pay these taxes, selling the business may be the only way to satisfy the tax bill.

However, there are ways for businesses to avoid this unfortunate situation. The most straightforward is a buy-sell agreement (see article on page 3). But the IRS also has two payment options that can help.

Section 6166: Deferred Payments

IRC Section 6166 extends the amounts of time in which an estate can pay the tax attributable to an interest in a closely held business. If the estate qualifies, the tax can be paid in installments over 14 years. In the first four years, the estate can choose to pay interest only, with payments of both interest and principal required over the following ten years. To qualify, the deceased's interest in the closely held business must exceed 35 percent of the adjusted gross estate.

Under 6166, the IRS assesses a special 2 percent interest rate on a certain portion of the estate. For 2008, it is assessed on the first \$1,280,000 of the estate's taxable value.

Section 6166 can certainly provide some relief for families, but it is important to



note that it is only applicable to the estate tax attributable to the business interest, not to the entire amount owed by the estate.

Section 303: Stock Redemption

Another option is IRC Section 303, under which company stock can be redeemed to pay estate taxes, generation-skipping transfer taxes, and funeral and administration expenses. To qualify, the value of the corporate stock must exceed 35 percent of the adjusted gross estate.

Under Section 303, the stock transaction is treated as a sale, not a dividend. The estate generally has no gain or loss because the value of the stock at the date of death becomes the new basis. This

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succession discussions will only diminish available options.

Get your team together.

Gather an advisory team to help guide succession discussions and decisions. The team could consist of an accountant, insurance agent and other family advisors, along with an attorney who specializes in estate planning.

The scenario is typical: Mom and Dad are in their late 50s or early 60s. They started the business when they were young, worked hard to make it successful and are now content to make a good living and not rock the boat.

Their kids, now in their 30s and 40s, have been working in the family business for years and are itching to take advantage of all the opportunities they think their parents are letting slide by. But if the kids took over now, would the company thrive?

With the right succession plan, the answer is probably yes. Kids often have the energy, ideas and drive to take the company to the next level — if their parents would just let them.

The problem: Parents often don't plan their exit early enough. Ideally, planning should begin ten years before retirement. This gives everyone time to prepare for moving up, moving out and moving the company forward.

Here are a few steps that can help make succession go smoothly:

Recognize your mortality. Start talking about your future and the future of the company now. While it may be uncomfortable to think about leaving the business, putting off

Identify potential successors. Some business owners have a strong desire to keep the business in the family, while others are open to selling to a third party. The advisory team should be engaged to identify the best options for your business.

Of course, circumstances sometimes dictate these decisions. For example, if the children are too young to take over the business, non-family succession might be the only option— even if it's just temporary, until the next generation is ready.

Start preparing for what's next. If selling to a third party is preferred, it will take time to prepare the business for sale. This means getting the finances in shape, streamlining operations and generally sprucing up the company so that it is most appealing when it comes time to sell.

However, if passing the business along to family or internal leadership is the choice, immediately begin to train management successors for their new jobs. Figure out which skills are needed and design training to fill the gaps. Give new leaders increasing power to make decisions — let them succeed and fail while making “thousand-dollar decisions” now rather than “million-dollar decisions” later. Help them learn from experienced leaders who are still around to provide good counsel.

Move on. Develop a timetable for departing and stick to it. This will ensure that you can develop exit plans that are effective for the company, and appealing for you, while fostering an effective transition to the next generation of management.

According to Russ Romanelli, managing partner at Wolf & Company, “If succession planning is done right, the new generation of leaders almost always thrives. The key is allowing an appropriate amount of time to make it work.” ■

If you would like to discuss succession in more detail call Russ Romanelli at 630-545-4557.

Planning Ahead

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favorable tax treatment is the biggest benefit of Section 303.

Of course, the company must have the cash available to redeem the stock. To ensure that this is the case, Section 303 purchases are often funded with a company-owned life insurance policy on the owner. The tax-free proceeds from the insurance are then used to purchase the stock from the estate.

Filing for Section 6166 or 303 elections must be done by the due date of the estate tax return. It is prudent to discuss these options with your CPA and estate planning advisor sooner rather than later. There may be other options that can be implemented now to save the company from extinction at the owner's death. ■

To discuss these and other estate planning strategies, please contact Jodi Mersinger at 630-545-4574.

The Ins and Outs of Buy-Sell Agreements

Is your business “bus-proof”? In other words, if an owner were hit by the proverbial bus today, would the transfer of ownership to his or her successors be accomplished smoothly?

Buy-sell agreements are vital documents that help protect companies in this and other scenarios by facilitating a smooth transfer of ownership and providing a mechanism for valuation. They also protect owners by establishing a buyer for their interests. They are essential for all types of closely held businesses — C corporations, S corporations, LLCs and partnerships — and should be in place as soon as the business is formed.

Know the Basics

Good buy-sell agreements cover a variety of topics and what-if scenarios. Most frequently, they dictate a buyout process so that nothing of financial consequence is left to chance, market whims or contentious partner negotiations. Planning ahead in this way can be particularly helpful in times of stress, a common state during a business break-up.

Well crafted buy-sell agreements usually cover:

Triggering events. What happens if an owner dies, becomes disabled or leaves the company, whether voluntarily (retirement, moving, wants a new challenge) or involuntarily (substance abuse, fraud, death, divorce)? The point is to control stock ownership and voting rights. By defining triggering events, the buy-sell agreement ensures that an orderly transfer of assets will ensue and the remaining partners aren't stuck with a departed owner's ex-spouse, children or estate as a business partner.

Buyout method. Most buy-sell documents include either a cross-purchase agreement or a redemption agreement. In a cross-purchase agreement, the remaining partners buy out the business interest of the

departing owner. This is often funded by a life or disability insurance policy.

In a redemption agreement, the company itself buys the departing partner's business interest. This can be accomplished using a variety of financing arrangements, including lump-sum or scheduled payments to the departing owner or his or her estate.

Non-compete requirements. To protect the company's future, many buy-sell agreements prohibit departing owners from competing with the company, either as consultants or by starting a similar business, at least for a certain period of time. Remember, an important purpose of the buy-sell agreement is to protect the viability of the company.

Valuation. There are many sound ways to estimate the value of a company, but good buy-sell agreements spell out the valuation date, standard of value and marketability discounts up front. Some agreements even name the firm or a specific analyst the partners have agreed upon to

perform the valuation. Periodic valuations may also be required by a buy-sell agreement so that the valuation on which a purchase price is based remains current.

Get the Right Help

Buy-sell agreements are legal documents and therefore require the expertise of an attorney. Typically, the attorney is hired by the company itself, although individual partners may hire their own legal counsel to review the document.

Of course, buy-sell agreements must be kept up to date. Be sure to review the company's buy-sell agreement periodically to ensure that it is still accurate and relevant. It should also be reviewed by your CPA, especially if there are major tax law changes or new valuations. ■

To discuss how a buy-sell agreement could benefit your company, please contact our firm.





Wolf Financial Group

The Healthy Way to Hire the Kids

Most businesses have accounting, computer and vacation policies. Why do so few have family employment policies? Making decisions about hiring younger relatives can be difficult. Skills and talents may vary widely, or maybe there's not a job for everyone. And sometimes a family member just doesn't work out as an employee.

Hiring the kids requires a lot of thought, and the time to do the thinking is before the next generation comes of age. Employment in a family business is not an entitlement; business needs and individual abilities must determine hiring decisions. When creating family employment policies, consider:

Experimentation. Summer jobs can be a great way for kids to "try out" the family firm and vice versa.

Create a summer job policy outlining the type of work kids are expected to perform, along with personal learning goals.

Education. Is a college degree required to work at the company? A graduate degree in a certain specialty? If so, detail the company's expectations before hiring family members.

Situation. In what position will the children start? Will they rotate through jobs in a training program? Should they work outside the family business first? Address these questions in writing.

Compensation. Family members should be paid based on fair market value for their job responsibilities. Detailing salary and bonus formulas will help to ensure that everyone is treated fairly.

Performance. All employees, including family members, deserve regular performance reviews. Spell out review schedules and adhere to them.

Separation. It's imperative to consider a separation protocol for family members. Indicate performance requirements for continued employment, and include specific behaviors or actions that will not be tolerated. Also specify severance package details.

Human resources issues are complicated. Having formal family employment policies in place can alleviate at least some of the emotion and angst inherent in mixing family and business. ■

For more information contact Kris Domaracki at 630-545-5671.