

FAMILY BUSINESS PERSPECTIVES

YOU CAN'T SOLVE THE PUZZLE WITHOUT ALL THE PIECES

WINTER 2008

LOOKING AHEAD

Retirement Planning for Business Owners

It started with a dream and you turned it into a reality, working long hours and building customer relationships to create a thriving business. Now here you are, 20 to 25 years later, hit with the realization that it's time to think about retiring.

Business owners are typically good planners. But when it comes to retirement, many are in the dark about how to plan. It's likely that you've set up some retirement accounts. But maybe you've opted instead to have the business itself serve as a retirement account, counting on a saleable entity to fund your later years.

SECURING A FINANCIAL FUTURE

The question is, how can you take this sum of money and invest it so that you can live the lifestyle you desire? This depends on your current financial situation, your goals and whether you plan to pass your business on to a family member or sell to a third party.

For example, some owners simply want to leave the company and have their salary continue into retirement. The problem is, salary continuation and its cash flow implications may hobble the company's efforts to hire replacement talent or make other investments. Some owners look for an installment-based sales arrangement, but that may fall apart when cash flow is tight. Rental income from a long-term lease on property may sound good, but it can also prohibit the company from making changes, like moving to a better location.

A safer course of action is funding retirement via a qualified or nonqualified retirement plan or savings and investments, which will provide a retirement income stream that is not tied to the business. Replacing your paycheck is likely going to be accomplished with a mix of income and growth investment strategies to hedge against inflation. Preserving and passing on your wealth will require more complicated estate planning strategies.

BUY CONFIDENCE

A recent poll by the National Association for the Self-Employed found that only 7.5 percent of its members felt "very confident" about retirement, while 56.6 percent felt "not very or not at all confident."

That's why it's crucial to enlist the help of a retirement specialist, whose job it is to smooth the transition from work to retirement. Your CPA, lawyer or other trusted advisor can help you find a credentialed Certified Retirement Financial Advisor (CRFA) or Personal Financial Specialist (PFS). ❖

Please contact our firm to discuss your retirement planning options.

Fear Factor

Some successful business owners don't look forward to retirement. Why? Simply put, they're afraid:

Afraid of feeling useless. After all those years in business, many owners are scared that they'll lose their connection to the "real" world. To combat this fear, put those business skills and talents to use by serving on a board or volunteering at the Service Corps of Retired Executives (SCORE).

Afraid of becoming obsolete. With no continuing education or conferences, no brainstorming or crisis resolution, how does one stay on top of trends and fresh ideas? Continue to pursue business interests. Start a roundtable, attend workshops or speak to groups to stay sharp.

Afraid of what's next. Does retirement mean death is just around the corner? Of course not. But it's wise to consider what will take up all that free time. Travel, recreation or even writing a book, perhaps? Make a list of all the personal goals still to be accomplished.

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Be Reasonable About Compensation

Salary is a frequent topic of conversation between CPAs and their S corporation owner clients. The question is: How much should the client, as a shareholder employee, be paid by his or her own company?

Owners are often motivated to pay themselves very small salaries because of potential tax savings. Wages are subject to payroll taxes, but dividends are not. By paying themselves low wages, shareholder owners can save on payroll taxes yet still reap the fruits of their labor by paying themselves big dividends.

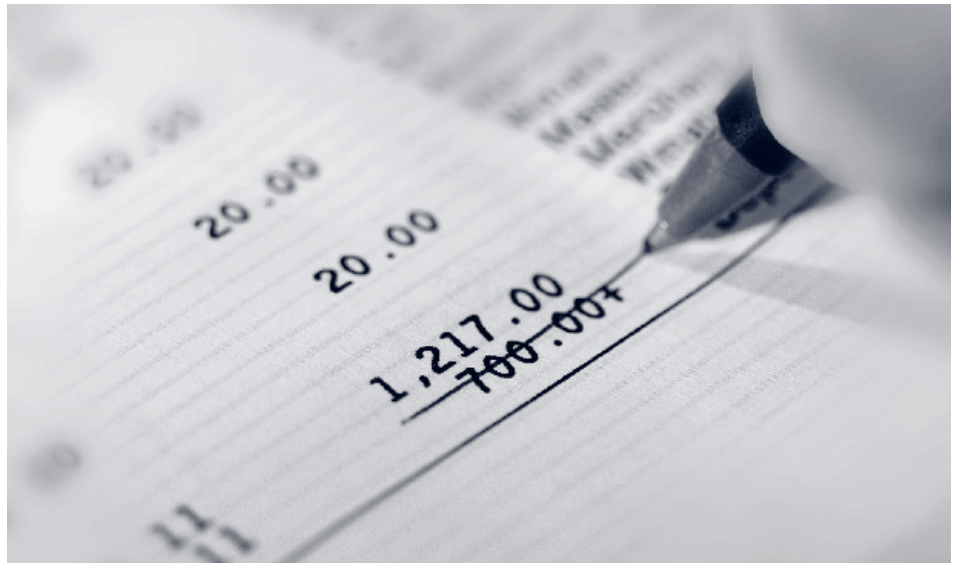
There's just one problem: This isn't legal. According to the IRS, for compensation to be deductible to a business, it must be reasonable for the services rendered. The IRS is specifically empowered to re-characterize distributions disguised as wages when indicated.

And if that happens, the company is subject to back payroll taxes, and both the company and employee face huge penalties and interest for underpayment and failing to file proper employment tax returns. The solution is to pay a reasonable salary — which of course begs the question: What's reasonable?

WHO'S TO JUDGE?

While there are no hard-and-fast rules to follow about what's "reasonable," the IRS, via court cases, has given clear signals about the factors it considers when deciding whether a salary is reasonable for the services rendered:

- The employee's qualifications
- The size and complexity of the business
- A comparison of salaries paid to sales and net income



- General economic conditions
- Salary comparisons to shareholder distributions and retained earnings
- Compensation paid in prior years
- The corporation's dividend history

For shareholder employees, the key to success is being able to justify to the IRS that the wages are indeed reasonable. Here are some tips for being prepared if the IRS comes knocking:

Conduct a salary survey. It's not too difficult to figure out what comparable jobs pay. Trade associations and networking groups often keep track of salary ranges. Consider the survey data, and adjust the shareholder employee's compensation accordingly.

Document decisions. Keep records of how salary figures are computed. Discuss salaries at annual meetings. Keep statistics, surveys, notes and other research filed with corporate meeting minutes.

Pay wages regularly. Be sure to treat shareholder employees just like other employees in terms of paperwork. Issue regular paychecks, deposit them in the family checking account, and use these wages for living expenses.

The IRS has made it clear that reasonable compensation is an issue of interest to them, so don't be shortsighted when it comes to salary decisions. ❖

Family Matters

There are valid strategies for splitting income among family members to reduce overall taxes. But be cautious. IRC Section 1366(e) states that members of an S corporation shareholder's family must receive reasonable compensation for services rendered to the company, whether or not they own shares in the corporation. Inadequate salary, rent or interest could result in reallocation, interest and penalties by the IRS.

Offer Incentives for Key Non-Family Employees

Put yourself in your non-family employees' shoes for a minute: You're working at a family business where you're surrounded by the owner's relatives. You're competing with them for salary, benefits and future job security. Do you even have a chance at promotions and ownership when Junior and all his cousins are your co-workers?

Being an outsider in a family business can be unsettling because even in the best-run family businesses, sound business decisions can be obscured by family ties. Yet, keeping key non-family employees happy, motivated and enthusiastic is often crucial to the company's success. This makes it important to take specific steps to help your most valuable non-family employees feel appreciated.

Communicate openly. Acknowledge key employees' unique circumstances and remind them that they are valued for their contributions to the business' success. Encourage them to give you straight opinions, even concerning family members. Invite their input on key business matters. Building this element of trust with non-family employees serves the company and employees well.

Pay fairly. Non-family employees often feel family members get preferential treatment. Be sure to compensate all employees reasonably in terms of salary and benefits. Offer promotions and opportunities

based on skills, talent and track record, not relationships.

Consider offering "ownership" opportunities. Family members often get stock in the company simply by virtue of their birth. Key non-family employees can also be given the economic benefits of ownership without actual transfer of stock through a "phantom stock" plan.



Under such a plan, employees are rewarded with performance-based compensation aligned with the value of company stock. As the stock appreciates or dividends are paid, the employee's phantom stock account is credited equally, as if the employee held actual stock.

Because they are designed to pay out beyond the current operating cycle, phantom stock plans force participants to consider the long-term impact of their business decisions. Access to the account is subject to a vesting schedule, which provides a strong incentive for key employees to stay with the company and continue to add value.

Offer deferred compensation. Some incentive programs are designed to encourage key employees to stay with the company with the promise of substantial financial rewards at some point in the future. So-called "golden handcuffs" and "golden parachutes" are deferred compensation programs that keep key employees in place. Golden handcuffs typically involve a specific vesting period, whereas a golden parachute essentially keeps an employee at the company until it is sold.

Unlike phantom stock, these programs are not tied to the performance of the company. Funding is often accomplished via life insurance. The cash value accumulated during the employee's tenure can be used to partially or fully fund the compensation. In the event of the employee's death, both the company and the employee's family receive non-taxable benefits.

Note that proceeds from phantom stock and deferred compensation plans are taxable to the employee when paid.

Be sure to properly structure the program and navigate complex IRS rules to avoid any unexpected tax consequences. Offering tax and retirement planning consultation to the employee is another way to underscore his or her value to the organization.

Because of the substantial legal and tax implications for your company, a CPA and attorney should be involved in crafting the compensation agreements. ❖

We can help you structure incentive programs for your non-family employees. Contact us today.

Mentoring 101

With all of the unusual personnel challenges associated with family businesses, you'd think human resources issues would be near the top of the list of things to address. However, because it's "all in the family," many family businesses put employee development initiatives on the back burner.

If this is the case at your company, a mentoring program may be of interest. Mentoring provides employees a formal relationship with someone more experienced and knowledgeable who is invested in sharing wisdom and guidance. A mentor is a trustworthy adviser — generally outside the family — who can teach, add perspective and offer suggestions in specific areas, from interpersonal skills to decision-making strategies.

The benefits of a mentoring program are many:

Accelerates learning — Mentoring helps employees learn faster and avoid mistakes.

Reinforces value — Those being mentored feel valued,

which fortifies their commitment to the business.

Establishes necessary skills — Focused mentoring can be key to a succession plan by filling gaps necessary to keep the business in the family.

Addresses sticky issues — Mentors can be objective about family business issues, which are often too emotionally charged to discuss with family member executives.

Finding a good match is crucial to a good mentoring relationship. Perhaps there's someone within the employee's network — former bosses, professors or professional contacts — who would be willing to fill the mentor roll. If not, industry groups, small business agencies, the Service Corps of Retired Executives (SCORE) and your company's professional service firms are good places to turn for suggestions.

Look for someone with leadership abilities who is objective, compassionate, admirable and a good listener. Remember, the mentor has the potential to influence and impact the employee's life and career in a big way. ❖



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