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Family Business

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Why you should consider an IDGT for your succession plan

Savvy family business owners know it's important to look beyond the next sales meeting and payroll run and focus on the long-term success of their company. That includes finding the most effective way to transfer the business to their successors.

If your goal is to transfer ownership to family members, an intentionally defective grantor trust (IDGT) can help you minimize taxes and provide your heirs a measure of comfort and financial security. Let's look at the advantages and disadvantages of IDGTs.

HOW DOES AN IDGT WORK?

Tom is the co-owner of a fast-growing grocery store chain and has the controlling interest. He's been too distracted with the company's hectic day-to-day operations to think much about succession planning. But after one of the stores flooded and caused extensive physical and financial damage, Tom is forced to think about the business's future.



After consulting his accountant, Tom determines an IDGT may help meet his succession and estate planning objectives. Tom can set up a trust to which he transfers family business interests (though the trust can hold other assets as well, such as real estate and securities) and name his heirs as beneficiaries. The transfer creates a taxable gift, but the business interests and any future appreciation in their value are removed from his estate.

The trust is considered “intentionally defective” because the trust includes a provision that causes Tom, as grantor, to be treated as the owner of the trust assets for income tax purposes, without causing the assets to be included in his taxable estate.

The “defect” is actually a good thing: The trust itself doesn't pay taxes, so the assets grow tax free, maximizing the wealth that Tom will pass to his heirs. As Tom pays income tax on the trust's income, those tax payments further reduce his taxable estate without tapping into his \$1 million lifetime gift tax exemption or using up any of his \$12,000 annual gift tax exclusions (the limits in 2008).

WHAT ARE OTHER FUNDING CONSIDERATIONS?

An alternative to gifting interests to the IDGT is selling them to the trust in exchange for a note. Tom, as the grantor, can trade an appreciating asset (business shares) to the trust for an interest-bearing but nonappreciating asset (a note), and maintain control of the company even if the trust has bought most or all of its shares.

This strategy also can avoid gift tax consequences if certain rules are followed. For instance, the trustee should pay Tom installments punctually, and Tom should be careful not to forgive the debt or he'll risk the IRS treating the sale as a gift. If he sets up the transaction properly, business earnings will cover note payments while providing him with enough income to maintain his lifestyle. If the company appreciates in value by more than the required

interest rate at the time of sale, the trust will accumulate value even after paying off the note.

In the case of a sale, Tom must take into account that the trust should have some economic substance independent of the business. This puts the trust in a reasonable position to issue a promissory note so it can buy the business interest. For example, Tom can fund the trust with additional assets such as cash or marketable securities equal to at least 10% of the family business interests he's transferring.

After determining how much of the company he can transfer, Tom will need to obtain a valuation to establish the business's fair market value and, if applicable, use a discount based on: 1) lack of control, and 2) lack of marketability.

Tom doesn't need to worry that the income tax burden will become overwhelming if the assets grow significantly more than expected. The trust may permit Tom to "fix" the trust defect, effectively breaking the income tax link between him and the trust. Doing so would cause the trust to be responsible for paying its own income tax from that point forward. Keep in mind that, once the trust is no longer defective, it can't be made defective again.

WHAT ARE THE DRAWBACKS?

An IDGT may not meet all of Tom's estate planning needs. The rules for creating the trust can be complex and the business valuation costs before

each transaction can be pricey. This tool also isn't without certain risks. For example:

- The IRS can treat the transferred shares as gifts if it believes the grantor sold business shares to the trust for less than fair market value.
- The IRS can try to reject the trust altogether and treat the business as though it were still in the grantor's taxable estate.
- The IRS can treat any taxes paid on trust income as an additional gift to the trust, in which case the grantor will have to decide whether to continue paying tax on trust income or simply cure the defect and let the trust pay its own tax.

The biggest drawback is that, if the company doesn't grow as anticipated, the interest on a promissory note and other costs could eliminate any value left in the trust. And once a business owner sets up an IDGT, the trust is irrevocable.

PLAN FOR SUCCESS

IDGTs can be a sound solution for minimizing the tax impact of transferring your family business to your heirs. But they require careful drafting and thorough consideration of all factors, including taxes, so be sure to weigh them all carefully before proceeding. Don't forget that there are a number of other strategies that can help you meet your succession and estate planning needs. 🏠

The reviews are in

How to ensure your performance evaluation process is effective

Performance reviews naturally rouse some anxiety among employees who are waiting to find out how their managers have rated their performance over the previous year, the size of their pay increase and perhaps the fate of a potential promotion. But when managers and workers have familial ties, natural anxiety can turn into emotionally charged battles over these evaluations,

as well as the compensation and perks that may result from them.

One way to maintain peace in your family business — and operate it more efficiently — is to have a performance program that rates and compensates employees solely on how well they do their jobs, without regard to family ties.

EQUAL TREATMENT FOR ALL

Many family business owners treat family employees differently. And how could they not? They've shared personal, and even professional, experiences that go back years, or often decades.

Unfortunately, many nonfamily workers feel at a disadvantage with these close, familial ties in place, so any hint of favoritism can weaken their morale and diminish their productivity — both of which can threaten your company's bottom line. That's why it's important to hold family and nonfamily workers to the same performance standards.

Rivalries within the family also must be considered. Some family employees may feel they're being treated differently than others, such as receiving fewer perks or less respect.

In these situations, consider having the senior family manager conduct the performance reviews for related workers or appointing a family committee to conduct family employees' reviews and address sensitive, family-related issues. Although nonfamily managers may be suited for this task, they may feel that they have to treat family workers with kid gloves for fear of jeopardizing their position in the company.



Family workers will appreciate these steps because they won't be subject to the single authority of a family manager with whom they may have a bad relationship. Nonfamily workers will appreciate the built-in accountability of these strategies, which help deter personal biases and preferential treatment toward family members.

> TAKE LEGAL COVER

The performance review process can help your family business stay out of legal trouble if a worker questions termination or alleges discrimination. A review is a written record that details an employee's strengths and weaknesses, and whether goals were accomplished.

Be sure specific notes are kept throughout the year, detailing any problems and whether discipline was warranted or progress made. This way, if you ever need to fire a worker, you'll have written proof of the employee's poor performance and the actions you took, such as giving a warning or requiring additional training, to help the worker correct the problem. This information will go a long way toward convincing a judge or jury that you acted fairly.

MAKING THE MOST OF THE PROCESS

As you know, performance reviews are a good time for your company and staff to reflect on individual and collective successes and failures and think about what needs to be accomplished in coming years. But it can be easy to get distracted and stray off topic. To ensure your family business and employees are gaining all the benefits from this process and staying focused:

Get employees involved. Make sure they understand the review process and the importance of it. Also, give them a voice in their review. This helps employees feel valued and view this process as a joint effort to help them live up to their potential in your company. Let them complete a self-evaluation that discusses their strengths, weaknesses and professional development plans for the coming year.

During the review, compare notes with the employee. This allows you to see not only how well your employees are meeting your goals and expectations, but also how well their goals and expectations match with yours.

Give constructive feedback. Some businesses view performance reviews as a forum for criticizing employees and doling out reprimands for a job not-so-well done. If you consider your employees a valuable asset, you need to provide them with as much positive feedback as negative comments. And feedback should be specific — examples are terrific — and relevant to the employee's work.


Unfortunately, many nonfamily workers feel at a disadvantage because of close, familial ties in the business, so any hint of favoritism can weaken their morale and diminish their productivity.

Create measurable goals. Develop action-oriented, specific and measurable goals for your company and require managers and supervisors to do the same for their staff. For instance, a goal for your marketing director might be to develop a pipeline of new product initiatives that address unmet consumer needs.

Discuss the future. Employees who are unsure of their future with your company may not go the extra mile or perform all their duties. As much as you can, discuss with each nonfamily employee the role you expect him or her to have in upcoming months or years. In particular, be forthcoming about whether they're place holders for future family successors or whether there's potential for a management position or an ownership interest. Also, be honest with family employees about their opportunities for advancement within the company.

Follow up after the review session. Some employees may need time to digest the feedback from a review, so check in with them a few days later, and encourage them to ask questions and voice concerns when they're ready.

GETTING RAVE REVIEWS

Performance reviews can have a profound effect on employee motivation and satisfaction. They provide employees with recognition for their work efforts and opportunities for improvement, and convey the message that your organization is genuinely interested in their performance and professional development. Take the time to develop an effective performance review program so your family business and employees can reap all the benefits. 

Teaching youngsters that money doesn't grow on trees

Parents and grandparents who don't teach children about finances may be putting their kids at a serious disadvantage. Youngsters who don't learn about spending, saving, budgeting and credit are at risk for financial problems later. And these issues may negatively affect your family business when this generation takes the reins.

So start teaching kids fiscal responsibility as early as possible. A good financial education can go a long way toward helping them lead financially

secure lives and to one day take over — and successfully manage — your family business.

IT'S ELEMENTARY

Interact with preschoolers in a playful way to help them become familiar with currency. For example, put a nickel in one hand and a quarter in the other and ask: Which one is the quarter? Which one can you buy more candy with? Also, encourage them to make deposits into their piggy banks.

As children get older, consider when to give allowances and whether they'll need to complete chores to receive the money. Some experts say allowances shouldn't be linked to chores, believing that children should be required to pitch in without being paid. Others believe that using an allowance as a payment for helping around the house can instill a strong work ethic. You can compromise by giving your kids an allowance not linked to regular chores, and pay them separately for certain work above and beyond regular household chores.

Also, teach your children or grandchildren to save some of their allowances and monetary gifts for a specific goal, such as buying a special item or donating to a charity. When youngsters are ready to buy something they've been saving for, take them shopping. This way, they can learn about how to make sound buying decisions and begin to equate the value of money to tangible items. Making their own purchases with their savings also lets children experience the pride and joy of setting — and achieving — a financial goal and reaping the rewards.



HANDS-ON TRAINING

As children grow up and get part-time jobs, open bank accounts for them and encourage them to continue saving by depositing their allowances and any extra money they receive. Let them fill out their own withdrawal and deposit slips and interact with the tellers. Teach them about bank interest rates and fees, and whether certain bank programs and promotions are beneficial.

This helps instill responsibility and teaches young adults early on how to conduct financial business. Keep in mind that these accounts should be separate from the ones used to save for youngsters' educations.

Don't forget to explain other financial tools, such as stocks, bonds and mutual funds, and concepts, such as compounding growth. Be specific. If you're discussing how an IRA works, show youngsters how much money they could earn if they started saving as a teenager compared to the savings they would earn if they started as a young adult.

You can even get your children or grandchildren started with an IRA. They — or you — can make contributions up to their earned income or the annual limit (\$5,000 in 2008), whichever is less.

ADVANCED STUDIES

Plant the seeds of entrepreneurship by encouraging your preteen to start his or her own small business.

> PRACTICE MAKES PERFECT

Tell youngsters that it's OK to make mistakes, as long as they learn from them and are accountable. If your daughter chips away at her savings and can't afford the outfit she's been planning to buy or your son spends most of his allowance on junk food in one day and doesn't have enough to last the entire week, don't bail them out.

Instead, explain how they can rebuild their savings and stay on budget. Rather than making youngsters feel guilty about their mistakes, encourage them to do better next time. By choosing your words carefully, rather than scolding, you can help your children feel comfortable coming to you about their money issues in the future.

Managing a business, whether it's baby-sitting, mowing lawns or walking dogs, can provide valuable financial lessons and work experience.

In addition, consider giving your teenager a credit card with a low spending limit and require him or her to pay the bill each month. If your child charges too much and has to carry the balance over, he or she will soon discover how finance

charges and late fees work. Of course, credit can be ruined quickly, so you'll want to closely monitor their accounts.

THE GREATEST FORM OF FLATTERY

Example is the best teacher, so also be sure to practice what you preach when it comes to managing your own money. Your children will want to imitate your success and will respect your tutelage. 🏠

> FOLLOW THE LEADER

7 LEADERSHIP SKILLS TO INSTILL IN YOUR EMPLOYEES

Your employees are the foundation of your family business. So instilling good leadership qualities in them — particularly as they take on supervisory and management responsibilities — is essential to their professional development and your company's success. Here are seven ways you can instill leadership skills in your employees.

1. Motivate. Motivation helps bring out the best in workers, which leads to greater efficiency for your business. Keep in mind that incentives don't have to be expensive. The key is to find what your staff will value. Providing employees with a personal assistant for a day or giving a prime parking spot for the month may be more appealing than an award plaque or gift card. For milestone accomplishments, provide bonuses, raises or promotions, as appropriate.

2. Give praise when it's due. Let employees know when they've done a great job, and tell the rest of your staff and customers. Recognition boosts pride and confidence, and shows your staff that you're paying attention.

3. Be respectful. Good communication and listening skills go a long way to convey respect. Although criticism is necessary sometimes, it should be given constructively and at appropriate times. Take workers aside to address issues and, if possible, wait until you have time to discuss the problem in depth.

4. Tune into their needs. As your employees' lives change, be sensitive to their needs. Encourage a healthy work-life balance and offer tools to help them achieve it, such as providing gym memberships or access to a nutritionist, and stocking the kitchen with healthy snacks. Your workers will feel better, work better and be more loyal.

5. Empower. Give workers opportunities to grow and arm them with the tools they need to succeed, including additional training to develop new skills, or new or updated software and equipment to do their jobs better.

6. Convey your vision. A leader should be able to convey what success will look like for the business and each employee, and what steps will need to be taken to get there.

7. Laugh. Having a sense of humor can be a great tension breaker and mood lifter.

Remember, your attitude and behavior set an example for those you lead. So hold yourself to high standards and model the behaviors you want to see in your employees, and your employees will follow.

