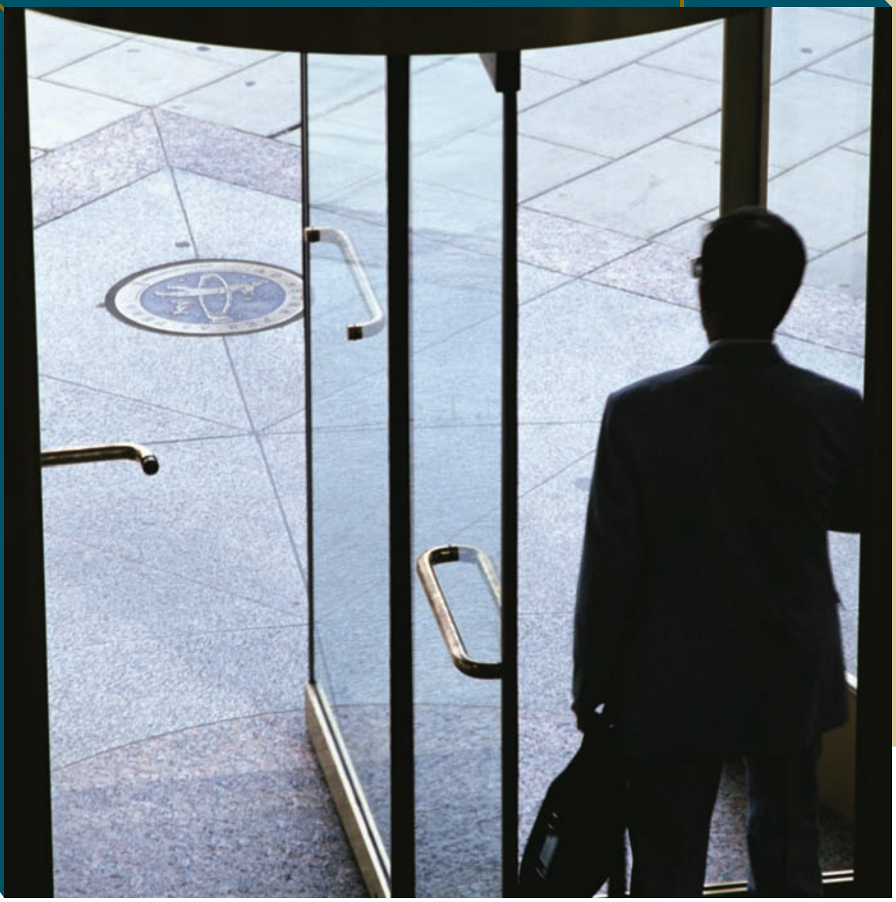
Inside Family Business



Is it time to say good-bye?

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March/April 2006

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Hard as it may be to accept, the day will come when it's time for you to step down from your company. Because you've invested dearly in building a successful business, it's only natural for you to want your legacy to carry on and to receive a prosperous return on your investment. Often, family business owners pass on their companies to the next generation of loved ones. But if there is no family member interested in taking over your company, how can you successfully exit the family business?

Consider your options

Like most family business owners, you may want to transfer the company to the next generation. For a smooth transition, you must prepare well ahead to avoid destructive infighting and resentment among your loved ones.

Issues to consider include:

- ❒ Naming a successor and formulating the overall leadership and management strategy,
- ❒ Dividing the business fairly among family workers and family shareholders,
- ❒ Taking into account the legal and tax aspects of transferring ownership,
- ❒ Planning for minimal disruption to operations during the transition, and
- ❒ Determining how to fund your retirement and your continued involvement, if any, in the business thereafter.

But what if there are no qualified or interested relatives to pass your business to? Your other exit options are to:

Sell it. Find an interested individual outside your family, such as an executive in the business who shares your passion, to buy it and carry on your legacy. You may need to help the buyer finance the sale and allow him or her to pay over time.

Also, look at other companies. A customer, supplier or even competitor may pay a handsome price to acquire

strategic capabilities that will enable it to expand or improve its business.

Take it public. The IPO process is long and hard — and may not be so prosperous. Prepare to spend time wooing Wall Street analysts and money paying transaction costs (which can run in the millions) and underwriting fees to investment bankers. The few that are successful must deal with being continually scrutinized by analysts, complying with Sarbanes-Oxley requirements and trying to survive downward market fluctuations.

Make it a lifestyle company. This approach drains the company of cash daily and rewards you. You'll stop investing in your business and start paying yourself a generous salary and bonuses, and issue yourself a special class of stock that pays you higher dividends than other shareholders. Although making a business into a lifestyle company would never work for a public company, it's a sensible option for family business owners with few or no other shareholders. Just don't forget about the tax bite.

Shut your doors. If no one wants to inherit or buy your business, you'll have to close it, liquidating its assets. Keep in mind that you'll likely have to settle for less than your company is worth.

Determine if you'll stay involved

Whether you choose to pass your company to the next generation or sell it to an outside party, your successor or new business owner will likely need to tap your knowledge and experience for a period after the transition. You can support the transition by becoming a:

Consultant. You may serve in this role for a designated period of time in exchange for fees. The benefit is that you get paid the consulting fee whether or not you actually consulted during that period. On the other hand, you may have to put retirement plans on hold because you have to be able to respond as needed. Although the business will be able to deduct consulting fees paid to you, you'll need to pay income taxes on them.

Worker. Staying on as an employee for a short period of time will allow you to still draw an income and receive insurance and other benefits. Plus, your company can continue to deduct these as business expenses as long as you actually earn them. But you'll be postponing retirement, and it may be difficult for you to serve as an employee and follow the lead of your successor or the new business owner.

Maintaining some level of involvement for a period after the transition will help ensure your successor or the new business owner gets off to a good start and the company continues with minimal disruption. It can also be a great way for you to ease into retirement.

Take time now

It's difficult to determine when you'll exit the business, but not planning for this event will have greater complications for you and your loved ones. So take the time now to evaluate your options. That way you'll get the most value from your business.

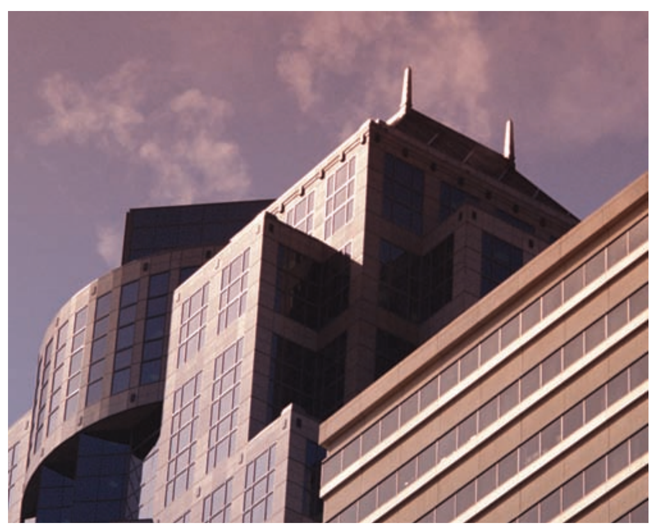
3 reasons to own business real estate in a separate entity

If you're thinking about buying business real estate, you may want to make the purchase through a separate entity rather than through your company. Why? By doing so, you may enjoy estate planning benefits, asset protection and income tax savings. Let's look more closely at these three advantages.

1. Estate planning benefits

You're creating your estate plan and are thinking about gifting shares of the company to your children. You're worried because your business owns the building from which the company operates and, by making the gifts, you may lose control over the business. Or you're comfortable with the idea of giving ownership to loved ones, but you're restricted from doing so because of professional regulations or other reasons.

You can resolve these dilemmas by setting up a real estate entity — such as through a limited liability company or limited partnership — that will have no bearing on the



ownership of your core business and then gifting shares of the real estate entity to your children, rather than shares of your core business. You can do the same with large pieces of equipment, having the separate entity buy the property and lease it back to your company.

But what about any real estate currently owned by your business? Depending on your business entity type, you may be able to simply transfer the real estate out of the company without any tax impact. But it may be impractical to transfer the property, so be sure to evaluate the tax consequences before taking action.

2. Asset protection

Any good investment strategy involves diversification. One way to diversify your portfolio is to invest in real estate because real estate may respond differently to economic changes than your business does.

By owning real estate outside your company, you can insulate the real estate against potential creditors of your business. So if your company couldn't meet its financial obligations, any assets, including land or buildings, held outside your business would be protected.

Similarly, by owning the real estate in a separate entity, you're shielding your business assets from potential creditors associated with the real estate. For instance, if someone were injured as a result of an accident that happened on the property, the liability would be borne solely by the entity that owns the land.

By owning the real estate in a separate entity, you're shielding your business assets from potential creditors associated with the real estate.

By diversifying, you hedge your bets against the possibility that an incident involving one aspect of your business will adversely affect all areas of your company. And if you're like most family business owners, it's likely your interest in your company and any land owned by you and your business make up a significant portion of your wealth. So it's worthwhile to find extra protection where you can.

3. Income tax benefits

The rent your core business pays to your real estate entity is deductible to your business. Although there is corresponding income that is attributable to the entity that owns the real estate, the net result may actually be positive if the income from your main business is subject to self-employment tax. Any ability to reduce income subject to self-employment tax will lead to a reduction in your income tax liability, assuming all other factors are equal.

There are other income tax benefits that may be realized in conjunction with the estate tax and asset protection benefits discussed above. If you create an entity and gift shares of it to family members, the income generated by that entity will be taxed to your family members at their income tax rates — which will be advantageous if they are in a lower tax bracket. And these family members may be able to take advantage of certain tax credits, such as the Hope and Lifetime Learning credits, that they wouldn't have been entitled to claim without the income.

Consider the reasons

Owning the real estate that houses your company in a separate entity may provide you with several financial advantages. But it may also make sense to keep it all under one business structure. So before you buy land or buildings through your company, weigh the pros and cons of making the purchase through a separate entity.

On board with an advisory board

By nature, a family business is a breeding ground for conflict and sensitive issues. Family obligations, deep emotional ties and personal passions can also create bias. As a result, you may not always act in the best interest of your company. To help address controversial matters with fairness to both your business and family, consider establishing an advisory board.

How it can help

An advisory board serves in a consulting capacity and isn't bound by the fiduciary responsibility to the company and shareholders that a regular board of directors must observe. So, unlike a regular board, an advisory board can feel more free to think out of the box to develop solutions to business problems and identify new business opportunities.

Advisory boards also can address differences among family employees on issues such as the direction the company should move in, how to expand and diversify the business, succession and retirement planning, and performance management and compensation. The values they can bring to your company include:

- Impartial, independent perspective to problems,
- Unity and collaborative solutions to business and family issues,
- Professional talent and expertise your company is lacking, and
- Broadened thinking to stimulate fresh ideas and identify new opportunities.

To fully realize this value, you must be open about every aspect of your operations, your business challenges and family dynamics.

How to set one up

If you believe your family business could benefit from an advisory board, here are some key elements to consider when creating it:

The purpose. An advisory board can define its scope of purpose and goals. Generally, it focuses on addressing major or strategic issues such as succession planning, compensation, growth and expansion — tackling one or a couple of important matters at a time. But to be more effective, you may want to outline its objectives based on your business's goals and needs.

Leadership. Initially, it may be more practical for you to serve as the advisory board's leader. But as your business grows in size and complexity and demands on your time increase, delegate this responsibility to another board member.

Member selection. To provide a more complete perspective, you'll want a mix of professionals from varying fields, demographics and backgrounds. An effective way of recruiting advisory board members is networking with business, industry, community, academic and philanthropic organizations. You may also want your professional advisors to participate, such as your accountant, financial advisor or lawyer, because they're already knowledgeable about your company's goals, issues and staff.

Specify the mix of traits and qualifications — executive or leadership skills, years of experience, competencies, education, affiliations or achievements — needed in members to fulfill the board's purpose. But also look for individuals who are willing to be frank with their observations and provide constructive advice while observing confidentiality agreements and maintaining discretion with sensitive business and family issues.

Operation. How often your board should meet and the degree of formality for conducting meetings and recording minutes depend on the number of members and the board's purpose and responsibilities. Generally, meeting at least monthly initially will help the group establish and maintain rapport and relevance to the business. Once it has been established for a while, the board should meet quarterly.

Compensation. You should cover costs advisory board members incur in traveling to and from meetings and pay them for their time. Cash compensation makes sense for family businesses that want to remain closely held, while companies that are publicly traded or planning to become listed may want to issue stock.

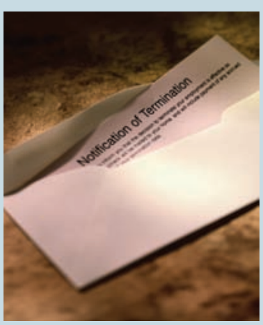
Why you should take the time

Although you can exercise a lot of liberty in setting up and handling an advisory board, recognize that it will require time and money. But the benefit — impartial, independent perspective to problems — makes it worth your while.

Avoid having to say "You're fired!"

Saying "You're fired" just like The Donald is a lot harder than it looks — especially when you're saying it to a family employee. But tolerating poor performance perpetuates a costly problem for your business and family, as well as holding back the individual from pursuing a more suitable, fulfilling career.

Fortunately, there are steps you can take to solve the problem without having to give a poorly performing family employee the boot:



Talk about the problem candidly. Be upfront with family workers about any concerns you have with their performance, explaining how it fails to meet expectations outlined in the written job description and company goals. Objectively present specific examples of performance gaps and the impact on your company. Also, give the individual the chance to comment on your observations and determine if there are other factors affecting how well he or she is handling job responsibilities.

Keep in mind that firing a family employee can cause lifetime animosities. You can minimize the effect on family relations by focusing the discussion on the worker's performance and explaining that this isn't personal.

Allow time to reflect. Be sensitive to the family member's feelings and give him or her time to think about the concerns. The worker may even need time to soul search, so consider paying for career counseling and giving some paid time off. After a little personal reflection, the individual may decide it's best to leave the company and pursue another opportunity, solving the problem and alleviating further tensions.

Give a second chance. The poorly performing family employee may want to keep working for your company, serving in the same role or transferring to a better-suited position. In either case, plan an intended course and timeline for improvement with clear performance benchmarks — emphasize that expectations must be met or termination will follow. Then monitor the individual, documenting accomplishments and problems and providing timely feedback. If he or she still doesn't deliver, it's time to issue a final pink slip.

How giving back helps your family business

Differentiating your family business is essential to succeed. But trying to compete against the fat advertising budgets of larger companies can be difficult, if not fruitless. One tried and true way to help your business stand out is through local community involvement.

The benefits

Family businesses are built on close, emotional bonds. It makes sense for you to extend these ties beyond your company to forge a strong connection with your surrounding community. The benefits to your business include:

Improved public relations. Getting involved in the community upholds company values that demonstrate care and concern for the greater good. This can translate into valuable public relations benefits. Your charitable involvement will also help you attract top talent, customers, suppliers and investors.

Respect and status. Developing strong connections in the community may lead to higher respect and status for your company. This can be used to gain more support for the charity or generate business opportunities.

Increased productivity. Focusing on a meaningful cause helps ignite passion and team spirit in an organization. This encourages stronger relationships among employees, enabling them to work together more cooperatively and productively.

Tax savings. Donating money, property or other assets to qualified charitable causes can reduce your tax bite. These gifts are generally deductible under limits established by the Internal Revenue Code.

Ways to get involved

Many businesses contribute by having an executive serve on the board of a charitable organization, volunteering their staff's time or donating money. And they often spread their efforts across multiple organizations. But you can achieve a bigger impact by structuring your company's donations of time and money around a strategic program dedicated to a specific cause.

One way is to establish a family foundation centered around a cause near and dear to you and your family. Some possibilities include funding research for a medical cure in memory of a loved one, environmental preservation and wildlife protection, and educational scholarships for the underprivileged.

Donating money, property or other assets to qualified charitable causes can reduce your tax bite.

Recognize that establishing a foundation requires a serious commitment of time, effort and resources, including diligence in ensuring compliance with IRS and other government requirements. To be successful, you'll need to establish a clear purpose for the foundation, as well as appointing or consulting someone with philanthropic experience to effectively manage it.

Lasting ties

Family businesses often remain in the same community generation after generation. Thus, a great opportunity exists to create lasting, prosperous ties for your company by getting involved in your community. Plus, you can enjoy that special feeling you get when helping others.