INSIDE Family Business

JULY | AUGUST 2007

Why there's no time for a break
Surviving a potential IRS audit requires planning now

Cherry picking your successor

Do you need to save more for retirement?

Keeping employees in the loop can prevent errors and strengthen morale

Why there's no time for a break

Surviving a potential IRS audit requires planning now

With summertime here, you're probably enjoying sun-filled days and picnics with family and friends. The last thing you may be thinking about is tax planning — let alone what will happen if the IRS audits you. But a little planning now will help ensure that your company can survive an audit.

WHAT ATTRACTS THE IRS'S ATTENTION

Various items on your tax return can prompt the IRS to want to take a closer look at your company's records. These audit triggers include:

- Significant inconsistencies with other years' tax filings,
- Deducted expenses that may seem unusually high compared to your income,
- Expenses and gross profit margin inconsistencies relative to what's standard in the industry for the year,
- Unusual deductions for your type of business,
- Use of rounded dollar amounts that appear stretched to your favor or suspicious and made up, such as $10,000 vs. $9,791 (you may, however, round off cents), and
- Shareholder loans.

If your return might contain any of these triggers, it's important to be prepared for a potential audit.

HOW TO BE PREPARED

Thorough record keeping is an important key to surviving a business tax audit. So, long before you're ever notified that you're going to be audited, you'll want to ensure your record-keeping process is organized and your tax return filings are well supported with complete, written documentation. Keep in mind that the tax code generally requires

businesses to maintain tax-related records for at least three years from the due date of the tax return, including extensions, or the date filed, whichever is later.

To be prepared, you should keep and be ready to present:

- Documentation prepared by or for your company, including product-purchase or service-related invoices, sales invoices including supporting materials, payroll records for your employees, and invoices and Forms 1099 for independent contractors,
- Tax-return related documents from financial institutions for interest and dividend income and proceeds of broker transactions,
- Cash receipts and disbursement records, such as bank statements, originals or legal copies of checks issued, and cash journals and ledgers,
- Credit card statements,
- Proof of payment for expenses paid in cash, including travel, meals and entertainment,
- Property and equipment purchase and lease documentation,

- Salesperson logs — including a description of business purpose, statements and supporting receipts for reimbursement — for use of personal property and equipment such as autos, computers and mobile phones, and

- Other records maintained in written or computerized logs, including business diaries, journals, ledgers and appointment calendars.

Remember, your accountant can help you evaluate your business's overall record-keeping practices and review other ways you may be able to decrease the chance of an audit.

WHAT TO EXPECT DURING AN AUDIT

If your family business receives an audit notice, how do you respond? Keep your cool and contact your CPA immediately. He or she should be present during the audit to provide a professional, accurate explanation and answer any questions. Who better to give details about your calculations and tax deductions claimed and help prevent any misunderstandings that could otherwise end up costing your family business additional taxes plus interest and penalties?

Next, arrange to meet with the auditor, your chief financial officer and your accountant at your accountant's office. Meeting off-site helps to avoid disruption to your daily business operation and keep the audit focused on your company's records for only the year (or years) in question.

HOW FAILING TO PREPARE CAN BE COSTLY

Incomplete records can lead auditors to deny deductions, adjust income or even estimate income and expenses. This typically results in the taxpayer owing the IRS back taxes, interest and penalties. Plus, the auditor could tack on an additional penalty for poor record keeping.

If your audit report is unfavorable and you disagree with the findings, you have 30 days to send a letter and arrange for an appointment at the IRS district director's office listed on your audit report. You'll be assigned an appeals officer to whom you'll explain your case. The appeals officer will review your case and make a determination. But if you lose, you could owe additional interest on late tax payments.

PREPARATIONS LEAD TO PEACE OF MIND

Certainly, undergoing an audit is no picnic. But getting your records in order and working with your accountant to prepare for one helps to start your family business off on the right foot with an auditor. Moreover, a diligent effort to comply with the IRS can make the audit process smoother — and even improve the outcome of your case. Isn't that worth taking a little bit of time out of your summer fun for?

> TAXPAYERS FEEL THE SQUEEZE AS IRS STRIVES TO CLOSE THE TAX GAP

Lost or unclaimed tax revenues from taxpayers in 2001 are estimated to total $345 billion, according to the latest figures from the National Research Program, a study by the IRS. With that amount of revenue at stake, the IRS is working to close the tax gap between taxpayers who comply and those who underreport income, underpay their taxes or don't file returns.

The IRS's focused efforts are paying off: Taxpayer compliance has improved to the tune of $48.7 billion — nearly a 3% boost and part of a strong upward trend — primarily due to a big increase in collections.

Who is under scrutiny? High-income taxpayers. Audits of individuals with income of at least $1 million increased more than 30%, and audits of individuals with income exceeding $100,000 increased by 18%.

IRS enforcement efforts for small businesses and large corporations held fairly stable, but the IRS has been focusing on flow-through returns for S corporations and partnerships; audits increased by 34% for S corporations and 15% for partnerships.

Cherry picking your successor

You need to know what to look for and where to look

Choosing your successor is one of the most important decisions you'll ever make for your family business — and it can be one of the most agonizing ones. Both *what* to look for in your next company leader and *where* to look for qualified candidates may not be readily apparent and could take significant time and effort to figure out. Here are some considerations to help you pick the right person.

THE TRAITS

Before you can find your next-in-line, you have to know what you're looking for. As obvious as this may seem, many business owners fail to give due consideration to the traits they desire in the next company leader. Rather, they often pass the reins to their first child or another close relative without using a selection process. But failing to determine the ideal traits could hurt your company's chances for continued success.

Another common mistake family business owners make is to focus more on the company's historical track record and what traits served the business well instead of looking ahead and determining what abilities are needed to succeed in the future.

In fact, companies usually benefit more from a new leader who has a fresh perspective and some skills and traits that differ from those of the previous CEO. Today's business world is constantly changing, creating both new challenges and opportunities. What makes for an effective leader today doesn't necessarily make for an effective leader tomorrow.

So, when considering the traits to look for in a successor, factor in both current and future leadership needs. Every family business is unique and may have different requirements, but there are some traits that are desirable in all leaders:

- Passion and inspiration,
- Diplomacy and respect,
- Ability to stay rational and composed under pressure,
- Effective communication and listening skills,
- Strategic, big-picture mindset,
- Competitive, results-driven attitude, and
- Accountability for decisions and actions.

For family businesses in particular there are some leadership traits that are always critical, such as the ability to balance the different perspectives and needs of family and nonfamily employees and shareholders and unite family and nonfamily employees to work together as a team.

THE SEARCH

Before you begin the search process, document the desired traits as well as the required professional experience, skills and education qualifications for your successor. Also, create a detailed position description. You should do both of these things even if you've already found your next-in-line. Pinpointing the desired traits and qualifications can help determine which skills and knowledge he or she needs to enhance before taking over.

If you're fortunate, you may have an eligible candidate in your family — a son, daughter or other family member who is ripe for the picking or, in time, could be with a little help. But sometimes

there is no family heir apparent with the desired qualifications.

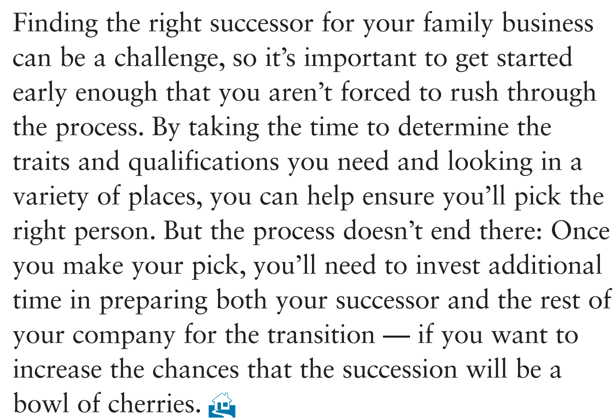
The next best group to look at is your nonfamily management. Look among your star performers and those who have solid experience in your company and the respect of shareholders, managers and family members.

If there are no good internal candidates, you'll need to consider bringing in an outsider — either until the next company leader from within can be trained or for the long term. You can identify suitable candidates through professional business and trade associations or hire an executive search firm, which also will help screen candidates. Recruiting someone from a competitor is another option.

DON'T PICK ALONE

When assessing your choices for your successor, get input from other company owners and managers and, if you have one, your board of directors or advisory board. This is especially important when considering your own offspring, because you can't help but be somewhat biased. Moreover, soliciting the input of other key business stakeholders early in the process will help you gain buy-in for your choice.

Also, speak with your professional advisors, such as your accountant and lawyer. They're very familiar with your family business yet removed from it, so they can provide an impartial perspective that still takes into account your company's unique needs.



A BOWL OF CHERRIES

Finding the right successor for your family business can be a challenge, so it's important to get started early enough that you aren't forced to rush through the process. By taking the time to determine the traits and qualifications you need and looking in a variety of places, you can help ensure you'll pick the right person. But the process doesn't end there: Once you make your pick, you'll need to invest additional time in preparing both your successor and the rest of your company for the transition — if you want to increase the chances that the succession will be a bowl of cherries.

Do you need to save more for retirement?

Thinking about retiring from the family business you spent years building can be frightening. Concerns about what you'll do next and whether the company will thrive without you can make it difficult to let go or even plan the financial details for your later years.

But relying on your family business as both a source of income and an asset to fund your retirement could put you in a financially vulnerable position. You're subject to all the risks inherent in a closely held business, particularly if you become disabled, have hefty expenses or experience a sustained period of inflation. That's why having a long-term savings strategy that doesn't rely solely on your family business is critical.

LEARN FROM OTHERS

Steve gave little thought to retirement, even though he was turning 54. His actions reflected this: He hadn't started grooming his sons, employees with the company, to succeed him, and most of his assets were tied up in the business. Then Steve suddenly became ill and was unable to work. Medical bills mounted, and his sons were at odds over who would take charge of the business.

Fortunately, Steve fully recovered and was on his feet after a few months. But this scare made him think about what would have happened had he not been able to return to the business: Because his sons were neither experienced enough to run the company nor financially prepared to buy it, Steve could have been forced to sell the business to an

> ONE FOOT IN AND ONE FOOT OUT

If you're not ready to completely walk away from the business world and the income that comes with it, a partial or phased sale of your family business might be right for you. In this arrangement, you sell a stake of your company to family members, employees or an outside party, perhaps with the understanding that the remaining stake may be sold in the future. This allows you to continue working and drawing a salary while you cash out a portion of your business equity.

Retaining shares in your business as a minority owner can allow you to receive income distributions without some of the hassle of being the boss. And the right partner will not only allow you to phase out your involvement over time, but also help you maximize the end value of your remaining investment in the business.

outsider to generate the cash needed to pay his medical bills and future living expenses. The incident also made him come to the conclusion that, though he loved his company, he did want to retire from it someday.

So he met with his accountant to start the process of succession planning. His CPA also outlined some tax-advantaged retirement plan options to help him begin building some assets outside of the company to help fund his retirement — and even make up for lost time.

3 POWERFUL RETIREMENT PLAN OPTIONS

A variety of tax-advantaged retirement plans are available, but here are three that may help you build your nest egg rapidly:

1. Defined benefit plan. These plans are ideal for individuals in their 50s — typically peak earning years — who are planning to retire within the next 10 years or so. Why? Because they allow participants to contribute over a short period of years what's needed to generate a large annual retirement payout, up to the lesser of $180,000 (in 2007) or 100% of the average of their three highest consecutive pay years. For those close to retirement, this likely will be a much larger contribution than is allowed under other types of retirement plans.

These plans often can be set up in conjunction with an existing 401(k) plan. But employers are required to provide a certain level of benefits to their employees, which means annual contributions within a certain range, determined actuarially.

The plan can be terminated when you retire, having served its purpose. Then plan distributions can be rolled over into an IRA, so you can take withdrawals according to your preference, subject to applicable restrictions and requirements.

2. Simplified Employee Pension (SEP) IRA. You can contribute up to 20% of your self-employment income or $45,000 (for 2007) — whichever is less — for your account. You will also generally need to contribute on behalf of your employees. The advantage is that you determine the amount to be contributed, one year at a time. If business is down one year, for example, you can elect to reduce the percentage or not make any contribution at all.

However, in any year you make contributions, you must generally contribute the same percentage of compensation for each eligible employee. Keep in mind that distributions are subject to ordinary income tax, and there generally is a 10% penalty if you make withdrawals before age 59½.

3. Solo or individual 401(k) plan. A solo 401(k) works just like the traditional 401(k), and you can also add a profit-sharing plan contribution. It enables you, as the owner (whether self-employed or the sole employee), to contribute the same amount as you would with a traditional 401(k) plan — $15,500, or $20,500 if you're at least 50 years old — and your company can contribute an additional 25% of your compensation up to $29,500. For 2007, total retirement plan contributions to such plans are limited to $45,000 ($50,000 if you're at least 50 years old).

With the exception of hardship distributions, you're not allowed to withdraw funds before age 59½ while you're employed. If you leave the company before age 55, you may be taxed on withdrawals and hit with a 10% penalty unless distributions are rolled over into an IRA or another qualified retirement plan. When you reach 70½ years old, you'll be required to begin taking distributions, unless your particular plan has an earlier set age.

This type of retirement plan is available only to sole proprietors who have no other employees (not including their spouses) or partnerships whose only employees are self-employed partners and their spouses.

GET STARTED TODAY

Often, family business owners focus so heavily on the day-to-day tasks of running operations that they overlook succession and retirement planning. But keeping most of your assets tied up in your company can be disastrous to you and your loved ones. Take the time now to review your financial situation before it's too late.

> KEEPING EMPLOYEES IN THE LOOP CAN PREVENT ERRORS AND STRENGTHEN MORALE

Internal communication is essential because it keeps your employees current on your family business's continually changing business situation, including company performance, challenges, strategies, product or service changes, policies, and succession or other organizational restructuring.

Without these key details, your workers may make a critical error, duplicate work, be less productive or fail to maximize opportunities. Keeping your staff informed about company matters can help to prevent these issues and strengthen employee morale and loyalty by:

- Helping workers to feel more connected and valued,
- Garnering employees' support for difficult business decisions, such as a new or changing business direction,
- Establishing trust between management and workers, and
- Promoting a sense of community among your staff.

Proactively sharing company information with your staff can also improve shareholder returns, according to *Connecting Organizational Communication to Financial Performance*, a study by Watson Wyatt. A formalized process and clear links between business objectives and employees' work are two communication practices that have a great impact.

The actual process of communicating with employees can be difficult for family businesses. Naturally, many business matters are discussed among family employees at home around the dinner table or at other gatherings. And certainly some information, such as shareholder ownership-related matters, may not be appropriate to share with nonfamily workers. Regardless, nonfamily employees may end up feeling insignificant and left out of the loop.

To help keep both family and nonfamily employees connected, consider distributing a company newsletter or report with pertinent updates monthly or quarterly. For any pressing needs, issue memorandums or hold staff meetings.

Take care to communicate sensitive matters, such as company restructuring or layoffs, in a face-to-face meeting. Keep in mind that employees may feel more comfortable asking difficult questions in a smaller, more intimate setting.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2007 IFBja07