# INSIDE Family Business

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# Got real estate?

*Special-use valuations can reduce estate tax and help keep your business in the family*

You've worked hard to build your family business and hope to pass it on to your heirs to preserve your legacy and provide for their financial security. Naturally, the last thing you want is for your loved ones to be forced to sell the company to pay estate taxes. Planning early to offset estate taxes is certainly your best bet. But what if you die before you're able to put a plan in place?

There's hope: If a significant portion of your estate consists of real property, your family may be able to use a special-use valuation to reduce estate taxes — and help keep your business in the family.

## HOW DOES IT WORK?

Real property's fair market value generally is based on its "highest and best use." For example, real estate in the heart of the business district of a major city might be valued by the IRS based on its use for prime office space, even if the owner uses it as a parking lot for the business. If the property's value for estate tax purposes is based on its highest and best use for prime office space, significant tax consequences will likely result, perhaps forcing the family to sell the parking lot — or even the business — to pay estate taxes.

But if certain requirements are met, the Internal Revenue Code allows an executor to value the real property based on its *actual* use, rather than its highest and best use. Let's say that you own a piece of land that, based on its current use, is valued at $2 million. Its fair market value based on its highest and best use, however, is $2.5 million. If the property qualifies for special-use valuation, your heirs can reduce the property's value for estate tax purposes by $500,000. Keep in mind that the special-use valuation tax break cannot reduce your federal gross estate by more than $960,000, as indexed for 2008.

## DOES YOUR PROPERTY QUALIFY?

There are specific requirements designed to ensure that the special-use valuation election is used appropriately. To be eligible, qualifications must be met in these four areas:

**1. Residency.** You (the decedent) must be a U.S. citizen or resident, and the property must be located in the United States and used for business or farming.

**2. Ownership and use.** The real property must have been owned and used in a qualified manner during at least five of the eight years before your death. To qualify on the ownership basis, the property must have been owned by either you or a family member for the requisite period. But ownership isn't enough: The property must have been used in your company for company business, and you or a family member must have materially participated in such use.

Even without material participation, your surviving spouse or a descendant could qualify for the special-use valuation in his or her own estate, provided that when the property was in your hands the requirements were met. Let's suppose, for example, that after your death your spouse decides to close the business and rent the property to another business

## > ESTATE PLANNING TIPS YOU CAN IMPLEMENT TODAY

There are a number of strategies you can apply now to reduce your estate and thus prevent your heirs from having to sell your business to pay estate taxes. Some strategies to consider include:

- Taking advantage of the $12,000 annual gift tax exclusion by gifting interests in your business or other assets to family members,
- Selling interests in your business to your heirs,
- Creating a buy-sell agreement that if properly structured sets the terms for sale of your interests in your business and establishes their value for estate tax purposes,
- Transferring interests in your business (or other assets) to a grantor retained annuity trust (GRAT) or other trust that removes future appreciation from your estate, allowing you to transfer interests to beneficiaries at a reduced gift and estate tax cost, and
- Buying life insurance through an irrevocable life insurance trust (ILIT), which gives loved ones a source of liquid funds to pay estate taxes and other expenses.

on a net cash basis. The other business continues to use the property in a qualified manner. At your spouse's death, his or her estate could elect the special-use valuation, provided all of the other factors were met.

**3. Value.** At least 25% of your gross estate's adjusted value must be "qualified real property." Adjusted value is the highest-and-best-use value reduced by certain debt, such as mortgages. In addition, at least 50% of your gross estate's adjusted value must consist of property that was being used for a "qualified use" by you or a member of your family at the time of your death, *and* that is passing to "qualified heirs."

**4. Qualified heirs.** A "qualified heir" includes your spouse, parents, grandparents, children and grandchildren. He or she must materially participate in the business for at least 10 years after your death.

If your heirs decide to sell the property, dispose of it or otherwise stop operating the business within the required 10-year time frame, the IRS may collect some or all of the estate taxes that would have been owed without the special-use election in place.

### WHAT OTHER OPTIONS ARE AVAILABLE?

If your loved ones are faced with the threat of selling the family business to pay off estate taxes after your death, the special-use valuation election is just one of several options they have.

For instance, your heirs may be able to defer estate tax payments for several years and then pay the tax liability in manageable annual installments. Or, if a catastrophe hits your company and it's worth much less six months after your death than it was on the date of your death, the executor of your estate can elect to use an alternative valuation date and garner significant estate tax savings.

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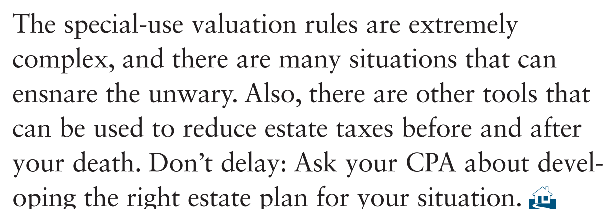
### START PLANNING NOW

The special-use valuation rules are extremely complex, and there are many situations that can ensnare the unwary. Also, there are other tools that can be used to reduce estate taxes before and after your death. Don't delay: Ask your CPA about developing the right estate plan for your situation.



# The not-so-usual suspects

*How to curtail employee fraud*

If you discovered a theft at your family business, your trusted employees may not be among the usual suspects that come to mind. Unfortunately, they need to be.

Workers commit a variety of crimes against their employers, ranging from misappropriating assets to stocking their homes with business supplies to taking vacations on the company dime. There's no foolproof method for stopping employees intent on doing wrong, but you can slow them down.

## VULNERABLE FUNCTIONS

A variety of company functions are particularly vulnerable to fraud. These include:

**Cash management.** Employees may steal cash on hand, divert cash receipts and alter bank deposits.

**Inventory and fixed-asset management.** Workers might steal company assets; divert and sell shipments; or use job materials, tools or other assets for non–job-related purposes.

**Accounts receivable.** Staff members may grant fake credits or take fraudulent write-offs for bad debts.

**Accounts payable.** Employees could forge checks to themselves, accept kickbacks from vendors, pay personal bills with company funds, or create and bill fictitious suppliers.

**Payroll.** Examples of fraudulent activity here include paying nonexistent employees, padding time records, falsifying salaries and committing withholding fraud.

**Financial statements.** Employees who are subject to incentive compensation could falsify financial results in order to qualify for additional pay or perks.

## AN OUNCE OF PREVENTION

A good first step in curtailing fraud is creating a fraud policy that spells out what constitutes fraud and how management will deal with those caught in the act. It should spell out the investigative process and make clear that, for specified severe violations, perpetrators will be terminated and prosecuted.

For some family business owners, it can be difficult to fire a family employee — even if the offense is fraud. Yet in severe situations continuing to employ the worker will serve only to undermine the credibility you have with the rest of your staff. It could affect your standing with your suppliers and customers as well. Here are some other steps you can take:

**Enlist employees' help.** Encourage workers to watch what is going on around them and to alert a supervisor when they believe theft or fraud is being committed. Protect reporting employees by providing a confidential means — such as a toll-free hotline — for them to express their concerns.

**Divvy up job duties.** Regardless of how much you trust your employees, separate accounting and finance-related responsibilities among several employees. For example, don't have the same worker in charge of receivables and cash deposits. Also, your company's internal control system should provide appropriate approvals and sign-offs prior to *all* checks being written. A dollar limit should be set for checks to be "signed" by an employee.

**Ensure compensation is competitive.** Employees who believe they're underpaid may be able to more easily rationalize committing fraud. Compare your pay rates to others in your industry and ensure that they're competitive.

**Partner with your accountant.** Your CPA can be a powerful resource in uncovering fraud and embezzlement. He or she can help you create effective internal controls as well as help monitor bookkeeping records, invoices, bank statements,

payments, journal entries, financial reports and other documents. And be sure to have your accountant perform scheduled and unscheduled financial audits. Surprise audits can help identify potentially dangerous gaps in your controls and procedures and let your employees know that fraud prevention is a high priority.

**Protect ownership.** Be sure to spell out in your ownership agreement a way to remove fraudulent executives from your company. One way is a low-value buyout or a total surrender of shares in exchange for agreeing not to prosecute. Be sure to discuss the matter with your attorney before taking action.

**Lead by example.** Owners or managers who pad expense accounts or take office supplies may lead some employees to believe that they're also entitled to a little extra as well. Ensure your leaders are acting appropriately.

## PLAN FOR PEACE

Even with safeguards in place, offenses may occur. If employees — family or nonfamily — breach a company rule, you must address the matter immediately. As mentioned, it's virtually impossible to completely fraudproof any company. Nonetheless, there's a lot you can do to protect your family business and preserve your peace of mind.

## > NEXT-GENERATION PEER GROUPS PROVIDE SUPPORT TO FUTURE FAMILY BUSINESS OWNERS

Some family business owners delay succession until they're forced to deal with it. Even if you're in perfect health and years away from giving up your company, you should start preparing for this transition now.

Getting your next-in-line ready to take the reins requires management and operational training and leadership development — a process that typically takes several years. To help your successor shift gears from employee to leader, consider a next-generation peer group.

A next-generation peer group is composed of people who hold the same role in a family business — successor — and are facing similar challenges in preparing to take over the company. The group provides an outlet for discussing personal and professional matters that members may not feel comfortable sharing with their spouses, other family members or friends.

Also, members benefit from a network of professionals whose feedback and advice help to promote professional growth and improve leadership skills. Here, they can receive counsel and support on management and operational issues and matters specific to family businesses.

Next-generation peer groups are usually self-governed, with each operating differently depending on the wishes and objectives of its members. Most groups insist on confidentiality, with some having members sign confidentiality agreements. To ensure each member's business industry doesn't directly compete with that of other members and for other reasons, some require an invitation to join. And the cost to join differs by group, typically ranging from $700 to $10,000 annually.

To find a next-generation peer group in your area, check with local colleges and chambers of commerce.

# Is there a micromanager in your midst?

The manager of any family business is, by definition, closely involved in running the company. But what if one is a little *too* involved?

Such "micromanagers" can wreak havoc on your family business, weakening morale, slowing productivity and heightening office tensions. Before this happens to your company, look around to see whether there's a micromanager in your midst and, if so, address the issue immediately.

## SPOT IT A MILE AWAY

Because their traits can resemble those of hard-working and committed employees, micromanagers can go undetected for some time. Taking on extra tasks, being involved in all aspects of the department's work and providing detailed instructions are all typically favorable qualities. So how do you distinguish between these two vastly different types of staff members?

The key difference is that micromanagers tend to go overboard. Hallmarks include:

- Taking over assignments,
- Wanting to be consulted on and approve every decision,
- Providing overly detailed instructions with every project,
- Offering endless and unsolicited input,
- Overcontrolling employees' work or making excessive changes,
- Constantly questioning workers' actions or differing work styles, and
- Requiring constant check-ins and status reports.

This kind of behavior creates frustration among employees the manager supervises, stifles their efforts and causes them to question their effectiveness — or even their desire to work for the company.

## NIP IT IN THE BUD

Once you discover a micromanager, you must confront the employee about the matter yet also be supportive. After all, this information may be difficult to hear because most micromanagers think that their actions are appropriate. It can be even harder for family members, who may believe that, because of their strong personal and financial ties to the business, they're acting in the company's best interest.

Although micromanagers can be destructive to a business, you can reverse the damage by addressing the problem right away. Here are some strategies you can implement to change a micromanager's negative behavior:

**Get to the root of the problem.** Why do they do it? Some micromanagers believe that only they can get the job done right or have difficulty seeing their staff as competent members of the same team working toward a common goal. Others are insecure about their positions or overwhelmed by pressure.

Still others are simply "wired" to take charge or get a rush from the power and authority of being in control. Whatever the reason, it's important that you and the manager identify the root cause to help develop the right solution.

**Provide formal training.** Be sure that the micromanager receives effective internal and external training and development, which include participating in a mentoring program with a company leader and management effectiveness workshops. Point out to the micromanager that minor mistakes will be made and the company will not fail. Also, explain that these mistakes are learning opportunities for both the manager and the employee.

If your successor is the micromanager, have him or her attend a peer group to learn how to deal with the professional and personal challenges of taking over and running a family business. (For more about peer groups, see "Next-generation peer groups provide support to future family business owners" on page 5.)

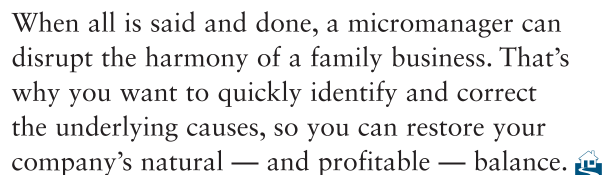
**Teach them personally.** Some managers may not understand how to enable or encourage their subordinates to successfully complete tasks. So you may need to step in yourself and offer leadership tips such as these:

- Take time at the beginning of a project to discuss and clarify desired outcomes, and use weekly meetings to get updates.
- Ask staff to explain their work processes, not dictating what they should be — this allows your manager to address concerns if an employee goes in the wrong direction while giving employees the opportunity to suggest alternative ideas and resolve the matter on their own.
- Guide staff without actually doing the work — this helps micromanagers develop more confidence and trust in their team's work while allowing subordinates to prove their skills and learn from their experiences.
- Focus work on leadership and developing business processes rather than individual tasks.
- Remember that employees don't have to complete a task exactly as others would, as long as the desired outcome is achieved.

**Follow up on the issue.** Get feedback from both the manager and his or her team on how well the strategies are working. And keep the lines of communication open with the manager to ensure he or she has the necessary support. Micromanagers can easily fall back into old patterns when work gets hectic or other stress is present. Bear in mind that management just might not be the right fit for this employee.

## RESTORE THE NATURAL BALANCE

When all is said and done, a micromanager can disrupt the harmony of a family business. That's why you want to quickly identify and correct the underlying causes, so you can restore your company's natural — and profitable — balance.



## > WHEN MICROMANAGEMENT IS NECESSARY

A manager's role is to monitor and evaluate employees' performances, provide them with instruction and motivation, and offer them guidance and support. Sometimes these responsibilities can seem controlling to staff — particularly those who are underperforming and need more direction and supervision.

So, in instances where deadlines are missed, customers aren't satisfied, projects are headed in the wrong direction, or an employee is unwilling or unable to perform to expectations, a manager may need to *temporarily* transform him- or herself into a micromanager to resolve the problem. It's only when a manager's input is excessive or unnecessary that he or she may be a bona fide micromanager.

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