focus

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Use umbrella insurance to protect your family *and* assets

Should an FLP be in your family business's succession plan?

Mergers and acquisitions
The ins and outs of earnout provisions

Estate tax law uncertainty: Keeping your plan on track

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Use umbrella insurance to protect your family *and* assets

Few people would ever consider skimping on their homeowners or auto insurance. But while these policies are a good insurance foundation, they may not be enough for the average family. Many folks, and especially those who've accumulated any level of assets, will find it prudent to add an excess liability policy, sometimes referred to as an "umbrella" policy, to their insurance coverage.

What's an umbrella policy?

An umbrella policy provides an extra layer of insurance that comes into play once your homeowners or auto insurance policy limits have been reached. Say a guest is injured tripping on your stairs, a driver in your house is at fault in an automobile accident or your dog bites a neighbor's child. In addition to medical and repair expenses, these events could lead to a lawsuit that could quickly exhaust your regular homeowners or auto coverage.

While every policy differs, most umbrella policies cover injuries to other parties, including guests in your house or other motorists.

Even if you prevail in a legal proceeding, you'd likely run up a costly bill. Lose, and a settlement could wipe out your home and other assets — even a portion of your future earnings.

Of course, you could simply boost the coverage limits on your auto or homeowners insurance, but that would likely cost you more money. Most umbrella policies cover incidents involving either your home or automobile. In addition, many cover claims that often fall outside other policies' coverage. An umbrella policy could cover, for example, a lawsuit for slander resulting from an offhand comment made at a neighborhood gathering.

What's covered? What's not?

When a loss occurs, the first insurance policy against which claims will be made typically will be your primary auto or homeowners policy. Once that coverage is exhausted, the umbrella policy generally kicks in.

While every policy differs, most umbrella policies cover injuries to other parties, including guests in your house or other motorists. Many also cover damage to property, including your vehicles, homes and other items. Finally, umbrella policies usually cover the cost of defending yourself in a lawsuit, and any settlements or payouts that result.

All the same, an umbrella isn't a blank check. For starters, many don't cover business incidents. If you operate a home-based business, you'll want to consider obtaining coverage separately. Similarly, few umbrella policies automatically cover employees on your property, such as cleaning people or child care providers.

How much coverage do you need?

When calculating the needed amount of coverage, consider several factors:

1. Your net worth. The higher this is, the more coverage you'll want.

2. The number and ages of drivers in your household. Not surprisingly, if you have several drivers, particularly if they're younger, go for more coverage.

3. You possess items that might attract lawsuits. If you have a backyard swimming pool, for instance, consider boosting the amount of coverage.

Many umbrella policies offer coverage starting at $1 million, and increase from there. Before assuming that $1 million is an adequate amount of coverage, tally the value of your assets, including your home, personal possessions and investments. You may find that your total is considerably over $1 million. What's more, a settlement from a lawsuit could exceed your net worth. As a result, a higher level of coverage may be prudent.

When you've determined an appropriate level of coverage, review it every year or two. Why? Because, as the value of your assets changes, your coverage should follow accordingly.

How much will it cost?

Fortunately, many umbrella policies are relatively inexpensive. In some cases, a $1 million policy may cost only several hundred dollars annually. Premiums can vary, based on the amount of primary insurance coverage you have, where you live, and your driving record and credit history.

It typically makes sense to purchase an excess liability policy from the company that issued your homeowners and auto insurance policies. Most insurers offer discounts for purchasing multiple policies. In addition, buying the policies together will make it easier for you to coordinate coverage.

Avoid a devastating loss

Just about everyone should consider his or her need for an umbrella insurance policy. In many cases, such policies can be relatively inexpensive. On the other hand, while the lawsuits they protect against aren't all that common, when they do occur, the costs can be devastating. An excess liability (or umbrella) policy can help you avoid financial ruin. ◈

Should an FLP be in your family business's succession plan?

One of the biggest concerns for family business owners is succession planning — transferring ownership and control of the company to the next generation. In many cases, the best time tax-wise to start transferring ownership is long before the owner is ready to give up control of the business.

A family limited partnership, or FLP, can help owners gradually transfer ownership while still retaining control. An FLP can also provide protection from creditors.

Because the limited FLP interests are noncontrolling interests, they generally can be valued at a discount. A discount can also be applied to reflect the fact that no outside market for the FLP interests typically exists.

Because of the discounts, greater portions of the business can be transferred before triggering gift tax. For example, if the discount is 30%, in 2012 you could gift an FLP interest equal to as much as $18,571 tax-free because the discounted value doesn't exceed the $13,000 annual gift tax exclusion.

If you want to transfer interests in excess of the annual exclusion amount, you can apply your lifetime gift tax exemption. And 2012 may be a particularly good year to use the exemption, because it's $5.12 million but, as of this writing, scheduled to drop to $1 million in 2013.

There also may be income tax benefits. The income earned by the FLP will flow through to the partners for income tax purposes. In many cases, the children will be in a lower tax bracket, potentially lowering the amount of income tax paid overall by the family.

Establishing an FLP

As the name suggests, an FLP is a limited partnership in which most or all partners belong to a single family group. Creating an FLP generally involves several steps. At the outset, the family business owner transfers his or her ownership interests to a partnership in exchange for both general and limited partnership interests.

The owner retains the general partnership interest, which may amount to as little as 1% of the assets. However, as the general partner, the owner can still run day-to-day operations and make business decisions. In other words, the owner can control the FLP assets, even though he or she owns just a tiny sliver of them.

Transferring interests

Once the FLP is established, the owner can transfer some or all of the limited partnership interests to his or her children or other family members, either by gift or by sale. These transfers can occur all at once or over a period of time. As they occur, the value of the FLP interests is removed from the owner's estate for federal estate tax purposes. What's more, the business's future income and asset appreciation moves to the next generation.

The children, as holders of limited partnership interests, have no control over the FLP, and thus no control over the business. The children also can't sell their interests without the general partner's consent or force the liquidation of the FLP.

FLP risks

Family limited partnerships (FLPs) might sound too good to be true. But, of course, that's not the case.

Perhaps the biggest downside of FLPs is that the IRS regularly scrutinizes them. If the IRS determines that the discounts applied when the partnership interests were transferred were excessive or that the FLP had no valid business reason for existing other than to minimize taxes, it could trigger additional taxes, as well as interest and penalties.

The IRS pays close attention to how FLPs are administered. Lack of attention to partnership formalities, for example, can indicate that an FLP was set up solely as a tax-reduction strategy.

Similarly, if a creditor can show that an FLP was established solely to evade a legitimate claim that existed before the FLP's formation, the transfers to and from the FLP may be determined to be fraudulent, and the creditors could be given access to the assets.

Protecting assets

An added benefit of an FLP is that the FLP's assets typically are protected from creditors, because they aren't owned by the individual partners. However, a creditor may be able to receive future distributions made by the FLP. Yet even this benefit is limited, because the general partner can decide *not* to make any future distributions.

If the family owns several businesses — say, a small manufacturing company and an apartment building — each can be placed in a separate FLP, which protects each entity from exposure to lawsuits against the other entities.

Additional FLPs can be structured to provide even greater protection from creditors. For instance, an FLP's assets can consist primarily of business equipment, which then can be rented to the family business. As a result, the business would have little income that creditors could reach.

In cases of divorce, if one limited partner no longer is a family member, the partnership agreement can stipulate that his or her interest return to the FLP. This helps keep the FLP within the family.

Summing it up

Because an FLP can be amended or liquidated before its term expires — though usually only with the consent of all partners — it also can offer more flexibility than other estate planning tools, such as an irrevocable trust. The FLP agreement also can provide a mechanism for resolving disputes.

An FLP can be an effective family-business succession and estate planning tool. But, an FLP isn't without some downsides — see "FLP risks" on page 4. Your accounting professional can help you determine whether an FLP should be part of your succession plan. ◈

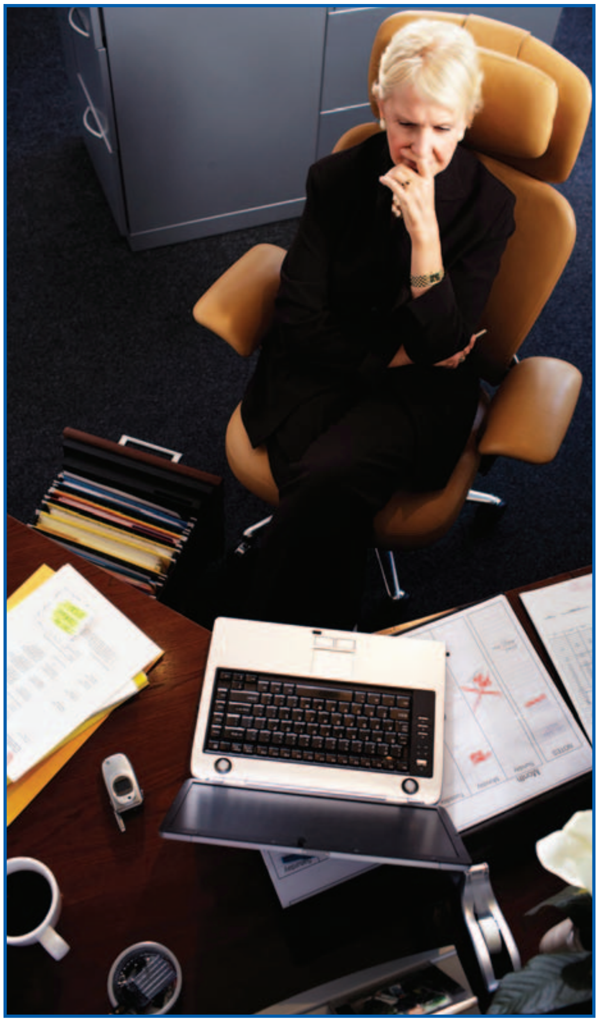
MERGERS AND ACQUISITIONS

The ins and outs of earnout provisions

Earnout provisions require business buyers to make future payments to their seller. Often used when the parties have trouble negotiating a sale price, earnouts require the company to achieve certain post-transaction financial targets. To be successful, such negotiations involve give and take as well as attention to detail.

Negotiation tool

Earnouts can be useful not only in instances where buyers and sellers can't agree on a price but also when the transaction is possible only if the seller decides to finance a portion of the purchase price. For example, the seller may believe the business has valuable financial prospects, therefore meriting a higher sale price, but the buyer may be unwilling — or unable — to pay it.



To break the deadlock, the seller might agree to accept a lower payment at closing with a held interest and the promise of receiving additional remuneration if the business meets certain financial milestones. As these remunerations are paid, the seller releases any held interests. In addition, the seller may maintain rights to assets of the company if the buyer fails to meet a specified schedule.

How it works

As you can imagine, earnout provisions have several components. A quantitative formula is typically used to determine how much is to be paid if a certain financial target is reached. For instance, a buyer might be willing to pay the seller 20% of annual earnings that exceed the prior year's earnings by a certain amount. A target also might be based on annual cash flow, sales or other metrics. The payout provision will specify when and how many payments are to be made.

The term covered by the earnout provision generally runs no longer than three years. A longer period can subject the seller to additional risk, because it increases the possibility of adverse business events that are beyond the seller's control. So if a longer period is envisaged, the seller should consider financing in the form of a loan or preferred stock in the company — both of which offer remedies in the event the business is mismanaged and the buyer can't meet its financial obligations.

Addressing the "what ifs"

Earnout provisions also address certain contingencies that could affect the business's ability to reach the agreed-upon milestones. Say, for example, an acquired company is required to achieve certain levels of earnings. After the sale, the new owner decides to write down the value of a large asset or invest in expensive new equipment that boosts depreciation expenses. The resulting changes could significantly lower earnings, and the seller could lose out on one or more earnout payments.

Earnouts can be useful not only in instances where buyers and sellers can't agree on a price but also when the transaction is possible only if the seller decides to finance a portion of the purchase price.

Such developments aren't uncommon, so earnout provisions should address contingencies. For example:

- Should accounting changes be allowed to reduce payouts?
- Should large capital investments be permitted to distort expenses?

The seller may require regular open-book access to accounting reports and other proof of financial operability to ensure accurate earnout payments. The parties will also need to address Acts of God, the receipt of insurance proceeds, an early sale of the business and arbitration procedures in case of disputes. Finally, to avoid disagreements in the future, both parties should specify how each contingency will affect earnout payments.

When all's been said and done

Because earnouts can be difficult to negotiate, be sure to consult financial experts, including a tax specialist. These professionals can help ensure that, when all is said and done, your deal is fair and will achieve your goals. ◈

Estate tax law uncertainty: Keeping your plan on track

If Congress allows current rates and exemptions to expire at the end of 2012 as scheduled, your family could lose significant amounts of wealth to gift, estate and generation-skipping transfer (GST) taxes. But Congress may extend current exemptions and rates or take other action.

Because of this uncertainty with estate tax laws, you need to make sure you're on the right track. If your estate exceeds $1 million — or your and your spouse's estates combined exceed $2 million — consider whether you should make gifts this year.

As long as you don't exceed your $5.12 million exemption (less any taxable gifts you've previously made), you won't owe *any* tax on the gifts. This likely will remove the assets from your taxable estate and, at minimum, will remove their future appreciation. Note, though, that in certain circumstances gifts made in the past might be included in your estate. So it's important to understand the consequences of making the gift. And, before making a gift, be sure that doing so won't jeopardize your own financial security.

During these uncertain times, it's also important to regularly review your estate plan. Make sure it takes maximum advantage of current estate tax law, and yet still has the flexibility to adapt to future estate tax law changes.

For example, if your estate plan includes a credit shelter trust to protect both your and your spouse's estate tax exemptions, make sure the plan allows you to take maximum advantage of the available exemption while still providing the surviving spouse sufficient assets to maintain his or her lifestyle. But proceed with caution — if your state is one of the many with an estate tax threshold lower than that allowed by the IRS, you might inadvertently create a *state* estate tax liability. So, plan accordingly.

Minimizing taxes is only one aspect of estate planning, but it can help you achieve other goals as well — such as providing for loved ones or supporting charity. That's why it's important to make the most of available tax breaks and be prepared for future estate tax law changes.

Gift, estate and GST tax changes

	2012	**2013**
Exemption	$5.12 million	$1 million*
Top rate	35%	55%

** GST tax exemption will be indexed for inflation.*

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THE RIGHT IDEAS
THE RIGHT RESULTS
ACHIEVED WITH THE RIGHT FIRM.
DON'T LET "SALT" SOUR YOUR BUSINESS MERGER OR ACQUISITION
Complying with complex state and local taxes (SALT) can be a daunting task...
Performing SALT due diligence in a business acquisition is even worse.
When evaluating a merger or acquisition, you need a firm that is expert in state and local taxes to help avoid unwanted surprises after the deal is done. Contact the tax professionals at Zinner & Co. today to minimize your risk of unknowingly inheriting another company's SALT liabilities.
The tax experts at Zinner & Co. can help your company to achieve its financial goals and prosper.
Knowing that you're under constant pressure to make operational decisions with tax implications, our experts are always accessible for both insight and reassurance.
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