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Tax changes on the horizon

Prepare with year end tax planning

Should you enact automatic 401(k) plan enrollment?

Warning! Warning!

Safeguard your family against a disaster by preparing financial recovery and family emergency plans

Compensation conundrum

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29125 Chagrin Boulevard
Cleveland, OH 44122-4692
ph: 216.831.0733
fax: 216.765.7118
email: info@zinnerco.com
www.zinnerco.com

Tax changes on the horizon

Prepare with year end tax planning

Year end tax planning is important every year, but it's particularly significant this year. Why? Many of the lower tax rates and other breaks that went into effect during the past 10 years are scheduled to sunset, or expire, on Dec. 31, 2010, unless Congress takes action. Preparing for potential changes can save you taxes in the long run.

Potential changes

Congress has considered various options for addressing expiring tax rates and breaks, but, as of this writing, nothing has been signed into law. Here are some of the potential changes to keep an eye on — check with your tax advisor for the latest information:

Income tax rates. Today, individual income tax rates are 10%, 15%, 25%, 28%, 33% and 35%. For 2011, these rates are scheduled to revert to 2000 tax rates: 15%, 28%, 31%, 36% and 39.6%. However, many believe that Congress will allow only the top two rates to increase. This could result in higher tax bills for those with taxable incomes of about $171,850 or more for single filers, and $209,250 or more for taxpayers who are married and filing jointly.

Estate tax. For this year only, the estate tax has been repealed; the tax is scheduled to reappear for 2011 with rates and exemption amounts at pre-2001 levels. This means estates worth more than $1 million would be subject to taxes, with a maximum rate of 55%. Many believe Congress will return to the estate tax regime in effect in 2009, when estates valued up to $3.5 million were exempt from the estate tax, and the top rate was 45%.

Capital gains and dividends. Currently, long-term capital gains and most dividends are taxed at 15% (0% for certain lower-bracket taxpayers). Next year, gains on assets held for one to five years are scheduled to be taxed at 20% (10% for certain lower-bracket taxpayers). Dividends are set to be taxed as ordinary income at the taxpayer's marginal tax rate, which may be as high as 39.6%.

529 plans. The American Recovery and Reinvestment Act of 2009 broadened the list of expenses for which tax-free withdrawals from a 529 plan can be used. Specifically, it added computer technology and Internet access expenses — but only through 2010.

Actions to consider

Although Congress may ultimately maintain some of the 2010 tax rates and breaks, it makes sense to start planning for possible changes now:

- If you have income whose timing you can control, such as self-employment income or retirement plan distributions, you may want to accelerate it into 2010 to ensure you pay tax on it at the lower rates.
- If you have deductible expenses you can control, such as 2010 property taxes that aren't due until 2011 or charitable donations, you may want to defer paying them until 2011, because deductions save more tax if your tax rate is higher.

- If you're concerned about estate taxes, it may be smart to make annual exclusion gifts to your loved ones this year. Gifts up to $13,000 per recipient per year are transfer-tax free under the exclusion, and they don't use up any of your lifetime gift or estate tax exemption.
- If you've been thinking about selling stocks on which you'll earn a capital gain — perhaps to rebalance your investment portfolio — consider doing so before the end of the year. That way, you'll lock in the existing capital gains tax rate.
- If you're planning to buy a new computer for your college-student child, it may make sense to do so this year. That way, you can tap into your 529 plan to pay for the purchase.

To be sure, it rarely makes sense to enter into a financial transaction based on the tax implications alone. However, if you have solid reasons, aside from the effect on your tax return, for making such a move, adjusting the timing to take advantage of a particular tax rate or break can pay off. Be aware, though, of other potential factors — such as the alternative minimum tax — that may cause a particular tax-saving strategy to be less effective or even to work against you.

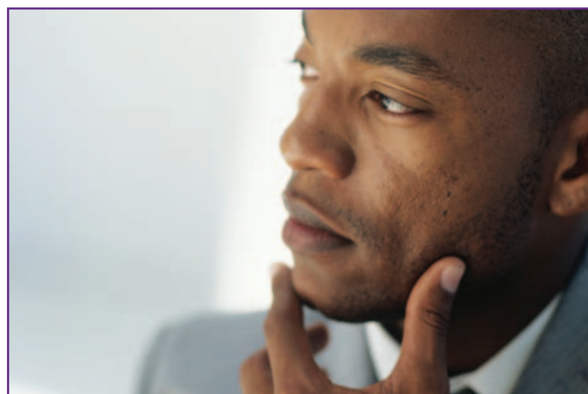
Although Congress may ultimately maintain some of the 2010 tax rates and breaks, it makes sense to start planning for possible changes now.

Be prepared

No doubt the beginning of 2011 will bring changes to tax rates and breaks. To prepare for the inevitable, consult with your tax advisor now to review your situation. ◈

Should you enact automatic 401(k) plan enrollment?

One of the easiest ways for employees to save for retirement is enrolling in their employers' defined contribution plans, such as a 401(k) plan. Yet, a chief complaint among employers who sponsor retirement plans is low participation among eligible employees. A solution is to enact an automatic enrollment program.



The basics

Under automatic enrollment, employees are, by default, signed up for the company 401(k)

plan and a portion of their compensation is "deferred" to the plan. By choosing to use an automatic enrollment program, you're changing an employee's decision from whether *to* participate in a 401(k) plan to whether *not* to participate.

However, if your company goes with automatic enrollment, it must follow recent IRS regulations that implement provisions of the Pension Protection Act of 2006 (PPA). The good news is that these provisions generally make automatic enrollment more attractive to employers.

Easing legal concerns

Before PPA, employers may have been apprehensive about enacting automatic enrollment because of legal concerns. PPA eases some of these concerns. For example, under PPA, so long as you offer "reasonable" investment options, employees can't sue you if the 401(k) plan loses money. Balanced funds, with investments in stocks and bonds or cash equivalents, are typically considered reasonable.

Additionally, PPA preempts state garnishment laws that require employers to give written notice to employees — or receive written permission from employees — before deducting funds from paychecks. Instead, you must give employees 90 days to opt out of automatic enrollment and refund any money deferred on their behalf. If they opt out, the refund is considered taxable income for the year but isn't subject to a 10% early distribution penalty.

A new safe harbor

Employers also were reluctant to enact an automatic enrollment program before PPA because of nondiscrimination requirements, which limited the total contributions made by "highly compensated employees" to a percentage of the total contributions by other employees. Highly compensated employees are those who either own 5% or more of the company or whose salary is more than a specified amount ($110,000 for 2010) during the year.

Thanks to a safe harbor in PPA, you can create a qualified automatic contribution arrangement (QACA) that exempts your company from meeting nondiscrimination requirements. In place of those requirements, you must match 100% of elective employee contributions up to 1% of compensation plus 50% of elective contributions between 1% and 5% of compensation. A plan can't match contributions in excess of 6% of compensation or increase the rate of matching contributions as an employee's elective contributions increase.

By choosing to use an automatic enrollment program, you're changing an employee's decision from whether* to *participate in a 401(k) plan to whether* not *to participate.

In lieu of providing matching contributions, you may make nonelective contributions that equal 3% of compensation for all eligible nonhighly compensated employees. Whichever option you choose, your contribution must fully vest in two years.

What about the automatic employee deferrals under QACAs? The minimum deferral rate is 3% of compensation for the first plan year for eligible employees. The minimum percentage must then increase to 4%, 5% and 6% by the end of the following three plan years. This amount may not exceed 10%.

Is a QACA right for your company?

To encourage employees to save more for their retirements, companies are increasingly enacting automatic 401(k) enrollment programs, such as QACAs. Thanks to PPA and recent IRS regulations, administering the plan is more clear-cut than ever. However, it's important to closely follow the rules. Your financial advisor can help you understand the regulations and determine whether a QACA is right for your company. ◈

Warning! Warning!

Safeguard your family against a disaster by preparing financial recovery and family emergency plans

The past decade has brought an unusually high number of natural and manmade disasters — including terrorist attacks, hurricanes, tsunamis, earthquakes, wildfires and floods. To protect your family from a financial shock if you have the misfortune of experiencing a disaster, you need a recovery plan. It's equally important to make physical preparations to ensure your family's safety.

Financial preparation

Insurance policies are your first line of defense. Assess such policies as homeowners, life, disability and long-term care. Contact your insurance provider to make certain you're covered regardless of the situation. For example, did you know that homeowners policies typically don't cover damages as a result of a flood or earthquake?

Next, take stock and document all of your financial and physical assets. Make a list of your bank accounts, titles, deeds, mortgages, home equity loans, investments and tax records. Inventory your physical assets not only in writing — including brand names and model and serial numbers — but also by photographing them.

It's also smart to back up your financial data and make duplicates of important documents and store them somewhere other than your home. Secure, offsite locations include a safe deposit box at your bank or, for digital files, a Web-based storage provider. Or ask your financial advisor or attorney to store it. This way, if the originals are destroyed as a result of a disaster, you can turn to your backups.

Physical preparation

Of course, if a disaster occurs, there's one thing that's more important than your financial security — the physical security of your family. So be sure to also create a family emergency plan, prepare a supply kit and secure a means to stay informed.

Cash comes in handy in a disaster

When a disaster strikes, government relief funds may be made available — depending on the severity of the incident — but those funds typically are distributed later rather than sooner. Having a cash reserve readily available is a key component of a financial recovery plan.

A good rule of thumb is to set aside three to six months' worth of living expenses in a savings or money market account. You can draw from this cash reserve to pay for a hotel room or purchase supplies until any relief funds are distributed.

You can take this one step further and keep a cash reserve in your home in case of an event where you're unable to access your bank accounts. Consider having at least $50 per family member in small bills.

Your family emergency plan should include a detailed evacuation route, as well as instructions should the disaster require you to stay put in your home. For your supply kit, stock it with provisions such as several gallons of water, nonperishable food, flashlights and a supply of batteries, and a first aid kit. Finally, to stay informed of the latest developments, consider buying a battery-powered (or better yet, hand-cranked) radio.

Don't procrastinate!

It's easy to say that a disaster won't affect your family's life, but life is uncertain. Give yourself peace of mind that, should a disaster strike, you're fully prepared by creating financial recovery and family emergency plans. Talk to your financial advisor for advice on financial recovery planning and visit ready.gov for more details on family emergency planning. ◈

Compensation conundrum

Offering fair pay packages to family-business employees isn't easy

Creating employee compensation packages can be complex because they may include a mix of a base salary, bonuses, ownership options and benefits. It can be even more difficult if your business is family owned, and you're determining compensation packages for both loved ones and nonfamily employees.

As the owner, you have to make tough decisions that can affect not only the company, but your family life. In this situation, it's smart to take a comprehensive approach by balancing the subjective with the objective.

Two-pronged problem

Compensation issues in a family business are two-pronged because they can arise both within the family and between family and nonfamily employees. First, salary inequities among siblings, for example, can breed resentment and fighting. However, simply paying them all the same salary can also create problems if one works harder and contributes more than the others.

Second, family business owners may feel it's their prerogative to pay family workers more than their nonfamily counterparts, even if they're performing the same job. Although owners naturally have the best interests of their loved ones at heart, they may inadvertently injure morale among essential nonfamily employees and risk losing them.

Nonfamily workers may tolerate some preferential treatment for family employees, but they're apt to become disgruntled over bigger differences, particularly if they feel the family employees aren't pulling their weight or performing at the same level.

Take unique business situation into account

Determining compensation requires an artistic element because every company's situation is

unique in terms of familial ties and financial needs and goals. So there's no one right way of addressing the matter. But there are some common strategies that are helpful in determining compensation for:

Family workers. Think beyond salary. Often, base salaries are intentionally kept low and the difference is made up with a sizable ownership stake in the business. Because family workers are generally in the company for the long haul, they'll receive increasing benefits as the business grows. But also ensure compensation is adequate to meet family employees' living needs.

Incentives are a key motivator for family employees. They may include a combination of short-term rewards paid annually to encourage ongoing accomplishments and long-term rewards to keep them driving the business forward.

Nonfamily workers. Nonfamily workers recognize that their opportunities for advancement and ownership are more limited in a family business. So, better salaries can be important to attract and retain top talent.

Another way to keep key nonfamily employees satisfied is by giving them significant financial benefits for serving long term with the company. You can structure this arrangement in a variety of ways, such as through phantom stock or a selective executive retirement plan (a "nonqualified" plan).

Apply proven methods

To balance the subjective aspect of determining compensation, add an element of objectivity to the process. For example, consider applying a market-value-based approach, which entails comparing what other companies in the market are paying for the same position.

Look at companies in your industry and, to the extent possible, of like size, revenue and geographic location. Your sources should include trade associations, job listings posted on other companies' and recruiting firms' Web sites, and newspaper and industry journal classified job listings.

For many family businesses, this approach will be quite different from how compensation decisions have been made in the past. To smoothly adopt this process, explain the benefits to your employees and gradually ease into the transition — doing so will gain buy-in and support from family and nonfamily workers alike. Consulting outside advisors can also help ease your employees' concerns.

Compensation issues in a family business are two-pronged because they can arise both within the family and between family and nonfamily employees.

Another method is to measure performance. If you tie compensation to performance, family employees will be more inclined to work harder and nonfamily workers will feel their compensation is fairer. This, in turn, will improve morale and promote harmony among family and nonfamily workers.

Be sure to tie compensation to individual contributions and your company's performance. Also, establish and communicate performance measures and short- and long-term goals at the employee and company levels.

Incorporating market-value- and performance-based approaches can help you separate personal and emotional connections and see compensation in a more objective light, thereby reducing discord among your employees.

A fair and peaceful outcome

When determining compensation packages for your family business, you have two goals: to be fair and to maintain family harmony. By taking into account the company's unique makeup and applying objective evaluation methods, you can better your chances of achieving your goals. ◈

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The Speculation and Uncertainty surrounding ESTATE TAXES

While the estate tax exemption is scheduled to revert back to $1 million this January 1 ...
there are steps to consider now as part of your succession and estate plan.

The right **ideas**.
The right **results**.
Achieved with the right **firm**.

Gifting ownership interests of a closely-held business may be the right course of action for business owners. For 2010, the annual gift exclusion is $13,000 per recipient and gifts are not limited to cash and marketable securities.

For example, a husband and wife own a business and have two kids. Each can gift $13,000 to each recipient, so $52,000 of value would transfer out of their estates and move from one generation to the next. This can be done each year.

A business valuation determines what an ownership interest is worth, with many factors contributing to the final result. With recent **economic conditions** and **industry trends** applying negative pressures on the values of businesses, many have lost some of their net worth in the current lean years. In addition, future earnings may take some time to rebound and generate business growth.

Because of these factors, ***now*** **could be the best possible time** to transfer business interests to your heirs and beneficiaries. With business values depressed and gift tax rates at their lowest levels, **the tax cost of transferring ownership interests is lower than it is likely to ever be again**. Further, this will allow future appreciation in value to take place outside of your taxable estate and to be credited to your beneficiaries.

Ownership interests in a closely-held business may be gifted without giving up control. Discounts may also apply, further reducing the taxable value of the ownership interest being transferred. In other words, a business owner can gift more each year and still remain under the $13,000 annual gift limit.

Zinner & Co. LLP can help you decide if gifting a business's interests is the RIGHT course of action for you – and we have the expertise to value your business.

Your Success is our Business.

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29125 Chagrin Blvd., Cleveland, Ohio 44122 • Phone 216-831-0733 • Fax 216-765-7118 • www.zinnerco.com