Wolf & Company LLP
Certified Public Accountants

2100 Clearwater Drive
Oak Brook, IL 60523-1927
630-545-4500

www.wolfcpa.com

family Business
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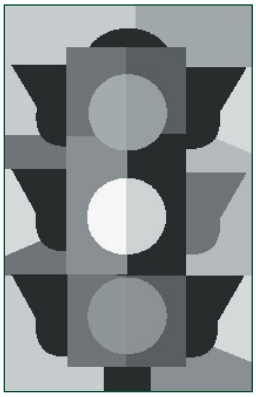
Contemporary Ideas for Family Businesses FALL 2007

Obey the Rules with Family Limited Partnerships

With the estate and gift tax environments in their current state of uncertainty, estate planning professionals continue to rely on tried and true entities such as Family Limited Partnerships (FLPs) to help clients manage their assets. According to Russ Romanelli, partner at Wolf & Company LLP, "FLPs serve as useful estate planning tools that allow taxpayers to reduce their estates through valuation discounts and provide increased creditor protection, continuity of family ownership, and family wealth management opportunities."

In recent years, however, the IRS has challenged the legitimacy of certain FLPs, frequently citing IRS Code Section 2036(a). FLPs are supposed to be set up so that their assets are truly separate from the transferor. The IRS has disallowed the tax advantages of some FLPs — or reduced the valuation discount applied — because the person who transferred the assets to the FLP actually retained use or benefit of those assets during his or her lifetime.

Abraham v. Commissioner



For example, the case of Estate of Abraham v. Commissioner illustrates how the IRS easily disqualified an FLP due to Section 2036(a) issues. In this case, the guardian of elderly Ida Abraham created an FLP as part of her estate plan. Her guardian was given sole discretion to use up to 100 percent of the FLP's income to pay Ida's living expenses — a decision the IRS considered antithetical to the intended purpose and spirit of an FLP.

The court concluded that the FLP was "merely a testamentary vehicle employed to shift assets to future generations while maintaining continued right to benefit from the FLP interests transferred." Chalk one up for the IRS.

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FLP Do's & Don'ts

Do transfer assets intelligently. If the transferor wants to use the assets during his or her lifetime, they should be kept outside the FLP.

Don't give the transferor control of distributions. FLPs are intended to be at "arm's length" from the transferor. Consider setting up an LLC as general partner or giving part of the FLP interests to a charity or unrelated party to ensure "arm's length" control.

Do include other family members' assets. If possible, include assets from more than just one family member. This reinforces the structure and business purpose of the FLP, and avoids the appearance that the FLP was solely created as a tax avoidance tool.

Don't distribute FLP funds to pay expenses. Ideally, the assets in an FLP should be left to accumulate value.

Do honor record-keeping formalities. Treat the FLP as the legitimate business entity it is.

WHAT'S INSIDE

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According to consulting firm Towers Perrin, Hurricane Katrina will cost an estimated $40 billion-$55 billion in privately insured losses, breaking the record set by the terrorist attacks of September 11 as the single most expensive insured occurrence in United States history. And those are just the insured losses. Events in recent years have reminded us that disasters can happen on a large scale. But smaller disasters impact businesses daily: floods…fires…computer crashes…PR crises. Every business is subject to devastating unplanned occurrences. Smart businesses are prepared for them.

Business Interruption Insurance

In addition to the basic insurance coverages your business requires, it may be worthwhile to invest in business interruption insurance. This policy covers operating expenses and profits you would have earned had the disaster not occurred. Some policies also cover temporary relocation expenses.

This type of insurance is typically an add-on to a property insurance policy. Talk to your insurance agent for more details.

What Could Go Wrong?

What's the worst thing that could happen to your business? While this topic may be painful to consider, thinking about worst-case scenarios is a necessity. Defining "disaster" as it applies to your business is something your entire executive team should be involved in. While you can't list them all, brainstorming the many possible disaster scenarios will give you time to prepare a response.

It's important to cover all the bases, from acts of nature to product liability risks to the sudden death or disability of key employees. Once this list of possible bad outcomes is generated, it's time to address each of them with a solid plan of action.

Have A Plan

Many companies' disaster recovery plans start and stop with technology back-up arrangements — and a fair number of them haven't been updated since the Y2K scare. Here are some ideas to keep in mind as you generate your disaster recovery plans:

• Start with your values. Your company's core values should drive your response to disaster, guiding you in terms of priorities and goals. What's most important to you? Start there in terms of recovery.

• Take care of the basics. Plan emergency response procedures to keep the business running. For example, in case of a devastating fire, consider a back-up location where you might move for awhile. Be sure you have off-site access to electronic files and resources. Keep a current contact list for employees, customers and vendors in a safe location. Talk to your financial and legal advisors about how they might be able to help.

• Document processes. If three of your key people are suddenly gone, what does that do to your business processes? If your technology fails, what processes can be done manually? Part of your disaster recovery plan should include details about how to perform critical tasks that will keep the business moving forward.

• Create a communication plan. Appoint a spokesperson for internal and external communications. Work with a public relations professional to create boilerplate responses to some of the more likely disasters your business might face. Educate all levels of personnel about where they should expect to get information and how to respond to the press.

• Don't forget employees. While customers often come first, employees must be cared for as well. This is especially true in the event of a natural disaster, when employees may be suffering personal losses or disruptions along with the company. Discuss in advance how your business will address these upheavals.

• Update your plan on a regular basis. In a crisis, you need a solid, reliable plan that accommodates current business conditions.

It's a good idea to review your disaster recovery plans periodically and remind all employees of procedures to be followed. ■

Family Business Forum

Our 2007 seminar series on ***Crisis Management,*** covered what to do when a crisis hits and how planning on a crisis is the best way to avoid one.

Watch for our 2008 seminar brochure which will be mailed out early next year.

Word to the Wise: Beware of Tax Strategy Scams

Everyone wants to save as much as possible on their tax bills. But sometimes, in an attempt to avoid tax obligations, taxpayers are tempted by illegal or risky schemes that promise to reduce or eliminate taxes.

Each year, the IRS publishes the "Dirty Dozen," its annual list of the most notorious tax scams. While some are outrageous — citizens asserting that filing a return and paying taxes is actually voluntary, for example — some are easier to fall for. Here are a few words of warning from the IRS about scams to avoid:

Abuse of Section 412(i) Plans — A section 412(i) plan is a legitimate tax-qualified retirement plan funded entirely by a life insurance policy or annuity. In this tax avoidance scheme, an employer purchases special insurance policies, designed so that the cash surrender value is temporarily depressed. Once transferred into employee 412(i) accounts, the cash value significantly increases, giving the employer a tax deduction for amounts far greater than what the employee recognizes in income.

Trust Misuse — Set up properly, trusts can be important estate planning tools. However, there are many unscrupulous promoters urging taxpayers to transfer assets into trusts with huge promises of reduced taxes, personal expense deductions and other financial benefits. According to the IRS, there are currently more than 150 active investigations into abusive trusts, and 49 injunctions have been obtained against promoters since 2001. If you're interested in setting up a trust, rely on a trusted financial professional.

Abuse of Charitable Organizations and Deductions — Attempting to shield income via charitable donations is nothing new, but abusive practices in this area seem to be on the rise. For example, a taxpayer may move assets to a tax-exempt organization or donor-advised fund, but maintain control over the assets. Another scheme in this arena is the overvaluation of non-cash assets donated to a charity. The IRS is also seeing a rise in private school tuitions being disguised as contributions to religious charities.

Offshore Transactions — Many business owners have received invitations to attend high-end "seminars" about "can't lose" business opportunities in other countries. Typically these schemes boil down to illegally hiding income in offshore accounts or using foreign trusts, wire transfers or several other means to hide money. The IRS continues to aggressively pursue people involved in these scams.

Abusive Roth IRAs — This scheme encourages taxpayers to transfer under-valued property to Roth IRAs. One ploy has taxpayers transferring under-valued stock to a Roth IRA, circumventing the annual maximum contribution limit and avoiding taxes on otherwise taxable income.

Disguised Corporate Ownership — Another unfortunate and illegal trend is the formation of domestic shell corporations and other entities for the purpose of disguising the ownership of a business. These anonymous entities are then used to help people underreport income, avoid filing tax returns, launder money and a host of other schemes. The IRS is working with state authorities to identify these shell corporations and their owners.

Phishing — Even the most careful Internet users have been taken in by "phishing" e-mails, which attempt to gain personal information via messages designed to look like they come from legitimate sources. Be wary of any e-mail that requests personal information, even if it looks real. Also, note that the IRS does not use e-mail to initiate contact with taxpayers. If you have any doubt about whether contact from the IRS is authentic, call (800) 829-1040 to confirm.

The most important step you can take to avoid being the victim of a tax scheme is to work with people whose advice and judgment you trust. ■

If you have concerns about a possible tax scheme, please contact our firm.

Obey The Rules

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Hillgren v. Commissioner

Estate of Hillgren v. Commissioner dealt with the case of Lea Hillgren, an active but mentally ill woman who relied on her brother Mark for financial assistance and guidance. Lea's FLP included seven parcels of real estate, four of which were encumbered by a Business Loan Agreement (BLA) between the siblings and ultimately controlled by Mark.

When Lea died, the IRS disallowed the tax discounts on those parcels, claiming that even though Mark controlled the FLP, the assets were basically used to support Lea. Indeed, crucial FLP paperwork wasn't even filed until after the estate tax challenge began, underscoring the Hillgrens' disregard for the FLP entity. Chalk another one up for the IRS.

The bottom line? In today's judicial environment, it's important to stay within the letter of the law regarding gift and estate planning. ■

If you have questions about how an FLP might work in your estate or gift plan, please contact Russ Romanelli at 630-545-4557.

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Make Time for An Annual Insurance Review

There are certain things we all should do every year — change the batteries in our smoke detectors, review our wills, and sit down with our insurance agent to conduct an insurance review. Most businesses need four basic levels of coverage:

1. Workers' compensation insurance covers workers injured on the job for both medical costs and lost wages. Be sure to check the classification of your employees — most states require a certain amount of coverage. Ask your insurance agent if your policy meets current standards.

2. General liability insurance protects your business against on-premises accidents and injuries, product liability and other risks. Be aware that general liability policies often carry detailed exclusions. Work with your agent to ensure that your policy covers your specific business risks. Also consider directors and officers (D&O) insurance for your board members.

3. Vehicle insurance should cover your corporate fleet, delivery vans, company cars — in short, all the vehicles your business owns. Just as with your private auto insurance, the higher your deductible, the lower your premiums. Talk with your agent about ways to reduce costs on your auto insurance program. In addition, remember to notify your agent of any new vehicles as well as vehicles you no longer own.

4. Property and casualty insurance covers most risks to property, such as fire and theft, as well as losses caused by accidents, injury or damage to others' property. Review your policies to ensure that they accurately reflect your risks and that your policy limits are high enough.

In addition to these coverages, many agents recommend an umbrella policy to supplement liability coverage. Also, consider business interruption insurance in case a catastrophe reduces or eliminates your business income. ■

If you would like assistance with business insurance, we will be glad to refer you to an appropriate expert.