

Trendlines

New Directions in Business and Personal Planning



It's nobody's business but the family's

The dos and don'ts of FLPs

The ABCs of PEOs

These "co-employers" can ease HR burdens, reduce costs

Couples need to marry matrimony with money management

Plus!

Moneylines: News briefs for businesses and individuals

*More U.S. businesses predicted to fail,
Students get an F in financial planning ...*

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It's nobody's business but the family's

The dos and don'ts of FLPs

A family limited partnership (FLP) can be a powerful tool for managing and transferring family wealth. As long as it's designed and operated properly, this arrangement allows you to transfer a business or other assets to the younger generation at a minimal tax cost — without giving up management control.

In recent years, however, the IRS has taken a tough stance on FLPs in audits, questioning whether partnerships were set up for legitimate business reasons and, in many cases, denying claimed tax benefits. Many of these disputes have ended up in court, and the IRS has pulled off an impressive string of victories.

An FLP can let you transfer a significant amount of wealth with little or no tax cost.

But this doesn't mean it's time to throw in the towel. Most of the taxpayers who lost to the IRS had structured or operated their FLPs carelessly. And examining what they did wrong provides a valuable lesson on how to do it right.

How FLPs work

In a typical FLP, you form a limited partnership with your children or other family members and transfer a business, real estate, investments or other assets to the partnership. Your children might contribute cash or other assets of their own in exchange for limited partnership interests, but it's more common for them to receive their interests by gift.

Eventually, your children will own most of the partnership shares, but you can continue to manage the business or other assets indefinitely by retaining a small ownership interest and acting as general partner.

The shares you give away are subject to gift tax, but, because limited partners have minimal control over partnership affairs, the value of their interests is discounted substantially for tax purposes.

By taking advantage of the \$1 million lifetime gift tax exemption and the annual gift tax exclusion (currently \$12,000 per recipient), you can transfer a significant amount of wealth with little or no tax cost. And because the assets are removed from your estate, their future appreciation in value escapes estate taxes.

What concerns the IRS

The FLP remains a workable planning technique, but there's a good chance the IRS will audit your gift or estate tax returns if you create one. It's concerned about taxpayers using FLPs as nothing more than a tax avoidance device. So, to survive an IRS challenge, you need to show that you had a substantial nontax business purpose for forming the partnership and that you're operating it as a legitimate business.



There are plenty of acceptable reasons for setting up an FLP. One is to facilitate the transfer of a business to the younger generation without giving up management control. Another is to simplify your life a bit by consolidating ownership and management of real estate and other investments.

Yet another common and viable purpose for creating an FLP is to provide a means to keep the family business in the family — and out of the hands of creditors — by having the business owned by the FLP rather than the individual family members.

What the courts have said

Having legitimate reasons on paper, however, isn't enough. The IRS and the courts may disregard an FLP for tax purposes if the facts are inconsistent with those reasons. In one case, *Estate of Strangi v. Commissioner*, the Fifth U.S. Circuit Court of Appeals ruled that assets Mr. Strangi had transferred to an FLP should be included in his estate and subject to estate taxes.

The IRS and the courts are leery of FLPs that give the transferor too much power over the possession and enjoyment of the partnership's property.

Several facts convinced the court that Mr. Strangi hadn't truly given up possession and enjoyment of his assets after signing them over to the partnership. For example, he transferred virtually everything he owned (including his home) to the FLP, but continued to live in the home rent-free. And he used partnership funds to pay his medical bills and other expenses.

In another case, *Senda v. Commissioner*, the IRS disregarded an FLP, resulting in almost \$500,000 in additional gift tax liability — and the Tax Court agreed.

Here the FLP may very well have been legitimate, but the taxpayers' informal treatment of the partnership made it difficult for them to defend their position.

Their failure to observe partnership formalities, such as documenting partnership transactions, caused them to lose significant tax benefits. This is especially disconcerting given that the Court accepted the discounts claimed on the gifts of the FLP interests.

How to stay in the clear

Recent cases tend to focus on the “don'ts” of FLP planning. But an examination of the courts' reasoning provides valuable guidance on the “dos” of forming and operating such a partnership as well. These include:

- ☞ Do have a legitimate nontax business purpose for the FLP, and be prepared to substantiate it,
- ☞ Do observe all partnership formalities, including keeping books and records and properly documenting all partnership transactions,
- ☞ Do transfer legal title to property to the partnership,
- ☞ Do create the FLP while you're in good health — if you establish it on your deathbed, the IRS will suspect that your motives are tax-related,
- ☞ Do keep enough liquid assets outside the partnership to support yourself,
- ☞ Do distribute partnership income to partners in accordance with their relative partnership interests, and
- ☞ Do have family members contribute assets in exchange for their interests, if possible, as doing so will eliminate the gifting issues that accompany many FLP challenges.

Then again, there are of course things you need to avoid. For example:

- ☞ Don't transfer your home to the FLP and continue to live there without paying fair market rent,
- ☞ Don't commingle personal and partnership assets,
- ☞ Don't use partnership funds to pay your personal expenses, and
- ☞ Don't retain too much control over who possesses and enjoys the partnership's assets.

The IRS and the courts are leery of FLPs that give the transferor too much power over the possession and enjoyment of the partnership's property. One effective way to ease this concern is to bring in an independent third party as a general partner.

Why you shouldn't give up

Despite the risks of an IRS challenge, don't give up on the FLP. It remains a viable business and wealth management strategy. Although a number of taxpayers have lost challenges in court, many properly structured and operated FLPs have succeeded. ■



The ABCs of PEOs

These “co-employers” can ease HR burdens, reduce costs

Whether they deal in turbines or tea leaves, business owners quite understandably tend to focus mainly on things such as strategic planning and product development that help them grow their companies. Managing employee benefits and other HR functions can be tedious, tricky and time-consuming.



Enter professional employment organizations (PEOs), which act as de facto business partners for companies, handling tasks such as workers' compensation, payroll, benefits, tax processing, unemployment insurance and regulatory compliance. Their goal: Reduce the administrative costs of a business while improving its benefits and simplifying its day-to-day operations.

Would a PEO bring these advantages to your company? That's a question well worth asking.

Reaping the benefits

PEOs have been around since 1975, when laws governing employee pension plans changed and helped create an industry that was initially known as “employee leasing.” Today, the favored term is “co-employment,” and, in March 2004, the *Harvard Business Journal* singled out PEOs as the fastest growing business service nationwide over the past 20 years.

The need is definitely there — owners of small to midsize businesses devote up to a quarter of their time to employment-related paperwork, estimates the Small Business Administration. Increasing enforcement by the federal government of overtime laws and the new financial reporting requirements under the Sarbanes-Oxley Act of 2002 also may be pushing businesses to seek outside help.

Another advantage to PEOs is the opportunity to boost the quality of your employee benefits. Because these firms are bulk consumers of insurance and other services, they allow you to offer your staff enhanced medical-plan choices and perks such as Flexible Spending Accounts and vision plans. These are the kind of benefits that can put you on equal footing with larger companies, helping you hire new talent and retain existing stars.

Shifting the risk

Turning over employment tasks to a third party may also help limit your legal risk, because the PEO is, theoretically, responsible for legal compliance with all workplace laws. PEOs work with clients under co-employment, which can also help you.

In a traditional employer-employee relationship, your federal ID number and the employee's Social Security number are essentially married. Under this structure, you're able to direct and control your employees, but you also acquire the employee's full liability — tax and otherwise — which can cause problems.

For example, let's say an employee sues your business, winning a \$1 million award. Many businesses couldn't survive such a judgment and would be forced to close or declare bankruptcy. But the co-employment structure changes that relationship, making the PEO the employer of record, and thereby shifting liability to it. Thus, the PEO would likely defend the lawsuit in court or help shoulder a settlement.

PEOs often tout their ability to apply risk management practices to workers' compensation claims. That can help them obtain insurance coverage on your behalf in an otherwise difficult market.

Because you and the PEO will be acting as a team, you should choose one whose values and culture are compatible with your own.

Beware, however, that some insurers are reluctant to deal with PEOs because, in the 1980s, some PEOs committed fraud and exposed their clients to litigation. Fortunately, in the decades since, tighter regulation has helped improve the industry's reputation.

2 ways to pay: PEO payment arrangements

If you opt to engage a professional employment organization (PEO) for your business, you'll need to evaluate the financial cost. Most PEOs charge for their services in one of two ways:

1. Flat fee. Here you should expect to pay between about \$50 and \$200 per employee per month. The actual fee will vary depending on your particular industry, company location and other factors.

2. Percentage-based fee. Under this arrangement, the PEO simply adds up all of your employee salaries and charges anywhere from 1% to 5% of payroll.

More often than not, a business with a small number of highly paid employees, such as a medical practice, would be better off paying a flat fee. Conversely, a company with a large number of moderate- or low-paid employees, such as a fast-food restaurant, would likely be better off paying a percentage-based fee.

Checking out candidates

Almost no business is too small to work with a PEO. Yet, before signing up with one, arm yourself with some questions and preliminary knowledge.

For starters, look for a PEO that's dealt with companies comparable in size to your own. Moreover, because you and the PEO will be acting as a team, you should choose one whose values and culture are compatible with your own.

Check the firm's references, too. Be sure you are comfortable with the credentials of the individual who would be handling your account. After all, this person will act as an ambassador for your company.

Some PEOs could be undercapitalized, which may raise the risk that the firm could go bankrupt, so also check their credit references and Better Business Bureau records. For an extra level of assurance, ask whether the PEO has received accreditation from the Employer Services Assurance Corporation (www.esacorp.org). This organization provides bonds of up to \$4 million for member PEOs.

Asking the right questions

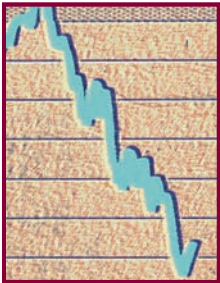
When you've settled on a likely provider, be sure to meet face to face with a firm rep and the team you'll be dealing with and ask some pointed questions. For instance, you may want to give your employees more benefit choices or merely lower their out-of-pocket expenses on the same benefit menu. Can the PEO help you accomplish either goal?

Also ask whether the PEO has successfully negotiated savings from insurers for its past clients and how it will present and explain the benefit program to your employees. Furthermore, find out whether it will occasionally re-evaluate the program to ensure that your company and employees are getting the best return on your investment.

Giving to get

Although PEOs can help some organizations manage a number of employment issues and offer something approaching a Fortune 500-style benefit package, they may not be ideal for every business. A PEO essentially takes over your HR department, and you may not want to put another organization between you and your employees.

But sometimes you have to give to get. In this case, by surrendering some control of certain administrative functions, you get more time to focus on the real reasons you went into business in the first place. ■



Moneylines: News briefs for businesses and individuals

More U.S. businesses predicted to fail. Worrying about customers or vendors — or indeed your own company — going under is all a part of doing business. Unfortunately, you may have more to worry about this year. The Global Index of Business Failures, issued by France-based corporate credit insurer Euler Hermes, is predicting a rise in the number of U.S. business failures this year. This is the first expected increase in five years. How to cope?

Don't panic — stay on top of your credit checks and be sure to proactively manage accounts receivable.

Students get an F in financial planning. Do you have a child, grandchild or young relative in or headed to high school? If so, you may want to ask them to tag along the next time you visit your financial advisor. Only 52.4% of high school seniors correctly answered personal finance and economics questions featured in a national survey issued by the Federal Reserve earlier this year. On the bright side, that number is still slightly higher than the results of the previous survey in 2004 — 52.3%.

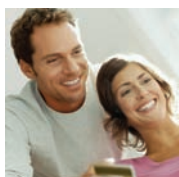
Very small companies enjoy new, simpler tax filing option. The IRS announced early this year that employers with an estimated annual employment tax liability of \$1,000 or less will be able to file the new Form 944 (“Employer’s Annual Federal Tax Return”) once yearly rather than the old Form 941 (“Employer’s Quarterly Federal Tax Return”) four times annually. If you own a very small business (likely employing only one or two employees at most), check with the IRS to see whether you still qualify.

Remember, banks are businesses, too. Understandably, many people view banks as daunting behemoths that set the rules the rest of us must follow. But, the truth is, banks need to make money just like anyone else. Consequently, many of the largest ones have been wheeling and dealing with a variety of customer-friendly promotions. What's the catch? In a word, penalties. Some have added or raised fees, increasing the risks of overdrafts and out-of-network ATM use — so don't hesitate to see whether you can get a better deal, but watch out for fees.



Couples need to marry matrimony with money management

When Gary and Marjorie decided to tie the knot, both were relieved as well as happy. Each had been married previously and, for many years, had all but given up on the idea of remarrying. The couple's past experiences also made



them realize the importance of discussing the financial implications of their impending matrimony. For help, they visited their financial advisor.

When many people think about financial planning before marriage, one (abbreviated) word comes to mind: prenup. But, as Gary and Marjorie's financial advisor was quick to point out, such an agreement is really only one option among many in managing the risk of any union.

Review the past

For Gary and Marjorie, as well as any engaged couple, a good point at which to start talking about the financial future is the financial past. For example, if one or both partners have children from a previous marriage, they may need to discuss child support, college tuition, gifts and legacies.

Major liabilities, such as heavy personal debt or obligations to ex-spouses, can put a strain on both their finances and the relationship. When a parent remarries, prenuptial agreements often spell out what the nonparent spouse is entitled to in a divorce or can inherit, and what goes to the children.

If the parent dies without making provisions for the children, his or her entire estate can pass to the new spouse and then to the new spouse's heirs. Parents often set up trusts to avoid this problem. For instance, a qualified terminable interest property (QTIP) trust lets the surviving nonparent spouse enjoy income during his or her lifetime but sets aside the principal for the children from the prior marriage.

Another area to consider is taxes. If one spouse's income is much greater, the other spouse may find him- or herself in a higher tax bracket

after marriage. Further, the engaged couple should check their IRA, pension plan and insurance policy beneficiaries. They may want to change those designations.

Look to the future

Once Gary and Marjorie had their financial pasts (and presents) on the table, their advisor suggested they look to the future. More specifically, they needed to decide who will own what.

Normally, a spouse's assets stay his or her sole property if they're kept in his or her name. But both these and assets acquired separately during the mar-



riage may become marital property if the couple uses them jointly or maintains them with joint funds. And if the couple lives in a community property state, a more complex set of rules applies.

They must particularly consider homeownership. Gary and Marjorie each own a house, so they'll have to work out which one they'll live in and which they'll lease or sell. On the bright side, married couples can exclude up to \$500,000 of capital gain on a residence at tax time. However, this amount will be limited if: a) neither spouse owned the house for at least two years, or b) absent certain limited exceptions, either spouse didn't live there for two years.

Should either of them want to retain sole homeownership, he or she should pay the mortgage as well as the upkeep and repair costs. Using common funds for these expenses can make the home marital property.

Get off to a good start

These are but a few of the issues that Gary and Marjorie — and, indeed, any couple, whether marrying for the first time or remarrying — need to consider. Anticipating as many potential financial challenges as possible should help ensure their marriage gets off to a good start. ■



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Above all, we place a premium on timeliness, thoroughness and accuracy.

Keeping up is not enough. We strive to stay ahead and lead.

