

Ideas for Your Success

First Quarter 2012

Mitigating business risks

Use a buy-sell agreement to ease ownership transition

Even during prosperous economic times owning a business has certain inherent risks. Given today's uncertain economic climate, those risks (both internal and external) can be compounded. For example, is your company prepared to handle the exit of a business partner? Setting up a buy-sell agreement in advance can help ease the transfer.

Spelling out the terms

In a nutshell, a buy-sell agreement is a contract among a business's owners that sets guidelines for the transfer of their ownership interests. The agreement gives the remaining owners (or the business itself) the right — or, in some cases, the responsibility — to buy an exiting owner's interest if a “triggering” event occurs. Such an event may include an owner's divorce, disability, retirement, desire to leave the company, death, or loss of a professional license or certification.

The agreement, therefore, creates a market for a withdrawing owner's interest. Additionally, by outlining when and to whom interests can be sold, it can help

avoid conflicts among the remaining owners or the withdrawing owner's family.

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Valuing the interest's price

A buy-sell agreement also addresses how the price of the interest will be determined, including defining the valuation method and the standard of value to be used. Agreements typically call for fair market value — the price at which the property would change hands between a willing buyer and a willing seller with neither party being under any compulsion to buy or sell and with both parties having reasonable knowledge of the relevant facts. Fair market value also assumes an arm's length deal.

Funding options

When a triggering event occurs, a substantial amount of money likely will be needed to buy the departing owner's interests. Properly funding a buy-sell agreement helps ensure that money will be available to cover the purchase.

A popular funding means is life insurance. Even though life insurance might be thought of primarily as a means to provide liquidity on the death of one of the owners, it's not limited to such situations.



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Payments *not* in full

Collecting delinquent customer payments requires special care

Tony's graphic design firm has been experiencing a problem collecting payments from its customers. He knows that the economic downturn has affected his clients, but it has also hurt his own bottom line. Tony and his managers are grappling with the question of whether the firm should redouble its efforts to collect the unpaid invoices or treat clients with sympathy to avoid losing their business.

After conferring with his business advisor, Tony decides he must calculate his collection rate and reassess his payment terms.

What's the AR turnover ratio?

You may think your collections are going badly but, until you put a number to what's going on, you'll likely find it difficult to fix anything. To better understand your collection rate, you must determine your business's accounts receivable (AR) turnover ratio.

Start by writing down the beginning and ending AR amounts for your last business year. Then add these two amounts and divide by two — this is your accounts receivable average (ARA). Finally, divide annual net sales (non-cash sales less returns and allowances) by your ARA to obtain the collection rate.

Clearly, this number alone won't tell you much. You'll also need to compare it with those of other similar businesses. To do so, ask your CPA if he or she has any benchmarking reports for businesses like yours.

A six-stage collection plan

After experiencing problems collecting late payments from his design firm's customers, Tony calculated his collection rate and reassessed his payment terms (see main article). He also needs to turn his attention to creating a collection plan. Assuming his terms are net 30 days, he might consider breaking his plan into six stages:

1. On or before the original due date,
2. One day after due date,
3. 30 days after due date,
4. 60 days after due date,
5. 70 days after due date, and
6. Beyond 70 days.

At each of these stages, Tony should assign a specific action. As he moves down through the stages, he should increase the severity of his actions — from friendly reminders (e-mails, phone calls) to more strongly worded requests for payment.



Along with knowing your collection rate, be constantly aware of the status of your receivables in total as well as how regularly each customer is paying you. Do this by frequently monitoring the business's AR aging schedules, with particular emphasis on amounts that are beyond normal payment terms.

Should payment terms be revised?

What adjustments to your collection process should you consider? To get the process started, look at how customers pay you. What percentage of payments come via check, credit card, bank debit and electronic funds transfer? Then examine your typical terms of payment by breaking this data into categories, such as per order; once per month payments from statements; and monthly, quarterly and annual prepayments. The objective is to align as many customers as possible to methods and terms that best fit your company.

For instance, say roughly 25% of your customers make quarterly payments by check. That means your staff is spending a lot of time (and your money) generating quarterly statements and processing paper-based payments. By converting these customers to annual prepayors or automatic payors, you'll get their money sooner and with less hassle and labor.

Of course, pulling off such a feat is easier said than done. Consider offering discounts or special sale prices to help make your case as to why customers should sign up for annual prepayments. The nature of your work, however, may prevent this option. Product-oriented businesses, for instance, usually can't collect in advance of providing the product.

Surviving means getting paid

Tony's firm isn't alone in trying to work with clients to collect delinquent invoice payments. Many businesses are facing the same issues in today's unsettled economy.

But the bottom line is that you must strike a balance between showing sympathy toward tardy paying customers and getting paid. In the end, if you don't get paid for your work, your company won't survive, regardless of the economic climate.

Broaden your tax planning in 2012

With the current uncertainty surrounding financial markets, the economy and tax laws, uncovering opportunities to increase your net worth may be challenging. Doing so will require you to broaden your tax planning, taking into account the effects of both business and personal financial decisions — not just at year end, but all year.

A balancing act

Focusing on tax planning alone may cause you to make poor business or investment decisions. Buying equipment, for example, can generate significant tax deductions. But if the money would be better spent elsewhere, your business may end up worse off financially.

On the financial planning side, investing in tax-exempt municipal bonds may be a good tax move. However, in many cases, taxable investments provide greater after-tax returns and, therefore, create more wealth.

It's equally dangerous to focus on business or investment planning without considering the tax implications. Acquiring another company may be a smart business move, for instance, but there may be several ways to structure the transaction, each with different tax consequences. To achieve the best result, you have to consider the business advantages and the tax benefits of each strategy.

Mix business and personal tax planning

It's also important to integrate business and personal tax planning. Suppose, for example, that your closely held

business is structured as a C corporation. To avoid double taxation you can, to the extent possible, distribute corporate profits in the form of deductible expenses, such as salaries. This would reduce corporate-level taxes. But you also need to consider personal income taxes.

Salary you receive from the corporation is taxed at individual tax rates as high as 35% at the federal level. Further, salary is subject to employment tax. Qualified dividends, in contrast, are currently taxed at a maximum federal rate of only 15%. Additionally, the first \$50,000 in corporate income is also taxed at a 15% federal rate.

When you look at your personal and corporate tax situation as a whole, you might find that you'd be better off distributing \$50,000 of corporate income as a dividend rather than salary. The combined corporate and dividend tax rates could result in lower overall taxes than what you'd pay on \$50,000 in salary. However, make sure that you're still receiving a "reasonable" salary, or the IRS might recharacterize dividends as salary and assess back income and payroll taxes, interest and penalties.

Stay on track

It may not be easy to find time to consider all of the tax consequences of your business and personal financial decisions, but it can be worth your while. Your tax advisor can help you keep on track.

Who should be your child's guardian?

Decisions are many for new parents; and the answers aren't always easy ones. Take, for instance, the unpleasant, but necessary, choice that you and your spouse must make as to who will be your child's guardian in the event of your untimely death.

If you fail to name a guardian in your will, a court will appoint one. It will base the decision on its assessment of the best interest of your child. But that assessment may be different from your own, and its selection may not be your first choice.

There are several issues to consider in making your decision. For example, choosing your parents as guardians may seem like a natural choice, but keep in mind that older parents may not be up to the task of raising a young child.

And don't forget to be practical. Let's say you'd love your sister to be the guardian, but she lives across the country with her husband and two children. Will relocating further traumatize your child? Is your sister's house large enough

to accommodate another child? Take your answers into account before naming a guardian.

Perhaps the most important issue to consider is whether you and your candidate share similar values, such as parenting philosophy, religious and moral beliefs, or educational values. Usually, a family member or trusted friend who shares your values is a good candidate.

In addition to your top pick, choose one or two alternatives. When asking the person to be your child's guardian, ensure he or she clearly understands your expectations and a guardian's responsibilities. Also, give the person time to consider your proposal before asking for an answer. This isn't a question to be taken lightly.

When your friend or family member accepts the offer, revise your will to indicate the change. Be aware, however, that the procedure can vary from state to state. Consult your estate planning advisor to learn the exact steps you must take to name your guardian.



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Using life insurance to fund the buy-sell is beneficial because it can ensure that the departing owner or his or her beneficiaries will receive the agreed-upon price for the business interests in a timely manner. It also can ease the strain on your company's cash flow or reduce the chance that you'll have to sell off assets to pay the bill resulting from a buyout.

With a cross-purchase agreement, for instance, each owner takes out a life insurance policy on the other owners. For example, let's say you buy an insurance policy on your business partner. When he or she dies, triggering the buy-sell agreement, you'll collect the death benefit and use it to buy his or her partnership interest from the estate.

Presuming the coverage is sufficient, owning the policy guarantees you'll have a ready source of funds to fulfill your obligations under the agreement. Other benefits are

that the insurance proceeds won't be taxable (as long as you plan properly), and that your tax basis in your newly acquired interests will be equal to the purchase price.

Keep in mind that a cross-purchase agreement can be cumbersome if there are more than a few owners because of the number of policies required. It also can be unfair if there's a significant disparity in the owners' ages or health, causing the policy premiums to vary substantially.

Take proactive steps

If your business partner were to die or leave unexpectedly, would your company be prepared to move forward without him or her? Having a buy-sell agreement in place before the event occurs can help ease the transition. Talk to your business advisor to determine if this strategy is right for your company.

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