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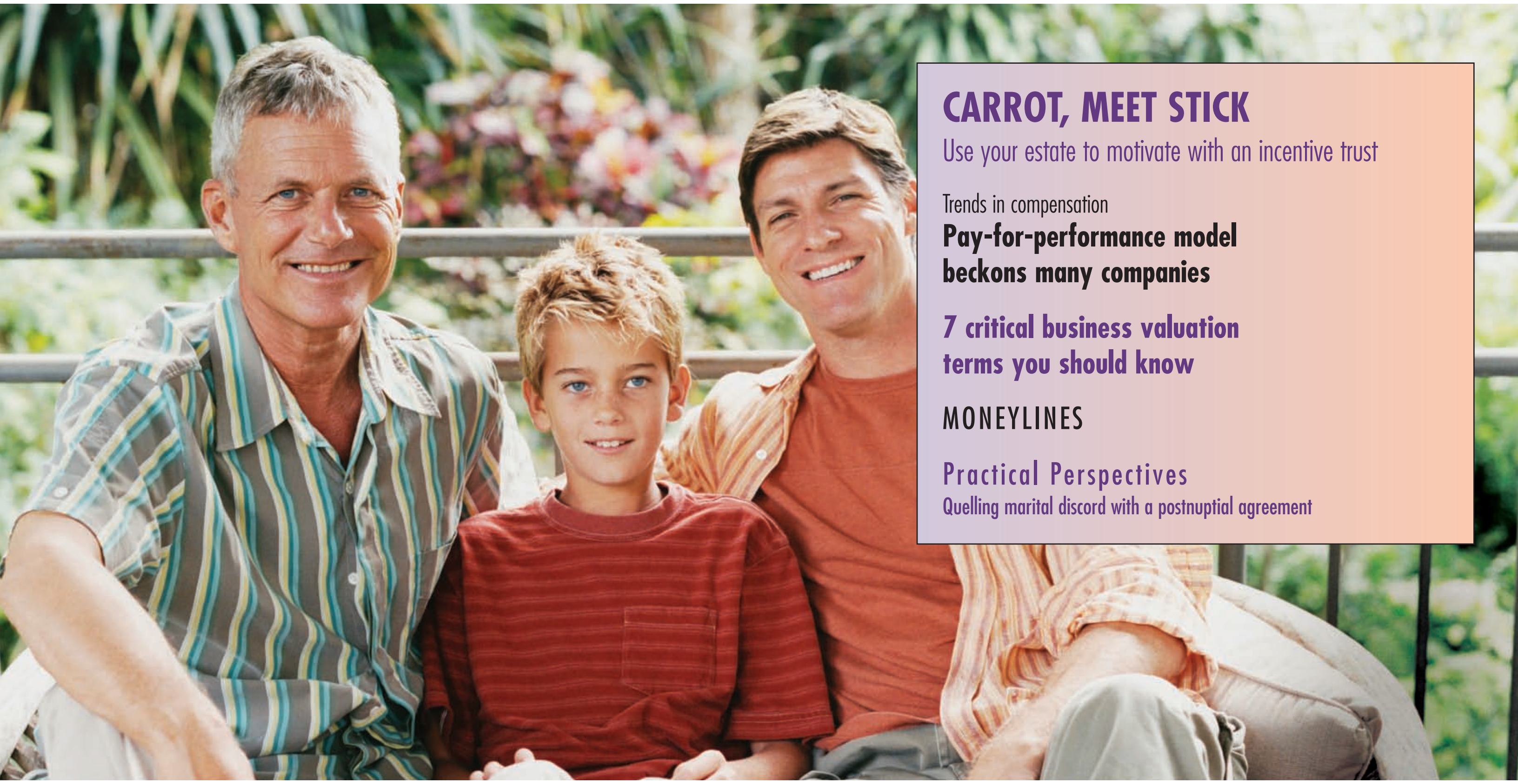
Ideas & Trends



CARROT, MEET STICK

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Practical Perspectives

Quelling marital discord with a postnuptial agreement

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CARROT, MEET STICK

USE YOUR ESTATE TO MOTIVATE WITH AN INCENTIVE TRUST

Many people think of their estate plan as, ultimately, a passive concept. That is, it can transfer your wealth to beneficiaries, but it can't really give them your wisdom or help them make sound life choices.

One way to shift this paradigm, so to speak, is to create an incentive trust. It uses the "carrot and stick" concept to help shape your loved ones' lives rather than only contribute to their finances.

Achieving goals

Essentially, an incentive trust sets guidelines for how a beneficiary becomes eligible to benefit from the trust. Distributions can, for instance, be contingent on a beneficiary graduating from high school, earning certain grades, or enrolling in or graduating from college.

Then again, perhaps you're more concerned about a beneficiary's physical well-being than his or her intellectual one. In this case, you might structure an incentive trust to disallow payouts if the beneficiary indulges in harmful or illegal behavior such as abusing alcohol or using illegal drugs. Going this route will, however, require that you appoint a trustee who knows the issues and who can monitor the beneficiary's activities and enforce the provision.

Essentially, an incentive trust sets guidelines for how a beneficiary becomes eligible to benefit from the trust.

From a business perspective, an incentive trust can include provisions that reward your beneficiary for becoming involved in the family business or mapping out a career path of his or her own. Build in matching charitable donations and you can help the beneficiary develop an appreciation for community service and volunteerism.

Risking it all

Of course, incentive trusts come with some inherent risks. If the provisions are too restrictive, or simply don't suit the beneficiary in question, the incentive may backfire.

For instance, say Esther, a 20-year-old college dropout, learns that her Aunt Esmeralda has provided her with $500,000 in trust. But Esther can withdraw the trust funds only if she returns to college and earns a bachelor's degree.

Problem is, Esther never really liked Aunt Esmeralda, who often scolded her for making bad choices and meddled in her life. And Esther didn't really like college either. As a result, the trust only furthers Esther's resolve to never return to college — no matter how much money she loses.

In other cases, the beneficiary may force him- or herself to complete a degree but wind up living an unfulfilled life because he or she had other dreams in mind. Or you might end up "motivating" a beneficiary to work for the family business when he or she really doesn't want to, which, in turn, could hurt the company.

Communicating with clarity

A big part of making sure an incentive trust will work is clearly communicating with your trustee.

He or she should generally have broad discretionary powers because, as time passes, a beneficiary's circumstances might change. For example, a student might develop learning or other disabilities that prevent him or her from achieving the academic goals set by the incentive provisions.

In general, the trust should provide enough of a safety net that, if the beneficiary fails to achieve the trust's goals, he or she will still be able to support him- or herself. The incentive provisions can apply to only a part of the trust assets. The trust should also provide for giving some or all of the funds to a secondary beneficiary, in case the primary beneficiary fails to meet the stated goals or dies.

Doing right (and just enough)

When all is said and done, you can use an incentive trust to do right by your beneficiaries — and give them *just enough* motivation to better themselves. If you go overboard with that motivation, you may wind up putting your estate — and your legacy — at risk. ❐

TRENDS IN COMPENSATION

PAY-FOR-PERFORMANCE MODEL BECKONS MANY COMPANIES

From the moment you hired your first employee, or took over the company you currently own, you likely started wondering how you'd keep your workers motivated. Of course, ideally, every employee would be *self*-motivated but, at some point, even the best staff member typically needs a target to shoot for beyond "a job well done."

Compensation is, one might say, the original motivator. Yet precisely how to compensate employees is no longer the simple concept it once was. One compensation model that has been beckoning many companies of late is pay-for-performance.

The concept

Under the pay-for-performance model, an employee's total compensation is the sum of two distinct parts:

1. A base component set by what the competitive market pays for a comparable position, factoring in skills and experience, and

2. A variable component determined by how well an individual or group of employees does in meeting specific goals.

The variable pay an employee receives is based on her or his performance or contribution as determined by measuring the worker's results against individual targets that are set and clearly communicated in the beginning of each performance period. Hence, those who contribute the most get paid the most.

For instance, if a companywide goal is to retain key clients by providing quality service, the variable pay part of an employee's total compensation could be linked to measurable indicators of delivering quality client service. The logic is that, if you set specific goals, employees can earn more by reaching or surpassing those goals. And this in turn will lead to heightened client service quality.

The upside

Essentially, an effective pay-for-performance program will help drive employees' performances toward accomplishing your company's strategic goals.

More specifically, it creates clear employee accountability for what you're trying to accomplish. With this kind of clarity about how you define success, employees should

IRS turns wary on S corporations' compensation

Another compensation issue making the rounds of late is increased IRS attention to precisely how S corporations are paying their shareholder-employees.

The roots of this conflict lie in the fact that, as "pass-through" entities, S corporations generally aren't subject to corporate income tax, at least at the federal level. Instead, their net income is passed through to shareholders, who are taxed at their ordinary-income rates. In addition, S corporation income isn't subject to Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes, nor are shareholder-employees' distributions subject to employment tax.

Given the potential employment tax savings, many S corporation owners are tempted to pay their shareholder-employees small salaries or none at all. Yet doing so doesn't sit well with the IRS. The agency is targeting shareholder-employees with salaries it deems unreasonably low in an attempt to reclassify some or all of their distributions as wages. If successful in such an effort, the IRS can demand unpaid FICA and FUTA taxes, plus penalties and interest, from the S corporation in question.

Although there's no way to "audit proof" an S corporation's salary structure, there are relevant factors to consider in trying to minimize the risks of an IRS challenge. These include whether a given salary seems reasonable in light of the shareholder-employee's role in the company (position, duties); how the salary compares with salaries paid by similar companies for similar services; and your company's size, growth history and financial condition.

If your company is structured as an S corporation and you haven't considered this issue, the time to do so is now. It's much easier to defend a clearly thought out shareholder-employee salary structure than one that has evolved haphazardly over time with no clear oversight.

be better able to focus on the tasks that will generate desired results.

Not surprisingly, top performers tend to respond well to these programs. They're motivated by the clear link between their work and the achievement of company goals. And they enjoy seeing their hard work rewarded — not to mention receiving a larger paycheck.

For employees who struggle with motivation, a pay-for-performance program sends a clear message to them — and their pocketbooks — about just how their performance measures up. Yet don't give up too quickly on these employees. Work with your managers to guide these workers to better results by making sure they understand their goals and pointing out ways to better meet them.

The risks

Naturally, pay-for-performance has its risks. Some observers believe that companies shouldn't use compensation to motivate employees because workers might stop focusing on work quality and start focusing solely on money.

Additionally, workers may feel that the pay-for-performance model pits staff members against each other for the highest raises. This may serve to foster unrest and poor morale instead of the productivity increases you want.

To combat these problems, your company should make the variable components that trigger pay increases as specific as possible. In addition, you might provide some of the performance pay on a team basis, rather than just on an individual basis. By providing additional pay to a team, you may help reduce or eliminate rivalry among staff members.

Not a quick fix

As you can likely see, pay-for-performance shouldn't be considered a quick fix for an ailing compensation program or waning company morale. It calls for taking a detail-oriented approach to how you compensate your company's various positions. Nonetheless, if motivation is your goal, a pay-for-performance program may be the means that could help you accomplish it. ❐

7 CRITICAL BUSINESS VALUATION TERMS YOU SHOULD KNOW

As a business owner, you'll likely need to have your company appraised at some point. Appraisals are essential in the event you decide to sell or merge the business, create or update a buy-sell agreement, or devise or refine your estate plan. A good way to preempt the uncertainties of the appraisal process is to learn some basic valuation terminology. Here are seven terms you should know:

1. Fair market value. This is a term you may associate with selling a car, but it applies to businesses (and their respective assets) as well. In a valuation context, "fair market value" has a long definition:

> The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

A good way to preempt the uncertainties of the appraisal process is to learn some basic valuation terminology.

2. Going concern value. This important valuation term often comes into play with buy-sell agreements and in divorce cases. Going concern value is the estimated worth of a business that's expected to continue operating in the future. The intangible elements of going concern often include factors such as having a trained workforce; an operational plant; and the necessary licenses, systems and procedures in place to continue operating.

3. The asset (or cost) approach. One of three common approaches that appraisers use to value businesses, this approach essentially calculates a company's worth by adding up its assets net of liabilities. The approach can take a couple of different forms, including the adjusted book value method and the excess earnings method, which some experts consider a hybrid of the asset approach and the income approach discussed below. (Your appraiser will explain how these methods work.)

4. The income approach. Another one of three common approaches to valuing a business, the income approach derives a company's value from its anticipated economic benefits. Common methods that fall under this approach include the discounted future earnings method and the capitalization of earnings method. (Your appraiser will explain how these methods work.)

5. The market approach. Yet another one of three common approaches to valuing a business, here an appraiser uses one or more methods that compare the subject company to similar businesses, business ownership interests, securities or intangible assets that have been sold. Typical methods the appraiser might use are the guideline public company method and the merger and acquisition (M&A) method. (Your appraiser will explain how these methods work.)

6. Valuation premium. Sometimes, because of certain factors, an appraiser must increase his or her estimate of a company's value to arrive at the appropriate basis or standard of value. The additional amount is commonly referred to as a "premium." For example, a control premium might apply to a business interest that possesses the requisite power to direct the management and policies of the subject company.

7. Valuation discount. In some cases, an appraiser needs to reduce his or her value estimate based on specified circumstances. The reduction amount is commonly referred to as a "discount." For instance, a discount for lack of marketability is an amount or percentage deducted from the value of an ownership interest to reflect that interest's inability to be converted to cash quickly and at minimal cost. ❒

Moneylines: News Briefs for Businesses and Individuals

Workers want your help with retirement planning. Once upon a time, employees were, essentially, on their own when it came to planning for their golden years. A 2007 survey of 1,380 workers and 1,652 benefit specialists conducted by insurer MetLife Inc. reinforces that, increasingly, this is no longer the case. Nowadays, employees want your help. In fact, 49% of workers surveyed reported wanting their employers to provide access to advice about retirement planning. That's up from 38% in 2006.

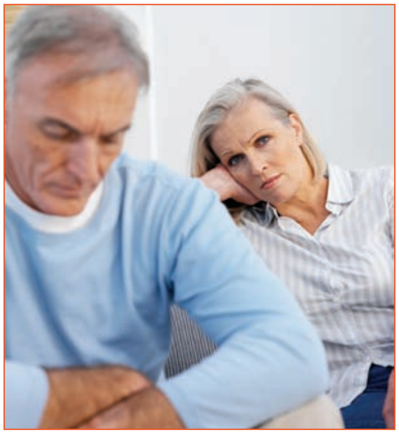
Refinancing your home? The IRS reminds you to learn the rules of deducting points. If you decide to refinance your home, you may also be able to deduct some of the costs of doing so, including points (certain charges paid to obtain the mortgage). The IRS, however, wants taxpayers to know that, when it comes to deducting points, there are rules to follow. You may deduct points only for payments made during the tax year, and you generally must deduct points paid solely to refinance over the life of the loan. Many other rules apply, so ask your CPA for help.

Small business owners beware: Loan scams increasing. Thinking about getting a loan for your small business? Watch out — not only for high interest rates, but also for fraudsters. A spokesperson for the Better Business Bureau (BBB) has reported that complaints from business owners about advanced fee loan scams increased from 1,700 in 2006 to over 3,000 last year. As of April, the BBB had already received between 400 and 500 complaints.

Gas prices, income and health care coverage top Americans' worry lists. Many, if not most, of us keep mental lists of the things that worry us the most. A survey of 2,003 adults released this year by the Kaiser Family Foundation, a nonprofit health care research organization, found that the rising cost of gasoline was the most "popular" worry, with 44% of respondents citing it as a concern. Being able to find a well-paying job or procure a decent pay raise came in second, with 29% of respondents noting these challenges. Close behind was having adequate funds or insurance for health care — 28% of respondents were worried about this.

QUELLING MARITAL DISCORD WITH A POSTNUPTIAL AGREEMENT

Denis and Marjene had been married for almost 20 years when, unfortunately, they reached an impasse. The problems started when Denis decided to leave his steady job as a civil engineer to pursue a startup centered on a product he'd invented. He wound up accruing substantial debt and even dipping into the couple's retirement savings.



It wasn't long before Marjene began to worry about losing their house as well as their retirement funds. Their discussions about money got so heated that they began to fear for their marriage. To get a better idea of just where their finances lay, Denis and Marjene paid a visit to their financial advisor, who made a bold suggestion.

The advisor suggested, cautiously, that the couple consider a postnuptial agreement. This is essentially a contract between married spouses settling one or more financial issues that would arise if the couple divorced. Couples have used postnups to, for instance, determine who owns what percentage of each asset, establish a mutual budget (or separate ones), and specify that a business is not divisible in the event of divorce.

Postnups aren't, however, available in every state, though they are in most. And state law controls the validity and enforceability of an agreement. In states where the agreements aren't available, couples can still create informal agreements that serve many of the same purposes.

The perks of postnups

Understandably, Denis and Marjene asked the inevitable question: Why? The advisor suggested that, rather than look at a postnup as a "what's mine is mine" proposition, they look at it as a way to calm each other's respective fears. Postnups can help lessen or remove the specter of money from a marriage and keep division of assets in their hands rather than those of their state's divorce laws.

Often, postnups serve as a means to assure both parties that, should the worst come to pass, both will be taken care of and able to go on living relatively the same lifestyle. A postnup can also, of course, simply revise a prenuptial agreement.

The inevitable risks

Naturally, the inherent risk of a postnup is that it will only worsen — or even trigger — marital problems. This is particularly true if the agreement is suggested after one partner's personal circumstances suddenly change.

For example, if Denis's company suddenly took off, and he brought home a draft of a postnup, he might appear to be trying to keep something from his wife. Or if Marjene suddenly lost her job and she mentioned the idea, it might put Denis on edge.

There's also the expense of a postnup. To be valid in states that recognize such agreements, each spouse must retain separate counsel and fully disclose his or her assets and debts. And then, when the document is drafted, a third, independent attorney should review it. This will, naturally, entail some significant legal expenses.

The advisor mentioned that his role in the process would be to gather the information to generate the financial statements the couple would need to draft an accurate and equitable postnup.

A means to clarity

In the end, the advisor re-emphasized that Denis and Marjene should look at a postnup as a means to clarity rather than a battleground for financial dominance. Eventually, they decided to move forward on the agreement, which, indeed, brought much peace to their marriage. ❐

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