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# LOOKING FOR A SUCCESSOR?

## FOR BEST RESULTS, KEEP AN OPEN MIND

Picking someone to lead your company after you step down is probably among the hardest aspects of retiring (or otherwise moving on). Sure, there are some business owners who have a ready-made successor waiting in the wings at a moment's notice. But many, if not most, have a few viable candidates to consider — often too few.

When looking for a successor, for best results, keep an open mind. Don't look only at your family — look everywhere.



But before you start, develop a list of must-have attributes — pertaining to areas such as skills, character and experience — to measure candidates against. Focusing on these specifics can help prevent you from becoming smitten with one candidate's reputation or personal achievements when a critical skill is lacking.

### Family members

If yours is a family-owned business, a natural place to look for a successor is, indeed, your family. Yet, because of the relationships and emotions involved, family business succession planning can be a dicey proposition. In fact, 70% of family-owned businesses don't survive to the second generation, according to a recent study by the Baylor University Institute for Family Business.

If your children do show an interest in your company, get them involved as early as you can. Encourage possible

successors to work after school and on weekends when they're younger.

When they're older, require that they work outside the business for at least a few years to learn the humility that comes from starting at the bottom and to gain some alternative perspectives. And when they return to the family business, have them work in multiple areas before moving them up to a leadership role. The one or two who "stick it out" during this long process may well make an excellent choice to succeed you.

Always keep in mind, however, that, even after a thorough apprenticeship, your children may decide that running the family business isn't for them. As disappointing as this might be, don't force them to take over your company; doing so may lead to disastrous consequences for everyone involved — as well as for your business.

### Nonfamily employees

Maybe your company isn't family-owned; or it is, but you don't have any family members who are likely to take over. Well, another logical place to look is within the ranks of your current employees.

*70% of family-owned businesses don't survive to the second generation, according to a recent study by the Baylor University Institute for Family Business.*

Keep an eye out for company "stars" who are still early in their careers, regardless of their functional or geographical area. Start developing their leadership skills as early as possible and put them to the test regularly. For example, as time goes on, continually create new projects or positions that give them responsibility for increasingly larger and more complex profit centers to see how they'll measure up.

### External candidates

If you can't pinpoint any feasible internal candidates, or maybe you can but you're concerned they may eventually leave the company rather than take it over, you'll need to bring in an outsider.

You can identify suitable candidates the old-fashioned way — through classified ads in a national publication such as the *Wall Street Journal* or via an Internet job board that specializes in executive and professional candidates.

You might also try conducting a search through a professional business or trade association. Or you could try recruiting someone from a competitor, assuming you can do so without creating an undue amount of animosity among the parties involved.

Yet another option is to work with an executive search firm, which also will help screen candidates. Carefully choose and communicate your criteria — and the reasoning behind them — to the recruiters conducting the search.

With good direction, they can often unearth some remarkable candidates.

### The right stuff

At the end of the day, any successor — whether family member, nonfamily employee or external candidate — must have the right stuff. He or she needs to be passionate yet diplomatic, competitive yet rational, and an effective communicator yet a good listener.

The person who fits this description could be anywhere. Take the time to find him or her and groom this individual appropriately, and you'll go a long way toward helping your company continue to succeed for many years after you've left it. □

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## QUALIFIED PLAN LOANS

# WHAT YOU DON'T KNOW CAN HURT YOU

Among the risks of offering workers a “qualified” retirement plan (one that follows certain rules to qualify for beneficial tax treatment), such as a 401(k), is that the arrangement may allow participants to take loans from their accounts. Although employees often appreciate this feature, taking out a qualified plan loan can get workers into trouble — and hurt your company as a whole.

### Some choices are yours ...

For starters, you don't necessarily *have* to give employees the option of being able to take out loans from their qualified plans. If you do want to make this option available, your plan document must be drafted to allow it. Your plan also needs to specify the rules for loans, including:

- ✓ The minimum and maximum loan terms,

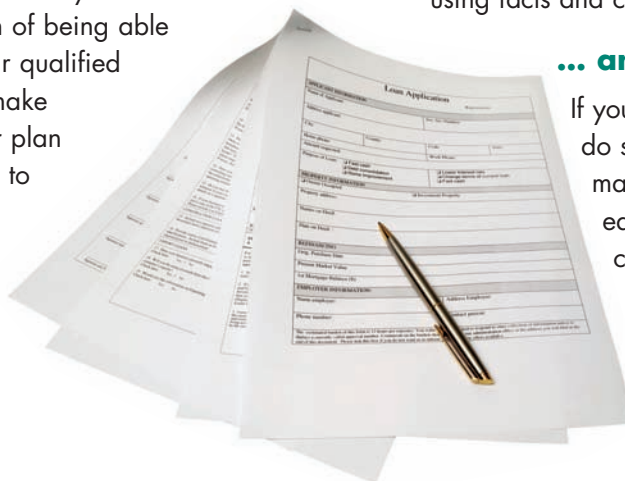
- ✓ The number of loans available, and
- ✓ Sources of funding available for loans (such as salary deferrals or employer matching).

Your plan may specify that participants can take loans only in the event of a hardship as recognized by IRS safe harbors. These include medical expenses, higher education, impending home foreclosures, funeral expenses or natural disasters. Or your plan may specify a hardship using facts and circumstances that you determine.

### ... and some are not

If you do decide to offer plan loans, you must do so within IRS rules. For starters, you must make loans available to all participants equally — your plan can't favor highly compensated employees.

In addition, loans must bear a reasonable rate of interest. Often, plan sponsors state that the loan interest rate follows the current prime rate or prime plus 1%.



The loan terms can't extend beyond five years, unless the loan is for the purchase of a principal residence. In that case, participants may take longer (up to 30 years) to repay.

Generally, qualified plans may allow a participant to take out a loan of up to 50% of his or her vested balance or \$50,000, whichever is less. This amount may be reduced by the amount of other outstanding loans the participant has against the plan. The calculation for determining this is complex; ask your plan administrator for details.

Plan loans also must be secured. This means, preferably, you or your plan administrator should obtain a signed promissory note with a pledge and assignment along with an additional sign-off on an authorized payroll deduction.

Moreover, loans need to provide for a level amortization schedule — not a “balloon” payment after a term of years. Generally, participants should make principal and interest payments at least quarterly. (An exception may apply to those on military leave or those absent under the Family and Medical Leave Act.)

### Taxable events threaten

If a participant fails to meet the loan terms or the statutory requirements, the IRS will view the loan as a “deemed distribution,” which is a taxable event. Thereby, the



## 3 fair warnings to your employees

The large sums that workers can amass in a qualified retirement plan, such as a 401(k), can tempt them to take out loans without fully understanding the rules. Here are three “fair warnings” you can provide:

**1. Loans inhibit growth.** Less invested means less potential compounded growth — even though the account will receive interest income from the employee. And less compounded growth could force an employee to postpone retirement or scale back on future plans. If all scheduled loan payments are made, the loan will perform similarly to a bond rather than an equity investment.

**2. Taxes aren't the only threat.** If a participant who is younger than 59½ fails to repay the proceeds within the time period provided, he or she will not only have to pay income taxes on the loan amount, but also may owe an additional 10% early withdrawal penalty. Thus, depending on his or her tax bracket, an employee could owe federal taxes equal to as much as 45% of the funds borrowed — a steep price to pay. State taxes will add even more in some states.

**3. Leaving the company could speed up the due date.** This last point may be a little awkward to bring up, but many qualified plans are set up so that departing participants must pay back any outstanding loans within 30 to 90 days of leaving. This is done because there's no longer payroll from which the plan can get automatic payments. If this is true for your plan, be sure your employees are aware of it.

participant will be taxed on the loan amount at his or her current tax rate as if a distribution had been made.

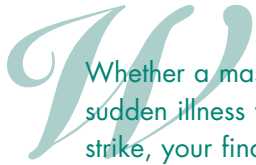
If structured to do so, some qualified plans may permit a “cure period” to resolve outstanding loans. But such a period can't be longer than one calendar quarter following the quarter in which the violation occurred.

A deemed distribution may also occur if your plan document doesn't allow for a participant's account balance to offset the loan. If a loan offset is allowed in the plan document, such a distribution is considered a qualified rollover event.

### The risks are many

This article only scratches the surface of some of the complex rules governing qualified plan loans. The bottom line is that offering these loans to your employees without fully understanding the rules — and educating participants on those rules — could hurt plan participation, lower morale and threaten productivity. □

# 5 EASY STEPS TO CREATING A FINANCIAL DISASTER RECOVERY PLAN



Whether a massive flood that affects thousands or a sudden illness that affects only you, should disaster strike, your financial solvency could very well depend on whether you have a clear strategy in place for paying the bills. Here are five easy steps to creating a financial disaster recovery plan:

**1. Assess your insurance.** The first place you should look to manage any risk is your insurance. The right combination of well-chosen, well-maintained policies can protect you from many of the worst disasters.

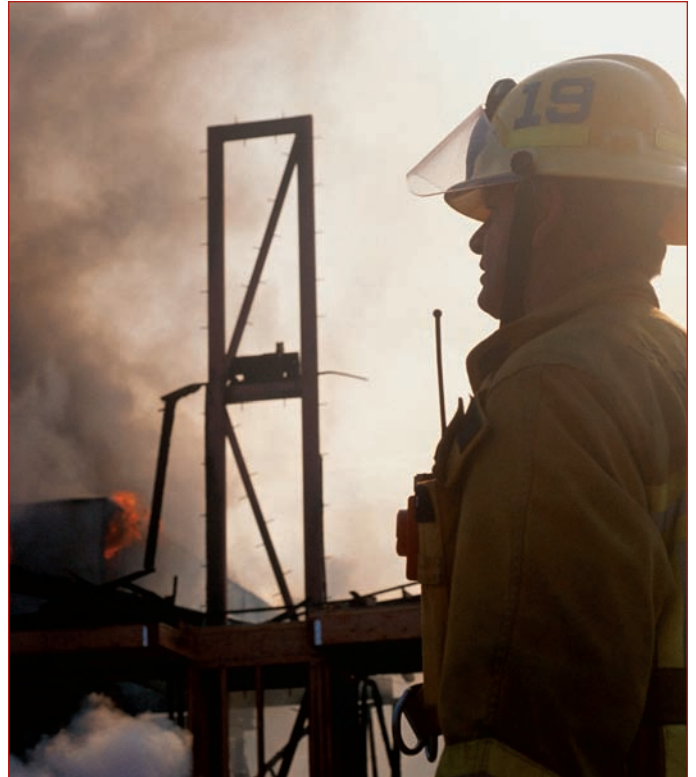
Identify your key risks and check to see whether you're covered. Key policies to consider include homeowners, life, car, disability and long-term care. Be sure you're indeed covered for everything you think you are. Many homeowners policies, for instance, don't automatically cover earthquakes or floods.

**2. Put away some cash for a (very) rainy day.** Try to estimate how long it would likely take you to recover financially from a disaster. Many experts recommend tucking away between three and six months' living expenses in a savings account or money market fund.

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For more extreme disasters in which you may not be able to access a bank or investment account, set aside some emergency funds. One rule of thumb is to keep on hand \$50 per household member in small bills.

**3. Document your financial and physical assets.** Create a detailed list of your bank accounts, investments and trusts, titles and deeds, mortgages and home equity loans, insurance policies, credit and debit cards, and tax records.



In addition, maintain an inventory of your physical assets. Doing so means not only writing down the details of your physical assets (brand/model names, serial numbers), but also photographing or videotaping them as proof of possession.

**4. Back up your financial data in multiple formats and locations.** The key here is redundancy. Back up your records on CD (or using portable USB flash drives) and store both hard and electronic copies with your financial advisor and in other secure places (such as a fire- and waterproof safe at your home and a safe deposit box at your bank).

Additionally, in case of a wide-scale disaster, consider storing copies of your financial documents in a different geographic location. If you have trusted family members or close friends out of state, perhaps ask them to hang on to your records.

**5. Create (or review) your will or consider a trust.** Taking disaster to its ultimate extreme, your untimely death could seriously compromise your family's financial stability. To help mitigate a long and costly



probate proceeding, be sure to create a will — or, if you already have one, review and update it regularly.

Another option is to create a living trust, which is a separate legal entity that holds your assets for your benefit during your life and provides distribution instructions after your death. Because the assets are no longer held in your name, they won't — except in very limited circumstances — have to go through probate. (There are many other trust types that serve various purposes. Consult your financial advisor for details.) □



## MONEYLINES: NEWS BRIEFS FOR BUSINESSES AND INDIVIDUALS

**Many companies still ill-prepared for technological disasters.** How ready is your company for the loss of its mission-critical data? Of the 189 tech-savvy businesses with more than 1,000 employees surveyed by technology researchers Forrester Research Inc. last year, 27% didn't have a backup data center. And of those that did, 48% had a center located within 50 miles of their primary locations — close enough to be affected by any major natural disaster. Look into your company's backup measures and make sure they, for one, exist and, beyond that, aren't subject to the same threats as your main office.

**IRS adjusts allowable living expense standards.** Let's think worst-case scenario: You owe a massive tax bill and can't pay it. Can the IRS claim your last few pennies? Not quite. The agency uses its allowable living standards, also referred to as collection financial standards, to calculate a taxpayer's ability to pay his or her delinquent tax liability. Late last year, the IRS redesigned these standards to, among other things, expand the number of household categories for housing and utilities and include a new category for out-of-pocket health care expenses.

**Your workers may not be retiring as soon as you think.** Like many business owners, you may be worrying about the day when all of those baby boomers start retiring in droves. Well, it may be a bit further off than anticipated. Only one in three of the almost 500 full- or part-time employees surveyed by accounting and finance staffers Robert Half Management said they planned to quit work entirely. If you have key workers whose knowledge and experience you'd rather not lose, perhaps start thinking now of flexible work options you might offer them.

**Got an IRA? Don't forget that the early bird gets the worm!** It's the early part of the year, which makes it a great time to contribute to your traditional or Roth IRA. Why? Because doing so allows more time for tax-deferred (or tax-free, in the case of a Roth IRA) growth. Also, don't forget that you can make 2007 IRA contributions as late as April 15 of this year.



# COMPARING COVERDELL ESAs WITH 529 PLANS

Floyd, an investment analyst, and Marietta, an educational researcher, are a married couple with a five-year-old son and a newborn daughter. Like many parents, they'd heard and read plenty about 529 plans, but they wanted to know whether there were any other college funding alternatives worth considering. They visited their financial advisor to learn more.



Their advisor pointed out that perhaps the most widely discussed alternative is the Coverdell Education Savings Account (ESA). Like 529 plans, ESAs can be used to amass funds for education expenses tax free. And Floyd and Marietta could make contributions to either plan — or both — on behalf of each of their children each year.

Moreover, under both plans, distributions are tax free for federal purposes if used to pay qualified education expenses at any accredited college or university, including most community colleges and technical training schools. The two plans, however, have some key differences.

## Contributions and deductions

The primary difference between ESAs and 529s relates to contributions. Whereas there is no federally mandated ceiling on contributions to a 529 plan, the maximum annual contribution to an ESA is \$2,000 per account beneficiary.

In addition, as joint filers, Floyd and Marietta's ability to contribute to an ESA would be limited if their adjusted gross income fell between \$190,000 and \$220,000, and eliminated if it exceeded that range. (This phaseout range is \$95,000 to \$110,000 for single filers.)

Plus, contributions aren't allowed after the beneficiary reaches age 18 (unless the beneficiary is a special needs beneficiary). Unlike other tax rules that look at a child's age as of year end, the ESA contribution rules look at the age as of the time of contribution.

So, if Floyd and Marietta wish to make a contribution for the year their child turns 18, they must be sure to do so before the child's birthday. Thus, if their son (who doesn't have any special needs) turns 18 on May 1, contributions for him must be made no later than April 30. (And they could continue contributing on behalf of their daughter.)

For federal tax purposes, neither 529 nor ESA contributions are deductible. Some states, however, allow state income tax deductions or credits for 529 plan contributions, at least if the plan is sponsored by that state.

## Matters of control

Perhaps the primary advantage ESAs have over 529s relates to matters of control. Unlike many (if not most) 529 plans, which would require Floyd and Marietta to invest in a managed portfolio based on the age of the beneficiary in question, they could choose the investments to hold in their ESA. As an investment analyst, Floyd is particularly drawn to this factor.

Additionally, the couple would have more control over where their ESA funds could go. ESA distributions are permitted for elementary and secondary education costs (including academic tutoring) as well as for college funding. So if they decided to send their daughter to a private grade school, they could use an ESA to pay for it.

## A question of circumstances

The limitless contributions allowed for 529 plans are highly appealing to a wide range of people. But, under the right circumstances, an ESA can serve as a useful alternative or supplement. Floyd and Marietta were glad they asked about it. □

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