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Certified Public Accountants

Business Owner's Perspectives

Trends and Strategies for Owners of Closely Held and Family Businesses

Winter 2019

Overcoming Generational Differences

How to Devise an Effective Dividend Strategy

A lot has been written about the generational differences between baby boomers and members of younger generations like Generations X, Y, and Z. Not surprisingly, members of each generation tend to look at the world differently and think about things in different ways.

This includes their approach to managing a family business. Unfortunately, these varying mindsets can sometimes threaten the continuity of a family business.

Different Generations, Different Mindsets

Many baby boomer family business owners—let's call them Generation 1, or G1—have had the mindset of reinvesting most, if not all, of the company's profits back into the business. Their thinking tends to be that it's more important to reinvest profits for growth than it is to take profits out of the business to support their lifestyle.

This has been a successful strategy for many family businesses that have grown exponentially over the years. By leaving profits in the business to fund growth initiatives and living modest lifestyles, many of these owners are in a position to pass on highly successful and profitable businesses to the next generation.

Problems sometimes occur when members of Generation 2, or G2, take over a successful family business. For years, they have watched their parents put most of the company profits back into the business instead of taking out dividends to support a more lavish lifestyle.

Of course, they're thankful that their parents have built a thriving, successful business to pass on to them. But they also want to enjoy some of the fruits of their labor by taking some money out of the business to support a lifestyle that, while not necessarily lavish, might be a little bit more expensive than the one their parents lived.

Facing this dilemma, some members of G2 decide that the only way they can monetize their business interest is to sell the family business. And this is certainly a viable monetization strategy: They could end up with millions of dollars of "walking away" money after the transaction is complete.

But at what cost? This strategy may effectively end the family business that might have been in the family for decades. More often than not, the G2 owners who sell the business end up with some degree of seller's remorse.

A Better Way

Many G2 family business owners don't realize that they don't *have* to sell the business in order to monetize their interest. Instead, they can take more of the profits out of the business by paying themselves a regular dividend.

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3 Writing Off Bad Debts

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Word to the Wise

What to Do If the IRS Comes Knocking

One of life's great mysteries is why the IRS chooses to audit a particular taxpayer. While there are some red flags and anomalies that might draw attention to a tax return, many audits are random, and the audit rate is quite low.

In fact, the number of audits conducted by the IRS has decreased every year over the past decade. In 2017, the agency audited just 0.5 percent of all returns, 1.06 million in total.

However, if your company is selected for an audit, here are a few tips to consider:

Stay calm. Don't panic if you receive an audit letter from the IRS. There's no reason to think your tax position isn't legitimate or that you won't prevail.

The IRS's Information Document Request (IDR) lets you know what the agency is seeking in terms of support documents relative to the audit. The IRS usually picks just a few issues to focus on. You should provide the examiner exactly what is requested—nothing more and nothing less.

It's important to note that the IRS notifies taxpayers by mail and that the audit will be conducted by mail or in person. If you are receiving phone calls claiming to be from the IRS requesting payment or demanding sensitive information, these calls are not legitimate.

Contact your CPA. Your CPA has experience with IRS audits and should be your first call. It's wise to give your CPA power of attorney so he or she can reach out to the IRS on your behalf and represent you during the audit.

Many CPA firms host IRS interviews for their clients at their offices and request that the IRS do their fieldwork there. Don't be surprised if your CPA asks that you *not* be present at these meetings and to otherwise limit your contact with the auditor. This is for your protection: You can't unintentionally incriminate yourself if you're not doing the talking.

Expect your CPA to negotiate deadlines and requests for paperwork on your behalf.

Be cooperative. IRS agents are not graded on how many adjustments they make or how much revenue they recover. There is no quota. Rather, efficiency is their goal.

The best approach? Provide the agent with what is requested in an organized and timely fashion. A respectful and professional attitude will work in your favor.

If your business is cyclical, have your CPA let the IRS agent know when you're going to be especially busy. The IRS is required to be flexible so they don't interrupt your normal day-to-day operations. Their stated goal is to give the taxpayer a "fair, efficient and timely" audit.

File with confidence. As a taxpayer, you should take all of the deductions your business is legitimately entitled to. Don't be afraid to do so. Just be sure to keep good records so you can support your numbers.

There may be areas where you and the IRS disagree on the tax treatment of specific issues. Often, resolution requires compromise. If some issues remain unresolved, you can appeal.

Keep in mind that not all IRS audits result in the taxpayer owing more money. While an audit can be intense, your CPA can relieve much of the burden and help you get through the process.

Our firm has represented many clients in IRS audits. We can help you, too.

Bad Debt Write-Offs

When Can You Deduct Uncollected Debt?

No matter how thoroughly you check your customers' credit or how diligently you pursue collection of accounts receivable, you can still end up with uncollected debt.

But there could be a silver lining: In certain situations, you can deduct bad debt on your federal income tax return to offset ordinary business income. This, in turn, could lower your business' overall tax liability.

Factors to Consider

Whether bad debt is deductible depends on several factors. The first step is to determine if an uncollected receivable meets the IRS definition of business bad debt.

According to the IRS, the uncollected debt must be closely related to your trade or business, and there must be a valid debtor-creditor relationship. Such a debt qualifies as bad debt "if your primary motive for incurring the debt is business related," states the IRS. Also, there must be a legitimate expectation of repayment and an intent by your company to enforce the debt obligation.

Specific examples of business bad debt cited by the IRS include loans to clients and suppliers that are not repaid after repeated collection attempts, credit sales to customers for goods that have been sold or services that have been rendered, and business loan guarantees.

If you have unsuccessfully attempted to collect debt over a reasonable period and there's no longer a realistic chance that the debt will be paid, then the uncollected amount will likely qualify as business bad debt. In this scenario, deduct the bad debt from your gross business income on Form 1040 Schedule C during the taxable year when it becomes wholly worthless.

Another factor is whether your business uses accrual- or cash-basis accounting. For the bad debt to be deductible, you must have previously included the debt in your business income, which wouldn't be the case if you use cash accounting. Therefore, you must use accrual accounting to deduct bad debt.

Recent Tax Court Cases

A recent Tax Court case helped clarify what qualifies as a bona fide business bad debt. In *Yaryan v. Commissioner, TC Memo 2018-129*, the Tax Court denied a business bad debt deduction because it concluded that the taxpayer wasn't engaged in an active trade or business but instead was just a passive investor in a business.

Meanwhile, another Tax Court case helped clarify the IRS' expectations in regard to providing proof that a debt becomes worthless during the year when you claim it does. In *Sarvak v. Commissioner, TC Memo 2018-68*, the Tax Court denied a business bad debt deduction because the taxpayer failed to present evidence that the bad debt was objectively worthless during the year he claimed it was.

These two recent Tax Court cases emphasize the seriousness the IRS places on ensuring that business bad debt deductions are legitimate, as well as the importance of substantiating the timing of your collection efforts.

Salvaging a Tax Benefit

While bad debt can be frustrating, you may be able to salvage a tax benefit out of an otherwise unfavorable situation. Talk to a qualified tax advisor before claiming a bad debt deduction to avoid running afoul of IRS regulations.

Let us know if you have more questions about deducting business bad debt.

A Wise Dividend Strategy

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However, doing so requires a shift in mindset—from thinking like a family member or employee to thinking like a business owner or investor. After all, what smart investor doesn't expect return on his or her investment? In the same way, owners usually shouldn't feel guilty about reaping regular dividends from the investment they're making in their own business.

This is not dissimilar to the strategies behind growth and income stocks. Growth stocks don't pay dividends but instead reinvest earnings back into the business to fund growth initiatives. Conversely, income stocks pay dividends to shareholders, which inhibits growth but provides regular income to shareholders who need it.

How Much Cash?

If you're a G2 family business owner, how much cash should you take out of the business to support your lifestyle? The answer depends on your goals for the future of the company.

Let's say your goal is to increase profits by 25 percent over the next five years. Based on projections, you determine that you'll need to reinvest 80 percent of profits back into the business to achieve this goal. In this case, you could distribute 20 percent of profits as dividends.

But what if you determine that you'll need to reinvest 100 percent of profits back into the business to achieve your profit goal? In this case, you'll need to adjust your profit goal downward in order to take out any dividends.

Open and Honest Discussion

Family business members of both G1 and G2 should openly and honestly discuss these issues during the business succession planning process. This is the best way to avoid misunderstandings that can lead to the premature end of a family business legacy.

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How to Manage Family Compensation

For family business owners, determining compensation arrangements for family members is difficult. You want to be fair—but "fair" doesn't necessarily mean "equal" when it comes to compensation.

Talking about salaries and profit distribution can create anxiety and ill will, which is why a formal family compensation policy is a must. This policy outlines the formulas by which family members are compensated and takes discretion out of the hands of the matriarch, patriarch, or family CEO. It sets realistic expectations for all family shareholders and employees and alleviates the need for uncomfortable compensation discussions or ongoing negotiations.

Generally, family members who work in the business should be paid a fair market salary for their jobs. Using this market-based approach promotes the perception of parity, both among family members and among non-family employees. It also lets you separate the family member's salary—earned by contributing to the company's success—from compensation derived merely by being a family member and shareholder.

For shareholders who don't work in the family business, compensation typically comes in the form of a profit distribution. The distribution schedule should be outlined in the family compensation policy.

For example, if one sibling serves as president of the company, he or she might earn the largest percentage of the distributed profits. Other family member employees would earn the next-highest percentage, and family shareholders who are non-employees might split the remaining percentage.

Another policy element might involve different classes of stock. Family members who work in the company might have voting rights, while those who don't work in the company might have non-voting shares.

Discuss options with your trusted advisors before creating the family compensation policy. Your CPA can help you think through the implications of these decisions and arrive at a plan that's right for your business and your family.