



# FINANCIAL *Planning for Business*

A Tax, Financial, & Investment Report

**WestPoint** *Private client*  
G R O U P



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## Introducing Roth 401(k)s

While the federal government has created a number of tax-advantaged savings accounts designed to help lower- and middle-income workers save for retirement, these plans tend to be less useful for employees earning larger salaries. But highly-compensated individuals currently not permitted to contribute to Roth IRAs, or younger workers expecting to be in higher tax brackets when they retire, stand to benefit when, starting this year, companies will be permitted to offer employees the option of contributing after-tax dollars to a new type of plan called the "Roth 401(k)."

As the name suggests, the Roth 401(k) incorporates elements of both traditional

401(k) plans and Roth IRAs. Included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), and available as of January 1, 2006, the Roth 401(k) allows workers to make Roth IRA-type contributions to 401(k) plans, but without the income restrictions and contribution limits that apply to Roth IRAs.

### Contribution Guidelines

Contributions to a Roth IRA are non-deductible, but earnings accumulate tax free, and qualifying distributions are also tax free. Currently, only taxpayers whose adjusted gross income (AGI) falls below certain levels (\$110,000 a year for single filers and \$160,000 for joint filers) are

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## Succession Planning with Buy-Sell Agreements

Planning for certain contingencies, such as death, disability, or retirement, is a concern that affects all business owners. For family businesses in particular, continuation planning is inevitably intertwined with business, tax, and estate planning. One succession tool that can help ensure a smooth transition is the buy-sell agreement. These multi-faceted agreements serve many valuable purposes, such as establishing a sale price for business interests; valuing an estate for estate tax purposes; providing

liquidity; and easing the transfer of ownership between partners, family members, or a third party.

### What Is a Buy-Sell Agreement?

There are three basic types of buy-sell agreements—cross-purchase, stock redemption, and hybrid. Depending on the number of owners, family involvement, and business structure, one type of agreement may be more appropriate for your purposes than another.

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## Introducing Roth 401(k)s

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eligible to contribute after-tax dollars to a Roth IRA. These income limits do not apply to Roth 401(k)s.

Workers will also have the opportunity to save far more money in the new accounts than they could using Roth IRAs. The 2006 annual contribution limits for IRAs of all kinds are set at \$4,000 for taxpayers under the age of 50 and \$5,000 for older workers. The Roth 401(k), in contrast, will be subject to the more generous elective salary deferral limits that apply to conventional 401(k)s—\$15,000 for taxpayers under the age of 50 and \$20,000 for older workers in 2006.

The Roth 401(k) has other advantages over the Roth IRA. Contributions are made through payroll deductions, rather than through separate arrangements with a bank. Because these plans are administered by employers, contributing to them should be more convenient for workers than opening

an IRA. An employee who is currently contributing to a traditional 401(k) plan could, for example, simply opt to have his or her contributions diverted to a Roth version of the same plan.

Lawmakers have stipulated, however, that matching contributions made by employers must be invested in a traditional 401(k), not a Roth account. This means that, even if employees make all of their contributions exclusively to a Roth 401(k) account, they would still owe tax in retirement on withdrawals from funds contributed on a pre-tax basis by their employers.

Workers should also be aware that the 401(k) annual deferral limits apply to all 401(k) contributions, regardless of whether they are made on a pre-tax or after-tax basis. If employees contribute to a Roth 401(k), they may have to reduce or discontinue contributions to their employer's conventional 401(k) plan to avoid exceeding these limits. Provided employees comply with these limits, however,

they are allowed to put money into both types of 401(k) plans.

In addition, employees considering the Roth 401(k) option should know that—like the 401(k), but unlike the Roth IRA—the Roth 401(k) will require them to begin taking distributions after the age of 70½. On the other hand, the Roth 401(k) resembles the Roth IRA in that investors will not be permitted to withdraw their money tax free until they have held the account for at least five years and are at least 59½ years old. The latter provision could make the Roth 401(k) less attractive to employees who are currently approaching retirement.

It also remains far from clear whether most employers who sponsor 401(k) plans will add the Roth 401(k) option to their plans as of January 1, 2006. To add to the confusion, questions linger about whether the Roth 401(k) will continue to be available after the EGTRRA provisions expire in 2010. **\$**



## Talking to Angels—How to Attract Private Investors

**R**aising money to start or build a business is one of the toughest challenges you are likely to face as an entrepreneur. Having a great concept is not enough: you also have to persuade banks and other investors that your business has a good chance of suc-

ceeding. To a much greater extent than a bank or investment firm, "angel" investors are willing to take a chance on less conventional business proposals.

### What Are Angel Investors?

Angel investors are typically successful entrepre-

neurs or professionals who are looking to invest capital in start-up ventures or growing businesses. They may be retirees who want to remain involved in their field in a less hands-on role. Because many of them have built one or more companies themselves, these investors

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## Talking to Angels—How to Attract Private Investors

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have a wealth of experience to offer novice entrepreneurs. In addition to providing financing for a company, many angel investors act as mentors to management, particularly during the start-up phase.

Some investors belong to groups that operate like funds, but most are independent businesspeople who prefer to invest in companies based in their local area. Even before you reach the stage of needing to raise cash, you should start networking. In many parts of the country, “social clubs” have been organized to help entrepreneurs and angels find each other. These clubs, which can be industry specific, typically give entrepreneurs the opportunity to make formal presentations before groups of investors, and they may also host informal networking events.

### Preparing for a Meeting with Potential Investors

Attracting funding from an angel investor is different from applying for a loan. While angel investors, like banks, will want to study your business plan, they may also spend considerable time getting to know you and your partners on a personal, as well as professional, level.

But even after you have impressed potential investors with your character and enthusiasm, most will not pull out their checkbooks unless you can clearly explain your goals for your business and how you intend to reach them.

Before starting your search for investors, spend some time creating a detailed outline of your company that goes beyond the basic business plan.

Angels will want to know all about your company’s product or service, as well as its customers, distribution channels, profit margins, and competitors. Research your market, and be prepared to explain to investors how your company will compete successfully in the prevailing conditions and over time.

Numbers are essential when making a pitch to an investor. Angels will ask about start-up and development costs, projected revenue streams, projected expenses, and sales forecasts. If possible, provide projections that cover a timespan of three years or more. Some investors will be reluctant to get on board unless you are contributing some of your own capital to the venture and have other sources of funding as well. All investors will ask questions about profitability, and how you intend to use the funds you are attempting to raise.

Once you have convinced an angel investor of the viability of your plan, you are ready to start negotiating a deal. However eager you may be to secure funding, resist the temptation to accept an offer that does not meet your needs. Your company will struggle if it is underfunded, and you may end up spending more time raising addi-

tional money than actually running your business. Ideally, your angel should be willing to make a substantial commitment to your business and have the wherewithal to invest more as the business expands.

Exercise caution in negotiating an equity arrangement with a potential investor. While some angels will be happy to stay in for the long haul, others will come in with a clearly defined exit strategy that assures them a return on their investment if the company reaches a certain level of success. Consider whether this is an arrangement which suits your long-term goals for the business.

It is equally important to clarify from the outset the level of involvement an angel will have in your business. The investor may or may not have a formal role in the organization or the power to influence major decisions. You may be happy to see your angel in the office every day, or you may just want an advisor you can call upon for occasional guidance or input.

As independent agents, angel investors can be hard to bring down to earth. But if you snag one, you will tap into a valuable source of cash and expertise. \$



## Succession Planning with Buy-Sell Agreements

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A *cross-purchase agreement* obligates shareholders to purchase the shares of another shareholder upon a triggering event, such as retirement, disability, or death. In the case of an owner's death, for example, shareholders may be required, or have the option, to purchase a deceased shareholder's stock, and the decedent's estate would be required to sell according to the terms specified in agreement. This technique generally works well for small businesses with few owners.

A *stock redemption agreement*, also known as an entity purchase agreement, is one in which the business agrees to buy (or redeem) the stock of a retiring, disabled, or deceased shareholder. This type of agreement is relatively simple to structure and tends to be more suitable than the cross-purchase agreement for larger companies with more owners.

A *hybrid agreement* allows parties to incorporate aspects of both cross-purchase and stock redemption agreements. Generally, the shareholders agree to offer the stock to the corporation first and then to other shareholders. The corporation may purchase all, or a percentage, of the stock, and the shareholders can purchase the remaining stock.

With buy-sell agreements, payment may come

from either the buyer or the business using, for example, money from the sale of assets or loans. Another option, and one of the most commonly used methods for funding a buy-sell agreement, is life insurance. In a cross-purchase agreement, each shareholder owns a policy on the life of every other shareholder. In the case of a stock redemption agreement, the corporation holds a policy on each shareholder.

### Tax Considerations

In many cases, cross-purchase agreements offer advantages over redemption agreements. For example, surviving shareholders receive "stepped-up basis" for tax purposes equal to the value of the purchase price of the decedent's stock. And when life insurance is used to fund the agreement, company creditors cannot lay claim to any proceeds. Furthermore, a cross-purchase plan avoids any impact the policy would possibly have on a C corporation's alternative minimum tax (AMT) calculation if the policy were corporate-owned.

Another advantage—shareholders receiving capital gains treatment rather than being exposed to the potential for dividend treatment under stock redemption plans—has temporarily been minimized with passage of the Jobs and Growth Tax Relief Recon-

ciliation Act of 2003 (JGTRRA). Prior to JGTRRA, dividends were taxed as ordinary income at rates higher than the long-term capital gains rates. With the reform, qualified dividends are now taxed at the same rate as long-term capital gains—15% for taxpayers in the top four brackets. This reprieve is temporary, lasting only through December 31, 2008, when these tax cuts expire and dividends will again be taxed as ordinary income.

In cases where children are the next ownership generation and may not have the financial resources to purchase stock, redemption buy-sells often work well. Given the tax reform, there is a brief window where transactions resulting in dividends will not necessarily increase tax liability. Proper planning is essential.

As you can see, business succession involves many ownership, tax, and management considerations. This article represents a brief overview of the many options and variables, so professional tax and legal guidance is essential. The best strategies for your business will depend on the number of owners, structure of the business, scheduled transfer of ownership, estimated time frame, and your personal financial goals and tax situation. \$

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