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THE ENTREPRENEURIAL EXECUTIVE

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LETTER FROM THE EDITOR

We are extremely pleased to present the *Entrepreneurial Executive,* an official journal of the Academy of Entrepreneurship®, a non-profit association of scholars and practitioners whose purpose is to advance the knowledge, understanding, and teaching of entrepreneurship throughout the world. The Academy of Entrepreneurship® is an affiliate of the Allied Academies, Inc., and the *EE* is a principal vehicle for achieving the objectives of both organizations. The editorial mission of this journal is to advance the knowledge, understanding, and practice of entrepreneurship throughout the world. To that end, the journal publishes high quality manuscripts, which are of practical value to entrepreneurship researchers and practitioners.

As has been the case with the previous issues of the *EE*, the articles contained in this volume have been double blind refereed. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies.

We intend to foster a supportive, mentoring effort on the part of the Editor and the referees which will result in encouraging and supporting writers. We welcome different viewpoints because in differences we find learning; in differences we develop understanding; in differences we gain knowledge and in differences we develop the discipline into a more comprehensive, less esoteric, and dynamic metier.

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Jim Carland
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ARTICLES

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BUSINESS ETHICS FOR UNSEASONED ENTREPRENEURS: TRENDS AND CONCERNS FOR PROFESSIONALS AND STAKEHOLDERS

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ABSTRACT

This manuscript looks at the importance of ethical behavior and decision-making in today's business operations. It points out who is involved and some of the ramifications of unethical business dealings over time. Ethical standards are entwined throughout our companies today no matter what their size. It is imperative that young entrepreneurs understand how some of society's accepted actions have evolved over time and the problems that can arise if not checked in the early stages of start up for new businesses. To develop an organization that normally operates ethically in all of their dealings the founder needs to set the trend early in the company's life span.

INTRODUCTION

Ethics play a major role in today's "arm's length" business transactions, and in turn, those transactions play a major role in the lives of all stakeholders. Taking a closer look at today's business ethics and how each party is affected can benefit all the participants in this dynamic process. Many entrepreneurs are new or relatively new to the business world and can be somewhat naïve about common business practices that have evolved over time. Questions arise such as, should a business have morality, or is that a human characteristic? Should all executives, managers, and employees answer to the same set of rules for ethical conduct? Are ethical standards the same for a person at work as they are when that person is not at work? Who is guilty if an employee performs an unethical or illegal act while working for a company? What should be done if an employee calls attention to unethical practices that are condoned by the company? Are there any correct answers or do the answers depend on the situation and circumstances? These questions and many more can be asked about ethical behavior (D'O'Brian, 1993). Recently, major unethical and/or illegal acts have been exposed in many of our corporations (Notes, 2003). This discussion will hopefully better equip our business leaders and young entrepreneurs to deal with ethical questions arising from situations in which they find themselves.

We cannot limit our discussion to "corporations" defined as large "super companies." Presently, most new businesses are created by entrepreneurs expanding into the new areas of previously unknown or undeveloped products and services. This requires that ethical standards be implemented and nurtured in all companies, regardless of size, to insure that these growing institutions - our future "super companies" - develop a corporate ethical culture compatible with valued societal ethics and the legal system in which they operate.

Budding new managers and executives should be particularly interested in business ethics and how they evolve because the honesty and integrity of the company's managerial team will directly impact its ability to successfully lead the company. Individuals and/or other companies contracting with the business for services and/or products also have a vested interest in and an impact on the ethical environment of the business. For example, a public accountant has to function independently of an organization in order to insure the integrity of findings during the audit; however, this does not mean that the auditing firm should divorce itself from a partnering association with the organization to improve ethical practices. This, in turn, enhances the audit results. In summary, management has a responsibility to the organization, the employees, the customers, and the public to operate a socially acceptable and ethical business. This is also in the best interest of all concerned. If the leadership of an organization does not practice ethical behavior and does not provide training in ethical and moral decision making for all employees, the image of the organization will be less than desirable and have less than desirable effects on its stakeholders.

WHO HAS CORPORATE ETHICS?

Ethics in business is not a new issue. In 1550 Charles V of Spain contemplated the status of the natives discovered in the New World. Should they be slaves or be assigned a higher status? Naturally, they had to be Christianized if they were going to be of any value in the known world. The ethos and mores of the Spaniards' own European society and culture did not allow them to even think about the natives as another culture of equal status. This was one of the problems discussed and argued in the 1500's, and similar problems are deliberated today with little more progress towards a solution than in the sixteenth century. Today's scholars argue about such issues as to whether or not payment should be made to third parties for the right of doing business in another country. The United States takes the stand that it is morally wrong to pay someone for the rights to trade in a foreign country or pay an individual (i.e., a purchasing agent or CEO) to award a contract to a company just because that individual has the power to do so. In the free market system, our American culture teaches us that it is not moral, ethical, or legal to bribe an employee of another company in order to gain contractual preference. However, in some societies and cultures, this type of behavior is perfectly acceptable and even expected if a company is to succeed economically. All levels of an organization must participate in ethical decision making in order to insure a truly ethical philosophy. In the current world economy with its ethnic and religious diversity and the sheer volume of daily business deals conducted among all countries, how do we establish and/or maintain an acceptable level of ethical standards? Different cultural groups across the world often have different approaches to the ethical issues generated by the world economy and its myriad transactions.

Board of Directors

The board of directors is the most powerful level of company management - at least by the formal hierarchical standards of today's business world. If the board of directors is at the top of the hierarchy, it would seem logical that this is where the ethical behavior patterns for the corporation should be developed. Generally speaking, in today's society, it appears that the gain or loss of large sums of money is not thought to be as important as whether or not the player followed the currently perceived business rules of fair play. In Adam Smith's day, the issues were basic constructs like "level playing field," equal access to market intelligence, non-monopolistic competition, and other similar premises. Today, an organization can ethically pursue and maximize profit as long as it obeys the written rules of business, established customs of the work place, and traditions. Although legislative bodies establish rules and laws, the top echelons of corporate management establish the customs and traditions in the culture of that company. Within this system, a disturbing trend has developed. Many companies have a written code of ethics or conduct that all employees are supposed to follow; however, that compliance seems to stop just outside the boardroom door. Inside that boardroom one will find many of the top level managers of the company who are also acting as board members whose role is to monitor management; thus, they are monitoring themselves. These top managers are also acting on behalf of all the stakeholders (especially the stockholders) and other board members from outside the corporation when the latter are supposed to be watching after the interests of the stockholders. Also, these managers/executives are sitting on each other's corporate boards, somewhat as a clique, and approving major compensation packages for one another while downsizing and laying off thousands of workers in the company to save money. It's not difficult to arrive at the conclusion that the concept of "arm length's transaction" has been violated (Bavaria, 1991). This seems to produce a double standard in which workers and lower level management are required to operate under an established code of ethics while some board members ignore that code, lining their own pockets at the expense of other board members, the working class majority, and the stockholder who is the true owner of the corporation. John G. Bennett, Jr., founder and chair of Foundation for New Era Philanthropy, represents one of the most extreme cases of an unethical board member. His company had no legitimate purpose whatsoever and caused "incalculable harm" to many not-for-profit entities before his seemingly pious motives were questioned (Stecklow, 1997). Enron's Board of Directors appears to have fallen short in many areas. They were receiving minimal information on the extent of partnerships that were being formed and allowing management to report large earnings from these deals. They allowed Enron's code of ethics to be bypassed on numerous occasions in allowing some of the partnerships to be formed, and they did not follow through with their monitoring responsibilities in many cases. Many of the board members have been charged with insider trading since the company failed. They appear to have been puppets of Enron's management team, a situation which is in direct opposition to the Board of Directors charge and role in any properly operated corporation (Tongue et. al, 2003). The recent determination of insider trading with Martha Stewart and ImClone and Merrill Lynch is another example of unethical developments originating with the Board of Directors (Scannell and Rose, 2004).

Top Management

Top management's primary role in the company is strategic development. This concept seems simple enough; however, strategy must be aligned with the underlying ethical behavior of the company. The way a company conducts itself in day-to-day transactions is a distinct signal by and reflection on those involved in designing and carrying out the transactions. Since top management is responsible for setting policy and establishing formal (or informal) codes of conduct and ethical behavior, the course of strategy adopted is a direct reflection of management's behavior. This in turn signals the employees about the type of actions desired and expected of them and subjects management to close scrutiny (Lane, 1994). When management engages in deceptive practices, a signal is given to all concerned that profitization and self-interest are the main concerns. At the end of the past decade, the Chair of Texaco determined that "the tone of the conversation [by senior executives at Texaco] was still unacceptable" even though it was without direct racial slurs, and Texaco settled racial discrimination lawsuits at a cost of $176.1 million (Walsh, 1997). Denny's Restaurants were also in the news during the 1990's for discrimination violations in serving customers (Carlino, 1999), and they continue to have problems currently with hiring practices (FDCH, 2000). Without some action to alter the perceived corporate ethical culture in these companies, the discriminatory attitudes of members of top management are likely to be seen as acceptable. As companies and corporations become more unethical and morally corrupt, one of the effects is the erosion of and decline in our societal norms and values as the corporate environment "spills over" into the society.

The difference between conscience and consciousness is another confusing issue in corporate ethics. Patrick Primeaux defines these terms as follows: consciousness refers to the whole of our knowing, and conscience refers to our understanding the difference between right and wrong. When top management supports financial misrepresentation by lobbying and coercing regulators to write loose and flexible rules that allow the former to finesse and manipulate income, this signals loose ethical behavior in terms of conscience AND consciousness. Enron and others have recently come under investigation and indictment for using these loose interpretations in instances of creative accounting that are particularly convenient to income smoothing or "big bath" losses. They are more or less free to call attention to these actions or not call attention to them in the financial statements (conscience and consciousness), which again is borderline ethical behavior (Zucca and Cambell, 1992). The options of reporting or not reporting and acting or not acting in certain situations is based upon personal needs and desires for personal gain, despite the fact that top management is supposed to be a steward for the owners (stockholders) of the company. The actions of managers and board members are the basis for the evolution of corporate ethics in any company, regardless of written or unwritten rules. The people at the top of the organization set the pattern for the employees to follow and influence the corporate conscience, consciousness, and ultimately, culpability. The current upsurge in entrepreneurship is a serious reason to look at our past and present business society, and to be concerned about the role models to whom the new entrepreneurs turn for example and direction.

Middle Management

Middle management has an obligation to follow the standards and strategy established by top management. The impact of unethical behavior at this level is not quite as profound since it remains more isolated in the particular manager's section or department. However, in some cases, middle management can affect overall company behavior through indirect methods or informal cultural power that is already established within the company. (Look at the trends that Denny's Restaurant Managers have set for the chain nationwide). In most cases, they affect only their subordinates, in which case they may override the positive ethical trend running throughout the organization in general. However, in a classic case of fraud at the middle management level, H. J. Heinz reported overstated income for five years before a janitor ignored orders to burn documents and instead handed them over to the company's auditors. The pressure of meeting corporate growth targets had led managers to accelerate recognition of revenue and to juggle profits. The Wall Street Journal summarized the managers' position: "An employee often confronts a hard choice - to risk being branded incompetent by telling superiors that they ask too much or to begin taking unethical or illegal shortcuts" (Getschow, 1979). The recent, highly publicized Martha Stewart case is a good depiction of the inner dealings and friendly relations between top and middle managers in several industries who have come under investigation, been indicted and/or convicted for numerous fraudulent and unethical acts in their respective companies.

Employees

Employees' attitudes and behaviors are molded by the actions, beliefs, and values, and the moral and ethical behavior reflected by management. However, employees have attitudes and values that allow them to act independently of what may be asked or even required of them by their superiors. If the employee has a high ethical standard and resists the unethical practices of others within the company, this also can have an overall effect on the organization. If they resist, it is possible to improve the situation for others in the future. In essence they ask, "Why should a few individuals, i.e., management, be able to destroy the moral and ethical beliefs and values of an entire organization?" If an organization evolves from the people within it and their ethical values are absorbed by the corporation, the employee also has an obligation toward the corporation to maintain acceptable levels of conduct. However, in the past few decades, the problem seems to be that the level of conduct acceptable to society has moved downward. Ethical erosion in the United States was reflected in the 1970's by foreign political payoffs, price-fixing schemes, and Watergate; in the 1980's there were problems with insider trading, defense scandals, and leveraged buyouts. In the 1990s Blue Shield fell victim to document falsification by "a few misguided employees" that cost it $2.16 million in fines, and Wells Fargo Bank became associated with insurance fraud when its clerks conspired to avoid reporting cash transactions over $10,000 (Olmos, 1997). These activities, in combination with a mentality of "profit is king" and "one must do whatever is required to maintain growing industries and profits," provide the framework for declining values in the American business population. How can this course of action be stopped? Some believe that training is the answer.

HOW DO BUSINESS ETHICS AFFECT CURRENT MANAGEMENT AND ASPIRING ENTREPRENEURS?

Management may be affected in several ways by business ethics and needs to be aware of ethical expectations and the ramifications that a lack of ethics can cause. Flory et. al. (1991) performed research to determine what caused or influenced ethical behavior. If ethical behavior can be predicted in individuals, then a corporation can identify people who are more susceptible to unethical decision making. The study used moral equity, relativism, and contractualism as constructs for ethical judgments. Moral equity is described as being concerned with many forms of belief about right and wrong human behavior. Normative beliefs are expressed in general terms as 'good', 'bad', 'virtuous', and 'praiseworthy'. Relativism is concerned with guidelines, requirements, and parameters inherent within the social and cultural system rather than within the individual. Contractualism deals with the unwritten agreements supposedly held between business and society. These areas were identified as the roots for our ethical behavior, and Flory developed a scenario based instrument that could be used to measure the ethical level of specific individuals. Pre-employment screening with psychological assessments, paper and pencil honesty tests, and the evaluation of past behavior represent an attempt to predict on-job behavior (Jayne, 1994). While this research needs more development, it is a step in the direction of helping management make decisions on personnel's attitudes and reactions to specific types of situations.

Management may also be affected by ethics through legal liability issues. For example, there has been a major gap between what an auditor, retained by management, sees as reasonable in a set of financial reports and what the public and the judicial system sees as reasonable. An additional repercussion for the auditor is that anytime a corporation falls into bankruptcy, the auditor comes under suspicion first and remains there until proven innocent. The recent failure of some of our leading accounting firms stands as proof that law and accepted practice have not been within the bounds of public acceptability. Accounting firms, along with many other service and manufacturing organizations, have taken the brunt of consumer losses because of the consumer's poor judgement. It appears that American business has been singled out by juries as an easy target on which to affix blame and from whose "deep pockets" to let the public have restitution.

The ethical issues facing management were primarily in the accounting area and ultimately focused on legal liability. The accounting profession, unfortunately, bought in on management's justifications and ultimately caused the downfall of several major corporations including ones in the accounting industry. Accounting firms are particularly under tight scrutiny by both government and public stakeholders because of the recent failures of several public companies. For accounting firms to remain self regulated and retain the respect of the public for their services, they must refrain from being identified with actions or behaviors that appear to be unethical in the public's perception. There is still a fine line to walk in the gray areas that have been established by the standard setters from over the years (Lomax, 2003) even though the SEC has become more aggressive in ethical codes and the Sarbanes-Oxley Act has also stiffened the actions for unethical behavior (Notes, 2003). Legal choices do not always equal ethical choices. The standard setters left flexibility in the rules to benefit the public with the results of financial reporting - not to benefit management or self. The combination of a bull market for a number of years, which inflated company values, linked to executive pay and bonuses and a board of trustees unwilling to check the actions of management to guarantee bonuses culminated in disaster for workers and stockholders alike (Lomax, 2003).

Accounting for employee stock options encouraged but did not require the accrual of expense/liability. While this choice allowed companies to meet "best practices," many companies lobbied hard to avoid recognition of the effects of employee stock options and to only provide the minimum required disclosures (Baliga, 1995). That was changed by the Sarbanes-Oxley Act of 2002. Major companies are now required to expense stock options at the time they are issued; however, the calculations are not standardized. Other suggestions for avoiding future unethical decisions by management are 1) revising 401(k) plans to restrict the number of company shares; 2) restructuring compensation committees to include only outside personnel; 3) maximizing all types of checks and balances; 4) tying pay to performance; 5) protecting whistle-blowers; 6) re-creating the rules for checking past performance of potential employees; 7) restructuring the board of directors, and 8) taking a closer look at what the public allows to slip by under the pretense of freedom and instant gratification--particularly in the area of higher stock prices. The public must look beyond its own pocketbook in order to curtail the unethical behavior in the public domain (Lomax, 2003).

The public plays a dual role in corporate ethics much like an accountant plays a dual role in the sanctioning of flexible financial reporting standards. The public--or at least the shareholders--will benefit from profit maximization through higher stock prices and dividends, and they will lose through overly generous compensation plans for management. Stockholders can also benefit by devious or "loose" reporting standards which circumvent loan and bond restrictions. Many times the bond holders lose on these deals also. Supposedly, the auditor protects the public; in many cases, the public demand for higher stock prices and dividends is the driving force for management to represent the corporation with "loose" financial reporting and pressure the accounting firm to attest to its validity. The question of ethics becomes very difficult to deal with when society's perception of what is fair and legal in business has become questionable. It doesn't have to be that way. When Coca Cola's Robert Goizueta died, his legacy was seen not only in the increase in shareholder value he created for his company, but in the trees planted, free manned clinics established, parks built, museums funded, and college buildings built by Coca Cola shareholders who used the wealth created in Coca Cola shares to benefit their community (Keller, 1997).

WHERE DO WE GO FROM HERE?

The trends in corporate ethics over the past few decades have not been encouraging in the U.S. It seems that large corporations are taking more and more advantage of the system for several reasons. They are trying to maximize profit in any way that gives them an advantage; whether the conduct is ethical or legal is not an issue as long as they do not get caught. Profit maximization is being intensely stressed by management to increase their compensation and by stockholders to increase their wealth through dividends and increased stock value. Neither party is directly concerned with the overall future health of the firm because both feel they have other alternatives if the corporation begins to falter. The emphasis is on self in both cases.

Schweikart (1992) outlines three levels of ethics that can be used to describe business attitudes today. They are listed below hierarchically starting with the lowest level:

1)	All decisions are governed by legally binding rules and statutes.
2)	Decisions are made in the context of an ethical code of conduct but are not totally bound by that code.
3)	Decisions are made in a highly defined sense of right and wrong, which is developed through moral and philosophical deduction.

Even though we have entered the 21st century, these levels still hold true for our society. Most business continues to be conducted on level one even after all the scandals from Enron, WorldCom, Tyco International, and the list goes on. To raise the level of ethics to the higher level dealing with moral and philosophical deduction is the challenge confronting American business and the newly developing international trade arena. To be successful in this endeavor we must concentrate on the individual more than the corporation as a whole. As stated earlier, the corporation is simply an extension of the collectivity of its people. Primeaux (1992) states:

> A company which claims to be ethical, but which has not promoted good ethical practices either within the organization or among its suppliers, customers, or shareholders will lose credibility in the long and short term as the chickens come home to roost.

He claims that a corporation will evolve in much the same way as an individual in relation to ethics. Therefore, if poor ethical conditions are created during the formation of the corporation, it stands to reason they will be difficult to change in the future. This is a primary reason for insuring that our new generation of entrepreneurs understands the decline that our nation's ethics have experienced in order for the new super companies of the future to regain a standard of which we, as Americans, can be proud.

Can training within the company correct all of the unethical behavior that pervades today's corporate world? Most people think that ethical behavior is formed in an individual at an early age and cannot be changed once a person has reached maturity. In fact, Peter Arlow (1991) suggests that age may be the most important factor in the role of Machiavellian tendencies (unscrupulous uses of political power). If so, training at this late date will not correct all of the occurrences of unethical behavior in business transactions in today's business world. However, not all employees are ethically unsound. Perhaps exposure to hypothetical situations of unethical behavior and suggestions on how to react would be helpful to those who are unaccustomed to dealing with these types of situations. The Treadway Commission has encouraged universities to incorporate ethical behavior training into their courses. Sometimes though, even "immersion" in ethical thought does not prevent disaster: Arthur Anderson developed educational materials on accounting ethics, held conferences and seminars that dealt with ethical behavior, and then became entangled with the Enron scandal (Loeb, 1991). Although training may not be able to change a person's ethics, it will make ethical people aware of situations where ethics are important.

In closing, consider what managers need to observe about a company prior to assuming a new position. The organization should have an established control system to deter unethical practices. The manager should be concerned with more than the financial health of the company. The underlying organizational culture should be of great importance to any employee whether worker or management. The new employee should check risk assessment in regard to management's attitude towards integrity and ethical behaviors and employee commitment to that attitude. The employee should watch specifically for areas that might be vulnerable to unethical manipulation such as accounting records, purchasing, environmental and safety issues, lobbying activities, human resources, and discretionary product information. If the corporation is truly conscientious, it will have a training program that includes a segment on ethical behavior for those situations that are not clearly defined as right or wrong (Sears, 1993). Trends in good ethical behavior have declined in business in the past few decades; to rectify the situation will require a concerted effort to reestablish personal beliefs and values that can once again look past self interest. Our current generation of entrepreneurs should understand the importance of the values and ethics of our founding fathers when creating new entities and how these values and ethics are the cornerstones of a successful present and future business environment and society.

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A FRAMEWORK FOR ASSESSING THE NEED FOR LEGAL READINESS IN SMALL AND ENTREPRENEURIAL FIRMS

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ABSTRACT

A great deal of attention is being given to legal problems in organizations and their efforts toward legal compliance. Most of the attention has been upon larger firms. This paper seeks to provide a framework under which both large and smaller entrepreneurial firms can assess their legal readiness. Industrial Organization theory suggests that the firm's profitability and growth prospects depend upon the external environment confronting the firm and the firm's actions and reactions to these factors. Research on the external environment of small firms has focused on economic, socio-cultural, demographic, and technological elements in small firms. However, legal issues have not been given extensive consideration. Clearly, legal issues can present substantial threats or opportunities to the firm. Surprisingly, in spite of recent recognition that legal issues can be particularly important to both large and small firms, the literature does not present a clear perspective of the legal factors that may be significant specifically to small business owners. We propose a framework for evaluating the potential impact of legal issues on a small firm. This discussion serves as the basis for a broader discussion of how political and legal elements may impact the small firm.

INTRODUCTION

Business and society in general, is placing a great deal of emphasis upon both legal compliance and legal problems in organizations. While large organizations may have a sophisticated approach to legal compliance, or "legal readiness", many smaller and entrepreneurial organizations generally are less prepared in this arena.

The influence of the external environment on a firm's actions can be conceptualized using the Industrial Organization theory of the firm (Hoskisson, et. al., 1999). This conceptualization argues that an organization's profitability and growth prospects depend upon the environmental factors it faces (Schendel, 1994). Business executives are urged to scan the environment in an effort to identify opportunities and threats that may affect their companies as part of their efforts to plan for the future and to position their organizations to compete (Elenkov, 1997; Goll & Rasheed, 1997). Students of strategic management are taught the benefits of scanning the external business environment in order to identify trends in society (for example, see Thompson and Strickland, 2001; Hitt, et. al., 2001; David, 2000). These factors or elements of the external environment are commonly grouped into the Economic, Socio-Cultural, Demographic, Global, Technological, and Political-Legal elements (Hitt, et. al. 2001).

The extant research on small firms and entrepreneurs has argued that small business owners and entrepreneurs also must be thoroughly aware of their external environment (for example, see Johnson and Kuehne, 1987, Smeltzer, Fann & Nikolaisen, 1988; Specht, 1987; Robinson, et. al. 1998). Generally, most research on the external environment of small firms has focused on economic, socio-cultural, demographic, and technological elements where small firms are concerned. However, legal issues have not been given extensive consideration (Robinson, Jackson, Franklin & Hensley, 1998). Clearly, legal issues can present substantial threats or opportunities to the firm. We define legal issues as including "any laws or regulations enacted by federal, state, or local government" as well as typical legal and legal compliance practices of business owners.

Most of the literature concerning legal threats and opportunities has been studied from the perspective of the large firms that dominate the U.S. economy. (For example, see studies by Hambrick, 1981 or Daft, Sormunen, and Parks, 1984.) Studies that identify legal issues impacting big business are not necessarily relevant to the legal concerns and issues facing the small business owner. We still do not have a clear understanding of the identity of legal factors that may be significant to small business owners. The legal issues important to big business may be of less relevance or of minor importance to small business owners.

Internal legal practices of businesses and the external laws and regulations affecting those businesses can impact small business performance (Robinson, Jackson, Franklin & Hensley, 1998). If the small business owner, with fewer human and financial resources than those available to big corporations, can identify critical legal factors for the benefit of the small firm, knowledge of these legal issues can improve the legal environment. The legal concerns unique to small business owners and the identification of those issues may be developed through a consistent inquiry into the practices of family-owned, and other small businesses.

Thus, the purpose of this paper will be to demonstrate need for additional research relating to the legal issues in the external environment of the smaller firm. Using an observational research method, we later hope to show that a few types of emerging legal issues can seriously impact the small firm. These findings will then serve as the basis for a broader discussion of how political and legal elements can impact the small firm.

LITERATURE REVIEW

In this paper the authors have artificially restricted the broad definition of legal issues to narrow the focus of the study and exclude less salient legal issues. In general, legal issues are defined as including "any laws or regulations enacted by federal, state, or local government" as well as typical legal and legal compliance practices of business owners. The specific definition of legal issues, for purposes of this paper, will include the following legal practices: use of contracts, decision-making constraints, human resource law, use of legal advisors, and other factors discussed here.

When examining the relevant literature only a limited number of helpful articles relating to small business practices was found. Without a foundation in the literature, it is difficult to develop a theory or formulate a checklist of essential legal issues affecting the small firm.

There is, however, no shortage of articles giving prescriptive advice on particular legal issues in the literature. Numerous articles advise a small business owner about how to handle everything from AIDS in the workplace (Franklin & Gresham, 1992; Hoffman & Clinebell, 2000) to sexual harassment (Robinson, et. al. 1998) and taxes. Compliance with tax regulations, environmental regulations, employment regulations, accessibility regulations, industrial and safety regulations, and the impact of federal laws on business are just a few of the myriad of legal topics addressed by the literature. When examining industry-specific topics, the review of specialized standards for performance and operations, quality and control, and industry-wide guidelines may also be determinative of how a firm channels it legal resources. Other opportunities for detailed review of legal concerns include the ownership of land and facilities and the impact of the locality on zoning and planning regulations that affect the business.

Beyond prescriptive advice however, we were surprised that the extant literature has simply not developed a useful profile of the legal issues that may be critical to the unique position of small business owners. The small business literature is lacking research manuscripts based upon theoretical underpinnings. Instead, ad hoc articles on various legal topics dominate the small business literature complimented with "legal advice" articles on specific legal issues.

SCANNING THE ENVIRONMENT

The extant literature related to scanning the environment is well known to readers of the small business management, entrepreneurship, new venture creation, organizational theory, or strategic management literature. Thus, this section will not elaborate the scores of articles that describe this critical activity. This review will focus on two recent directions in the literature. First, we will highlight the efforts of small business owners to identify significant political and legal issues in their industry. Secondly, we will focus on the implications of failing to do so as noted in recent articles by West and DeCastro, 2001.

Perhaps the state of our understanding of legal issues and small businesses can be surmised by reviewing a recent special issue in Entrepreneurship: Theory & Practice (Katz, Aldrich, Welbourne & Williams, 2000). The entire issue was devoted to "Human Resource Management" (HRM) issues and small and medium-sized businesses. Surprisingly, none of the articles emphasized legal issues related to small firms. The absence of legal issues is shocking since the human resource function is responsible for so many legal issues related to the personnel in a firm, such as fair hiring, Aids/HIV, wrongful discrimination, labor relations, affirmative action, OSHA, workers compensation, sexual harassment, etc. (Carrell, Elbert & Hatfield, 2000). Ironically, the guest editors noted that "very little serious academic work on human resource management was carried out within smaller firms" (Katz, et. al., 2000, p. 7). Apparently, this lack of serious academic work with regard to legal issues in small firms (at least at it relates to HRM) was a problem in their own special issue. Not one of the seven articles in the special issue addressed legal issues related to HRM in a serious or extensive manner.

Legal issues are rarely discussed in small business studies (See, for example, Smeltzer, L. R., Fann, G. L. & Nikolaisen ; Fann and Smeltzer, 1989; Lang, Calatone, and Gudmundson (1997) or Beal (2000). For instance, the studies by Fann and Smeltzer (1989) and Land, Calatone, and Gudmundson (1997) conclude that it is important for small business managers to recognize the importance of external environment issues with regard to "customers and competitors". The Fann and Smeltzer (1989) article focused on competitors while the Lang, Calatone, and Gudmundson (1997) study emphasized environmental threats and opportunities generally. Lang, et. al. study small firms found positive relationships between perceived threats and information seeking and between perceived opportunities and information seeking. Yet, there was a negative relationship between perceived threats and perceived opportunities. Thus, their study suggests the possibility of selective perception among small firm managers. Beal's (2000) study concluded that political conditions do not appear to be critical to either the mature or the growth stages of industry development. The fact that these studies neglected the area of legal issues may not be an indication that legal issues are not important but perhaps just indicate a focus upon other issues.

Review of the current literature leads to only two journal articles that specifically emphasize the importance of political issues (cited in Sawyerr, 1993; Sawyerr, 1994; Sawyerr, Edbrahimi, and Thibodeaux, 2000). However, the sample of small firms in the first study was gathered from Nigerian firms. Given the political upheaval in Nigeria, the political elements of the general environment are obviously important. However, the situations in the U.S. and Nigeria are arguably very different. In the second article, Smeltzer and Fann (1988) conclude that small business owners do not value the advice of accountants, bankers, and lawyers. Their finding is curious given the findings of Chrisman and McMullan (2000) that small firms benefit from the advice of outsiders such as SBDC consultants. Chrisman and McMullan suggest that small business owners do value the advice of friends and family as well as their own ability to read about trends and issues in magazines.

Sonesy, Baugh, Newton and Gulbro (1997) conducted the only study of specifically emphasizing legal issues in small businesses. Their phone survey of 27 small businesses in a single state conducted in 1996 revealed that only one-third of the firms had made changes to comply with the Americans with Disabilities Act, Civil Rights Act of 1991, or Family and Medical Leave Act. This finding is particularly disturbing because each of these laws had been passed 6, 3, and 5 years, respectively, before the survey was completed. The findings give cause for alarm about the state of readiness among small firms with regard to emerging legal issues, such as environmental hazards, limited liability corporations, detailed employee record keeping, or arbitration clauses.

DISCUSSION

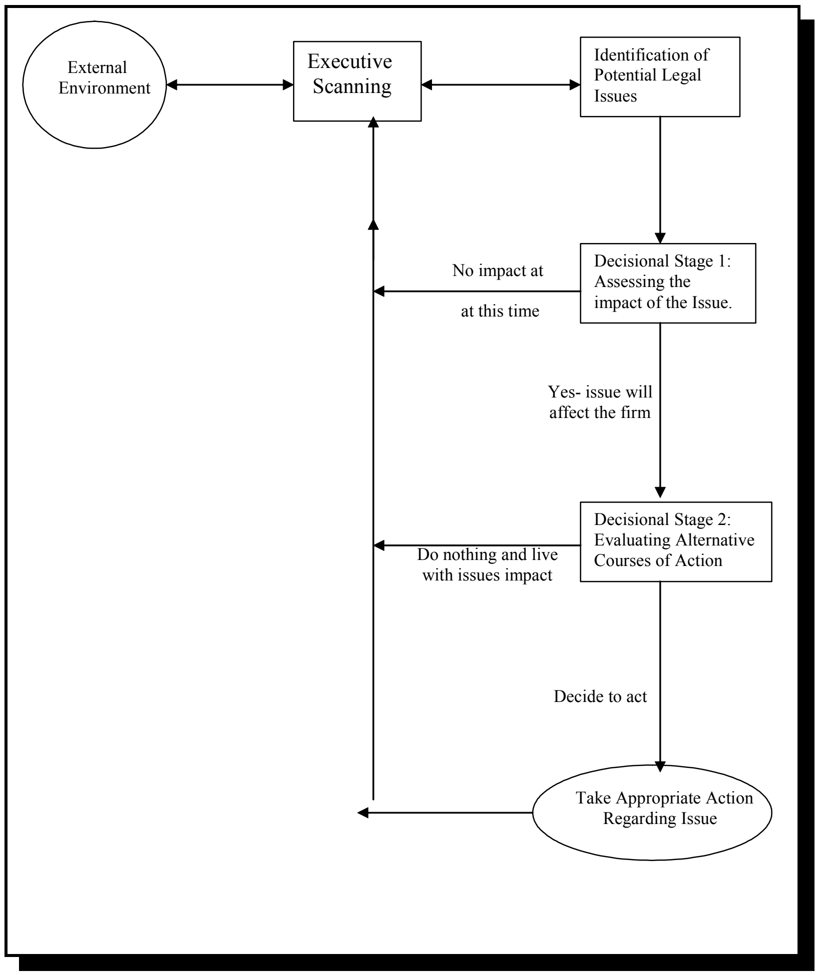
The identification of the legal issues that were discovered as part of our research process suggest that small firms must be cognizant of these issues just as they would economic, socio-cultural, or technological issues. The ramifications of not knowing this information are extremely important.

According to research by Lang, Calantone, and Gudmundson (1997), their study of small firms found positive relationships between perceived threats and information seeking and between perceived opportunities and information seeking. However, they identified a negative relationship between perceived threats and perceived opportunities, which raised the possibility of selective perception among small firm managers. This finding suggests that small firms may only seek out information in the normal course of managing their firm. Thus, new legal issues or political changes may not be evaluated unless they immediately affect the firm. Their research suggests that small business owners do not casually survey their legal environment in search of potentially important issues. They only survey their legal environment if they have a priori knowledge of the issue's potential importance. Beal's study (2000) suggests that small business owners fail to scan the environment simply because they are "constrained by their involvement with daily operations" (Beal, 2000, p. 44).

Such a situation is ripe for disaster. According to West and DeCastro (2001), the failure to correctly identify legal, regulatory, and political elements of the external environment may represent a resource weakness and distinctive inadequacy. The small business owner may fall into a trap by believing that he knows the relevant legal and regulatory issues that impact his or her firm. However, as prior research suggests (Franklin & Gresham, 1992; Robinson, et. al. 1998), small firms often do not have a grasp on these types of issues. Thus, we would suggest that the following steps be taken, at a minimum, to ensure that the firm is adequately positioned to meet the legal issues that may impact it (See Figure 1).

The proposed model suggests that the external environment is a significant factor for small as well as large businesses. Further, as discussed in this article, there is strong support for the executive scanning activity of the organizational leadership. Part of that continuous scanning is to react to critical issues thrown at the organization from the external environment. Our model suggests that small business leaders adopt a general decision-making approach to handling the issues surrounding law and legal compliance.

Figure 1



Step 1: *Identification of potential legal issues.* Further research can identify the broad categories which will likely include anti-discrimination laws, safety and health laws, pay laws, tax laws, incorporation laws, contract laws, and others. This area needs additional research and a fleshing out of the relevant categories.

Step 2: *Decisional Stage 1* - Assessing the impact of the future. If there is no impact at the immediate time then the leader continues executive scanning. However, if there is impact that is immediate or significant future impact can be recognized now the leader moves to the next step. For instance, a small employer may feel that they need no immediate reaction to the Civil Rights Act Amendment of 1991. However, many larger employers found that it was important to prepare for possible discrimination complaints in advance of having a complaint. Small business leaders need to be able to assess both the immediate and the long-term issues as they arise. The literature needs to help in this area.

Step 3: *Decisional Stage 2* - Evaluating alternative courses of action. The possibilities will include deciding upon the appropriate reaction or living with the impact of the legal issues on the organization. Small business owners and leaders need additional information to help make their choices at this stage.

Step 4: *Take appropriate action.* At each step the small business leader is continuing to scan the external environment. For instance, as cited above, there was a flurry of very significant employment laws at the beginning of the prior decade. The Americans with Disabilities Act was passed in 1990 and the Civil Rights Act Amendment was passed in 1991. Leaders cannot afford to focus exclusively on one legal area without maintaining the scanning since yet another critical issue may quickly emerge. Small business owners and leaders need help in scanning the relevant legal environment.

SUMMARY

Small firms are acknowledged not to have the resources necessary to cope with potential errors relative to their larger competitors (Palmer, Wright & Powers, 2001). We believe the legal issues identified in this study are only the "tip of the ice berg" representing the legal, political, and regulatory environment.

We believe this study emphasizes the need to stay abreast of current issues in the legal, political, and regulatory environment of the small firm.

In fact, we propose the discussed model as a starting point in improving the legal readiness of the small business leader.

As potential consultants to small firms or as faculty advisors to consulting teams, Small Business Institute Directors are in a unique position to influence small firms. Clearly, you can only suggest what should be done. However, many owners of these small firms will readily listen to your advice. Perhaps the summary comments by Barney, Frances, and Ringleb (1992) best summarize the perspective that should be taken.

Indeed, virtually every introductory organizational theory and management author cites the importance of the legal environment facing organizations. However, much organizational research remains relatively naive about the organizational implications of the law. Several bodies of law seem likely to affect and constrain organizational actions, including tax laws, laws about equal employment opportunity, employee health and safety, product liability law, antitrust law, and the criminal law discussed in this article. A significant challenge facing organizational scholars is to become sufficiently familiar with these bodies of law that they can anticipate their implications for the organizational phenomena under study (Barney, Frances & Ringleb, 1992, 345). Clearly, their advice extends to SBI Directors in their capacity as advisors to student groups and consultants to small firms.

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CURRENT STATUS AND CONSIDERATIONS OF HOBBY LOSSES AND THEIR IMPACT ON ENTREPRENEURS

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ABSTRACT

Various legitimate "at risk" entrepreneurial start-up activities- especially family oriented businesses- are subjected to constrictive guidelines established by statute and the courts, possibly discouraging otherwise promising entrepreneurial activities by timid taxpayers not wishing to be aggressive. Conversely, the hobby loss rules act to prevent the expensing of what otherwise would be personal expenses disguised as "valid" business expenses, thereby causing significant losses of revenue to the Treasury. Somewhere between the two extremes are legitimate activities entered into for the purpose of making profits yet are treated with hostility by the service.

This paper explores the background and current status of the hobby loss rules and their unexpected impact on the small entrepreneur.

THE ENTREPRENEURIAL SAGA BEGINS

The hobby loss restriction has been a valued part of the IRS armada for many years, restricting attempts by taxpayers to claim expenses (and thus deductions from income) beyond rather meager income derived from the taxpayers' "pet" projects. The logic behind such restrictions is otherwise reasonable: e.g., if the taxpayer does not earn a profit from the activity, some other alternative reasoning behind the activity must exist. Usually it is assumed that the activity is undertaken purely for the taxpayer's pleasure and therefore the taxpayer is attempting to pay for the activity at the government's expense.

Such an audit approach is simple; it doesn't require much effort to handle the situation to disallow such deductions. Unfortunately, this conclusion makes it extremely easy to overlook or ignore other tangible or intangible aspects of the alleged business "effort," particularly when the entrepreneur abandons the activity or is convinced that the Service does not deem the activity to be a viable entity. Of course, some entrepreneurs go on to prove the Service wrong, but many do not continue after an unfavorable audit event.

While this tough approach is understandable from a revenue enhancement viewpoint, it is arguably quite lacking in considerations relevant in the business world and available to entities that, for whatever reason, from the Code's viewpoint, were otherwise "legitimately" established. There has always been a presumption of legitimacy for the more complex the business forms (i.e., the establishment of a corporation or partnership), but even that legitimacy is sometimes challenged.

It is almost automatically assumed that if someone has incorporated or developed a partnership agreement for the business entity, "serious" business reasons must exist for the expenditure of scarce capital. In fact, the Code encourages such expenditures by allowing the amortization of the start up expenses over a sixty month period.

This postulate, however, does not seem to consider that such start up costs are not inconsequential to an individual taxpayer: often the individual naturally wishes to minimize the beginning and ongoing operating costs of the business activity to enhance survival possibilities of the business through the conservation of scarce capital. Further, the prudent taxpayer also wishes to minimize personal exposure to loss of capital if the activity later collapses or becomes unfeasible. While certain theoretical lip service is given to these notions, it appears in reality this risk is often not seriously considered by the Code nor by the Service.

Interestingly, there has been utmost "hostility" to many forms of activity whereby a child and a parent jointly venture into some activity, especially in the areas of music, sports and/or art. These areas, while others certainly exist, provide valuable insights when contrasting presumptions with everyday reality. A hypothetical yet illustrative case might be useful to explore the various ramifications of the matter.

OUR HYPOTHETICAL SITUATION

Assume the taxpayer has a gifted and very talented child in music or dance. Because many such children exist, simple economics precludes outside third-party agencies in fronting funds to cover the costs to develop, produce or market all children who have outstanding potential. Thus, a commonly litigated situation develops: the child's parent becomes the child's agent or business manager and establishes a business activity such as management, consulting, production or some such activity for profit. Unfortunately, the income level is paltry at best in the early years and expenses far exceed revenues. Because the music and/or entertainment business is extremely competitive, success usually comes only after several years of effort.

Thus the tax "rub." A business activity, in general, is expected, per the regulations, to make a profit for at least two out of five years. Suppose then, before the fourth or fifth year of full operations, an audit of the third or fourth year occurs. Of course no profit has yet been earned, even though the business is strengthening. The result of the audit could be catastrophic.

AND SO "OUR TASK" BEGINS- THE PROOF OF A FOR-PROFIT BUSINESS

While we generally view the tax code as designed to reward risk takers, it does not do so here. Interestingly, the Service recognizes that horse racing takes time, and grants additional time to achieve a profit (seven as opposed to five years). Unfortunately, in some businesses, it may take ten or more years to generate a profit -- even horse racing!

While sometimes hostile to the so-called hobby business, the courts have been gracious in providing clearer and more articulately defined guidelines than those of the Service. As gratifying as it is to have these clarifications or enhancements, even these precepts arguably fall short and in some cases seem openly hostile to the entrepreneurial spirit.

DEDUCTIBILITY?

The first real "test" is whether the talent manager/agent's expenses can be deducted in the first place. *Welch v. Helvering, 54 S. Ct. 8* (1933), teaches an expense is necessary, and accordingly deductible, if a prudent person would incur the same expense and the expense is expected to be appropriate and helpful in the taxpayer's business. In *Blackmer v. Commissioner, 70 F2d 255* (1934), the court teaches that a "necessary expense" is one that is appropriate and helpful, rather than necessarily essential to the taxpayer business. *Commissioner v. Tellier, 383 US 687* (1966) held that "normal and necessary" means that the expenditure must be normal, usual and customary, as well as appropriate and necessary and helpful to the operation of the business. *James M. Green, T.C. Memo 1989-599* held that if the taxpayer is not engaged in profit, no deduction attributable to such activity is allowed as a deduction, and conversely, if truly engaged in for profit, the deduction is allowed. *Flint v. Stone Tracy Co., 220 US 107* (1911) defines a 'business' as "that which occupies the time, attention, and labor of men for the purpose of a livelihood or profit." Interestingly, in *Holmes v. Commissioner, 83 AFTR 2d 99-298, 184 F3rd 536* (1999), the Tax Court held that "an activity is engaged in for profit if the taxpayer **entertained** an actual and honest, even though **unreasonable** or **unrealistic**, profit objective in engaging in the activity" (emphasis added). Finally, the Tax Court held in *Lou Levy, 30 T.C. 1315* (1958) that an artist's agent who invests money in hopes that artist will become a star may deduct the related expenses.

In *Valerie Jean Genck v. Commissioner, T.C. Memo 1998-105*, the Court allowed the taxpayer's expensing of its rental of recording studio used in production of CDs and blank CD's as supplies as opposed to capitalization of those expenses. In *Charles Hutchinson v. Commissioner, 13 BTA 1187* (1928) theatrical clothes as opposed to "everyday" clothes were allowed as deductible. Conversely, the court held that wigs, makeup, skin care, and hair care were not deductible unless proven for business use.

Thus, the business expense must be "normal and necessary" but not "essential" to the taxpayer's business, and the business - that is, an activity intent upon profit - depends upon the finding that an actual, honest, however unreasonable or unrealistic, profit objective was envisioned.

WHOSE INCOME/DEDUCTION?

Another major question raised consistently by the Service is whether the income or deduction is attributable to the parent/agent or to the child/performer? A good working definition of a talent or personal manager was given in *Waisbren v. Peppercorn Products, Inc. 41 Cal. App 4th 246*, wherein the court noted that a talent/personal manager's primary function is to advertise, counsel, direct and coordinate the artist in the development of his career, including the direction of the artist/client's personal affairs. In *Anthony J. Carino, Jr., T.C. Summary Opinion 2002-140*, the execution of the personal management agreement by Mr. Carino, the petitioner, and his daughter did not constitute a change in "Mr. Carino's relationship with his daughter from parent to manager for profit." … "[H]e has no agreement or understanding in place providing him with a percent or interest in any **future** earnings…"

In *Fritschle v. Commissioner, 79 T.C. 152* (1982) the central issue was whether the income received by the taxpayer and claimed by the Service to belong to her children was actually the taxpayer's income. It was held that payment for work done at home mostly by taxpayer's children was taxable to the taxpayer, as she had sole responsibility for the performance of all work and the children merely assisted. *IRC §73* was not applicable because the children were not the actual earners of income. The critical factor viewed by the court was **the predominate command of the taxpayer over the income**, citing *Harrison v. Shaffner, 312 US 579* (1941). The court in *Johnson v. Commissioner, 78 T.C. 882* (1982) noted that the true earner cannot always be identified by pointing "to the one actually turning the spade or dribbling the ball." Thus, because the true earner cannot always be clearly identified, the issue of who controls the earning of the income is critical. Recall *§73* normally operates to tax a minor child on income he is deemed, in the tax sense, to have earned. If, on the other hand, there was a finding in Fritschle that it was the services of children that were contracted and that the children were the true earners of the income, *§73* would then tax the children on the income. For example, a baseball bonus paid to the mother was actually income to the major league baseball player. *Allen v. Commissioner, 50 T.C. 466* (1968), *aff'd, 401 F. 2d 398* (3rd Cir. 1969). Although the contract of employment was made directly by the parent and the parent receives the compensation for the services, the income would be considered taxable to the child because it was earned by the child. (*H. Rept. 1365, 1944 CB 821)*. In reality, this language merely recognizes parents as the contracting parties when, due to legal capacity, minor children cannot enter into valid contracts. Critically, it must still be shown that the services of the child were being contracted for and- more importantly- that the children controlled the earning of the income. (Fritschle).

In *Cecil Randolph Hundley, 48 T.C. 339* (1967), the business expense deduction was allowed for the parent/agent of a pro baseball player. The agreement between the two was based on the time spent in training and representing the player/child and it was clear that the ultimate receipt of payment was uncertain and undeterminable. However, payments were made to parent/agent after services were rendered but while the taxpayer parent was still engaged in the agent/manager trade or business. The court looked at the following primary elements: the time spent in coaching, training, and representing player, which included the diligent "cultivation of clubs, traveling." The court noted the agreement may not be arms length in the normal sense and must be carefully scrutinized, but that the agreement stood "every searching test." Further supporting the case was the testimony of independent witnesses who observed and testified as to the contract's existence.

Thus, it appears that the Service will continue to attack the identification of the income earner but it is clear that in some cases the courts will side with the taxpayer if the child did not **control** the earning of that income.

THE NINE (PLUS) "PRONG" TEST(S)

Treas. Reg. §1.183 is the most litigated aspect of an alleged hobby activity, yet in casual reading it appears to be broad and general enough to consider all valid points that might be raised by an entrepreneur. Unfortunately, the interpretation of the regulation has often been extremely restrictive. Treas. Reg. §1.183-2(a) notes in part that "*the determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Although a reasonable expectation of profit is **not** required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit… it may be sufficient that there is a small chance of making a large profit… an investor in a wildcat oil well who incurs very substantial expenditures is in the venture for profit even though the expectation of a profit might be considered unreasonable. In determining whether an activity is engaged in for profit, greater weight is given to **objective** facts than to the taxpayer's mere statement of his **intent***" (emphasis added).

Thus, the regulation gives credence for viewing all, not just limited, aspects of the taxpayer's situation. The example of a wildcatter is quite illustrative in that few expenditures of capital can be so worthless or so enriching, and such an argument could be easily raised for a child artist's expenses, as well as any new business venture.

Treas. Reg. §1.183(b) views the following matters as critical: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, that are earned; (8) the financial status of the taxpayer; and (9) elements of personal pleasure or recreation. The court in *Abramson v. Commissioner, 86 T.C. 360, 371* (1986) noted that while *§1.183-2(b)* has nine points it found that **no single item is controlling.** "A profit objective may be analyzed in relation to the nine factors set out in section 183 regulations, but those factors are not applicable or appropriate for every case. The facts and circumstances of the case in issue remain the primary test." A review of the nine points and judicial reviews notes some interesting and instructive contrasts.

Manner in which the taxpayer carries on the activity.

The Service views as important the carrying on of the activity in a businesslike manner: keeping books and records, following the business practices of similar activities, the change of operating methods and/or adoption of new techniques to improve profitability, and/or the abandonment of unprofitable methods. In *James T. Tarkowski, T.C. Memo 1989-379*, the court noted there was no profitability, no detailed business records, no plan of business, or no information on how much time spent -- all elements which are needed to be considered in a business versus hobby determination. *Lundquist v. Commissioner, T.C. Memo 1999-83*, noted, among other things, that the intermingling of accounts indicates that an activity is more closely related to hobby rather than business. *Golanty v. Commissioner, 72 T.C. 411* (1979), notes that in order to claim business deductions… the "burden now rests on persons to show that they intended to make profit." In this case, the taxpayer had substantial other income to live comfortably despite losses from horse breeding.

Lou Levy, 30 T.C. 1315 (1958), held that an artist's agent who invests money in hopes that the artist will become a star may deduct the related expenses. In contrast, in *Saul H. Nova, T.C. Memo 1993-563*, the case involved an agent/*father's* treatment of his son's golf career via deductions on the father's tax return as a business expense. The litigated issue did not revolve around the notion of a contract existing (i.e., the Carino issue) between father and son; rather, the court held that the sponsorship did not qualify as an activity engaged in for profit because of the taxpayer's "failure to calculate when he would receive a return on his investment" before entering into the agreement. Further, the court pursued a line of reasoning that the taxpayer failed "to require his son to meet goals or financial conditions in order to maintain sponsorship." *Christopher J. Bush, T.C.*

Memo 2002-33 further amplifies the judicial view of business principles and foundations on these matters: the decision was founded on the notion that "petitioner failed to create any type of budget or break-even analysis" in order to determine if a profit could possibly result from the venture. There, the taxpayer did not exhibit any effort to make the achievement of profits possible or the amount of capital necessary to achieve a profit. There was no attempt to obtain clients other than the child, nor were there requirements of expertise in dance or expertise in professional talent management. The court noted that the personal satisfaction Mr. Bush derived from the child's success "proved" the activity was not for profit. Bush operated the activity with a separate bank account and claimed that their intent was for profit.

In *Sullivan v. Commissioner, T.C. Memo 1998-367*, the profit motive was found lacking when no significant attempt was made to improve profitability. *Jesse Rupert, T.C. Memo 2001-179,* noted little or no history of engaging in activity for profit nor any personal involvement, and the activity was rules not for profit. The potential for profit was cited in *H. Connely Plunkett, T.C. Memo 1984-170*, including consideration as to whether the activity was likely to achieve a profit in the future. *David Krebs, T.C. Memo 1992-154,* was successful for the taxpayer and noted that a businesslike conduct, time and effort expenditure, and knowledge in the business indicated bona fide profit objective. In *Rick Richards v. Commissioner, T.C. Memo 1999-163* the taxpayer and wife were respectively engaged in writing and acting/modeling for profit and the court upheld their deductions despite losses. They had hired agents to negotiate screenplay prices, but unfortunately failed to profit due to the natural precariousness of the entertainment business. The wife had kept a journal of auditions and callbacks, had a long history in the profession, and had performed in various plays, commercials, and TV shows. *Wiles, Jr. v. US, 312 F2d 574* (1962), held that a business expense deduction was not allowed because a **persistent** failure to make a profit is **a** (not the sole) factor that may be considered. Losses that continue beyond the **period usually necessary** for an activity to become profitable may indicate the lack of profit motive.

The courts seem to constantly raise the bar (see *Bush* above) on what is considered a normal business activity. A review of these cases suggests that these activities are being held to a higher standard than many existing and legitimate enterprises. It is suggested that numerous operating but otherwise "legitimate" (perhaps more appropriately, profitable) business owners do not prepare a budget, much less a break even analysis; current owners may not even know of this business tool or how to use it. While it is true that new computer programs make the preparation of this analysis simple, the nature of most new businesses cannot be compared to the business practices of larger, well established businesses or the theoretical practices espoused by the courts. Similarly, few small businesses actually prepare business plans unless required to by a lender. While standard software programs are available to accomplish this "requirement," this activity is often perceived as a necessary evil for funding and is rarely completed unless explicitly required. And, when completed, the exercise probably contains little realistic planning.

It is suggested that the cumulative overhead to establish such requirements are prohibitive to many entrepreneurs and the courts are knowingly -- or unknowingly -- using these "theoretical" devices to deny for-profit determination. It is often opined that a business does not exist if one bank account is used both personal and business purposes, yet the same computer programs discussed previously can easily segregate data and separate the business and personal dimensions, one or two bank accounts notwithstanding. This fact is often overlooked in rational decisions on the subject. For example, numerous businesses -- especially construction companies -- can use one bank account for various distinct and important "jobs," yet the Service and the courts always seem to use the single bank account issue as the death knell for the struggling start-up business. In summary, in order to establish legitimacy, the courts seem to require a separate bank account, financial statements, record maintenance, good bookkeeping, budgets, break even analysis, corrective methods to achieve better results, return on investment analysis, contractual arrangements (arguable as seen below), and other sophisticated operational aspects often foreign to new entrepreneurs.

The expertise of the taxpayer or his advisors.

Points considered by the Service include the taxpayer's extensive study of accepted business, economic, and scientific practices, or consultation in accordance with such practices, which should not significantly vary unless the taxpayer is attempting to develop new or superior techniques in the business at issue. In *Kathleen A. Carr, T.C. Memo 1996-390*, it was held that expenses from a talent manager in developing and promoting an artist's career are essential to the business, thus deductible. "Talent managers" must obtain work for their clients in order to generate income for their businesses. Here, the taxpayer "organized, advertised, and put on showcases for directors, producers, and casting people involved in the entertainment industry to demonstrate the talents of her artistry." Accordingly, the ordinary and necessary expenses of a personal manager are deductible if they are incurred while developing the careers of clients. As expected, the manager must show expenses were indeed designed to expose their clients to the industry. The taxpayer bore the burden of proof concerning entitlement to any deductions claimed. *Colonial Ice v. Helvering, 292 US 453* (1934). "Normal and necessary" requires that the expenditure be normal, usual and customary, appropriate, necessary and helpful to the operation of the business. *Commissioner v. Tellier, 383 US 687* (1966

In *David Krebs, T.C. Memo 1992-154*, the court looked to a businesslike conduct of activity, time and effort, and noted that a **knowledge in the business** indicated bona fide profit objective. Similarly, in *Clayden v. Commissioner, 90 T.C. 656* (1988) the court noted that knowledge of the industry or consultation from those who know the industry shows the business was intended for profit. In *Rick Richards v. Commissioner, T.C. Memo 1999-163* the taxpayer hired agents to negotiate screenplay prices, his wife kept a journal of auditions and callbacks, had a long history in profession, and performed in various plays, commercials, TV shows. *Lou Levy, 30 T.C. 1315* (1958), determined that an artist's agent who is experienced in the area and invests money in hopes that they become a star may deduct the related expenses.

In this area, the courts appear willing to accept the taxpayer's hiring or engaging someone with expertise, again, forgetting the average person may not have the resources to afford such advice. While there is no doubt expertise is essential in today's complex world, it also seems that self education, including courses on similar matters, would also be as effective, and while this self education is mentioned in the regulation, the service and the courts seem to place a premium on prior experience and paid or other consultants, as opposed to self educational methods. That said, there are nonetheless court cases that recognize the self education of the taxpayer as an important factor.

The time and effort expended by the taxpayer in carrying on the activity.

The regulation suggests an investigation of the amount of personal time and effort devoted to the activity, particularly if the activity does not have significant personal or recreational aspects, and includes withdrawal from prior occupation to devote to the activity. A limited amount of time dedicated to an activity does not indicate a lack of profit motive where competent and qualified persons perform such activity.

Time and effort is not clearly defined as that expended during the normal work day only. Most entrepreneurs dedicate long hours during non business hours to their businesses, yet these do not seem to be held as critical as those during so-called normal business hours. Once again, if paid or other agents can do the work, the courts seem to have little trouble with this prong, but, again, most entrepreneurs only have themselves and perhaps their immediate family members.

Expectation that assets used in activity may appreciate in value.

The expectation in this alternative prong is that the value of the entity's assets will increase in economic value, accordingly allowing the business owner to eventually report an economic profit, despite possible year-to-year operating losses. In *James Tinnell v. Commissioner, T.C. Memo 2001-106*, sales from CDs were shown to have realistic future profit potential from an otherwise speculative activity. Logically, early recordings of successful artists are viewed as extremely valuable and traditional assets, such as but not limited to real estate, can be more readily shown to have appreciable value, despite the fact those properties may not be currently generating a positive cash flow.

It is rather interesting that there is no human "appreciation" considered by the Service or the courts; rather, the Code and the Service view "assets" as traditional brick & mortar and technological, as opposed to the most scarce and unique resource of all: human. Naturally, some might be taken aback if we were to view humans as balance sheet assets. In some foreign countries, human capital is recognized and the issue has been debated in the United States. It follows that, when considering other regulation guidance, the human potential for appreciation should be considered rather than ignored. If anything, the human resource has enormous and trainable potential; the prima facie case is made by summing up the countless tax dollars spent for education. Yet when it comes to the provision of a clear and precise path for a prodigy child with a taxpayer's life, the Code discounts the notion.

The success of the taxpayer in carrying on other similar or dissimilar activities.

The Service and courts consider whether the taxpayer had engaged in similar activities in the past and/or converted activities from unprofitable to profitable enterprises despite a present lack of profitability. In *Rick Richards v. Commissioner, T.C. Memo 1999-163* the court noted the long history in the profession and the fact that the taxpayer had performed in various plays, commercials, and TV shows. Conversely, in *Christopher J. Bush, T.C. Memo 2002-33,* there was no showing of the taxpayer's attempt to obtain clients other than the child, and no expertise in dance or professional talent management was required.

The Service and the courts seem to believe a true business should be expansive (e.g., obtain new clients), and quite often this belief is correct. Yet, with limited resources, it must also be agreed that expansive activities too early in the life cycle could doom the business. The multiple failures of attempted mergers of firms with vast amounts of human and financial capital provide ample examples. Further, expansion many times requires the dilution of quality and the additional commitment of personal time, requirements that struggling entrepreneurs simply cannot meet.

The taxpayer's history of income or losses with respect to the activity.

The regulation notes that a series of losses during the initial or start-up stage may not necessarily indicate that the activity has not been undertaken for profit, but losses should not continue beyond the period which "customarily is necessary" to become profitable. Fortuitously, losses sustained due to unforeseen circumstances beyond the control of the taxpayer should not be considered by IRS auditors. In *Stella Waitzkin, T.C. Memo 1992-216*, a profit motive was established despite a 10-year record of losses. Even though the taxpayer had other sources of income, the taxpayer had gained greater recognition and revenues each year. Compare: *John G. Parker v. Commissioner, T.C. Memo 2002-76* where the court held the petitioner was not engaged in "for profit" activities, with one reason being he had a record of substantial losses over many years. In *Christopher J. Bush, T.C. Memo 2002-33*, the taxpayer did not exhibit any effort to achieve the profits possible or to consider the amount of capital necessary to achieve a profit.

Perhaps the most subjective of all the prongs, the regulation attempted to establish a firm time frame for an "acceptable" loss period. However, as can be seen from the various cases, such a time line is practically unrealistic; each situation is unique. Yet, this three- strikes-and-you're-out mentality pervades.

The amount of occasional profits, if any, which are earned.

The regulation suggests that profits versus losses incurred should be compared to the taxpayer's investment (and assets of the business). From such a comparison, the regulation then views occasional small profits versus a large investment as unpersuasive to the finding that a for-profit enterprise exists; large occasional profits from small loss/investment criteria are considered more compelling. The regulation notes: "An opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated." *Hirsch v. Commissioner, 11 AFTR 2d 1156* (1965) noted that a profit or income motive must dominate the taxpayer's business in order to consider the activity a trade or business. Tempering that rather strict view is *Hunter v. Commissioner, 91 T.C. 371* (1988), where the taxpayer must have "an expectation" to make a profit, although such a view **might not be reasonable** but nonetheless allowable as long as they enter into the activity with the profit motive and continue the activity in such a manner. In *Stella Waitzkin, T.C. Memo 1992-216* a profit motive was established despite recording losses for 10 years, and despite the taxpayer having other sources of income as the result of the taxpayer gaining greater recognition and revenue each year. Conversely, in *John G. Parker v. Commissioner, T.C. Memo 2002-76* petitioner was not engaged in a "for profit" activity, one reason being he had a record of substantial losses over many years.

It would seem here our case of a child prodigy is truly on point with this prong of the tests, as it cannot be denied that certain outcomes (such as singing, sports, and the like) could be highly lucrative. However, the Service argues such is not the case when dealing with human as opposed to "capital" resources, vis-à-vis oil fields and the like.

The financial status of the taxpayer.

The regulation urges a comparison of alternative income and capital versus the suspect activity. It also suggests that substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not undertaken for profit, especially if there are personal or recreational elements involved. For example, in *S. K. Johnson III et ux, T.C. Memo 1997-475* the court noted the "fact that taxpayers could afford to operate activity at a loss was irrelevant."

In general, this one prong is often used as an attempt to show that the "true" intent of the taxpayer was simply to provide a tax write off while assisting his child. No doubt this can be the case in numerous audits, however, the regulation is also clear that the review must consider all aspects of the matter, and not utilize a one-size-fits-all approach. Thankfully, it is clear all attributes must be considered.

Elements of personal pleasure or recreation.

While personal pleasure or recreation is considered, it is not necessary that an activity have exclusive intention of realizing a profit or maximizing profits. The regulation notes: "[a]n activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph." In *Henry L. Sutherland, T.C. Memo 1966-155,* if the motivation of acting as agent for child was **primary for child's benefit** as opposed to purposes of *§ 183* [activity engaged in for profit, a/k/a the. 3 of 5 year rule], he cannot deduct expenses. In *Christopher J. Bush, T.C. Memo 2002-33*, the court noted the personal satisfaction of Mr. Bush received from seeing the child succeed "proved" the activity was not for profit. Conversely, in *Cecil Randolph Hundley, 48 T.C. 339* (1967) the business expense deduction was allowed for pro baseball player by the parent/agent. As noted previously, the agreement between the two was based on time spent in training and representing player/child, and it was clear that the ultimate receipt of payment was uncertain and undeterminable. The court looked at the following primary elements: the time spent in coaching, training, and representing player, which included the diligent "cultivation of clubs, traveling," etc. The court noted the agreement may not be arms length in the normal sense and must be carefully scrutinized, but that the agreement "stands every searching test."

The Service and the courts seem to enjoy using this prong as a reason why the situation obviously cannot be for profit. The *Bush* case above provided good example of assuming the worse and ignoring the realities of the situation. However, the *Hundley* case is a clear example that, if properly handled, the personal enjoyment factor can be sufficiently negated. To say personal enjoyment is a tipping of the scales seems to be an excessive weighing of the situation, as few people, when being truthful, will admit to doing something constantly if they did not enjoy the situation.

SUMMARY

It would appear that, in order to successfully defend from a hobby loss attack, the following must be achieved, documented, and/or considered: the taxpayer must attempt to follow strictly the guidelines of *Treas. Reg. §1.183* and consider the various court rulings outlined previously. These requirements seem to include (but appear to be ever evolving expansively): a business plan, a break even analysis, a budget, separate bank accounts, a good accounting system, the conduct of activities in a businesslike manner for profit, utilizing contractual arrangements (although subject to very close scrutiny), and preferably "forming" or conducting the entity as a formal business entity, such as a corporation, LLC, or partnership. There should be consideration of hiring and engaging outside experts, and/or proof of extensive and documented self study, and preferably actual working experience in the area. There appears to be a premium placed on the high devotion of personal time (particularly if one quits a former job and concentrates on the new activity) and effort to the activity during normal business hours, although hired agents are acceptable. If profits are not forthcoming there is an expectation of entity assets appreciating in value, but not human resources. There appears to be a definite emphasis on the entity obtaining more or new clients as quickly as possible. The courts and Service will review the profit and loss history, although history is an oxymoron due to the short time period involved and the definite bias towards the 2 of 5 year rule. The view of speculative risks and therefore occasional profits for highly speculative ventures is ordinarily sufficient but again, not with human resources alone. The activity is likely to be highly scrutinized if the owner has other financial resources and appears to be benefiting from a tax write-off. And finally, while not in and of itself sufficient per the regulation, the notion of personal enjoyment is usually viewed as the 'icing on the cake.'

All of this certainly sounds like a perfect business approach in a perfect world; however, if all the effort is expended on activities such as maintaining records and expending funds, there would be little if any time or resources to expand the business or maintain operations. There is no doubt the courts review the cases individually and with great detail. However, it is suggested that the courts sometimes may forget to recall the trials and tribulations of individuals versus corporate situations, where more structure is normally expected. There is no doubt some taxpayers attempt to take advantage of a system for tax reasons, but many others are attempting to legitimately forge a better tomorrow for themselves and their families.

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THE ENTREPRENEURIAL AUDIT: INNOVATION EFFICIENCY IN THE 21ST CENTURY

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ABSTRACT

An entrepreneurial audit is a comprehensive examination of a firm's entrepreneurial and innovation characteristics. It evaluates the ability to identify and respond to opportunities, create and maintain an "entrepreneurial" environment, analyze the utilization of resources, and understand organizational efficiency to maximize time-to-profits. This corporate entrepreneurial behavior has been shown in repeated studies to improve financial performance.

This entrepreneurial audit uses a qualitative managerial analysis approach to allow for the diversity of executive perspectives and organizational behaviors to be fully encompassed. The audit begins with assessing the fundamental mission, vision, and competence of the corporation. Then, six component areas of an audit are scrutinized: 1) Internal Environment, 2) Entrepreneurial Culture, 3) Starting Points of Innovation, 4) Innovation Process, 5) Team Dynamics, and 6) Resource Allocation. Appendix A contains a summary of the questions that an executive may use to assess a firm's entrepreneurial environment and support for innovative behaviors.

The conclusions of the entrepreneurial audit are an indication of a firm's entrepreneurial momentum and innovation efficiency. This momentum is a framework for the firm's ability to respond to environmental opportunities and threats in the 21st century. The audit summary offers an organization a baseline of innovation efficiency and a strategic tool in which to begin entrepreneurial renewal.

There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things.

Niccolo Machiavelli

ENTREPRENEURIAL AUDIT INTRODUCTION

In the global markets of the 21st century, businesses in pursuit of sustained competitive advantage are finding that lower costs, higher quality, and improved customer service are not enough to maintain their competitive edge. As the pace of product, service, and process innovation increases, companies must be better tuned to compete in their own fiercely competitive industry. They must be faster and more flexible, aggressive and more innovative in order to maintain their competitive edge…they must be more entrepreneurial.

One of the more bewildering business outcomes is why certain companies continue to produce new products and process innovations as a matter of practice-3M, General Electric, Disney, Intel, Sony for example, while others struggle to produce even a glimmer of originality. Most corporate executives would acknowledge that their business has untapped potential in the new competitive environment, and yet, few seem to excel at planning for innovation and using the entrepreneurial process as a key strategic business asset. While several notable books have been authored on this topic, including *Fifth Discipline* (Senge), *Innovator's Dilemma* (Christensen), *Leading the Revolution* (Hamel), and *Innovation* (Kanter) to aid top management, most corporate environments remain geared to preserve the status quo.[1]

If Post-It® Notes, Pentium® 4 Microprocessors, or Playstation® innovations are perceived to be valuable product offerings to customers and the income statements of the firms that create them, then understanding entrepreneurial environments should be a priority. An Entrepreneurial Audit assists in assessing a firm's environment for innovation efficiency and time-to-profit within new ventures. Crucial to sustaining competitive advantages is a method for inspecting the entrepreneurial-ness of an organization. In the end, management must understand the environment the firm has created for itself as it regards fostering innovation and new ventures; an environment that generally allows for a short window of opportunity and wealth generation.

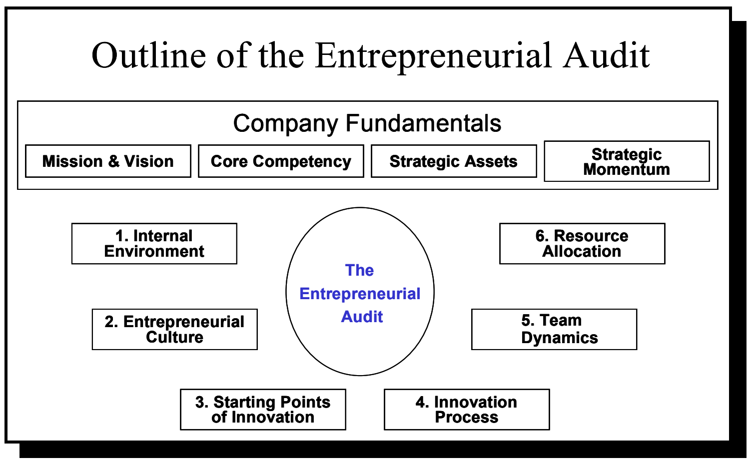
The fact that an entrepreneurial posture produces superior financial results has been illustrated repeatedly (MacMillan & Day 1987; Miller & Camp 1986; Morris & Sexton 1996; Wiklund 1999, Zahra and Covin 1995). While the goal is obtainable for some, understanding where you are today in the process of becoming more entrepreneurial is the purpose of this article. This entrepreneurial audit offers a qualitative approach to discern a firm's entrepreneurial and innovation characteristics. While there are quantitative instruments available to access entrepreneurial posture or intensity (Hornsby, Kuratko, and Zahra 2002; Morris and Sexton 1996), some executives may find it futile to attempt to distill a firm's entrepreneurial assessment into a quotient. In fact, using a questionnaire, or a few metrics already gathered as a matter of business practice, may not be truly taking the pulse of a firm's ability or inability to change itself and respond to market shifts and opportunities.

Thus, this article will offer one method for comprehending an organization's entrepreneurial norms and it begins with assessing the fundamental mission, vision, and competence of the corporation, then six components of an audit are scrutinized: 1) Internal Environment, 2) Entrepreneurial Culture, 3) Starting Points of Innovation, 4) Innovation Process, 5) Team Dynamics, and 6) Resource Allocation. The Entrepreneurial Audit will pose questions for each component section. Appendix A contains a summary of these questions. Figure 1 outlines each of the inputs that must be cohesive in order to excel at innovation efficiency.

ENTREPRENEURIAL FUNDAMENTALS: VISION, ASSETS, AND MOMENTUM

The entrepreneurial audit begins with assessing the fundamentals of the corporation, its mission and vision, strategic assets, and strategic momentum. For an organization to succeed in today's ultra-competitive global environment, it is essential to understand the strategic capabilities and areas of strengths. Companies continually have a multitude of innovation ideas for management to evaluate. The entrepreneurial potential of the company is closely aligned with the fundamentals of the company. Understanding these fundamentals is the first step in the entrepreneurial audit process.

Figure 1



The company's mission and vision set a direction for your organization that is a central point for all strategic decisions, both for current business and new innovation. What is the five-year vision of your organization? Can your organization articulate the role innovation plays in that vision? Does it match? The mission defines where the company is headed, while vision describes what it looks like when you arrive. When potential new innovations are aligned to the company mission and vision, the organization is in a better position to support the project to make it successful. Corporate antibodies and barriers to success are lessened or removed altogether.

Strategic assets are those resources the organization relies on to create current revenue flow. They are also the assets the organization relies on to engage a new opportunity and are the genesis for sustainable competitive advantage. Can you quickly list three of your corporate strategic assets? How does this list of new opportunities map to the strategic asset list?

As an example, Coca-Cola's strategic asset list would include their secret cola formula, their brand, diverse beverage and food lines, and worldwide distribution network. At Disney Imagineering Studios ideas are strategic assets. There are several fully developed, but dormant, concepts on the Disney Imagineering Studio shelves regarded as valued assets. In fact, they are stored on the lower shelves so they can be easily uncovered time and again for inspiration (Jones 1996).

Momentum is a force that can assist overcoming many uphill battles in the realm of innovation. Offering impetus and direction, momentum carries customers and discovery to new heights. Intel Corporation's 34-year history of strategic momentum in silicon innovations has led to eight significant market moving microprocessor cycles, from the 8086 through the Pentium® 4 microprocessor. Intel is rewarded with 75% of the global market share and is accepted as the standard of today's personal computer industry. Can you easily identify the top two areas of your business that have market or technology momentum?

INTERNAL ENVIRONMENT: CAPABILITIES, STRUCTURE, AND COMPETENCIES

The Entrepreneurial Audit facilitates the process to identify the capabilities, structure, and competence of a company as they relate to entrepreneurial potential. These elements provide the internal foundation for entrepreneurial and new innovation effectiveness of a company. The key is to understand how engineering, marketing, and operations interact to create and deliver new opportunities.

Capabilities of the firm are the means by which the objectives of the organization get accomplished; it is a matter of matching an organization's strength to environmental opportunity. Capabilities can be the skills or professional attributes of the various departments, the size or capacity of the various functional departments (e.g., marketing, engineering, etc.), and the experiences and track record of the departments. To launch the 2002 Envoy at General Motors, an entirely new SUV vehicle, required not just the standard new product development steps. The intelligent engineering design, the manufacturing ability, and factory capacity allowed GMC to produce a refreshing and innovative SUV with such excellence that it won Motor Trend's 2002 Sport/Utility of the Year.

Organizational structure is a mechanism that can either help or derail entrepreneurial endeavors. People, communication, and ideas are built to support innovation, yet they can also interfere. The devastating effect of corporate silos stifles breakthroughs. Intel Corporation uses a multi-discipline Product Life Cycle (PLC) team approach. One such example is the Communication and Internet Server Division (1999-2000) that used the multi-discipline PLC team structure to create a market-leading 1U rack server for the Internet data center market. The functional departments, marketing, engineering, operations, and manufacturing, have specific roles within the PLC process for new product development. Those roles are defined within the PLC structure for the objectives of the project to be accomplished. The specific objectives for this project were: 1) robust product features, 2) flexible configurations, 3) low material cost, and 4) gain time-to-market advantage. The PLC cross-discipline team applied the PLC process and utilized the mechanisms to organize the project and meet the milestones throughout the development process to launch the new product successfully in the spring of 2000.

The core competence of your organization is regarded as the cornerstone of entrepreneurial strategy. It is the combination of capability and structure of the company. A firm that desires to continually maximize its use of resources for new innovation opportunity must understand how core competency relates to entrepreneurial efficiency. It is this efficiency that indicates where it can excel, and conversely, where the firm cannot and should enter. Many firms fail to create lasting entrepreneurial value simply because they venture outside their core area of competence (Zook and Allen 2001). What is your company's core competencies? Does everyone in the company understand the firm's core competence as it relates to innovation?

Toys-R-Us understands their competency as toy merchandising in the children's retail market. The successful expansion into children's clothing allowed them to use their expertise to organize this new venture, select styles and trends for the stores, and to market effectively to the target audience - parents (Block and Macmillan 1993).

ENTREPRENEURIAL CULTURE: INNOVATIVENESS, RISK TAKING, PROACTIVENESS

An entrepreneurial culture often starts at the top. When former 3M CEO and scotch tape inventor William McKnight broke his leg, he found plaster casts to be heavy and tiring. 3M scientists acquired a technology for synthetic materials that were lighter and stronger than plaster. Instead of accepting six weeks of drudgery, this action-oriented culture resulted in a fiberglass-reinforced synthetic casting tape that is widely used today.

Within the firm, innovativeness, risk taking posture, and proactiveness will directly affect the capacity to be creative and entrepreneurial. Do the underlying beliefs and assumptions that employees have regarding their conduct and expectations (i.e., culture), support original thought, calculated risk, and action? These are the firm behaviors that foster change and produce new opportunities. Corporate entrepreneurship is not determined by desire, but by organizational culture and action.

Innovation emphasizes research and development that leads to new products or new processes. An innovative culture seeks unusual or novel solutions to problems, supports technical leadership, and covets brainstorming as much as cost savings. While most organizations claim to be innovation-oriented, few actually use measures to gauge innovation; rather, they concentrate on optimization. What metrics does your organization use to measure entrepreneurial innovation?

Risk taking is a willingness to pursue opportunities boldly and aggressively, but not recklessly. The individual willing to move forward when others are doubtful or unable to see the potential are those supporting an entrepreneurial culture. These people, or even committees, are willing to explore risky growth opportunities, make necessary decisions despite uncertainties, and be aggressive in responding to competitors. This posture is sometimes in short supply because few managers are fired for neglecting to pursue an opportunity when compared to those who do not meet this quarter's numbers.

Proactiveness is concerned with implementation and taking determined action to bring an entrepreneurial opportunity to realization. An idea can gain support from 10 people and then get derailed by just one individual. But action, especially early wins with regard to an opportunity, is more difficult to scuttle. Thinking and being innovative is necessary, but hardly sufficient. Champions move quickly past the identification of opportunity to the implementation of their innovative concept. A proactive culture creates an internal strategy, drafts resources, and outlines milestones while others are still at the drawing board. How many unsolicited business plans does your CEO receive from managers each year? Do you consider your culture proactive, reactive, or unresponsive?

STARTING POINT OF INNOVATION: INFORMAL, FORMAL, AND CUSTOMER

The genesis of new innovation is of vital interest to an audit, and an organization's health. Domains that can be identified as breeding grounds for worthy ideas must be nurtured and cultivated. Where is the birthplace of your organization's new business ideas? Areas of particular interest to an audit include informal, formal and customer mechanisms to foster innovation.

Many organizations have informal methods for introducing ideas for products or new processes. Everyday, people get together at lunch and discuss various topics, but often wind up talking about potential inventions that challenge their wisdom and invigorate them personally. How often do you see sales, marketing, engineering, or manufacturing people sitting together at lunch sharing the brown bag experience? The outcome is the exploration of thoughts that, coupled with ingenuity, create new products. Another informal method to disperse valuable ideas is the use of a suggestion box (most currently suggestion e-mail). The utility of this approach varies widely depending on the perception of what is actually done with the input.

Some of the more entrepreneurial companies obtain opportunities by offering a more formal approach, while still inviting everyone's participation.

Are all your employees offered a forum where they feel invited, if not obligated, to submit innovative ideas? Some firms have processes already in place; Disney has the Gong Show, Texas Instruments it is the IDEA program, and Royal Dutch/Shell offers the "Game Changer" program.

Shell allocated $20 million to invest in employee-generated ideas. During a three-day innovation lab, the ideas were coached, financial plans developed, and crisp 10-minute presentations assembled. Funding ranged from $100,000 to $600,000 in 1999 and of Shell's five largest growth initiatives, four had their genesis in the Game Changer process (Kanter 1983). The IDEA (Identify, Develop, Expand, and Action) initiative at Texas Instruments opens the door for proposals submitted to one of forty worldwide IDEA representatives with an immediate $25,000 with a stroke of the pen. Approximately $500,000 to $1 million is spent on this program annually to fund innovativeness.

The 'Gong Show' at Disney occurs three times each year and invites employees to pitch film ideas to senior executives. Colleagues are used to first critique the business concept and presentation, and then they unleash their idea upon management. Approximately 40 ideas are shared each session and feedback, positive and negative, is shared immediately (McGowan 1989). Again, the purpose for uncovering innovation starting points is to identify potential areas or programs that cultivate discovery and warrant investment.

The customer is an integral starting point of innovation. Customers often instigate innovation, set market timing, and confirm the "customer value proposition" of your product's success or failure. What mechanisms does your firm have to direct customer feedback to the appropriate product group?

The Customer Value Proposition:
Customer Value = Customer Benefit - Customer Cost

Expectations of your company by the customer also set a pace for innovation in products, services, and processes. The customer dynamics in the marketplace determine modifications to your organization's strategy and structure. For example, a rapidly expanding product line, such as consumer electronics DVD players, will require Sony to plan for appropriate product cycling, staffing, and service infrastructure. Customer's expectations, perceptions, and reactions to your new innovations are crucial to the next generation of products or services.

A good example of customer based innovation is "Build-Your-Own" PC offered by many of the leading personal computer companies (e.g., Dell, Hewlett-Packard, etc). The customer is provided a kiosk at a retail store or a "configure to order" web site for them to work through selections and create a tailored order for their exact needs, peripherals, performance, colors, etc. Ultimately the customer determines if you are innovative and what financial success you will have in the market place.

INNOVATION PROCESS EVALUATED: EFFICIENCY, SUCCESS, AND FAILURE

New innovation revenue is the life-blood of any healthy organization - especially in highly competitive industries. At 3M for example, the corporate financial planning strategy is to have 30% of all revenue over the past four years be new innovation revenue. If a new venture within the organization can shave one-third off the development cycle, how much is that worth to your organization? There should be no reasonable argument against better time-to-money and time-to-profit efficiency, except for when quality or safety is compromised. What is your average time-to-profit?

Innovation cycles can vary widely from industry to industry. Pharmaceutical companies research and test drugs for years and General Motors may take five years to develop a new car. Contrast that by Sony's rapid prototyping processes that can test a new product concept within weeks and have it to market within months. Clearly, the type and pace of successful innovation varies by industry, and changes by new market dynamics as well, e.g., the Internet. However, if a relative and significant percentage can be shaved off your development cycle, the payback is clear. The Entrepreneurial Audit endeavors to find the bottlenecks for time-to-profit efficiency. Do you have a mechanism to gauge the profit timeline and adjust the performance of your organization given specific profit goals? What are the best practices and benchmarks in your industry to align your organization to compete?

Efficiency is one element; continued learning from mistakes is also paramount. A vital element to future new venture success is recognizing what has worked and that has not from a historical innovation perspective. Successes can be modeled as BKM's (Best Known Methods) for future ventures. Seasoned members of the successful team can participate in future ventures to strengthen the new organization and improve the learning curve. How does your firm cross-pollinate experienced employees for future success of new ventures? Beyond success and failure is the documentation of the venture's key discoveries so organizational learning can occur. Is the management of a current successful or failed venture required to document experiences for the corporate knowledge bank?

Failures are readily and quickly ignored or buried in obscurity sometimes due to politics and the embarrassment of the failed endeavor. Not so, at General Electric. Failure is a key learning tool for the organization. "Intelligent failures" are supported by the organization as key learning experiences to be recognized. The Halarc, an innovative new light bulb intended to last ten times longer than a standard bulb using a fraction of the energy, was a large gamble at $50 million development investment. However GE quickly learned consumers were not ready to pay $10.95 for a "revolutionary" new light bulb in the late 1970's. The project failed. But, instead of "punishing" the Halarc team, GE celebrated a great try by handing out cash awards and promoting several Halarc team members into new jobs. GE wanted everyone to know that it was okay to take an intelligent "big swing" at a new innovative product, and miss. Does your organization offer "get out of jail cards" for those who risk and fail at a venture?

TEAM DYNAMICS:
CHAMPION, SPONSOR, REWARDS

Venture capitalists understand that ideas are a dime a dozen, that only execution counts. So how does an organization execute? It is usually through a team of motivated individuals with a leader at the helm and a senior advocate eliminating obstacles. Effective entrepreneurial teams generally have a champion, a sponsor, and rewards to rouse the innovative spirit.

Champions are people who encourage projects during critical stages, keep decision-makers and sponsors informed, lead team members, and enthusiastically promote the project at all levels of the company. These champions excel at forgoing alliances with others, internal and external to the firm. One report noted that 90% of raw ideas actually never advanced beyond the idea generator's desktop (Howell and Shea 2001). Thus, understanding the market opportunity, envisioning the resources and steps required to produce outcomes, and building support via communication are the coveted people who move ideas from a desktop to a marketplace. Do you recruit and retain future champions when hiring? What percentage of your organization is filled with potential champions?

To succeed, champions need someone to provide cover on occasion. This person, called a sponsor, provides clout, occasional protection, marshals resources, and offers coaching in an effort to nurture an idea until it gains momentum. Sponsors offer advice and imitate knowledge on how to be effective within the broader organization. Without this advocate, success can be elusive. In short, a lack of internal direction and support is highly detrimental to success. Art Fry, of Post It Notes® fame, and Ken Kutaragi, the inventor of Sony's Playstation®, both had sponsors to support their successes. From an audit perspective, look at your senior managers and see who specifically has the interest and the talent to mentor an innovation-minded team. Currently, whose people are the most entrepreneurial on an ongoing basis?

The final part of the team dynamics is remuneration for risk taking, extra work, and intellectual creativity. Many people seek financial rewards; some seek power, status, or the freedom that innovation brings to them personally, thus remuneration is as varied as the individuals involved. While most accept that personal financial wealth cannot match that of the outside entrepreneur, offering something for fomenting improved firm performance is essential. One must review the firm reward system to understand if the compensation offered is motivating people beyond their wildest dreams. How does your organization reward innovative people?

IBM named its first eight Fellows in 1963 in recognition for prominent technical accomplishments. This status entitled the recipient to five years of support to pursue novel or innovative opportunities. Other reward avenues to motivate might include on-the-spot awards, paid vacations, innovator of the month awards, bonuses tied to revenue generation, or outright shares of stock. Not all risks to the company are the same. Are your rewards the same? It is important to note that the creativity and passion that drive the team is often internal to the individual and thus difficult to finesse. The bottom line is to understand what truly motivates your people to pursue their ideas and passions.

RESOURCE ALLOCATION: STRATEGIC, TRADITIONAL, SKUNK WORKS

For entrepreneurial activities and innovation to occur within the firm, resources must be made available in some manner. How does your firm earmark or attract resources as it regards supporting new products? There are generally three approaches to appropriating resources to new endeavors: strategic speculation, traditional new product development, and skunk works projects.

Strategic speculation is investment in products and innovations believed to hold great promise for the company during the next year or two. Thus, these projects warrant special attention and are offered unparalleled access to equipment, people, and financial resources. Budgets for these endeavors are often set at the highest reaches of the organization through a special disbursement or perhaps part of a new venture budget. Pioneering firms digging at the frontiers of their respective business sectors are constantly looking for new innovations to secure their future. Banking on new significant innovation is key to this strategy.

Traditional new product development is a mixture of marketing, engineering, and management working together to craft new goods, services, or processes. Lines of responsibility are usually clearly drawn and boundaries are inferred from historical norms. This approach for resource allocation generally is more structured, having been the traditional method for some new products brought to market. Budgets are set during the annual process and widespread communication regarding the product is generally the custom in this approach.

Skunk works projects start as small enterprises and individuals are often left to their own devices to procure the resources required. 3M's Post-It Note® is often considered the pinnacle of skunk works success. Under this system, individuals scrimp, scrounge, or "borrow" people, assets, or facilities to create a new product for the organization. Often, this approach has zero financial resources earmarked at the start. Thus, individuals may toil with their ideas during regular business hours, but nights and weekends are when progress is achieved since they are not working on officially sanctioned projects. The counterculture mentality of skunk works initiatives often put them at odds with others in the organization, but to these people, another's contrary opinion should not prevent progress. What are skunk works projects within your firm right now?

In short, there is no hierarchy of resource disbursement; no one approach is necessarily better than the others. But if multiple methods are available for stimulating innovation efficiency and entrepreneurism, the more likely desired results will be obtained. From an audit perspective, the bottom line is which, if any, of the three resource methods does your firm offer to support entrepreneurial enthusiasm?

CHALLENGES OF AN ENTREPRENEURIAL AUDIT

The obstacles to conducting an Entrepreneurial Audit are the same as those faced by firms attempting to be innovative by developing new products and services. Most stumbling blocks are not linked to environmental conditions or even technological challenges related to the product itself. Most impediments are internal to the firm with people frequently at the top of the list (Morris, Davis, and Ewing 1988).

Table 1 offers a list of factors that have been found to constrain the entrepreneurial spirit in organizations. Resistance to change, lack of motivation, fear of failure, resource constraint, and corporate structure were the main constraints to entrepreneurial behavior. Moreover, the mere act of asking questions or seeking opinions in an audit is enough to make many employees nervous or outright fearful, especially those who covet the status quo. Thus, confidentiality must be guaranteed and perhaps independent auditors should be used. Employees often perceive an audit as an opportunity to unload negative feelings about the organization or specific individuals. The auditor can learn a great deal from this information but must protect everyone's interests while remaining highly determined to grasp the reality of the climate.

The Entrepreneurial Audit provides any organization the opportunity to critique itself in a practical and open process. Management has an internal and an external option for conducting an Entrepreneurial Audit no matter which organizational situation they find themselves. An internal self-diagnosis approach of auditing entrepreneurial efficiency relies on three elements for success; 1) credibility, 2) an unbiased audit team, and 3) a confidential approach utilizing the Entrepreneurial Audit structure. Alternatively, a professional consultant with expertise in entrepreneurial organization process and innovation efficiency can be utilized if there is potential for significant turf protection or emotion from the organization. Employees should be encouraged to participate in a candid, active, and involved way. If anonymous feedback methods will stimulate increased participation, then offer a means to conduct the audit in confidence.

Table 1: Factors that Impact Corporate Entrepreneurial Spirit	
1.	Absence of innovation goals
2.	Resistance from others
3.	Top management support
4.	Resource availability
5.	Firm's posture towards failure
6.	Reward system does not promote such behaviors
7.	Rigid formal planning systems
8.	Politics and turf protection
Adapted from Morris and Trotter (1990)	

ENTREPRENEURIAL AUDIT SUMMARY

In review, the objective of the Entrepreneurial Audit is to evaluate how to create a more efficient, innovative, and competitive organization. Conducting an Entrepreneurial Audit within the six areas described is an important declaration to managers, employees, and customers that the organization values efficiency, new innovative ideas, and competitiveness. It states to the organization that its interest lies in progressing and improving opportunities for invention. It also states that efficient execution is crucial for a sustained competitive advantage. The organization will begin to understand that new innovation, when done efficiently, will have a positive impact on the bottomline, thus, creating additional opportunity. Table 2 contains a summary justification for conducting an Entrepreneurial Audit.

Table 2: Entrepreneurial Audit Justification

1.	Provides a thorough critique of your organization's competitiveness via a high-payback (ROI) exercise.
2.	Asks probing questions about the organization effectiveness to stimulate creativeness.
3.	Moves people off the status quo tendencies, which are a detriment in today's competitive environment.
4.	Generates an understanding of how much your organization is acting like an innovative-minded team.
5.	Evaluates if the competition is out-innovating you.
6.	Defines the bottlenecks to improve innovation process.
7.	Prepares your organization for new opportunities.

An Entrepreneurial Audit will allow you to clearly understand the strengths and weaknesses of your organization as it relates to innovation efficiency. The bottom line is that entrepreneurial posture and firm performance have been positively linked by several studies over the years, irrespective of past performance. Entrepreneurial firms do better overall, understanding a firm's entrepreneurial innovation efficiency begins with this entrepreneurial audit process.

The conclusions of the Entrepreneurial Audit are an indication of a firm's entrepreneurial momentum and innovation efficiency. This momentum is a framework for the firm's ability to respond to environmental opportunities and threats in the 21st century. The audit provides strategic tools in which to begin entrepreneurial revitalization.

ENDNOTES

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APPENDIX A

Sample Entrepreneurial Audit Questions Summarized

I. Entrepreneurial Fundamentals: Vision, Assets, and Momentum

- ♦ How does your organization foment, analyze, and prioritize a new opportunity?
- ♦ What is the five-year vision of your organization? Can your organization articulate the role innovation plays in that vision? Does it match?
- ♦ What are three of your corporate strategic assets?
- ♦ Where in the organization are your top two areas for market or technology momentum?

II. Internal Environmental: Capabilities, Structure, and Competencies

- ♦ What resources and abilities can you immediately count on if a new business opportunity arises?
- ♦ What structures are in place for engineering, marketing, and operations to interact to create and deliver on new opportunities?
- ♦ How do you define your core competency?
- ♦ What percentage of your employees understand the firm's core competence and how it relates to innovation?
- ♦ How does your list of new opportunities map to your core competency?

III. Entrepreneurial Culture: Innovativeness, Risk Taking, Proactiveness

- ♦ How do the underlying beliefs and assumptions that employees have regarding their conduct and expectations (i.e., your culture) support original thought, calculated risk, and action?
- ♦ Does your organization use metrics to measure entrepreneurial innovation?
- ♦ How many unsolicited business plans does your CEO receive from managers each year?
- ♦ Do you consider your culture proactive, reactive, or unresponsive?

IV. Starting Point of Innovation: Informal, Formal, Customer

- ♦ How are customers invited to define the next generation of your product?
- ♦ Where is the birthplace of your organization's new business ideas?
- ♦ Who are the most creative people in your firm?
- ♦ Are all your employees offered a forum where they feel invited, if not obligated, to submit innovative ideas?

V. Innovation Process Evaluated: Efficiency, Successes, Failures

- ♦ What can the organization do to allow venture managers more time to pace their venture team for market delivery versus jumping through excessive internal hoops?
- ♦ Does your organization offer "get out of jail cards" for those who risked and failed at a venture?
- ♦ How does your firm cross-pollinate veterans of previous ventures into key roles for new ventures?
- ♦ What is the documenting process for a successful or failed venture?

VI. Team Dynamics: Champion, Sponsor, Rewards

- ♦ How do you recruit and retain future entrepreneurial champions?
- ♦ What percentage of your senior managers have the interest and talent to mentor an invigorating team?
- ♦ What mechanisms does your organization use to reward innovative people?
- ♦ To what degree are risks and rewards correlated with different ventures?

VII. Resource Allocation: Strategic, Traditional, Skunk Works

- ♦ How does your firm earmark or attract resources as it regards supporting new product ventures?
- ♦ Which of the three methods (strategic, traditional, skunk-work) does your firm offer to support entrepreneurial enthusiasm and innovation?
- ♦ What innovation is being funded at a strategic level as to be considered your firm's future?
- ♦ Can you identify one or two skunk works projects underway somewhere in your organization?

SUCCESSFUL SUCCESSION: A STUDY OF A FIFTH GENERATION FAMILY FIRM

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ABSTRACT

The fragmentation of ownership resulting from multiple generations of succession in a family firm creates challenges for the chief executive officer and management team. In order to insure business survival, family concerns may have to be subordinated to business considerations. The older family firm can take on a chameleon-like appearance – sometimes appearing to be a conventional corporation and at other times appearing to be a family business. This study examines a family firm in transition from the fourth to the fifth generation and the complexity of this succession.

INTRODUCTION

The dominant form of business enterprise in the United States today is the family owned business. Estimates of the percentage of family owned corporations in the United States range from 80 to 90 percent (Birley,1986; Shanker & Astrachan,1996). Moreover, these companies make significant contributions to our economy (Howorth & Ali,2001; Ibrahim, Soufani, & Lam,2001). Family owned businesses account for 60 percent of total U.S. employment, 78 percent of all new jobs, more than 50 percent of GDP, and 65 percent of all wages paid (Matthews, Moore, Fialko, & Kaye, 1999).

The family business literature has not settled on one precise definition of the family firm. In their review of the literature, Sharma, Chrisman and Chua (1996) found 34 different definitions for family business. The dimensions to be considered are degree of ownership by the family, degree of management by the family, and the ability to transfer the business from one generation to the next. For the purposes of this paper, I will refer to a family firm as a business in which a family possesses controlling ownership, controlling management, and the ability to pass these elements to the next generation.

One strategic issue that concerns all family firms is succession – the ability to pass the leadership of the business from one generation to the next. Dyer and Sanchez (1998) report that succession is the leading topic for academic articles in the family business literature over the past 15 years. Indeed, this should be the focus of the literature as research reports that 70 percent of family businesses fail to pass the test of succession. We can only imagine that the loss of productivity to the nation is enormous. Referring to succession as "the core of the family business literature," Sharma, Chrisman and Chua (1996) note that the element of family involvement with its emotions and non-business concerns differentiates succession in family business from succession in publicly owned firms.

A family business may be described as three overlapping subsystems: business, ownership, and family (Gersick, Davis, Hampton, & Lansberg, 1997). In the Three-Circle Model of Family Business, the individual may be placed in any of seven sub-sections concerning their relation to the family business. An individual may be an owner only, a manager only, a family member only, or some combination of the three dimensions. For example, an individual could be a family member and an owner, but not an active manager in the business.

The most common conception of a family business is that of a founding entrepreneur who conceives of an idea for a business and works for years to bring this dream to reality. Consumed by his passion for the business, the founding entrepreneur wants to pass his legacy on to his children. Research shows that this common conception is correct. Approximately 75 percent of all family businesses are owned or controlled by one person or a married couple, another 20 percent of family businesses are controlled by siblings, and the final 5 percent are owned by a group of cousins. Gersick, Davis, Hampton and Lansberg (1997) refer to the three types of ownership as Controlling Owner, Sibling Partnership, and Cousin Consortium.

The natural progression for a family firm is for ownership to become more diverse with each generation. Typically, the founder passes the business on to the second generation which may be a group of siblings. The second generation often splits the ownership of the firm among a naturally larger number of their children and the result is a group of cousins owning the business.

This incremental dispersion of ownership may be blocked by a family member who seeks to re-consolidate the ownership of the business by buying back the stock owned by his relatives. According to Gersick, Davis, Hampton and Lansberg (1997), it is possible for a Sibling Partnership to revert to a Controlling Owner, or for a Cousin Consortium to revert to a Sibling Partnership or Controlling Owner form.

CONCEPTUAL BACKGROUND

Research shows that only 30 percent of all family firms successfully complete the succession from the first generation to the second, only 12 percent of family businesses survive to the third generation, and only 3 percent continue into the fourth generation and beyond (Ibrahim, Soufani, & Lam, 2001: Lansberg, 1988; Shanker & Astrachan, 1996). The family business literature concerning succession has focused on the movement from the first generation to the second because this is the most common form of succession. There is little research concerning succession beyond the third generation. We are left to suppose that successions in the third, fourth, and fifth generations are similar to the initial succession from the first generation to the second. While it is recognized that most third, fourth, and fifth generation family businesses (older family businesses) are in the form of Cousin Consortiums, and that this ownership form is different from the Controlling Owner or Sibling Partnership form, we do not find further exploration of older family businesses. This paper will examine an older family business and compare its process of succession to the typical family firm as described by the literature.

The process of succession in the family business begins with the preparation of successors as children. Children of business owners are exposed to "shop talk" or the language of the family business practically every night at the dinner table and at virtually every extended family gathering. Longenecker and Schoen (1978) propose a seven stage process of succession which begins with childhood and is highlighted by the entry of the successor into the family business at a lower level and later the ascension of the successor to the leadership of the firm. Succession, then, is a process rather than an event. The successor should be carefully taught by the older generation and groomed for the position of leadership over a lengthy time period (Longenecker & Schoen, 1978).

If a business is to survive, someone has to assume the leadership role when the older generation retires or passes away. While this is conceptually obvious, in practice it becomes a difficult situation. The very characteristics that brought success to an entrepreneur may render him or her a poor teacher of the next generation. Teaching is an art that requires patience and the loosening of control. Many entrepreneurs have gained success through proactive or dictatorial management styles in which they achieve goals and control events. To prepare successors, they must set aside natural tendencies (Aronoff & Ward, 1991).

The family business literature also describes other problems in the path of succession. First of all, some companies lack an interested or capable successor which brings the succession dialogue to an end because the business will not survive as a family firm. Given that there is an available, qualified successor, many more challenges arise. One primary problem is that some family business owners are reluctant to plan for succession (Ibrahim, Soufani, & Lam, 2001). This reluctance may stem from a desire to retain the position of prominence within the family. Some owners see retirement as a loss of power and status. Some owners value control of the business above all else because they have invested their lives to achieve their status, often at great personal cost. Others refuse to train or coach their chosen successor in a type of undermining behavior. They search for fault in the successor and create reasons to fire them (Lansberg, 1988). Still others act as if they are immortal and need no successor. Others determine that they will die in office (Howorth & Ali, 2001).

Often communication is poor between generations – both sides may be hesitant to express their goals in the business. Indirect communication through third parties, such as spouses, can confuse and confound the situation. Feelings of entitlement on the part of the younger generation may emerge. Selfishness and lack of concern for other parties often reigns in family businesses. Lack of forgiveness for mistakes on all sides and lack of appreciation, recognition, and love may be major family obstacles to succession (Hubler & Kaye, 1999).

METHODOLOGY

One approach to gain insight into succession in older family businesses is through a careful examination of an exemplary firm. This follows the case approach suggested by Yin (1994). The qualitative case study seeks to describe the subject in depth and detail (Patton, 2002). Case studies seek to answer 'how' and 'why' questions (Howorth & Ali, 2001). This research study examines the case of Schumaker's Furniture Inc. of Southern City, a family business in its fourth and fifth generations of ownership and management.

The primary method of data collection was semi-structured, tape-recorded interviews with the entire top management team at Schumaker's. Each of the seven management team members was interviewed privately. I asked open-ended questions concerning the individual, the company, and the role of the family in the business. The responses were tape recorded and transcribed. See Appendix 1 for a list of elicitation questions.

I employed content analysis of the data looking for patterns or core consistencies and meanings. I developed the following categories in the data: personal background information, this is a family business, this is a regular corporation, survival, and succession. Each category consisted of ten to twelve sub-headings. See Appendix 2 for Interview Categories. I used the MAXQDA software system to code and analyze the data.

Additionally, members of the management team supplied a limited amount of company documents. Field notes and informal conversations complemented the taped interviews. I also had the advantage of a common background in a family retail furniture business. This knowledge of the industry and the workings of a family business gave me insight and empathy into the situation at Schumaker's. However, as a researcher, I must acknowledge my position as the third generation son and chosen successor of a Controlling Owner and the possibility of bias that this implies.

Analysis

Schumaker's First and Second Generation

In 1880, Jacob Schumaker (1824–1892) opened the first retail furniture store in Southern City. Born in Germany, Schumaker immigrated to the United States in 1849. He settled in Southern City and started a general merchandise store in 1859. After the Civil War, Schumaker focused on the furniture business, going exclusively to furniture with the opening of the store on St. Ferdinand Street. One of Jacob's three daughters, Mathilda, married a salesman-handy man by the name of Julius Schultz (1863-1943). Within a few years of the marriage (1892), Jacob turned over the daily operation of the business to his daughter, Mathilda, and his son-in-law. See Figure 1. The first two generations in the business followed the Controlling Owner form as outlined in the family business literature. Schumaker's neatly progressed to the Sibling Partnership form in the third generation and on to the Cousin Consortium in the fourth and fifth generations.

Third Generation

Julius and Mathilda Schultz had four children – Albert (1896-1981), Ben (1898-1972), Gertrude (1895-1927), and Julia (1893-1983). Albert and Ben married sisters, Mathilda and Christina Fabacher, lived in adjoining houses, raised large families (Albert had 9 children, Ben had 8), and managed the furniture business together. Ben handled the finances of the business, while Albert did the merchandising and buying for the store. This Sibling Partnership managed the business into the 1960's. Ben and Albert shared amazingly close lives by today's standards. The concepts of sharing and teamwork, which are evident today at Schumaker's, started with the two brothers. Julius and Mathilda Schultz gave company stock to all four of their children, although Ben and Albert managed the business. Gertrude Schultz married Durward Bailey (1897-1964) and Julia Schultz married Sidney Anderson (1887-1971). Today, the Bailey family and Anderson family still own stock and have representation on the company board of directors, although the Schultz families control the board by having a numerical majority of representatives and percentage of stock ownership.

Ben and Albert decided to limit the number of their children whom they would allow into the furniture business to two from each of their families for a total of four. During the 1950's, Albert's sons - Marion and David, and Ben's sons – Peter and Ben, Jr., entered the business and took on the functional roles of management. The management team of six Schultzs worked into the mid ‘60's when the fourth generation took over from Ben and Albert.

In 1966, Schumaker's opened the present store location with 60,000 square feet of space. They closed the original St. Ferdinand Street store in 1982 and moved the entire operation to the Florida Boulevard site by adding a 37,000 square foot warehouse and distribution center and remodeling the showroom floor in 1983.

Fourth Generation

David Schultz was the eighth of Albert's 9 children and the youngest of the four selected by the two fathers. He viewed the succession from the third generation to the fourth as follows:

> *The two fathers had always agreed that there would just be two from each family in the business. There were 17 children between the two families. We were nine, and they were eight. I don't remember seeing any conflict about it. The four who wound up here really liked it and the others definitely were not interested. The six of us operated together. Our generation started taking over in the mid ‘60's.*

The business sailed steadily along through the ‘60's, ‘70's, and early ‘80's. David Schultz described the management team:

> *The four of us were like a good gumbo – we were all different and we had some good arguments. I thought they were healthy. Peter took a lot from myself, my brother, and his brother. Peter was president, but we all felt like we were equals. We respected him. He did that for 15 years after the daddies died.*

During the mid ‘80's, the state suffered an economic recession brought on by a crisis in the petroleum industry. Schumaker's Furniture faced difficult and trying times. David's son, Dan, recalled the situation:

> *I remember every Friday was their staff meeting and they would be there from eight to four in the afternoon and you'd walk into the room after that staff meeting and you could feel the heat. In fact, it was like, if you got a page to go to the conference room everybody was like – uh oh, he's no longer here with us any more. It was pretty rough. Peter retired in 1989 because he was ready to get out. Marion retired in 1991and Benjamin retired in 1997 for the survival of the company, when the oil prices dropped out. We were just too top heavy in management.*

The oil crisis was compounded for Schumaker's by a Federal government change in investment tax laws. David Schultz stated, "We had doctors and lawyers who were investing in apartment buildings. When the government changed the rules, it brought many doctors and lawyers down. We lost over $1.5 million in accounts receivable."

The Schultzs turned to a retail furniture industry consulting company called Target for help during the crisis of the mid and late ‘80's. Target advised the company to downgrade their merchandise assortment. Schumaker's had been at the high end of the industry selling expensive, well-known brand name furniture such as Henredon, Drexel, and Century. Although the downgrading of merchandise shocked and upset some of Schumaker's customers and even the Schultzs themselves, the business survived. However, the direction given by Target called for the company to drop far lower in merchandise quality than was necessary. The Schultzs corrected this course and upgraded their selection of merchandise as the crisis lessened.

The late ‘80's were turbulent for Schumaker's. Operating under further advice from Target, the Schultzs sought to enhance systematic and professional management practice by hiring a sales manager from outside the family. David Schultz explained the situation:

In 1988, Target said we needed a sales manager. So, we stepped out of the box and hired Susan (Hudson). She comes from a big Catholic family in Alexandria. She is one of eleven and she is right in the middle. She worked her way through college, like we did. She worked at Goudchaux's (a local department store). She graduated from the "Sternberg University" of retail (Mr. Sternberg was the owner and manager of Goudchaux's). She was a department head. We had a headhunter find her for us. She did a fantastic job.

Susan Hudson had worked her way up through the department store ranks and she brought a professional yet humanistic approach to management with her. Ms. Hudson gave the following insight:

> *Then, I interviewed for a position as sales manager for Schumaker's. Previously, they had shared that position among the four Schultzs. I think I was the second non-family member of the management staff. That was 1988. I was sales manager two to three years. Then, Peter Schultz retired; David took over his reigns as president. Within the next year, Marion, his brother also retired.*

Peter Schultz decided to step down from the presidency and active management of the company. He still serves in an advisory capacity as chairman of the board of directors. David Schultz further explained:

> *It was touch and go. The bank had cut us off. Peter reached 64 and decided to retire. So, we decided to let Target choose who should take over. We were all interviewed by Target. Target said I was the one who should take over. In 1989, the board elected me president.*

This was the turning point for Schumaker's. The company could well have gone into bankruptcy; however, David Schultz did not let the oil crisis of the '80's overcome the company. His son-in-law and operations manager, Robert LeBlanc, commented as follows, "That was rough. Schumaker's lost money several years in a row. Peter stepped out and David stepped in and cut spending and balanced the budget. He drill sargeant'ed it back to profitability and micro-managed it back."

Schumaker's is a Regular Corporation, not a Family Business

The decade of the '90's saw David Schultz lead Schumaker's back to health. Sales increased from $4 million in 1989 to the present level of $11 million. Although sales have been flat the past three years, the business has been profitable enough to pay a dividend each year to the stockholders. The adversity of the '80's required a drastic change in the composition of the company. Today's Schumaker's is a family business of the Cousin Consortium form; however, many aspects of the business more closely resemble a public corporation than the typical Controlling Owner, first or second generation family firm. In order to survive, the management of Schumaker's cast off some attributes of a typical family business. Family members were forced to retire, placing the interests of the company above the individual family member. The management brought in consultants, listened to their advice, and implemented it in a professional manner. Schumaker's management went outside the family and hired a professional sales manager who brought form and procedure with her, rather than the intuitive management of the past. The Schultzs allowed an outside agent – Target – to decide who should be president in 1989. All of these decisions and actions reflect professional corporate business thinking. In many ways, Schumaker's more closely resembles a public corporation than a small family business. David Schultz asserted, "I tell the staff, we are operating this for our stockholders and they are due a return on their investment."

Today, there are approximately 144 Schumaker's stockholders. This dispersion began with the third generation. The two Schultz families, Albert's and Ben's, inherited 60 percent of the stock, while the Baileys and Andersons received 40 percent. When he passed away, Albert Schultz gave his stock to his children. Three of Albert's children belonged to Catholic religious groups – the Jesuits, the Sisters of St. Joseph, and the Caritas. Because of the children's vows of poverty, the religious groups received the stock. Consequently, no single individual owns a controlling percentage or even a large portion of the stock. This diffuse ownership resembles that of a public corporation. From the view- point of Schumaker's management, there is little likelihood of a single individual ever owning a controlling interest in Schumaker's.

The implications of this fact are immense for the company. On the bright side, the wide spread ownership has eliminated the inheritance tax issue as a threat to Schumaker's. Perhaps, the greatest killer of the American family business is the 55 percent inheritance tax imposed by the Federal government. Because no single individual owns a large percentage of the company, Schumaker's will not have to be sold or liquidated to pay inheritance taxes.

However, there are several problems with the fragmented ownership. First of all, the president is not as strong as a Controlling Owner would be. The president of Schumaker's reports to a board of directors, which can remove him from office if he acts against their wishes. Additionally, the stockholders have enough power to demand that a dividend be paid when the company makes a profit. This may turn out to be the Achilles heel of Schumaker's. The chief executive officer may not be strong enough to withhold the funds necessary to permit the company to expand to a new location when the business environment demands this action. Indications are that a new store location will be needed within two to three years because of residential movement and new competitor store openings.

A secondary problem with the fragmented ownership at Schumaker's is that it makes the company a less inviting career path for a talented young family member. The primary reason many individuals, who have other options or opportunities, enter into a family business is the expectation that some day they will become president and owner of the business which will lead to great financial reward. Presently, ownership is not a likely scenario at Schumaker's.

Fifth Generation

David Schultz, at the age of 68, is still president and CEO of Schumaker's. With the exception of Susan Hudson, he is surrounded by a very young management staff – all of whom are in their 30's. Please see Figure 2 for an organization chart of Schumaker's top management team.

Susan Hudson – The Bridge.

During the struggle of the late 1980's, David Schultz came to appreciate the dedication and leadership provided by Susan Hudson. David fostered her rise to upholstery buyer and then merchandise manager over all the buying. At his request, the board of directors approved her promotion to the position of vice president and general manager in March, 2001. From the stand point of the typical family business, it is extremely unusual to find a non-family member in the second highest management position in the company and to have this person slated to become president and CEO, but this is the case at Schumaker's. Susan Hudson explained as follows:

> *Frankly, I see my role here to be a catalyst, a bridge between the generations, because at the time that I was asked to take on some of these responsibilities there wasn't enough experience on the part of the fifth generation to move up. I see myself as the bridge and teaching as much as I can.*

Susan's position is surprising because in most family businesses control is everything. If Ms. Hudson becomes CEO, the Schultz families might lose control of the company. To the Controlling Owner, a non-family member as CEO would mean the end of the business as a family firm. However, Schumaker's is different because the board of directors would still control the company even with a non-family member CEO. Susan's power would be limited and the Schultzs on the board would scrutinize her actions. Here are some comments about Susan Hudson from the management staff. Tom Smith, sales manager and son-in-law of Peter Schultz, remarked:

> *She very well deserved it (the promotion) and I don't think anyone has any grudges against it. Even the board members when they voted on it. When the board members voted, I don't think Susan had to leave the room. They just made the decision real fast. Everybody just feels real good with her and comfortable.*

Leslie James, the Marketing Director and Buyer, concurred with David's opinion of Susan. She remarked as follows:

> *This speaks a lot to her dedication and ability. I am 150 percent comfortable with it. I think she has this company's best interests at heart. I don't think she is here for her benefit. She's here to help the company grow.*

Amid the chorus of approval from the young management staff concerning Susan, one caveat did emerge. If Ms. Hudson is to become CEO, she must have a working knowledge of the financial side of the business. The successor must receive training in all aspects of the business, especially delicate financial issues. One mistake described in the family business literature is the founder (or incumbent CEO) who is reluctant to train his appointed successor and therefore undermines this person's position in the company.

Succession to the Fifth Generation

The literature also speaks loudly to the need for a succession plan. There is no formal succession plan at Schumaker's, other than the fact that the board of directors will make the decision. There is a general consensus that Susan will become president when David retires, beyond this there is only speculation. Susan Hudson commented:

> *A succession plan? No, and there should be one. There's an unofficial one working through our brains, and we're giving it a lot of thought. I lose sleep at night thinking about it. What would happen if David and I were not here? I think it's very wise that we're not appointing anyone.*

The unofficial succession plan, then, is to not appoint anyone with the intent of fostering a healthy competition among the fifth generation. The management team consists of Leslie James – Marketing Director / Buyer and non-family member, Dan Schultz – Facility Manager / Buyer and son of David Schultz, Robert LeBlanc – Service Manager and son-in-law of David Schultz, Sally Boudreaux – Business Manager and non-family member, and Tom Smith – Sales Manager and son-in-law of Peter Schultz, as well as David Schultz and Susan Hudson. David Schultz stated the following:

> *All of them are possible: they could replace Susan. It is not just because you are my son, that you are going to be general manager, or you are my son-in-law. One of those others on the staff could be general manager. They are going to be tested and interviewed by outside people like they did me. We work for our 140 stockholders.*

Given the fact that all the members of the management team will receive consideration for the presidency when the time comes, the question remains as to who is the most likely successor. The most natural candidate, given that Schumaker's is a family business, is Dan Schultz, David's son. Dan remarked:

> *Eventually, I would like to be where my dad is, president, and run the company. And have the opportunity to hand it off to the sixth generation. Right now, I'm satisfied with taking the next ten or so years to learn more of the business before I get there. I'm willing to wait my turn.*

Other members of the management team confirmed that Dan is the most likely successor because of his length of service with the company, ten years, which is the longest of any of the 30-something-year-old management group. Further, the consensus is that Dan is not ready to be president yet. Dan has followed his father in the business and learned a management style from him as well. David Schultz steered the company through the crisis of the 1980's using a strict, authoritarian approach – the "drill sergeant" style. Both father and son respond to adversity with resolve and sometimes anger. This anger occasionally has been directed toward employees. Susan Hudson describes herself as "being a middle child. I'm a peacemaker. I'm one of 11 and I was right in the middle." She is still in the middle, but now it is at Schumaker's. Susan Hudson, at age 51, could fill a 10 or 15 year gap between the generations. Dan's objective over that time period should be to increase his communication and interaction skills with the employees – this is his road to the presidency.

While the other four members of the management team will receive consideration for the top spot, the youngest member with the least amount of tenure, Robert LeBlanc, may be the brightest star. Sally Boudreaux remarked:

> *Honestly, out of all the boys – Robert is the smartest and he's the youngest, so he's got a lot to learn, too. He's really smart and can understand what's going on. He wants to do better and I don't think he'll be back there forever (in warehouse management).*

Robert has reunited the delivery and service departments under one supervisor and has instituted procedures and policies to streamline the operation of the business. He is well spoken and displays good leadership skills.

The management team also discussed the possibility of going outside the company to find a new leader after Susan's tenure. The family member most often mentioned is Melinda Schultz, David's daughter. She currently works for Robb and Stuckey, one of the top 50 furniture retailers in the country, as a designer and manager. Melinda graduated from Louisiana State University in 1985 with a degree in interior design. David advised his daughter to seek employment elsewhere because "Schumaker's couldn't afford her." The timing for Melinda was poor because of Louisiana's economic recession and the turmoil at Schumaker's. Circumstances could change for Ms. Schultz, although the company still may not be able to afford her services. An offer of ownership of a large percentage of the company might be necessary to lure someone like Melinda to Schumaker's. However, as previously discussed, this is not currently possible.

Whether it is someone from outside the current management team or only those actors already present, the leadership of the fifth generation at Schumaker's will have to find its own procedures and organizational form to manage the business. The next generation does not have to follow the pattern of a strong president like David Schultz. They may find that some form of power sharing will be in order along the lines of the two brothers of the third generation or the four cousins who formed a "good gumbo" in the fourth generation. The board of directors will decide on the management team of the fifth generation, given the recommendation of some outside agency similar to Target. The composition of the board will change greatly in the next ten years as the fourth generation exits. A key to survival and prosperity will be the replacement of the exiting board members.

Schumaker's Is Still A Family Business

When a visitor walks in the door of Schumaker's Furniture store, the first impression is one of a rich and bountiful display of beautiful furniture.

After a salesperson's greeting, the visitor is allowed to walk freely through the store. Prominently displayed among the rooms of furniture is a television set with a continuous loop video tape describing the family behind Schumaker's. Robert LeBlanc, David Schultz's son-in-law and operations manager, described the company compared to other places he has worked:

> *I think we have much more of a family atmosphere. I appreciate the fact that we have a lot of employees who have been here 35, 37, 27, 22 years. We pray every morning. We end our morning meeting with a prayer every day. It creates the atmosphere. The atmosphere here is much more family oriented.*

The business reflects the core values of the Schultz family. They are a hard working and conscientious group. They describe their desire to succeed and passion for the business as the German work ethic. Susan Hudson commented:

It is the discipline, the passion. It is a driving energy. It is a focused direction. It is a guilty feeling if you don't do everything you possibly can from when you get here in the morning until the end of the day. Every minute should be spent doing something productive and not self-serving. For me, the company comes first, when I come in the door. You have to give back more to the company than you think they owe you.

Dan Schultz stated the idea of involvement in the family business. When asked why he came into the business, Dan replied:

> *I've had that question asked a lot. It wasn't until I went to Germany to visit my Schumaker relatives that I heard that they have a business over there called a Kliebod, which is a bed and breakfast that's been in the family for 300 years – so this is small fries. Hans, who runs it, was asked at one point, why did you come into the business and why did you love it so much? He said, 'I do it for those that came before me and I*

do it for those who come after me. ' And I said that explains it to me. That's my reason.

CONCLUSION

The family business literature addresses the question of how to categorize family businesses – Controlling Owner, Sibling Partnership, or Cousin Consortium – and gives us a percentage of each type of family firm. We also have an idea of how many firms persist beyond the third generation of family ownership – 3 percent. This study seeks to give life to the bare numbers by examining a rare specimen in detail. Additionally, the majority of the literature focuses on the younger firm and the succession from the first generation to the second. The succession of older firms is even more complicated than the succession of younger firms. There are lessons to be learned by studying these older family firms, which are both complex and successful businesses.

Schumaker's is not just a Cousin Consortium, nor is it merely a fifth generation family business. Upon closer inspection, Schumaker's changes color like a chameleon. At times, it mirrors a public corporation: ownership and management are separated, the board of directors participate in the strategic decisions of the company, the stockholders require a return on their investment, individual family members are not as important as the survival of the company, and a non-family member is vice president and successor to the CEO. At other times, nothing is more familial than Schumaker's. There is prayer in the morning, the family video in the store, the German work ethic, and the motivation of heritage – "those who came before me, and those who will come after me."

The fragmentation of ownership at Schumaker's has created a situation in which ownership is not the primary driving force for the management team. Interestingly, the major killer of family businesses – the inheritance tax – is not a concern for Schumaker's because of the dispersion of ownership. Schumaker's will not be sold because of crippling inheritance tax problems in the fifth generation. Conversely, the fragmentation of ownership has created the two problems of a weakened chief executive officer compared to Controlling Owner family businesses and the less inviting career path for a talented, young family member.

The study of older family businesses requires further research, both of a qualitative nature and a quantitative basis. The assumption that the Cousin Consortium is the dominant form of fourth generation and beyond family business may be correct, but further research would shed light on this and other issues. Schumaker's does not face inheritance tax problems and acts like a public corporation. Is this true of other older family businesses? We can learn valuable lessons from Schumaker's, but, as in any case study of limited sample size, we must be careful not to make broad generalizations. Clearly, the issue of succession is entirely different for a fifth generation firm than the typical first or second generation family firm.

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Figure 1. Schumaker – Schultz family tree.

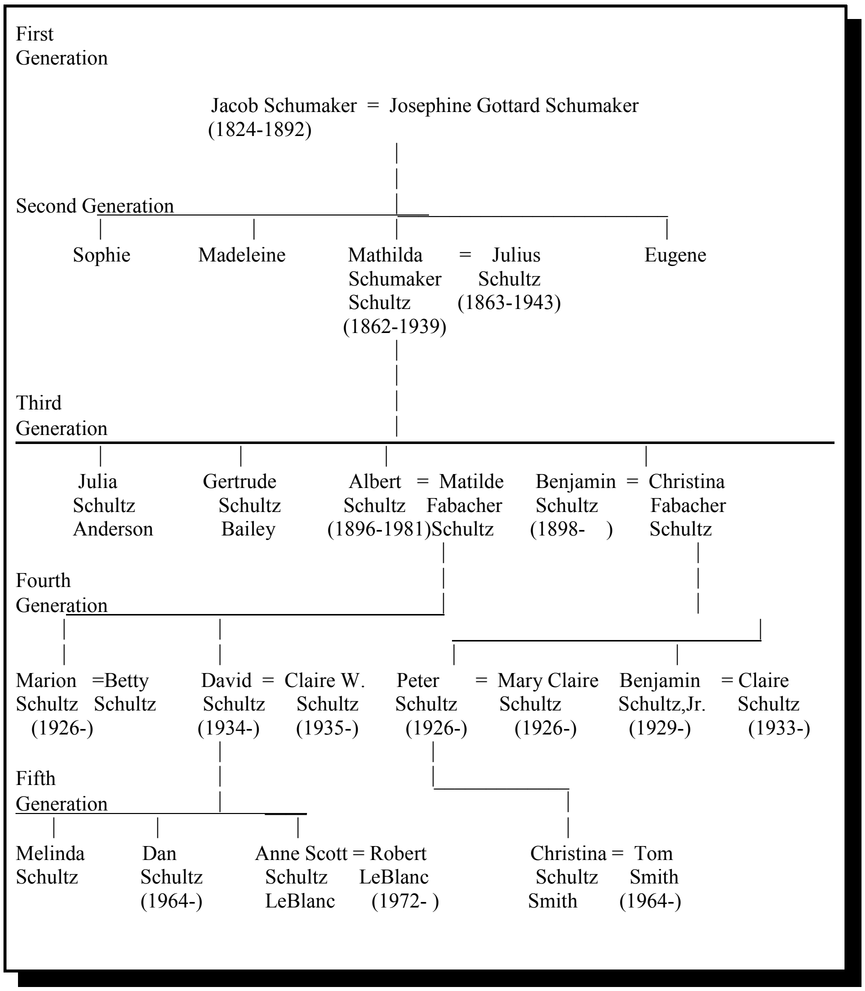
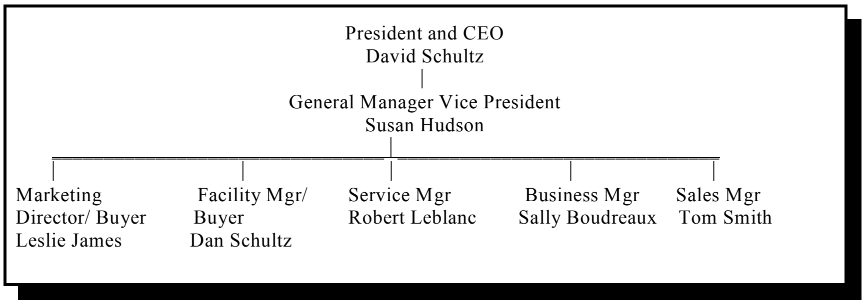


Figure 2. Schumaker's organization chart.



Appendix 1
Interview Elicitation Questions

A. Personal

1. Tell me about yourself, your background.
2. What is your position with the company?
3. Tell me about what you do here. What are your responsibilities?
4. How long have you been with the company?
5. Do you enjoy the business? What aspects do you like best?
6. What do you not like? What is the toughest part of your job?
7. Why did you come into the business?
8. What are your plans for the future?

B. Company

1. Who are your competitors?
2. What is the greatest threat to your company?
3. What does your company need that it does not have?
4. What are the obstacles to your company's success?
5. How will the obstacles be overcome?
6. Does your company have plans to grow?
7. What are your company's strengths?
8. Why do customers buy from your company?

C. Family

1. Is this a family business?
2. Which family members are in the business?
3. How many family members are in your generation?
4. What are their positions?
5. Who has control of the company?
6. Does the family interfere with the business?
7. What are the plans for the next generation?
8. What about estate tax problems?
9. Who will lead the next generation?
   Who decides this question?
10. What is the method of selection?
11. Is there conflict between family members?
    Between generations?

Appendix 2
Interview Categories

1.	Personal background information
	David Schultz, Sr.
	Dan Schultz, Jr.
	Susan Hudson
	Tom Smith
	Sally Boudreaux
	Robert LeBlanc
	Leslie James
2.	This is a family business
	The tape
	Family atmosphere
	German work ethic
	The people
	Heritage
	Work somewhere else first
	The Boys Club – The Good Old Boys – The Four
	The role of women – non-family members
	It's all right to have discussions at Schumaker's
	Anger – temper
	Lack of capital
	1 of 18, 3 of 36
	Switching hats
3.	This is a regular corporation
	Target said Schumaker's needed a sales manager
	A headhunter found Susan
	Target chose David, Sr. to be president
	The board decides
	144 stockholders

Appendix 2 Interview Categories	
	We work for our stockholders
	Bonus on merit
	Susan hired Dan, Jr.
	David applied without telling his father-in-law
	Track to CEO
4.	Survival
	David, Sr. saved the company in the late ‘80's
	Drill sergeant
	Two of the four were forced to retire
	Location deterioration
	Threat from Kirschman's
	Other competitors
	Internal versus external
	Change
5.	Succession
	Roles of management staff
	Attitudes of management staff
	David, Sr. president – the last of the 4th generation
	Candidates – Susan, Dan, Robert, an outside Schultz (Melinda)
	Susan – the bridge
	Dan is not ready
	Robert– smart and young
	David – the quiet one
	Lynn – the perfectionist
	Ami – dedicated, hard-working
	They are all in their 30's

COLLEGE EDUCATION FUNDING: MAXIMIZING FAMILY TAX SAVINGS AND FINANCIAL AID

Ellen D. Cook, University of Louisiana at Lafayette

ABSTRACT

With the average cost of a college education at public and private institutions estimated to rise to $60,000 and $200,000, respectively, by the year 2007, the need for financial planning for college is more critical than ever. While changes and additions to the Internal Revenue Code have fulfilled Congress' intention to "maximize tax benefits for education and provide greater choices for taxpayers in determining which tax benefits are most appropriate for them" (H.R. Conference Report), "the mere number and perplexing intricacies of these benefits make it extremely difficult for taxpayers to choose and interpret the ideal option" (June 2004 testimony of former IRS Commissioner Fred Goldberg).

Further complicating the overall planning process is the impact of various funding alternatives and tax incentives on eligibility for federal financial aid. Last year a record $90 billion in financial aid, an increase of more than 11.5 percent from the prior year, was awarded to students at both private and public institutions. Thus, a basic understanding of the financial aid process is an essential component to effective planning for the college years. All of the pieces of this complex puzzle will be explored in the paragraphs that follow.

INTRODUCTION

Despite the ever-growing cost of a college education, finaid.org reports that although families are saving for college, they aren't saving enough. Specifically, between two-thirds and three-fourths of families say they are currently saving for their children's college education. However, of those, one-third have saved less that $5,000. Further, these savings tend to be in taxable accounts, especially low-risk (but also low-yield) investments. Savings accounts are the most popular savings vehicle with three-fifths of families using them, a quarter using CDs, and half using stocks and mutual funds. About a quarter of families use UGMA (Uniform Gift to Minors Act) accounts, a third use savings bonds, a sixth using Coverdell education savings accounts, and a sixth are using section 529 accounts.

In the current climate of ever-increasing college costs and ever-decreasing federal income tax rates, most financial planners agree that the starting point for evaluating all college funding alternatives is the effect that the financing alternative will have on available financial aid. Generally, those who qualify for federal financial aid (grants, loans, and work-study programs) should attempt to maximize those benefits first, while those that don't qualify will have a more simple plan - to maximize tax benefits. As a basic rule of thumb, those who earn less than $70,000 and up to $120,000 to $125,000 a year will probably qualify for aid with chances increasing with more than one child in college. Because tuition is growing at a faster rate than income (about three to four times the yearly inflation rate), those who qualify now for financial aid will probably continue to qualify in the future.

BASICS OF FINANCIAL AID

To fully understand the impact of financial aid on tax incentives, a basic understanding of the financial aid process is necessary. Two formulas are used to determine a student's eligibility for financial aid–the Federal Methodology Formula (FM), established by Congress and used by every accredited college in the United States, and the Institutional Methodology (IM) used by many colleges and private scholarship programs. Although the specific items considered in each formula may vary, both formulas measure a particular family's ability to pay against other families' ability to pay. The information used for FM analysis is collected on the Free Application for

Federal Student Aid (FAFSA) which may be found at www.fafsa.edu.gov while the IM information is collected on the CSS/Financial Aid PROFILE in addition to the FAFSA. It is possible to estimate eligibility for financial aid with financial aid calculators which may be found at www.finaid.org and www.collegeboard.com.

A student's "adjusted financial need" or eligibility for financial aid is determined by the Financial Aid Formula Needs Analysis as illustrated in Table One. The computation begins with the "Cost of Attendance" (COA) which includes tuition, fees, room and board, books and supplies, personal expenses including clothing and entertainment, transportation to and from college, and other needs such as a computer. The COA is furnished by each college and may be adjusted by the financial aid counselor for special circumstances. The student's "Expected Family Contribution" (EFC), the most complex component of the financial needs analysis, is then subtracted from the COA to determine the "Basic Financial Need." Because funding for a college education is expected to come from both parent and student sources (unless the student is considered independent), the EFC is the sum of the parents' contribution from income, the parents' contribution from "assessable" assets, the student's contribution from income, and the student's contribution from "assessable" assets. Currently, the federal formulas for financial aid are constructed on the premise that parents are expected to contribute from 22 to 47 percent (the percentage is based on the amount of income) of their "discretionary income" and up to about 5.64 percent of their discretionary assets to cover college costs. Students are expected to contribute 50 percent of their available income and 35 percent of their assessable assets to funding their education. In planning, it is important to determine from the FAFSA and other supplemental data which assets are "assessable" or includible in the list of assets and which ones are not. For example, in most cases, life insurance, annuities, retirement accounts including IRAs, and the family home are not considered assessable. Finally, the "Student Resources" (scholarships/grants; VA benefits; cash gifts paid directly to the college for tuition; payments from prepaid tuition plans; payments from employer-provided education assistance plans) are subtracted from the Basic Financial Need to get the "Adjusted Financial Need."

Table 1: Financial Aid Formula Needs Analysis	
Cost of Attendance (COA)	Set by and provided by the college--tuition, fees, room & board, books & supplies, personal expenses such as clothing and entertainment, cost of computer, transportation to and from the university
-Expected Family Contribution (EFC)	Computed by using family financial data submitted on financial aid application forms: Parents' contribution from income (if divorced, custodial for greatest part of year is listed and other parent's contribution is treated as a resource) + parents' contribution from assets + student's contribution from income + student's contribution from assets
=Basic Financial Need	
-Student Resources	Scholarships/grants; VA benefits; cash gifts paid directly to the college for tuition; payments from prepaid tuition plan; payments from employer-provided education assistance plan; sources other than family income and assets
=Adjusted Financial Need	
Adapted from material in *"Tax & Financial Planning for College Expenses after the 2001 Tax Act: What Every CPA Needs to Know," presented for Louisiana Society of CPAs, May 15, 2002 , Rick Darvis, College Funding, Inc.*	

It is apparent, then, that financial aid eligibility is maximized by keeping both the EFC and Student Resources as low as possible. It should be noted that there is evidence that Congress may change the treatment of assets in the Federal Needs Analysis Methodology in the next Reauthorization of the Higher Education Act of 1965 expected in late 2004. Specifically, a proposed formula would stop distinguishing between financial aid student and parental assets and replace that with a uniform treatment of family assets, a change that most certainly would have a significant impact on the computation, and as will be seen later, on tax planning.

TAX PROVISIONS AND THEIR IMPACT ON THE FINANCIAL AID FORMULA

Included in the Internal Revenue Code (the Code) are education provisions that may be categorized in two ways – (1) those that encourage taxpayers to save for future higher education expenses and (2) those that are intended to help taxpayers meet current higher education expenses. The first group, intended for long-term funding includes two major savings vehicles–qualified tuition programs or QTPs (section 529) and Coverdell Education Savings Accounts or ESAs (section 530) as well as other more traditional provisions such as custodial accounts and education savings bonds. The second group includes strategies that may be divided into three main categories--exclusions which allow taxpayers to exclude amounts from taxable income such as scholarships (section 117) and employer-provided education assistance (section 127), deductions including those that allow for "above the line" or "for adjusted gross income (For AGI)" deductions such as the student loan interest deduction (section 221) and the deduction for qualified education expenses (section 222), and credits which are dollar for dollar reductions in the tax liability including the Hope and Lifetime Learning credits (section 25A). The major provisions of each education incentive, including the impact on financial aid, will be discussed in the paragraphs that follow.

SECTION 529 PLANS

Section 529 of the Code establishes guidelines which allow parents to prepay higher education tuition costs for their children or themselves by making transfers to one of two types of state or institution-sponsored QTPs–college savings accounts, which are similar to mutual funds, and prepaid tuition plans, which are intended as hedges against inflation. While most of the older plans were prepaid tuition plans because of the obvious benefit of locking in current tuition costs, college savings accounts or plans have become more popular because they are more flexible and less costly administer. Institution-sponsored plans are new. One of the first of these, the Independent 529 Plan (www.independent529.com) will offer tuition certificates redeemable toward tuition at any of 300 plus member colleges and universities (Hurley).

In a college savings account, the account owner contributes cash to a plan account for a beneficiary, the contribution is invested according to the terms of the plan, and funds may be withdrawn and used for qualifying purposes at any college. Distributions are generally tax-free if used for broadly defined qualifying expenses. In a prepaid tuition plan, an account owner contributes cash to a plan account, in essence purchasing tuition credits and locking them in at current rates. When the beneficiary attends a college participating in the program, the tuition credits are used to pay for tuition and other college expenses, and the distribution is considered tax free. The tuition credits may be redeemed for cash and used to pay tuition and other expenses with the same tax-free consequences even if the beneficiary attends a nonparticipating college.

According to a recent Congressional Research Service Report, by June 30, 2003, more than five million accounts were in existence (a 50 percent increase from 2002) with the total value of savings in the program about $35 billion (a 60 percent increase from 2002). The tax and non tax advantages of QTPs listed below have contributed to the huge growth of these funds:

Federal income tax exemption. Earnings on invested funds accumulate tax free, and withdrawals are tax free if used to fund qualified higher education expenses or if made upon the death or disability of the beneficiary.

Conversion of other savings vehicles. The account owner may roll over money in U.S. Savings Bonds and Coverdell Education Savings Accounts to fund a 529 plan without incurring income tax on the distributions. There can be gift tax consequences, however.

Coordination with Hope and Lifetime Learning credits. A taxpayer may use other education incentives including the Hope or Lifetime Learning credit for a taxable year and exclude from income amounts distributed from

QTPs on behalf of the same student as long as the distribution is not used for the same qualifying expenses.

Estate planning benefits including annual gift tax and generation skipping tax exclusions. Contributions to QTPs, which are entitled to the $11,000 annual exclusion, are considered a gift of a present interest thereby removing the assets from the estate as long as the donor is listed as the owner. Further, a special provision allows contributions of up to $55,000 in one year prorated over five years. The $55,000 (or an amount up to $55,000) does not reduce the donor's unified credit and immediately removes all future appreciation of the initial contribution from the contributor's taxable estate. If the contributor dies within the five-year gift tax period, his or her contributed funds will be treated as part of his or her estate on a prorated basis. In addition, the generation skipping tax is not applicable to transfers under a section 529 plan.

State income tax incentives. Many states conform to federal rules in terms of deferral/exemption of tax on interest/withdrawals. In addition, thirty-two states (and the District of Columbia) grant a full or partial tax deduction for contributions to the plan. Finally, several more states provide low and moderate income families with matching contributions or scholarships through their 529 plans

Exemption from creditors' claims. More than one quarter of the states explicitly shield section 529 plan assets from creditor claims.

Control and flexibility. Rollover rules allow one change in beneficiary per 12 month period (be careful if more than one person has created an account for the same beneficiary) to a family member including son/daughter or descendent of either; stepson or stepdaughter; brother, sister, stepbrother or stepsister; father or mother or ancestor of either, stepfather or stepmother, niece or nephew, uncle or aunt, cousin (which allows grandparents to transfer among grandchildren), in-laws, spouse of the beneficiary or any of the above. The account owner also retains the right to specify the amount, timing, and recipient of any distribution. Withdrawals may escape taxation and penalty if rolled over within 60 days to a QTP account for a family member of the beneficiary or if the withdrawal or distribution resulted from the death or disability of the beneficiary or as a result of the beneficiary receiving a scholarship. Importantly, withdrawals are not limited to higher education expenses. Of course, if funds are withdrawn for nonqualified purposes, the withdrawal is subject to both ordinary income tax rates plus a 10 percent penalty.

Broad definition of qualified expenses. While the Hope and Lifetime Learning credit definition of qualified education expenses is restricted to tuition and fees, the definition for QTPs also includes books and other expenses for vocational schools, two-year and four-year colleges as well as graduate and professional education; room and board if the beneficiary attends school at least half-time; and expenses of a special needs beneficiary that are necessary in connection with his/her enrollment or attendance at eligible educational institutions. In practice, however, due to their nature, PTPs only cover tuition and fees.

No federal contribution limits. Unlike Coverdell education savings accounts and other incentives, there is no federal limit on contributions to 529 plans regardless of the income level of the account owner. Congress did not impose a requirement on the use of section 529 accounts but rather left it to each state to establish adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary. Most states do impose a limit based on an estimate of the amount of money that will be required to provide seven years of post secondary education with the current median limit $235,000 and the high $250,000.

As attractive as 529 plans are from a tax perspective, there are several tax and non-tax pitfalls of which taxpayers should be aware including the following:

Penalties on withdrawal. Two types of penalties may be imposed on withdrawals–federal penalties and plan penalties. Section 529(c)(6) imposes a 10 percent penalty on the income portion of any distributions in excess of qualified higher education expenses computed using the annuity exclusion ratio. In addition, some plans impose penalties on "disqualified use" of funds which may include expending funds on education at a college or university that is not a member of the group, nor a "partner" (Auster, 2003). For example, Florida's plan, the largest in the country, imposes a 100% penalty on income, which means that only original contributions are returned.

Taxable earnings taxed at ordinary income rates. The lower five and 15 percent tax rates on capital gains do not apply to the taxable portions of distributions from 529 plans.

Losses on investments in 529 plans do not result in capital loss deductions. In order to recognize any losses at all, the account owner must close the 529 account (and then, of course, to prevent the withdrawal penalty roll over the account within the required 60-day period). Any loss on the sale is treated as a miscellaneous itemized deduction subject to the two percent limitation. Further, the loss is not deductible for alternative minimum tax purposes.

Adverse impact on medicaid. Since Prop. Reg. 1.529-1©) allows the account owner to withdraw funds, there is a possibility that the state Medicaid agency could require that the 529 accounts first be used to pay for medical and long-term care expenses before Medicaid payments can begin.

Complexity of interaction of 529 plans and other education incentives. As discussed later in this paper, the value of a section 529 plan is diminished by every tax benefit that would otherwise be available for the same education expense but that cannot be claimed when the expenses are paid with funds from a section 529 plan (Auster, 2003).

Hefty fees. Management fees on the accounts vary from one to 1.5 percent of the account balance depending on the fund.

Limited control over investments. Investment selection is limited because, by statute, the plan administrator must, for the most part, develop investment strategies, although there are some limited choices allowed to account owners.

Possible loss of favorable tax status in 2011. Although experts feel that it is unlikely that Congress will fail to extend the tax-free status of qualified distributions, the current provisions do expire in 2011 making the income portion of all distributions taxable.

Contributions in cash. Contributions to section 529 plans (and section 530 accounts as well) can only be made in cash. Thus, this method of transferring wealth from one generation to another uses the unified transfer credit dollar for dollar while alternative methods may be accomplished with a valuation discount for transfer tax purposes (e.g., interests in family limited partnerships and limited liability companies, or shares in closely-held corporations). A 25 percent valuation discount, for example, allows one-third more assets to be transferred free of transfer taxes (Auster, 2003).

Adverse impact on financial aid eligibility. The treatment of both qualified tuition plans and college savings accounts in the federal financial aid formula may significantly decrease the eligibility for financial aid. Specifically, both the assets held in the plans as well as the withdrawals from the plans may be detrimental to financial aid eligibility. In general, the impact of these plans on financial aid eligibility is dependent on two factors–the type of QTP and the identity of the account owner. College savings accounts have a low impact on need-based financial aid eligibility. In the FM, a college savings account (plan) is classified as an asset which will reduce financial need by a percentage of the account value, 5.64 percent if the parent is the account owner and 35 percent if the student is the account owner. It should be noted, however, that some private colleges using the IM count all 529 accounts as 35 percent assets regardless of the owner. If neither the parent nor the student is the account owner, generally the plan is not considered in the financial aid formula. For this reason, grandparents, and most recently, employers are increasingly the owners of these accounts. Further, the IM treats sibling 529 plans as an asset of the parent if parent is the owner thus reducing aid by 5.64 percent of the balance. While the Higher Education Act does not comment on whether a distribution from a college savings plan, or at least the earnings portion, is treated as student income which reduces aid by 50 cents on the dollar, the *Application Verification Guide* (the Handbook) indicates that it is not. The same is true for the earnings on prepaid tuition plans.

Prepaid tuition plans have a high negative impact on financial aid eligibility in that distributions reduce the beneficiary's need dollar for dollar either by reducing the COA or by being classified as a Student Resource. However, the balances of prepaid tuition plans are not considered assets for purposes of the FM (under the IM, the plan is considered a parental asset which reduces aid by 5.64 percent of the balance). According to FinAid, efforts are underway (with support from states and the American Council on Education) to get Congress, through the renewal of the Reauthorization of the Higher Education Act of 1965, to change the financial aid treatment of prepaid tuition plans to that similar to college savings accounts (i.e., asset of account owner and hence a low impact on financial aid). Until that time, if the QTP will not be sufficient to cover expenses of the beneficiary's entire degree program, there may be benefit to taking full advantage of financial aid for earlier years while saving QTP funds for the later years of the beneficiary's education.

Table Two summarizes both the tax advantages of QTPs and their current treatment in the Financial Aid Needs Analysis.

Table 2: The Impact of Section 529 Qualified Tuition Plans on Financial Aid

	College Savings Account
Tax Benefits	Account owner contributes cash to a plan account for a beneficiary. The contribution is invested according to the terms of the plan. Contributions qualify for the annual gift tax exclusion; no federal deduction although some 25 states offer deduction. Funds may be withdrawn tax free if used for qualifying purposes at any college. Qualifying expenses include tuition & fees, books & other expenses for vocational schools, 2-year & 4-year colleges as well as graduate & professional education; room & board if the beneficiary attends school at least half-time; expenses of special needs beneficiary necessary in for his/her enrollment at eligible educational institutions. No AGI phase-outs or federal contribution limits.
Impact on Financial Aid If Owned by Parent	Balance: An asset of parent which reduces aid by 5.64% of balance. For the IM, sibling 529 plans are also treated as asset of the parent if parent is the owner; reduces aid by 5.64% of balance. Distribution: While the Higher Education Act does not comment on treatment, the Handbook indicates that it is not. The same is true for the earnings on prepaid tuition plans. 529 plan for the student is not assessed if owned by a person other than the parent or student.

Impact on Financial Aid If Owned by Student	Balance: An asset of student if owned by custodial account or student; reduces aid by 35%. Distribution: While the Higher Education Act does not comment on treatment, the handbook indicates that it is not. The same is true for the earnings on prepaid tuition plans. 529 plan for the student is not assessed if owned by a person other than the parent or student.
Prepaid Tuition Plans	
Tax Benefits	Account owner contributes cash to a plan account and the contribution purchases tuition credits or credit hours based on then-current tuition rates. Contributions qualify for the annual gift tax exclusion; no federal deduction although some 25 states offer deduction. Funds may be withdrawn tax free if used for qualifying purposes at any college. Definition of qualifying expenses is the same as for College Savings Plans. No AGI phase-outs or federal contribution limits.
Impact on Financial Aid If Owned by Parents	Balance: Under FM, not an assessable asset. Under IM, a parental asset which reduces aid by 5.64% of the balance. Distribution: Under FM, a "resource" that will reduce aid dollar for dollar. Financial aid treatment may change to "asset of account owner" during the next reauthorization of the Higher Education Act of 1965.
Impact on Financial Aid If Owned by Students	Balance: Under FM, not an assessable asset. Under IM, a parental asset which reduces aid by 5.64% of the balance. Distribution: Under FM, a "resource" that will reduce aid dollar for dollar.

COVERDELL EDUCATION SAVINGS ACCOUNTS

Section 530 allows qualified taxpayers to make nondeductible annual contributions into an education savings account (a trust or custodian account administered by a bank or IRS-approved entity) totaling $2,000 per year from all sources in behalf of any individual under age 18 (a special needs beneficiary of any age qualifies). Earnings accumulate tax free, and distributions, if made for qualified education expenses, are totally or partially excluded from income based on a computation similar to the annuity exclusion. The Economic Growth and Tax Relief Reconciliation Act of 2001 broadened the definition of qualified expenses beyond those for post secondary education to include tuition for public, private, and religious schools including grades K-12 as well as the cost of tutoring, computer equipment including software that is primarily educational in nature, room and board with no limits, uniforms and extended day program costs. Withdrawn funds must be used before the beneficiary reaches age 30 or rolled over to another family member under age 30 to avoid the 10 percent penalty. However, the penalty is waived if the nonqualifying distribution is due to a beneficiary's death, disability, or receipt of a scholarship.

Unlike QTPs, not all taxpayers are eligible to make contributions to section 530 Coverdell educational savings accounts. The provisions include an AGI phase out between $95,000 and $110,000 for single taxpayers and $190,000 and $220,000 for married filing jointly taxpayers. Of course, taxpayers above these limits can make a gift of $2,000 to their child who may then make the contribution. Further, there are no AGI limits for corporate or tax-exempt organizations who may also make contributions. Taxpayers are able to claim a Hope credit or Lifetime Learning credit and exclude from gross income amounts distributed (both the contributions and earnings portions) from an ESA on behalf of the same student as long as the distribution is not used for the same educational expenses for which a credit was claimed. An ordering system, to be explained in the final section of this article, applies with funds first going toward education credits and then deemed to come from ESA distributions.

In terms of the financial aid formula, financial planners suggest that ESAs are the worst place to have college savings because of the negative impact on financial aid eligibility. As illustrated in Table Three, in the FM, the ESA is considered a student asset which reduces aid by 35 percent of the balance and distributions of both principal and earnings (according to the Handbook, although the HEA is silent) are treated as student income reducing aid 50 cents on the dollar. Under the IM, the ESA is considered a parental asset if the account is in the parent's name or the parent is custodian and, as such, reduces aid 5.64 percent of the balance each year. In addition, some private institutions consider ESA accounts of the student's siblings assessable assets decreasing aid by 5.64 percent of their balance.

Table 3: The Impact of Section 530 Coverdell Education Savings Accounts on Financial Aid

Tax Benefits	Non-deductible contribution of up to $2,000 per year for a beneficiary under age 18. Except for special needs beneficiaries, contributions must end at age 18 and assets must be withdrawn by age 30. Distributions non-taxable to extent funds used for qualified education expenses--tuition, books, fees, tutoring, computer equipment and software, uniforms for both higher education and elementary and secondary education at public, private, and religious schools. Taxpayer may claim a HOPE credit or Lifetime Learning credits and exclude from gross income amounts distributed (both the contributions and earnings portions) from an ESA on behalf of the same student as long as the distribution is not used for the same educational expenses for which a credit was claimed. An ordering system will apply with funds first going toward education credits and then deemed to come from ESA
Impact on Financial Aid If Owned by Parent	Balance: Under FM, a student asset which reduces aid 35% of balance. Distributions: Both principal & earnings treated as student income reducing aid 50 cents on the dollar. Under IM, considered a parental asset if parent is custodian; reduces aid 5.64% each year. If the student's siblings have ESA accounts and the student is required to file the PROFILE application form, the value of the siblings' ESAs is assessed at the parents' 5.64% rate.
Impact on Financial Aid If Owned by Student	Balance: Under FM, a student asset which reduces aid 35% of balance. Distributions: Both principal & earnings treated as student income reducing aid 50 cents on the dollar. Under IM, considered a student asset if anyone other than the parent is custodian; reduces aid 35% each year.

While sections 529 and 530 provide tax incentives for long-term college funding alternatives, several code sections offer current tax savings opportunities through exclusions, deductions, and credits. The major provisions of these sections are discussed in the sections that follow and are summarized in Tables Four and Five.

Table 4: Tax Planning for Education–Current Tax Savings–Exclusions and Deductions

Provision	Summary	Qualified Education Expenses Defined	Effect on Financial Aid
§ 117 Exclusion for Scholarships	Excludes from income scholarships to extent covers qualified education expenses for degree-seeking undergrad student. No AGI phase-outs.	Tuition, books, supplies, equipment but not room and board.	"Nonassessable income" that does not affect either parental or student income. However, assistance is considered a "student resource" & will reduce aid dollar for dollar.
§127 Exclusion for Employer-provided education	Employee excludes from income up to $5,250 of employer-provided qualified education expenses. No AGI phase-outs.	Tuition and fees for undergrad and graduate courses; books, supplies, equipment. Doesn't have to be work-related courses.	"Nonassessable income" that does not affect parental or student income. However, assistance is considered a "student resource" & will reduce aid dollar for dollar.
§221 Student Loan Interest Deduction	For AGI deduction of $2,500 for interest paid on qualifying student loan. Phase-outs: Single: $50,000-$65,000 AGI; MFJ: $100,000-$130,000 AGI	Tuition, fees, books, supplies, equipment; room & board, transportation, other necessary expenses.	No impact on financial aid.

Table 4: Tax Planning for Education–Current Tax Savings– Exclusions and Deductions			
Provision	Summary	Qualified Education Expenses Defined	Effect on Financial Aid
§222 Deduction for Qualified Higher Education Expenses	"For AGI" deduction for payment of qualified education expense. S: AGI not > $65,000 & $130,000 MFJ. $2,000 deduction for Single AGI between $65,000 & $80,000 and MFJ $130,000 & $160,000.	Tuition, fees	Unclear how deduction might affect financial aid as there is no language in the Higher Education Act governing the $4,000 in 2004-2005 for interaction between the new tax deduction and Title IV assistance.

EXCLUSIONS FROM INCOME

Section 117 allows for the exclusion from income of amounts received by a degree-seeking undergraduate student in the form of a scholarship to the extent the funds are used to pay for tuition, books, and fees. While these scholarship payments do not affect income or assets in the financial aid formula, they are considered a "student resource" which reduces financial aid dollar for dollar. Similarly, section 127 allows employees to exclude from income employer-provided educational assistance of up to $5,250 for the payment or reimbursement of qualified educational expenses including tuition, fees, books, supplies and equipment for both undergraduate and graduate courses. In the financial aid formula, the exclusion is considered "nonassessable income" and does not affect either parental or student income. However, like the scholarship exclusion, the assistance itself is considered a "student resource" reducing financial aid dollar for dollar.

Table 5: Tax Planning for Education–Current Tax Savings–Education Credits			
Provision	Summary	Qualified Education Expenses Defined As	Effect on Financial Aid
§25A Hope Credit	Credit of up to $1,500 per student. 100% of first $1,000; 50% of next $1,000. Must be enrolled half-time. A non-refundable elective credit. If parent pays the expenses, must be able to claim exemption for student on tax return. Regulations explain who gets credit in special circumstances. AGI phase-outs: S: $42,000- $52,000; MFJ: $85,000-$105,000	Tuition, fees, during first two years of post secondary education. Courses must be associated with degree program. Athletic fees, insurance, activity fees, books are not eligible unless required as a condition of enrollment and paid directly to the institution.	Section 480(a)(2) states that tax credits cannot be considered income or assets for purposes of calculation. Section 480(j)(3) provides that determination of need for HEA Title IV aid programs–student's cost of attendance minus the EFC and non-Title IV assistance-is not to include the credits as non-Title IV assistance. Limited evidence suggests that financial aid officers are far from uniform in how to consider the tax benefits when packaging aid
§25A Lifetime Learning Credit	Credit of up to $2,000 per family; 20% on up to $10,000. A non-refundable elective credit If parent pays the expenses, must be able to claim exemption for student on tax return. New Regulations explain who gets credit in special circumstances. AGI phase-outs: S: $42,000-$52,000; MFJ: $85,000-$105,000.	Tuition, fees, including grad courses/continuing ed. Available for all post secondary education–not necessarily associated with degree.	Same as Hope Credit

STUDENT LOAN INTEREST DEDUCTION

The section 221 deduction, which allows taxpayers who are not claimed as dependents by another to deduct "For AGI" or "above the line" up to $2,500 of interest on qualified education loans for college or vocational school expenses (debt for which the taxpayer is legally liable), has no impact on the financial aid formula. Section 221 defines qualified education expenses as those for tuition, fees, room and board, books, equipment, and transportation reduced by nontaxable education benefits. Eligible institutions include colleges, vocational schools, or other post secondary institutions, and eligible students are required to take at least a half-time load in a degree, certificate, or other qualified program. A qualified education loan includes any indebtedness incurred by the taxpayer solely to pay qualified higher education expenses incurred on behalf of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred; attributable to education furnished during a period during which the recipient was an eligible student as defined in Section 25A(b)(3), i.e., a degree candidate carrying at least half the normal full-time workload; and paid or incurred within a reasonable period of time before or after the indebtedness is incurred. The Regulations (1.221-1(e)(3)(ii)(A) and (B) and 1.221-1(f)(3)(ii)(A) and (B)) provide a 90-day safe harbor rule.

It is important to note that the loan must be incurred solely to pay qualified educational expenses; interest on mixed use loans does not qualify for the deduction. Further, loan amounts must be reduced by nontaxable education benefits including the section 127 employer-provided educational assistance, nontaxable distributions from section 530 Coverdell ESAs, distributions subject to the Series EE bonds interest education exclusion, and veteran's educational benefits. The allowable deduction phases out for single taxpayers with AGIs between $50,000 through $65,000 and married filing jointly taxpayers with AGIs between $100,000 through $130,000.

The requirements make tax planning in advance of making the loan, specifically determining in whose name the debt should be incurred, critical. Because of the AGI (adjusted gross income) phase-outs discussed earlier, it may be advantageous for the student who generally has a lower AGI in the years during which the loan is repaid to incur the indebtedness. However, to preserve a later deduction, the student who is a dependent should avoid making interest payments while still claimed as a dependent. On the other hand, if parents will be making the loan repayments and wish to protect deductibility of the qualified education loan interest for themselves, the indebtedness should be in their name.

Of course, once the student is no longer a dependent, he or she is allowed a deduction for interest on a loan in his or her name even if someone else makes a payment. For example, if a third party such as a parent, grandparent, or employer, who is not legally obligated to make interest payments does so in behalf of a taxpayer who is legally obligated to make the payment, the taxpayer is treated as receiving the payment from the third party and, in turn, paying the interest which is deductible if otherwise qualified. This treatment is similar to that of third party payments of tuition for purposes of the Hope and Lifetime Learning credits in Reg. 1.25A-5(b)(1).

Regulations issued in May 2004 are intended to "ensure that students obtain the maximum deduction permitted under the law." The Regulations clarify several issues including the treatment of capitalized interest and certain loan origination fees (they are deductible), interest paid by third parties in behalf of the taxpayer (as mentioned earlier, treated as paid by the taxpayer), and the definitions of qualified education loan and eligible educational institution discussed earlier.

DEDUCTION FOR QUALIFIED HIGHER EDUCATION EXPENSES

Section 222 allows an above-the-line or "For AGI" deduction of \$4,000 for 2004 and 2005 for taxpayers with AGIs not exceeding \$65,000 (\$130,00 for married filing jointly) for qualified higher education expenses paid by the taxpayer and not otherwise deductible or excludible under other provisions. For the same time period, taxpayers with AGIs above those limits but not exceeding \$80,000 (\$160,000 in the case of married filing jointly) are entitled to a maximum deduction of \$2,000. The deduction is scheduled to expire after tax year 2005. As is the case for the Hope and Lifetime Learning credits, qualified expenses include tuition and fees for the taxpayer, taxpayer's spouse, or a dependent of the taxpayer paid to an eligible education institution (accredited college, university, vocational school, or other accredited post secondary educational institution) for courses of instruction.

Individuals claimed as a dependent by another and married taxpayers filing separate returns are not entitled to the deduction. An important restriction allows the deduction only to the taxpayer who pays the qualifying expenses. Therefore, in order for a parent to take the deduction for expenses of a dependent child, the parents must pay the expenses. Expenses paid by a dependent or a third party other than parents do not qualify for the deduction. Unlike distributions from ESAs and QTPs, the deduction may not be taken in the same year as Hope or Lifetime Learning credits for the same student. Further, while the entire tax-free distribution from an ESA reduces the deduction, only the earnings portion of a tax-free distribution from a 529 plan reduces the deduction. It is unclear how this deduction might affect financial aid as there is currently no language in the Higher Education Act governing the interaction between the new tax deduction and Title IV assistance.

HOPE AND LIFETIME LEARNING CREDITS

The section 25A Hope credit provides for a nonrefundable (cannot exceed tax liability) credit of up to $1,500 per student (100 percent of first $1,000 and 50 percent of next $1,000) for qualified education expenses paid during the year on behalf of a student (taxpayer, taxpayer's spouse, taxpayer's dependents) enrolled at least half-time in a degree program during the first two calendar years of post secondary education (college or vocational). Qualified education expenses generally include tuition and fees only, unless additional fees (such as athletic fees, computer fees, books and equipment fees) are required for enrollment in the institution and the amounts are paid directly to the institution. Expenses related to noncredit courses or courses associated with hobbies, games, or sports are usually not eligible for the credit unless they are part of the student's degree program. In addition, expenses paid with non-taxable income (excluded scholarships, distributions from ESAs) do not qualify unless the scholarship amount or ESA distribution is included in taxable income.

The credit, which is phased out for single taxpayers with AGIs beginning at $42,000 and married filing jointly taxpayers with AGIs beginning at $85,000, may not be claimed on a married filing separate return or on a return of an individual claimed as a dependent of another. Although the dependent may not claim the credit, expenses paid by a dependent are treated as paid by the parent, thus allowing the parent to claim the credit. Also, in a recent Letter Ruling (LTR 200236001) and consistent with final regulations, the IRS allowed the Hope credit to a student whose parents could have, but did not, claim him as a dependent. Observers note that this interpretation clearly favors the wealthy in that parents whose income level is such that credits and dependency exemptions are lost due to AGI limits may forgo the exemption and allow the student to claim the credit. Finally, unlike the treatment of the section 222 deduction, the Regulations also specify that payments made by third party directly to the institution are treated as student payments.

While the section 25A Hope scholarship credit was introduced to help ensure middle income students have universal access to the first two years of post secondary education, the Lifetime Learning credit was designed to offer continued support to a broader audience--traditional undergraduate students, graduate students, and "lifetime learners" who are not necessarily enrolled in a degree program. With the same AGI phase outs as the Hope credit, the section 25A Lifetime Learning credit provides for a 20 percent nonrefundable credit computed on the first $10,000 of expenses paid per taxpayer. Thus, the Lifetime Learning credit has a maximum per family unit; the Hope credit has a maximum per student. While the Hope and Lifetime Learning credits may not be taken in the same year for the same student, it is possible to switch from one credit to the other from year to year.

In terms of the impact of tax credits on financial aid, by statute, the receipt of the tax credits is to have no effect on a student's eligibility for, or level of, federal student aid. For calculation of the EFC under the Higher Education Act, HEA Section 480(a)(2) states that the tax credits cannot be considered income or assets for purposes of that calculation. Also, HEA Section 480(j)(3) provides that "the determination of need for HEA Title IV aid programs--student's cost of attendance minus the EFC and non-Title IV assistance--is not to include the credits as non-Title IV assistance. Any non-Title IV assistance included in this calculation reduces a student's need and hence, his or her eligibility and level of assistance under need-based Title IV aid" (Stoll).

COORDINATION OF TAX INCENTIVES

Recent changes in tax law have made planning for education both more flexible and more complex. In addition to recognizing the interaction with financial aid goals, the use of all tax benefits must be carefully planned and coordinated. When calculating current tax benefits for qualifying education payments, an ordering process is required. For taxpayers qualifying for the Hope or Lifetime Learning credits, qualified education expenses are first applied to the scholarship exclusion, then to credits, and finally to QTP or ESA distributions. If, on the other hand, the qualified higher education deduction is to be used, expenses are first applied to the scholarship exclusion, then to the QTP or ESA distributions, and finally to the deduction.

It should be noted that distributions from QTPs get more favorable treatment than those from ESAs in that only the excluded earnings portion reduces qualifying expenses available for the higher education deduction while the entire amount (earnings and contribution portions) excluded from an ESA is deemed to reduce the qualifying expenses. For example, assume tuition of $5,000. If the taxpayer makes a qualifying withdrawal from a QTP of $5,000 ($1,000 earnings and $4,000 original contribution) in order to pay the tuition, the expenses eligible for a credit or deduction are reduced only by the $1,000 earnings portion. Therefore, the other $4,000 would qualify for the credit or deduction. On the other hand, if the $5,000 withdrawal is used to pay tuition from an ESA ($1,000 earnings and $4,000 original investment), the expenses eligible for a credit or deduction are reduced by the entire $5,000 distribution.

Tables Six and Seven illustrate the coordination, in relatively simple examples, of various education incentives. From a tax planning perspective, note that tax free distributions from ESAs, QTPs, scholarships, or employer-provided education plans should be used to pay for expenses that do not qualify for the Hope or Lifetime Learning credit such as room and board, books, equipment or supplies as illustrated in Tables Six and Seven. Further, to maximize tax savings, qualified expenses should be paid with QTP distributions rather than ESA distributions due to the more favorable treatment of QTPs. To accomplish this, funds currently in an ESA may be rolled over tax free into a QTP (keeping in mind the gift tax consequences of transfers to QTPs).

Table 6: Coordination of Tax Incentives–Scholarships, Credits, Coverdell ESA	
Assume that the following expenditures were made:	
Tuition and fees	$15,000
Books, supplies, equipment	4,000
University-provided room & board	6,000
Total expenses	$25,000
Sources of funds were:	
Scholarship	$5,000
Coverdell ESA	15,000 ($10,000 earnings/$5,000 principal)
Total funds	$20,000
Scenario One–Take the Lifetime Learning Credit	
Apply the scholarship exclusion, which applies to tuition and fees and books, etc. first. For maximum results, apply against books, equipment, supplies first as the Hope/Lifetime Learning credits only apply to tuition/fees. Thus, the $5,000 scholarship is totally excluded from income. Remaining qualifying expenses are:	

Tuition and fees	$14,000 ($15,000 - $1,000)
Books, etc.	0 ($4,000 - $4,000)
Room & board	6,000
Total	$20,000
Compute the Hope or Lifetime Learning credit next.	
Hope credit = $1,500 (100% of first $1,000 of expenditures and 50% of next $1,000) OR	
Lifetime Learning credit = $2,000 (20% of up to $10,000 in expenses).	
Thus, use the Lifetime Learning credit. Remaining qualifying expenses are:	
Tuition and fees	$ 4,000 ($14,000 - $10,000)
Books, etc.	0
Room & board	6,000
Total	$10,000
The distribution from the Coverdell ESA was $15,000. Since the qualifying expenses are LESS than the distribution, part of the distribution is taxable.	
Qualifying Expenses	$10,000 = 67%
Distribution	$15,000
Thus, 67% of $10,000 earnings or $6,700 of the distribution is NOT taxable. The remaining $3,300 is taxable.	
Summary: $5,000 scholarship exclusion; $11,700 ($5,000 principal and $6,700 earnings) distribution exclusion; $2,000 credit. $3,300 is taxable.	
Scenario Two–Take the Hope Credit	
Apply the scholarship exclusion, which applies to tuition and fees and books, etc. first. Thus, the $5,000 scholarship is totally excluded from income. Remaining qualifying expenses are:	
Tuition and fees	$14,000 ($15,000 - $1,000)
Books, etc.	0 ($4,000 - $4,000)
Room & board	6,000
Total	$20,000

Compute the Hope or Lifetime Learning credit next as was done in the previous scenario but use the Hope Credit of $1,500 rather than the Lifetime Learning credit of $2,000 because it "consumes" less of the qualifying expenses.

Remaining qualifying expenses are:		
Tuition and fees	$12,000 ($14,000 - $2,000)	
Books, etc.	0	
Room & board	6,000	
Total	$18,000	

The distribution from the Coverdell ESA was $15,000. Since the qualifying expenses are MORE than the distribution, none of the distribution is taxable.
Summary: $5,000 scholarship exclusion; $15,000 distribution exclusion; $1,500 credit. Additional credit in scenario one better if tax bracket is 15% or less.

Table 7: Coordination of Tax Incentives–Scholarships, QTP or ESA, Education Deduction

Assume that the following expenditures were made:	
Tuition and fees	$15,000
Books, supplies, equipment	4,000
University-provided room & board	6,000
Total expenses	$25,000
Sources of funds were:	
Scholarship	$5,000
QTP or ESA	15,000 ($10,000 earnings/$5,000 principal)
Total funds	$20,000
Scenario One–Distribution from a QTP	
Apply the scholarship exclusion, which applies to tuition and fees and books, etc. first. For maximum results, apply against books, equipment, supplies first as the Hope/Lifetime Learning credit only apply to tuition/fees. Thus, the $5,000 scholarship is totally excluded from income. Remaining qualifying expenses are:	

Tuition and fees	$14,000 ($15,000 - $1,000)
Books, etc.	0 ($4,000 - $4,000)
Room & board	6,000
Total	$20,000

The distribution from the QTP was $15,000. Since the qualifying expenses are MORE than the distribution, none of the distribution is taxable and there are remaining expenses for the FOR AGI deduction for qualifying education expenses. Be sure to apply the room & board to the QTP exclusion since that is not a qualifying expense for the QEE deduction. The remaining qualifying expenses are:

Tuition and fees	$10,000 ($14,000 - 4,000*)
Books, etc.	0
Room & board	0 ($6,000 - 6,000)
Total	$10,000

*Note only the excluded earnings of $10,000 reduce the qualifying expenses.

The remaining qualifying expenses of $10,000 may be used for the deduction which is limited to $4,000 in 2004 and 2005.

Summary: $5,000 scholarship exclusion; $15,000 nontaxable distribution; $4,000 For AGI deduction

Scenario Two–Distribution from an ESA

Apply the scholarship exclusion, which applies to tuition and fees and books, etc. first. Thus, the $5,000 scholarship is totally excluded from income. Remaining qualifying expenses are:

Tuition and fees	$14,000 ($15,000 - $1,000)
Books, etc.	0
Room & board	6,000
Total	$20,000

Assume that the distribution was from a Coverdell ESA instead of a QTP. The QTP gets favorable treatment in that only the excluded earnings portion reduces the qualifying expense. However, all of the distribution from a Coverdell ESA is deemed to reduce the qualifying expenses. Since the qualifying expenses are MORE than the distribution, none of the distribution is taxable and there are remaining expenses for the FOR AGI deduction for qualifying education expenses. The remaining qualifying expenses are:

Tuition and fees	\$ 5,000 (\$14,000 - 9,000)
Books, etc.	0
Room & board	0 (\$6,000 - 6,000)
Total	\$5,000
The remaining qualifying expenses of \$5,000 may be used for the deduction which is limited to \$4,000 in 2004 and 2005.	
Summary: \$5,000 scholarship exclusion; \$15,000 nontaxable distribution; \$4,000 For AGI deduction	

CONCLUSION

With the cost of a college education increasing at more than twice the rate of inflation and three times the growth of the average family income, early planning to fund a college education is more critical than ever. Most financial planners agree that the first step in the complex area of college funding is the determination of whether or not a student will qualify for financial aid. The plan for those who may qualify is to incorporate many of the strategies discussed in this paper in terms of ownership of assets and timing of expenditures aimed at maximizing aid eligibility. Those taxpayers should use tax savings vehicles with the lowest impact on financial aid. On the other hand, those who will not qualify for financial aid will look to more tax-favored strategies to maximize family tax savings. In both cases, a thorough understanding of the various short-term and long-term tax savings provisions included in the Internal Revenue Code, their coordination with each other, and their interaction with the financial aid process should be part of every family's overall financial planning strategy.

Financial planners will be closely monitoring activities in Washington both before and after the election. Simplifying the "appalling array of education-related incentives" placed number two on a list of short-term priorities in former IRS Commissioner Fred T. Goldberg, Jr.'s June 15, 2004, testimony before the Subcommittee on Oversight of the House Committee on Ways and Means. In calling for action in this area, he endorsed Congress' and the Administration's recent proposals to consolidate benefits, simplify rules for expenses, increase the number of qualifying taxpayers, and standardize definitions.

Specifically, the President's 2005 Budget lists several simplifying provisions including a proposed new Lifetime Learning credit that would cover student loan interest up to $2,500, would apply the credit on a per-student rather than a per-taxpayer basis, would increase the AGI phase-out limits, and would index dollar limits. Bills by Congressman Amo Houghton would create an "Education Credit" that combines the Hope and Lifetime Leaning Credits and offers a tax credit for one-half of the first $3,000 of post secondary education expenses. The credit would be on a per child basis and would not be limited to the first two years of post secondary education. Senate Finance Committee Chairman Charles E. Grassley's Anticipatory Initiatives for Matriculation (AIM) Bill would make permanent several education incentives enacted in EGTRRA and remove the limitation on the deductibility of student loan interest. As the President and the 108th Congress continue to concentrate in the education incentive area with a number of bills currently at various stages in the legislation process, family tax planning for a college education will only become more complex.

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