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Trust UPDATE

Stillman BANK

Can you keep your family business in the family?

A few years ago, *The New York Times* reported on the estate of Allen Frechter. Mr. Frechter owned Plexi-craft Quality Products, which he ran until the day before he died at age 86. Frechter had no plan for keeping the business going after his death. In fact, given what his son, the executor of his estate, discovered about the business, it was surprising that the business lasted as long as it did.

- Purchase orders were all handwritten.
- There were no computerized customer lists.
- There wasn't even a product list.
- Data for analyzing how the business was doing were not available.

Fortunately, the son had good business sense, and experience in managing a business of his own. He was able to turn things around. He moved the business to a less expensive location, began a system of digital data entry for the prior six years of sales, and modernized the business in ways that his father was unable to do. The firm was projected to double its revenue in about six years.

Not every family is lucky enough to have such a talented heir to take the helm. The better course is to plan for business succession in an orderly fashion.

Identify the future leaders

The first question, perhaps the hardest question, concerns the next generation of leadership. Are there family members who will participate in the business, who eventually will take command? Or will key employees be in a position to acquire the business, with the skills needed for continued prosperity? How will these individuals be groomed to meet

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their future responsibilities?

If family members will be active in the business, it is important to get some of the business' equity into their hands early on. An ownership stake provides a critical incentive, and there may be long-term tax advantages as well.

The future leaders of the company are the people who are willing to put their names to a buy-sell agreement, the promise to acquire the business in the future on terms acceptable to both parties today.

Get a sound business valuation

The buy-sell agreement, in turn, must be founded upon a reasonable value for the business itself. Valuing a family business is as much an art as a science, and it is a job for a valuation expert. The vague question "How's business?" must be quantified, reduced to numbers. Among the factors to consider to get a starting value:

- historical earnings
- dividend-paying capacity
- tangible assets
- goodwill and intangible assets
- prior sales of company stock
- values of comparable companies
- the general outlook for the industry
- the general outlook for the economy

In general, a discount is applied to the value of a family-owned business that reflects its financial fragility. These discounts may include ones for lack of liquidity, for minority interests that lack meaningful control or influence over management decisions, or for the harm that the company may suffer when it loses the services of key personnel. Family businesses do not typically have a "deep bench" of management talent.

Fundamentally, the asserted value of a business must pass a "willing buyer, willing seller" test. The more documentation goes into the valuation, the more secure all parties should feel about it.

Understand the tax hurdles

The valuation sets the bar for the seller and the buyer of the business. It also potentially sets the bar for the tax authorities. Federal estate taxes kick in at $5.34 million in 2014. The threshold is usually much lower in the minority of states that have retained their "death taxes" (estate tax, inheritance tax, or both).

For married couples, the marital deduction defers federal estate taxation until both the husband and the wife have died. What's more, with the new "portability" election married couples may routinely double the value of the federal exemption, to over $10 million. That's enough to remove the tax worry from a large fraction of family businesses.

Owners of larger businesses will need the services of an experienced estate planner to address the death tax conundrums. Life insurance and trust planning may enter the picture at that point.

Rely on professional counsel

Given the evolving tax environment and the inherent complexity and unfamiliarity of estate planning, consider assembling a "cabinet of advisers" to create and implement the business succession plan. Key players on the team should include:

- *An accountant* who is familiar with the company's financial history;
- *An estate planning attorney* who understands state inheritance laws as well as death tax exposures;
- *An insurance agent* to look at creative ways of funding the buy-sell agreement and developing a pool of capital to meet death duties;
- *A banker* who can bring financial acumen as well as access to credit at a critical point in the business' life;
- *All the family members who are active in the business,* as well as key employees who are positioned for future leadership slots.

Assembling the team transforms succession planning from "something we need to get to" into an active process of executing current tasks and supervising the plans that the team develops.

Put us on your team

Over the years we've helped many business owners with their succession planning. Our counsel includes expertise in estate settlement and trust management, as well as sensitivity to the variety of family issues that attend wealth preservation and wealth management. We would be pleased to share this expertise with *your* family as well. ☐

The nonbusiness side of family business

What happens when some of the children are active in a family business and others are not? How can one treat all the heirs "equally"?

This is one of the knottier problems in estate planning. The resolution could involve having voting and nonvoting ownership interests, for example. If the owner's estate will include significant property outside the business, that may be used to "balance the scales."

Another idea to explore is the use of a trust to manage the ownership of the business. This can provide for greater flexibility, while protecting the business assets from claims by creditors of the heirs. A trust may be used to address what has been referred to as the "four D's" of estate planning:

- death;
- disability;
- divorce; and
- drug dependency.

Perhaps that's five D's after all. The trust document will outline the hopes and expectations of the trust creator, regarding both the operation of the business and the rights of the beneficiaries. The trustee may be given considerable discretion, if that is appropriate.

A professional, corporate trustee, such as us, may prove invaluable in these situations, especially if family harmony is less than perfect. We invite your questions, if you own a family business.

Check your beneficiary designations

As the new year begins, it's a good time for going over one's estate plans. The amount exempt from the federal estate tax grows to $5.34 million this year, which should excuse the vast majority of 2014 decedent estates from owing anything. However, nontax circumstances may have come into play, rendering a will less than fully effective. For example, there may be new heirs to consider, or asset values may have changed in a way that now causes the testamentary plan to veer from the original intention. If that might be your situation, a will review is called for.

Having a will is important, but having a will is not enough. Another key item that controls the passage of one's property at death is the beneficiary designation. Life insurance proceeds, retirement plan accounts and IRAs are all examples of property that will not pass through the probate estate unless the estate itself is designated as the beneficiary. These need to be reviewed from time to time, and marking the beginning of the new year as the checkpoint should keep them in accord with one's wishes.

Even a well-planned beneficiary designation may go awry, as a recent court case shows. Leonard Kidder named his wife to be the sole beneficiary of his company's 401(k) plan at his death. However, his wife died before Leonard did. He then updated the beneficiary designation, naming his three children to share the account equally.

So far, so good. Some years later, Leonard remarried. He didn't change his beneficiary designation, but the law known as ERISA did. To comply with ERISA, the company 401(k) plan provided that a surviving spouse will inherit any plan balance unless the spouse has filed a waiver of his or her rights. Leonard's second wife did not file such a waiver. Although they had been married for just six weeks when Leonard died, the second wife claimed the 401(k) balance as hers.

The children objected, but to no avail. The plan terms were clear and unambiguous. ERISA allows for a one-year waiting period for spousal rights to vest, but does not require such delay. Leonard's plan did not include a waiting period. If Leonard really wanted to preserve the inheritance for his children, he needed to take appropriate steps before he remarried.

401(k) versus IRA

The outcome was different in another court case pitting a second wife against children from a first marriage. Wilson began living with Chandler in 1990. In 1994 he took a lump sum distribution of his 401(k) money and rolled it into an IRA. He made additional IRA contributions from 1995 to 1999. Wilson and Chandler married in 2000.

Two years later, anticipating a possible divorce, Wilson transferred half of the IRA money into a new account. His four adult children from a previous marriage were the beneficiaries of this account. Wilson died in a flash flood in 2005, at age 65, before getting divorced. Chandler filed suit to claim all the IRA money, alleging that Wilson could not deny her the right to the funds that originated in an ERISA-qualified plan.

Not so, the Court ruled. The spousal rights accorded to ERISA plans do not extend to IRAs. What's more, in this case the rollover of the funds to the IRA occurred long before the marriage took place, so there was no spousal consent possible when the transfer was made.

Don't leave it to chance

We can be pretty confident that Wilson achieved the result he intended with his IRA. About Kidder there is less certainty. Did he know that his new wife would get his 401(k), and so would have been happy with the result? If so, he would have been well advised to have changed the beneficiary designation, in order to remove all doubt and avoid the expense of litigation. On the other hand, perhaps Kidder was ignorant of the plan rules that vested his 401(k) money in his wife upon the moment of his remarriage. Consultation with an estate planning attorney might have set him straight.

When you are meeting with your estate planning advisors, don't overlook the importance of beneficiary designations in the implementation of your testamentary plans. ☐

Flying high

Depreciation deductions allow businesses to recover the cost of their investments in assets that have a limited useful life. To stimulate the economy, Congress has, from time to time, created a temporary window in which "bonus" depreciation is permitted, encouraging purchases of depreciable assets. For example, a 50% bonus was enacted for qualified property placed in service after May 5, 2003, and before January 1, 2005.

Critics may debate the effectiveness of such measures, but this one definitely stimulated Michael Brown. His career was selling "high-end" life insurance, no policies under $10 million, and he was very good at it. Brown's business took him all over the country. Generally, he chartered airplanes, but this did not always prove satisfactory. In 2003 Brown decided that he needed a private jet to be able to meet with his prospective customers at their convenience. As he began his shopping, Brown made it clear to everyone that he needed the deal to close in 2003 so that he could secure the bonus depreciation for that tax year. Eventually, Brown found an appropriate jet that cost $22 million. However, in the course of his shopping, he had seen a jet that included a conference table and large digital display screens suitable for PowerPoint presentations.

Brown concluded the purchase agreement for his jet in December. He also made the down payment for the reconfiguration of the interior of the jet to accommodate the conference table and displays in January 2004, for an additional half-million dollars. Although Brown lived in California, he arranged to take delivery in Oregon, on December 29, 2003, to avoid paying California sales tax. Brown then had his pilot use this jet to fly him first to Seattle, then to Chicago, for business meetings that day. He believed that these trips constituted putting the jet "into service" for tax purposes, and so he claimed some $11 million in bonus depreciation for 2003.

Not so fast, said the IRS. This business jet wasn't just for transportation; its purpose also was to create a suitable environment for making presentations to potential customers and other insurance agents. As such, the jet actually wasn't put into service until the modifications were completed in January.

The law is surprisingly murky on this point. After a review of the case law, the Tax Court agreed with the IRS. Not just any use of an asset will satisfy the "placed in service" test; it must be available for its intended use on a regular, ongoing basis. The Court accepted Brown's December business trips as legitimate, and it ruled that they were enough to negate the fraud penalty that the IRS had assessed. Unfortunately for Brown, a separate accuracy-related penalty was upheld. ☐