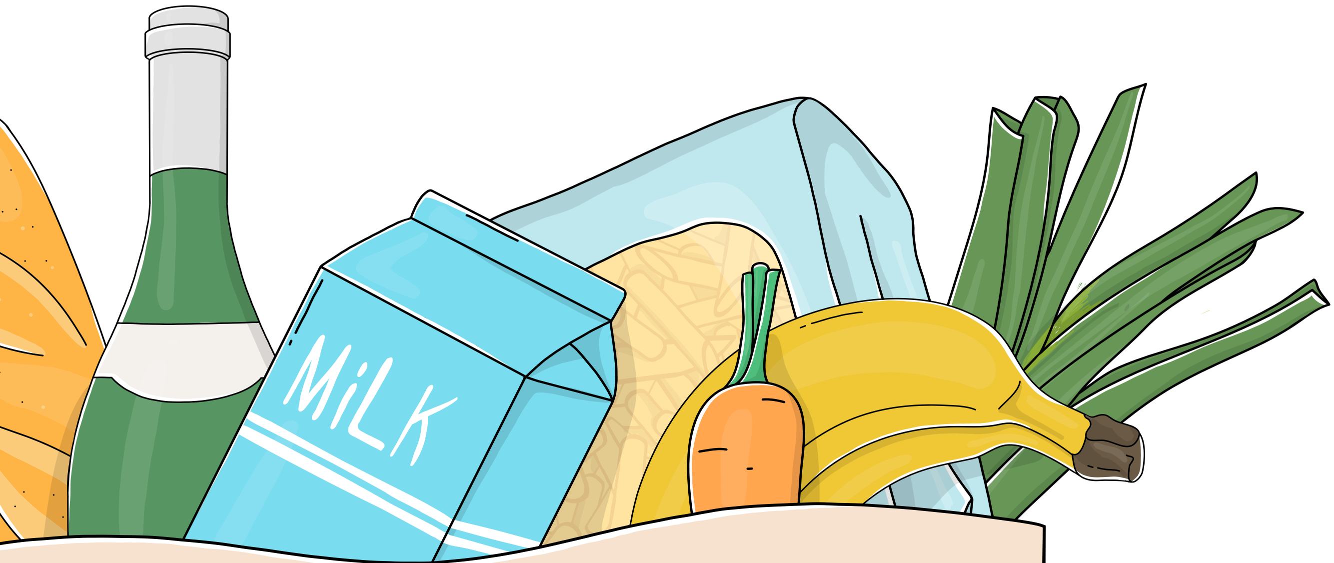
IN THIS ISSUE

Trust UPDATE

Stillman BANK

August 2020



Can you keep your family business in the family?

This is a true story. The details are truncated, but the facts are from court records and news sources.

Russell Lund began his career in 1922 at Hoves Grocery in Minneapolis, working as a 10% partner in the cheese and cracker department. In 1939 he became a full partner in Hoves' perishable department. He opened two more Hoves stores in the next three years, and they were successful. In 1964 the stores were renamed Lunds, and they continued to prosper.

To keep the business in the family, Lund arranged for a series of trusts to own the business. Lund died in 1992, as did his son. That left his four grandchildren effectively as 25% owners of the Lunds grocery chain. One grandson, Tres, was already CEO in 1992, and he continued to manage the firm. Each of the grandchildren received substantial payouts every year from the trusts, based upon the profits of the grocery business.

However, that stipend was insufficient for one granddaughter, Kim. As early as 1992 she began talking about cashing out her equity in the business. The trusts imposed a requirement of unanimous consent of the four grandchildren for any change in ownership, and the others did not support Kim. In 2014 she filed a lawsuit demanding the right to sell her interest, a lawsuit that she won. Kim testified that the reason she wanted to liquidate her ownership was that she wanted to become a philanthropist.

That led to another lawsuit over the value of Kim's share of the business. This was a tricky proposition, because the business owned real estate and had very little debt. The siblings offered her some $20 million, while her lawyers demanded $80 million. That much new debt would cripple the business, Tres responded. Eventually a court decided Kim should get $45 million. That decision was appealed all the way to the Minnesota Supreme Court, which declined to review the case. Expansion plans for the grocery chain were put on hold while the financing was worked out.

Thus far, the Lund family business has weathered a severe storm, and is still in the family. There will be more storms in the future.

Identify the future leaders

The first question in estate planning for a family business—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, as Tres did? 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 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, with the promise to acquire the business in the future on terms acceptable to both parties today.

Continued on next page

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 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

Typically, a discount is applied to the value of a family-owned business that reflect its financial fragility. These may include discounts for lack of liquidity, for minority interests that lack meaningful control or influence over management decisions, and 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 that 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 above $11.58 million in 2020. The tax threshold is usually much lower in the minority of states that have retained their "death taxes" (estate tax, inheritance tax, or both). Also, that exemption is scheduled to drop roughly in half in 2026.

That exemption may seem generous. But returning to the Lunds situation, if each remaining share of the business is also worth $45 million, the estate tax exposure for each of the remaining siblings would be over $13 million! Where would the cash come from to pay for that inheritance?

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, owners of a family business should consider assembling a "cabinet of advisers" to create and implement the business succession plan. Key players on the team 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; and
- All the family members who are active in the business, as well as key employees 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 supervision of 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 a 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, as in the Lunds situation? 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 Ds" of estate planning:

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

Perhaps that's "Five Ds" 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.

IRAs: Traditional or Roth?

IRAs have wonderful tax advantages. The traditional IRA offers the possibility of a tax deduction (depending upon one's income and tax filing status) and full deferral of taxes on investment earnings until withdrawal. The Roth IRA does not give rise to a deduction, but all withdrawals are potentially tax free, including withdrawals of investment earnings. Withdrawals of contributions are always without tax consequence. Finally, the rules for Required Minimum Distributions (RMDs) that kick in at age 72 do not apply to Roth IRAs.

The conventional wisdom has been that traditional IRAs are better if one's tax bracket will be going lower during retirement and the deduction happens during the working years in the higher brackets. However, the highest tax brackets now apply at income levels much higher than the deduction thresholds, so this analysis has lost much of its force.

The Roth IRA is to be preferred if one hopes to preserve tax deferral for as long as possible. Also, if one wants to take $10,000 out of a Roth IRA to cover certain retirement expenses, such as a family cruise, only $10,000 need be withdrawn. With a traditional IRA, one must withdraw enough to cover the income taxes as well as the retirement expense. That might mean, for example, that $13,000 would have to be taken so as to cover both the retirement expense and the tax on the withdrawal.

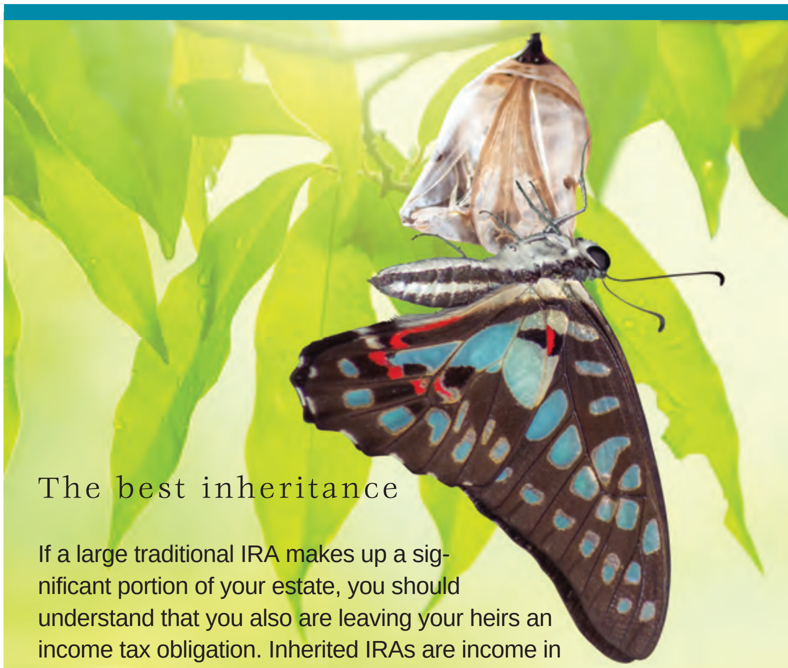
However, here are some situations in which the traditional IRA may be the better choice, because lowering your adjusted gross income will affect more than just your tax bill.

You are buying health insurance through a state marketplace. Federal subsidies are available to those who purchase their health insurance from a state marketplace. The subsidies are tied to Modified Adjusted Gross Income (MAGI), and contributions to a traditional IRA will lower one's MAGI. As income falls, the subsidy grows. For 2020, subsidies are available to those with less than $49,960 of income ($67,640 for married couples).

You plan to apply for an income-based repayment plan for your federal student loans. Some programs link repayments to adjusted gross income. Contributing to a traditional IRA may generate both an income tax deduction and a reduction in loan payments. Some loans may be forgiven in 20 to 25 years, or in the case of some public service situations, as little as ten years.

You want to lower the Medicare surcharge. Medicare looks back two years at your income to determine the surcharge on your monthly payments, which can range from $202 to $491 per month. Contributing to a deductible IRA may lower your income enough to reduce that surcharge. If you are working and can contribute to a 401(k) plan, the opportunity for reducing adjusted gross income is even greater. Anyone who is 63 or 64 and planning to enroll in Medicare at age 65 should take a careful look at this option.

You earn too much to contribute to a Roth IRA. If your 2020 MAGI is over $139,000 ($206,000 for marrieds filing jointly) you are not eligible to make a contribution to a Roth IRA. You are still eligible to make a nondeductible contribution to a traditional IRA, and the tax on investment earnings will be deferred for the deductible and nondeductible portions alike. As a high income earner, if your desire is to still contribute to a Roth IRA, you may wish to consider a "backdoor Roth IRA" strategy as a means of indirectly contributing to a Roth IRA. In essence, an IRA owner makes a non-deductible contribution to a Traditional IRA and then later converts it to a Roth IRA. Before using this strategy, however, it is important to discuss the tax implications with your tax advisor. Also, please keep in mind that, as a result of recently enacted legislation, converting assets from a Traditional IRA to a Roth IRA can no longer be reversed. ☐



The best inheritance

If a large traditional IRA makes up a significant portion of your estate, you should understand that you also are leaving your heirs an income tax obligation. Inherited IRAs are income in respect of a decedent, and so the heir must pay income taxes on all distributions. Subject to a few exceptions, inherited IRAs must be distributed over the ten tax years following the owner's death. If your heirs are in low tax brackets, the income tax burden may not amount to much. If they are in higher brackets, or have a particularly good year, the tax could be substantial.

One answer to consider is converting all or a portion of the traditional IRA to a Roth IRA. The Roth IRA also must be distributed over ten years, but no distributions will be required until the tenth year, allowing for maximum tax-free growth.

You will have to pay income tax on the full amount of the conversion. Also, keep in mind that a Required Minimum Distribution (RMD) may not be rolled into a Roth IRA. Consult your tax and financial advisors if you think this might a be good idea to explore.

Being certain

Bellamy was an expert in classical Arabic literature. He joined the Department of Near Eastern Studies at the University of Michigan in 1959, became a full professor in 1968, and continued teaching there until his retirement in 1995.

In 1998 Professor Bellamy created the Bellamy Trust for the management of his estate. In 2011 the trust was amended "to endow a full professorship, named after the Grantor, in the field of medieval classical Arabic literature" at the University of Michigan. Negotiations between Bellamy and the University were undertaken with the supervision of a lawyer in 2011, and a gift agreement was struck matching the terms of the trust. If there was no one on staff that met the qualifications, the University was obligated to look for an outside applicant.

Professor Bellamy's colleague, Trevor Le Gassick, was the trustee of the trust and eventually the executor of Bellamy's estate after he died in 2015. Le Gassick transferred $2.5 million to the University in February 2016 to endow the professorship, and another $1 million in July 2016 to fund a graduate student fellowship.

When the University advertised for applicants for the Bellamy Chair, the notice stated the position was for an assistant professor, not the full professorship as promised in the gift agreement. The trustee protested, the advertisement was pulled, and Professor Ali, who already worked in the department, was hired. However, Ali did not have the requisite qualifications, a fact attested to by other faculty members. What's more, on the day that Ali was appointed, the trustee heard the department chair say that "the motive behind Professor Ali's appointment was to alleviate Department budget issues by having the Bellamy Trust rather than the Department pay Professor Ali's salary." The University evidently intended to move away from teaching classical Arabic literature and wished to add Bellamy's gift to its general fund.

Trustee Le Gassick sued the University for breach of contract, breach of fiduciary duty, and for failing to loyally honor Professor Bellamy's wishes. The University asked for summary judgment, saying that Le Gassick had no standing to bring such a lawsuit. Once the gift was complete, a new trust was created to manage the money, one entirely under the University's control. The lower court granted that motion.

The Michigan Court of Appeals later reversed. The relevant law permits lawsuits to enforce a charitable trust by "the settlor, a named beneficiary, or the attorney general of this state, among others." The trustee falls into that final category. As the fiduciary for Bellamy's estate, Le Gassick had a duty to see to it that the terms of the gift were adhered to. The summary judgment was reversed and the case returned to the lower court for additional proceedings. ☐