Headline: Family Business Trusts

Subhed: Protecting Valuable Assets from Outside Threats

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James runs a rapidly growing family business.

Things are going great now, but he worries about the future. If he should suddenly become incapacitated, who will run the enterprise for the benefit of his wife and children, none of whom have yet mastered the skills required to manage a commercial operation?

After consulting with his attorney, James comes up with a solution: a revocable trust that designates a skilled trustee to take the reins of the business in the event James can no longer perform his duties.

“A revocable trust is created while a business owner is still alive,” said Michael P. Sampson, partner in the Minneapolis law firm of Maslon LLP. “It allows the owner to retain control of business assets while arranging for a trustee to step in and manage things in case the owner becomes incapacitated.”

The revocable nature of the trust is important for anyone who, like James, wants to retain ownership and control of the business assets. And a revocable trust can also help the family avoid costly probate if James should die.

AVOID PROBATE

Family businesses often establish trusts to solve many critical problems.

On the death of the business owner, for example, a trust can protect against costly probate, secure sensitive business information from prying eyes, guard family assets from crippling lawsuits and creditor claims, and even prevent turf wars among surviving children.

The traditional use of trusts to avoid estate taxes has become less important since federal tax law recently increased the estate tax exemption to $11.2 million for individuals and $22.4 million for married couples.

The good news is trusts can be created by organizations of all sizes.

“Even smaller family businesses can use trusts,” said John J. Scroggin, partner in Atlanta-based Scroggin & Company, a law firm active in business and estate planning.

“The issue is driven not by size in terms of revenues or assets, but by a desire for long-term protection of a business.”

How can you use trusts to help your own family business?

For starters, consider using one to efficiently allocate assets to the younger generation.

While a will can do the same thing, a trust is more difficult to challenge and has the advantage of avoiding probate.

“Probate can be expensive and time-consuming,” Sampson said. “That is especially true in states such as California, Florida, Illinois and New York, where probate is very complicated, or for businesses operating in more than one state with their different probate laws.”

In addition to saving money, avoiding probate can also protect your business secrets.

“You might not want your competitors looking up your will at the courthouse to see how much money or debt your family has,” Sampson said.

Public records are also sometimes accessed by predators who try to victimize people who have inherited money.

PROTECT ASSETS

Can a trust that allocates family business assets to the next generation be *revocable*?

Yes, but there are inherent risks.

Consider Sarah, who wants to do just that.

Sarah’s attorney tells her if she makes the trust revocable, all of the business assets will remain under the ownership of the family. As a result, they will be at risk of being attached by creditors or lost in lawsuits.

The assets might also be seized to satisfy any nursing home bills incurred by the person who establishes the trust.

For those reasons, Sarah decides to set up an *irrevocable trust.* Because the trust will own the business assets, they will not be subject to risks of loss, either before or after she dies.

The terms of an irrevocable trust can address the demands of complex family dynamics. For example:

Protecting the income of a young child: Adam and Sylvia, who own all of the stock of ABC Company, have a 9-year-old child named Jane. They establish an irrevocable trust that designates Adam’s brother Jason as the trustee. In the event of the death of the parents, Jason will run the enterprise. Jane, the trust’s beneficiary, will receive stock dividends and distributions from any assets.

Avoiding sibling disputes: Andrew and Beth are concerned that when they die their children might squabble about the family business assets, putting the organization’s survival at risk.

Daughter Suzy has already said she wants to run the business, while her brother John feels the business should be sold and the assets distributed.

“A trust can designate that Suzy will run the business, and that John will not be involved but will receive a certain amount of money monthly from the trust,” said Nicole N. Middendorf, CEO of Prosperwell Financial in Plymouth, Minn.

Protecting a victim of addiction: Bart and Susan want to avoid leaving a sudden windfall to their son Chet, who is struggling with drug addiction.

How can they make sure Chet is taken care of in the event of their deaths, while avoiding a waste of inherited assets?

“A trust can designate that Chet receive a certain amount of money every month,” Middendorf said. “Or, to avoid funding the addiction, a trust can pay his rent so he always has a roof over his head. The trust could even mandate that he pass a drug test to receive his monthly payment.”

Controlling a spendthrift: Some people are just bad with money. Henry and Ida are afraid their daughter Beverly will spend her inheritance on fancy cars and travel.

That’s why they decide to set up a “spendthrift trust” that will release funds only for expenses related to health, education, maintenance and support.

“A spendthrift trust can be a valuable way to protect beneficiaries from spending all of their inheritance,” said Arlene Cogen, a certified financial planner and philanthropic leadership consultant based in Portland, Ore.

Avoiding claims arising from multiple marriages: James wants to make sure that if he dies, his wife Mary receives income for life from the company dividends and asset distributions so she can take care of their children, Betty and Jack.

But if Mary should remarry and then later die, James wants to make sure the money from the business goes directly to Betty and Jack – not to Mary’s new spouse or the new spouse’s children.

Again, a trust can mandate that complex asset distribution pattern.

Avoiding claims arising from a childless marriage: Harris and Marge have three children named Deborah, Francine and Bart.

Deborah is married to a man named Frank but has no children and is not expected to. Harris and Marge are concerned that if Deborah is given some of the equity and then dies, the equity will pass on to Frank, a nonfamily person who could try to dictate business decisions and make unreasonable demands, such as hiring his friends.

Furthermore, if Frank remarries and then dies, his new spouse, a stranger to the family, might end up owning a third of the business. And that person might demand an exorbitant buyout to avoid a lawsuit.

“In this example, when Deborah dies without any descendants, a trust can call for her interest to pass on to her siblings or their descendants,” Scroggin said.

STAY FLEXIBLE

All of those scenarios illustrate the flexibility of irrevocable trusts. They can do all kinds of things for people who are too young to run a business, have no interest in doing so, are incapacitated or need to be protected from their own damaging decisions or habits.

Trusts solve business problems by separating legal ownership and control of a business from the enjoyment of the business assets by beneficiaries.

Flexibility, though, runs both ways. Attorneys advise against micromanaging the family business transition.

“Sometimes people take control too far by not including enough flexibility for the beneficiaries,” Sampson explained. “As a result, what seems like a reasonable provision in a trust today might make no sense some years down the road.”

He offered an example.

Mark heard “incentive trusts” could be established to prevent the problem of a child becoming a “trust baby” and slacking off instead of working. So to inspire a work ethic in his son Jerry, Mark established a trust that would provide distributions to match his son’s earned income each year.

Mark’s attorney encouraged him to include a provision allowing additional distributions in the trustee’s discretion, just to provide flexibility.

One day Jerry was driving home on a motorcycle when a serious accident left him unable to ever work again. If it were not for the provision allowing discretionary distributions beyond the amount of Jerry’s earned income, the trust assets would not have been available to provide the money required for his medical attendant.

There’s a moral to that story.

“Don’t try to design for a scenario that is too specific,” Sampson advised. “It’s a good idea to include a provision that the trustee can make distributions of income and principal in the trustee’s discretion – just in case something unanticipated happens.”

Sampson also suggests another point of flexibility: the ability to change a trustee who is uncommunicative or too tight with distributions.

“There should be a way to replace the trustee,” he said. “You can even give that power to beneficiaries as long as the new trustee is truly independent.

“The replacement should not be an employee of one of the beneficiaries, for example, or a relative. The flip side is that the trustee must be strong enough to sometimes say no to the beneficiaries. The balancing act is to provide enough flexibility without giving so much freedom that the trust becomes a sham.”

Trusts need to recognize the possibility of future surprises. That’s why the trend today is toward the use of “discretionary trusts” – irrevocable trusts that do not specify a set amount of income for beneficiaries but rather allow for trustee discretion.

Discretionary trusts offer considerable protection from creditors and lawsuits. That’s because the law says a creditor can only access the assets of an irrevocable trust to the same extent as the beneficiary.

So if the beneficiary cannot get at the money in the trust to pay a business expense without the permission of the trustee, neither can a creditor

START EARLY

Starting the trust planning process early will help protect your family business assets from a sudden loss through an unexpected lawsuit or death.

“Planning should start as soon as your business has assets worth protecting,” said Bill Babb, senior consultant for the Family Business Institute in Raleigh, N.C.

“You want a smooth and safe transition program in place before the death of someone in an ownership position. The risk of delay is that your business assets go to creditors and the IRS rather than to the people you want to receive them.”