WebsterBank

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Trusted Insights

WEALTH MANAGEMENT

Estate planning must go on

There are several clouds over the practice of estate planning as we begin 2021. Will there be legislative action this year to increase the revenue from federal transfer taxes? Might some traditional tax-saving strategies be at risk? Perhaps most important, what will be the effective date of any tax changes? There is a possibility of them being retroactive to the first of the year.

Apart from the unpredictable legislative agenda, there is also the question of volatile asset values during the pandemic. For estates of those who died during the pandemic, and for wealthy families who have or are planning to implement substantial wealth transfers, our lead item in this issue of Trusted Insights could prove especially valuable.

We seem to be far from a return to normalcy, yet estate planning is a vital service that must not be delayed indefinitely. We are ready to assist you and your clients in any way that we can. Please call upon us whenever the question of fiduciary services arises in your practice.

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How to value a gift in an uncertain economy

ON THE ONE HAND, WHEN THE ECONOMY IS VERY UNCERTAIN IT WOULD SEEM TO BE THE WORST TIME FOR WEALTHY PEOPLE TO THINK ABOUT MAKING MAJOR ASSET TRANSFERS, GIVEN THAT NO ONE WANTS TO RUN OUT OF MONEY.

On the other hand, many assets have lost substantial value during the pandemic, notably closely held businesses and real estate. Reportedly some commercial New York City real estate has lost as much as 75% of its value. What's more, when wealthy people die during a pandemic, their executors will have to come up with a realistic value for all their assets. The Tax Court ruled in 2019 on a gift tax case that arose from a gift in 2009, after the last economic downturn and during a period of similar grave uncertainty.

> "**The Tax Court ruled in 2019 on a gift tax case** that arose from a gift in 2009, after the last economic downturn and **during a period of similar grave uncertainty.**"

The factual setting

Aaron Jones founded the Seneca Sawmill Company (SSC) in Oregon in 1954. The company prospered and expanded over the years. In 1989 Jones became convinced that emerging environmental rules would restrict his access to timber from federal lands. He established the Seneca Jones Timber Company (SJTC) to purchase and manage privately held forest land, and that company became a primary supplier of logs to the sawmill. Over the years 150,000 acres of forest was acquired. Although the two companies were legally separate, their ownership and management were closely intertwined. SJTC could not sell timber to third parties without the approval of SSC.

Although the two companies were prosperous, the 2008 recession had a major impact on them. Housing starts fell from an annualized rate of 2.3 million in early 2006 to just 490,000 in early 2009, sharply reducing the national demand for lumber. SSC had to reduce employee hours to avoid layoffs. Lumber companies in the area that did not own their own timberlands did not survive. New financial projections were done in April 2009, and additional steps had to be taken by SSC to comply with loan covenants.

Mr. Jones began his estate planning in 1996, hoping to keep his companies in the family and operating in perpetuity. In accordance with that plan, in May 2009 Jones established seven trusts to have partial ownership interests in SSC and

SJTC. Jones reported the funding of the trusts as a taxable gift worth more than $7 million and paid the gift tax on it.

After Jones died in 2014, the IRS challenged the gift tax valuation.

The IRS reaction

As so often happens, the case before the Tax Court became a battle of appraisal experts. The estate's expert valued the companies as a going concern, using the discounted cash flow method of valuation. That produced a total value for the firms of $21 million before discounts. In contrast, the expert testifying for the IRS used a net asset value approach, treating the companies as a natural resource holding company rather than an operating business. He came up with $140 million as the total value of the firms.

The Tax Court felt that each approach should be given some weight, noting that the firms were in fact both operating companies and resource owners. However, given the severe restrictions on SJTC's ability to independently sell its logs, that factor had to be significantly discounted.

The estate argued that tax effects needed to be taken into account in the valuation, because a willing buyer would certainly do so. The IRS argued that tax effects should be ignored, because the companies were structured as pass-through entities, but the Court pointedly observed that none of the IRS' valuation experts backed up that theory. The tax effects were allowed. Also, the estate successfully defended a 35% discount for lack of marketability of the interests.

The element that makes this case especially relevant in these times is that the estate argued for using the April 2009 financial projections in determining the value of the gifts one month later. The IRS considered those projections to be overly pessimistic and unreliable, given the economic uncertainty. However, that uncertainty was precisely why the management had done the additional April projections, using the same methodology as had always been employed in earlier years. *The Court accepted the April data as proper* [*Estate of Aaron U. Jones v. Commissioner*, T.C. Memo 2019-101 (2019)].

This decision suggests that appraisals done in the shadow of the COVID-19 pandemic can be successfully defended before the IRS.

Disharmony in the family **business**

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. Every year, each of the grandchildren received substantial payouts 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

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 such as Webster Bank, often coupled with a family member as co-Trustee who is knowledgeable about the business may prove invaluable in these situations, especially if family harmony is less than perfect. We invite your questions, if you or any of your clients own a family business.

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.

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:

- *A business exit planning expert*, such as Webster Bank, who can design and coordinate implementation of the business exit plan to maximize sale proceeds and meet the goals of the business owner(s);
- *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.

Short takes

Prince's estate heading to **Tax Court**

Pop superstar Prince's estate filed an estate tax return, and the IRS didn't like it. The Service asked for an additional $32.4 million in estate taxes and $6.4 million as a penalty for substantial understatement of tax.

The issues are valuation, as one would expect. The estate reported Paisley Park, Prince's home, to be worth $5.1 million; the IRS said $7.6 million. Prince's right of publicity was worth $3.2 million per the estate and $6.2 million by the IRS' calculations. The estate says that the value of Prince's interest in NPG Records was $19.4 million; the IRS came up with $46.5 million. And so on.

The estate also asserts that it relied upon qualified appraisers in making good-faith determinations of value, and so the penalty is not appropriate.

In its response, filed November 19, 2020 the IRS did not back down one inch. It asserted that the estate had failed to provide fair market values based upon the work of qualified independent appraisers. The Tax Court case is expected to be a battle of the appraisers, unless a compromise can be reached.

In a possibly related development, in early December it was reported that Bob Dylan had sold the copyrights to all his songs. No reason was given for the sale at this time, and the price was not announced, but it was estimated by some at $300 million. This could have been a shrewd estate planning move by the 80-year-old singer, as there can no longer be a valuation dispute for this asset.

Attorney as **investment manager**

Phillip Farthing, a Virginia attorney, was the trustee of several trusts created for the Higgerson family. In 2014, trust beneficiary Edith Higgerson filed suit against Farthing, alleging mismanagement of trust assets, excessive and reckless stock trading, and collection of excessive trustee's fees. She died in 2016 before the case concluded, but her estate, other Higgerson beneficiaries, and a successor trustee joined the suit.

Farthing lost the case rather decisively. The court found damage to the trust of $1.3 million, excessive trustee fees of $779,471, and it awarded the Higgersons $101,062 in attorney's fees.

Farthing was covered by $1 million worth of malpractice insurance, issued by ALPS Property & Casualty Insurance Companies. Following the verdict, ALPS filed a declaratory judgment action contending that the policy did not cover any of the damages awarded by the state court. ALPS also asked to be reimbursed for their costs of provided Farthing with his state court defense.

“**Farthing was covered by $1 million worth of malpractice insurance,** issued by ALPS Property & Casualty Insurance Companies. Following the verdict, ALPS filed a declaratory judgment action contending that **the policy did not cover any of the damages awarded by the state court.**”

At trial, the parties conceded that the awards for excessive trustee fees and attorney fees were not covered by the insurance policy. The Court found that a contract exclusion for "... any conversion, misappropriation, improper commingling or negligent supervision by any person or client or trust account funds or property, or funds or property of any other person held or controlled by an insured in any capacity or under any authority, including any loss or reduction in value of such funds or property" meant that the poor investment management decisions of a trustee would not be repaired by the malpractice insurance.

The exclusion language was not ambiguous.

The Higgersons will have to look only to Farthing's assets for their recovery, which may prove insufficient. The decision does not reveal the size of the trust or how long the trustee's malfeasance was allowed to continue [*ALPS Property & Casualty Ins. Co. v. Higgerson*, 805 Fed. Appx. 193 (4th Cir. 2020)].