UNDERSTANDING FAMILY BUSINESS TRUSTS

How to protect your assets from outside threats

By Phillip M. Perry

Editor's note:
Are you operating a family business? If so, I recommend that you read this article from award-winning journalist Phillip Perry and learn how to protect your assets and avoid costly fees.

Carefully designed family business trusts can help avoid probate, buffer lawsuits and creditor claims, and resolve disputes about the distribution of assets to the next generation. Plan early to protect your business from an unexpected lawsuit or death.

A growing family business

James' family business is thriving, but as the owner, he's worried who will run the company should he become incapacitated.

After consulting with his attorney, James determines a revocable trust is the best solution because it designates a skilled trustee to run the business in the event James can no longer perform his duties.

A revocable trust is created while the business owner is still alive, which gives families peace of mind, said Minnesota attorney Michael P. Sampson. "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," he added.

The revocable nature of the trust is important if James wants to retain ownership and control of the business assets. A revocable trust will also help the family avoid costly probate if James should die.

All businesses can benefit from a trust

The good news is that even smaller family businesses can utilize trusts, said Atlanta-based attorney John J. Scroggin. "The issue is driven not by size, in terms of revenues or assets, but by a desire for long-term protection of a business."

Trusts can 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.

Avoiding probate woes

Upon the death of a business owner, for example, a trust can protect against costly probate, secure sensitive information, guard assets from crippling lawsuits, and even prevent turf wars by surviving children.

"Probate can be expensive and time consuming," said Sampson. "This 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."

A trust offers more security than a will. Wills are public records and can be accessed by competitors trying to evaluate how much debt or money you have. In addition, predators may try to victimize people who have inherited money.

"Having your property passed along under the terms of a trust avoids the creation of public records that result from court involvement," said Sampson.

Revocable versus irrevocable trusts

A trust that allocates family business assets to the younger generation can be revocable, but it has inherent risks. For example, Sarah's attorney tells her that if she makes the trust revocable, then all business assets will remain under the ownership of the family.

As a result, the assets may be attacked by creditors, lost in lawsuits, or even seized for any nursing home bills incurred by the person who establishes the trust. To avoid these potential risks, Sarah decides to set up an irrevocable trust.

When to consider an irrevocable trust:

1. **To protect the income of a young child.** Establish an irrevocable trust that designates someone as the trustee. In the event of the death of the parents, that person will run the enterprise, and the trust's beneficiary will receive stock dividends and distributions from any assets.
2. **To avoid sibling disputes.** "A trust can designate that one sibling will run the business and that another will not be involved but will receive a certain amount of money monthly from the trust," said Nicole N. Middendorf, CEO of Prosperwell Financial.

   "Money often brings out greed," said Middendorf. "People can be tempted to make decisions based on their own interests rather than on what makes sense for the future of the company and the family."
3. **To protect a beneficiary with an addiction or a disability.** Specify a certain allowance every month to avoid leaving a sudden windfall to a beneficiary struggling with a drug addiction. The trust can even mandate that the person pass a drug test to receive his monthly payment. A similar arrangement can also help when the beneficiary might have a mental disability.
4. **To control a spendthrift.** A "spendthrift trust" will release funds only for expenses related to health, education, maintenance, and support. "This is not a foolproof mechanism, however," said Oregon-based consultant Arlene Cogen. Creating a trust that provides the individual with a set income stream is one way to counter creative beneficiary petitions, Cogen added.
5. **To prevent claims from an estranged spouse.** Consider establishing a trust with a paid salary for the beneficiary while the equity and profits remain in the trust, protected from lawsuits. If the inheriting person is

in debt, a trust can protect business assets from the claims of creditors.

6. **To avoid claims arising from multiple marriages.**
James wants to make sure that if he dies, his wife Mary will receive income for life from the company dividends and asset distributions. If she remarries and then dies, James wants to make sure the money from the business then goes directly to their children instead of to Mary's new spouse or subsequent children. A trust can mandate situations like this that require a more complex asset distribution pattern.

7. **To avoid claims arising from a childless marriage.**
If you are concerned that a nonfamily person might try to dictate business decisions and make unreasonable demands, then a trust is a good option. "Trusts often are used to assure that business interests are retained for the benefit of family members rather than passing to outsiders," said Scroggin.

Stay flexible

As you can see, irrevocable trusts offer flexibility and options, especially for those people who have children too young to run a business or who have no interest, are incapacitated, or are just poor decision-makers. Trusts solve business problems by separating legal ownership and control of a business from the enjoyment of the business assets by beneficiaries.

Attorneys advise against micromanaging the family business transition and instead advocate including flexibility for the beneficiaries. What seems like a reasonable provision in a trust today might make no sense years down the road, Sampson said.

For example, Mark established an "incentive trust" to prevent his son, Jerry, from not working. The trust provided distributions that matched his son's income each year. Fortunately, Mark included a provision allowing additional distributions at the trustee's discretion.

One day, Jerry was involved in a serious accident that left him unable to ever work again. Without the provision, the trust assets would not have been available to Jerry.

The moral of the story: "Don't try to design for a scenario that is too specific," said Sampson.

Discretionary payments

The trend today is toward the use of "discretionary trusts" because they allow for surprises. They are irrevocable trusts that do not specify a set amount of income for beneficiaries but instead allow for trustee discretion.

Discretionary trusts offer considerable protection from creditors and lawsuits. If a beneficiary cannot get at the money in the trust to pay a business expense without the permission of the trustee, then neither can a creditor.

Discretionary trusts also allow the trustee to invest for the highest total return without needing to worry about meeting arbitrary mandated payouts.

Start early

"Planning should start as soon as your business has assets worth protecting," said Bill Babb, a consultant in Raleigh, N.C. You want to have a transition program in place before the death of an owner, added Babb.

When seeking outside help to plan your trust, toss a wide net. Experts suggest hiring an attorney, an accountant, a management consultant, and a banker.

"No one has the promise of tomorrow," said Babb. "Procrastinating puts your business assets at risk of going to creditors and the IRS rather than to the people you want." ■