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WE OFFER *Peace of Mind*

WEALTH MANAGEMENT

April 2023

Two family business stories

Business succession involves values and planning.

The following stories are true, the information was taken from court decisions and newspaper reports. They are offered as examples of the unexpected problems that may occur with family businesses.

The unsatisfied daughter

Frederic Upsher-Smith founded a pharmaceutical company in 1919. The company survived the Great Depression and the war years, but it did not prosper. In 1969 the husband of Frederic's granddaughter purchased the firm for $1,500. At that time, the company had only one employee and two skin care products. The husband, Ken Evenstad, took the company in a new direction, focusing on generic medications. The business boomed. In 1984 Evenstad bought out his only partner for $4 million.

Beginning in 1993 and for the next 20 years, Ken and Grace Evenstad made gifts of stock to their children, Mark and Serene, until each family member held 25% of the company. Mark and Serene had worked for the company as teens. Serene chose not to work for the company after she graduated from Wellesley College, while Mark eventually rose through the ranks to running it when he was 31, in 2001.

Mark did such a good job managing Upsher-Smith that in 2014 his parents gave him an additional 1.5% interest in the company. This greatly upset Serene, who felt that it was only fair that she and Mark have the same ownership interest. Her father could not understand why she felt that way, given that she contributed nothing to growing the company. The family members became estranged. Serene skipped her parents' 50th wedding anniversary.

Upsher-Smith was sold to a Japanese firm in 2017 for $1.3 billion. Serene received $283 million as her share, but she was not satisfied, believing that she had been treated as a second-class shareholder. What's more, she argued that her father and brother had "looted" the company before the sale, reducing its value. The family offered to settle the dispute with her with an additional payment of $150 million, which Serene tentatively accepted. But when she learned that Ken planned to terminate a family trust to fund the payment, Serene took the fight to a whole new level. "I couldn't believe the betrayal," she said.

Although Serene has received $328 million in total from the family business over the years, she is seeking an additional $228 million in damages, according to court records. She wrote to her father, shortly before he died in 2020, "You could have ended this at any time if you had been willing to treat me fairly and with respect."

Ken did not respond to that, but Mark did. "How have you been

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'harmed' by mom and dad? How have you helped them in their time of need?"

A court resolution of the dispute is expected later this year.

The Biltmore estate

George W. Vanderbilt, the grandson of Cornelius Vanderbilt, acquired thousands of acres of land in North Carolina, where he built a mansion from 1889 to 1895. Named Biltmore, the 178,926-square-foot building is the largest privately owned residence in the United States.

George had one child, a daughter, Cornelia, who married John Cecil. The Cecils opened the Biltmore to the public in 1930 at the request of the City of Asheville, in hopes of promoting tourism during the Great Depression. It closed during World War II. In 1932 the TBC corporation was formed to own and manage the estate.

The Cecils had two sons, George and William. They worked to make the estate profitable as a tourist attraction. After Cornelia died in 1976, the brothers disagreed on the future of TBC. George surrendered all of his shares in TBC in exchange for 3,000 acres of the estate and the dairy operation, which was more profitable at that time.

In 1995, on the 100th anniversary of the opening of the mansion, William turned management responsibilities over to his son, William Jr. According to Wikipedia, the house is assessed at $157.2 million for property taxes, but that is reduced to $79.1 million, thanks to agricultural deferments. TBC has shown a profit every year since 1995, with the exception of 2008 during the Great Recession. Money is earned by selling tickets to tour the house, and from a variety of supporting operations owned by TBC.

William Jr. and his wife, Mimi, had two children, Bill and Dini. Bill became TBC's president and CEO, and Dini became the Vice Chairman of the Board of Directors. Around 2001 Dini met with a consultant from the Family Business Consulting Group. After reading books on the subject, in 2003, Dini started a Family Preservation Program for TBC, which involved two annual meetings of all her and Bill's children. During these meetings they would work on policies and educational programs for the benefit of their families, which were intended to help them become more effective owners of TBC, as well as keeping TBC in the family.

The children ranged from 8 to 15 years old at the first meeting. As they grew older, the children attended educational seminars that focused on topics such as financial literacy or family-based money management.

As far as we know, this effort to give the youngest generation a sense of responsibility for the family enterprise has succeeded. We only know about these facts because of a court case. In 2010, William Jr. and Mimi made taxable gifts of all their ownership in TBC. They gave the voting shares to Bill and Dini, and the nonvoting shares to the grandchildren. The couple each reported taxable gifts of over $10 million. Upon audit, the IRS disputed those values, and sought additional taxes. The details of the business management by the family came out in the Tax Court testimony.

William Jr. and Mimi both died before the resolution of the case, which came this year, 13 years after their gifts. It was a complete victory for their estates, and a vindication of their estate planning strategy.

How to value a family business

For business owners, before estate planning questions and issues of succession can be addressed, an accurate valuation is needed. The higher the business value, the greater the tax exposure, and the more important the estate planning steps.

Business valuation is as much an art as a science. One begins with the set of fundamental factors that the IRS looks at:

- **the history of the business;**
- **the current outlook for the economy and the industry segment;**
- **book value;**
- **the company's earning capacity;**
- **the company's capacity to pay dividends;**
- **goodwill and intangible assets;**
- **prior sales of company stock;**
- **sales of comparable companies.**

That's just the starting point. Valuation discounts also may apply to the transfer of interests in a small business. Discounts for lack of marketability and for having a minority interest, for example, have become routine. There may also be a discount for the loss of key employee services. IRS has experts in this area, so it is important for the business owner to rely on experts of his or her own. A business valuation must be completed with great care and without bias for it to be effective in tax litigation. As one planner was heard to comment, when it comes to arranging a professional appraisal of a business, "expensive will be cheap."

Put us on your team

These two stories may seem unique at first glance, but the issues presented are common to many family businesses. How does the older generation provide for fair treatment of those who participate in the business and those who profit passively from it? How will ownership be passed to the next generation? How will the taxes on those transfers be paid?

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.

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Proposed new TAXES and tax increases

President Biden's proposed budget for the 2024 fiscal year includes a wide array of new taxes and tax increases. The budget calls for $6.37 trillion in 2024 federal spending, while projecting that revenue will be just $4.8 trillion. In other words, spending will exceed revenues by $1.846 trillion. Put another way, for every dollar of expected tax revenue, the federal government will spend $1.33.

Although the House Republicans are expected to resist the call for tax increases, the President's proposed budget sets the framework for the debate. Here are some highlights from the 219-page "Green Book" explanation of the tax increases that affluent taxpayers will want to watch out for.

Retirement plans

Single taxpayers with adjusted gross income over $400,000 ($450,000 for married filing jointly) would be subject to enhanced minimum distribution requirements if the sum of their IRAs and vested qualified retirement plan accounts exceeds $10 million. Half of the amounts over $10 million will have to be taken as a minimum distribution, potentially subject to income taxes. The taxpayer may choose which accounts to tap for the distribution, unless the account totals are $20 million or more. In that event, the enhanced minimum distributions must come first from any Roth IRAs and designated Roth accounts. Note that this rule applies regardless of the taxpayer's age; it is not limited to those 73 and older. The penalty tax on premature distributions will not apply.

Taxpayers at that same income level would have a new limit on rollovers and conversions to Roth IRAs. The object would be to eliminate the "back door Roth IRA" that some higher-income taxpayers have used to get around the income limits. This rule would apply regardless of the account balances.

Estate taxes

Under current law, the value of a farm for federal estate tax purposes may be reduced if the farm will stay in the family and be actively farmed after the owner's death. The maximum reduction in value was set at $750,000 in 1997, and has since been inflation-adjusted to $1.31 million. That is not large enough for some farm properties, so the proposal would increase the maximum adjustment to $13 million.

Under current law, an annual gift tax exclusion is available for as many donees as a donor wishes. The 2023 exclusion amount is $17,000. For example, a grandfather with three children and seven grandchildren could give each of them $17,000 in one year, a total of $170,000 in gifts, without incurring a federal gift tax, without even having to file a gift tax return. The budget proposal would cap the total benefit at $50,000, while leaving the exclusion amount unchanged.

Grantor-retained annuity trusts (GRATs) have been a popular method for wealthy families to pass substantial value to younger generations at a minimum gift tax cost. The proposal would require GRATs to have a term of at least 10 years, and the gift tax value would have to be the greater of 25% of the value of the assets transferred to the GRAT or $500,000.

A new minimum tax

Perhaps the most radical proposed change would be a new 25% minimum income tax for taxpayers whose wealth is greater than $100 million. Minimum taxes are not new, but they have been triggered by the "overuse" of tax preferences, not by wealth. The radical aspect of the proposal is that it would apply a 25% tax to unrealized capital gains, in addition to the usual income sources.

Determining who has a net worth greater than $100 million could prove problematic. Personal real estate and valuable fine art would have to be included in the calculation, for example. The proposal would not require annual appraisals of illiquid property. Instead, the greater of the adjusted cost basis or the last valuation event would provide a baseline, and that would be increased every year by the five-year Treasury rate plus two percentage points. Taxpayers could offer appraisals to rebut that presumption.

A partial list of possible tax changes

- Required distributions of "excess" retirement plan accumulations
- Limits on conversions to Roth IRAs
- Increase the top income tax rate to 39.6%
- Increase the corporate income tax rate to 28%
- Quadruple the new excise tax on the repurchase of corporate stock
- Increase Medicare taxes on income above $400,000
- Impose a new minimum tax on unrealized capital gains
- Tax carried interest as ordinary income
- Limits on dynasty trusts
- New requirements for grantor-retained annuity trusts
- Cap the usage of annual gift tax exclusions
- Cap the benefit of like-kind exchanges

Source: https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf

IRS clarifies RMDs

The SECURE 2.0 Act of 2022 changed the age at which Required Minimum Distributions (RMDs) must begin from IRAs and qualified retirement plans. The age had been 72; now it is 73. However, the new rule was not made retroactively. That means that those who turned 72 in 2022 are still required to take an RMD for the 2022 tax year. There is a grace period for receiving the taxpayer's first RMD, until April 1 of the following year (2023, in this case).

Taxpayers who turn 72 in 2023 will not need to take an RMD this year, they can wait until next year. Their first RMD won't be required until April 1, 2025. However, the RMD can be taken at any time during the year. Taking advantage of the grace period means that there must be two RMDs in a single year, which could increase overall taxation.

The SECURE 2.0 Act was enacted on December 29, 2022. In Notice 2023-23, the IRS recognized that some financial institutions may not have been able to adjust their reporting systems with so small a window. Some taxpayers may therefore have received the wrong advice about their RMDs. In the Notice, the IRS gave financial institutions until April 28, 2023, to correct any misinformation that may have been sent to taxpayers.

Water rights as real estate

A group of ranchers own a license to divert water from an adjacent river during Diversion Season each year. The right is defined in cubic feet per second. Each ranch owner owns a percentage of the land subject to the water right, and so each owns a proportionate amount of the water right.

One owner has concluded that he no longer needs the full allotment of water rights, and so he wishes to sell a portion of it, reinvesting the proceeds in other real estate. In private advice, the IRS concludes that because the water rights are perpetual, subject only to the right of the state to terminate them based on a finding that they are not being put to beneficial use, they qualify as real estate.

This conclusion is very important to the taxpayer. If he is selling one real estate interest and investing the proceeds in other real estate used in his trade or business, the transaction qualifies as a like-kind exchange. All taxes on the sale of the water rights are then deferred, and the tax basis is carried forward to the newly acquired property.

Quotable

"The difference between death and taxes is death doesn't get worse every time Congress meets."

–Will Rogers

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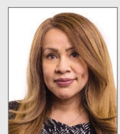
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