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CASE STUDY: ESTATE PLANNING WHEN SELLING A FAMILY-OWNED COMPANY

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We represent a husband and wife who sold their company a few years ago. The planning occurred in five stages and exemplifies planning which **saves taxes**, **provides asset protection**, and **structures an inheritance** for future generations.

Quick Overview

Stage 1: Created an intentionally defective grantor trust ("**IDGT**") to benefit each of their children and transferred a portion of their company stock to the trusts.

Stage 2: Following the sale of the company, created a family limited partnership ("**FLP**") and contributed the sales proceeds to the partnership in exchange for limited partnership interests.

Stage 3: Created a **Dynasty Trust** to benefit their grandchildren and future generations and transferred some of their limited partnership interests to the trust.

Stage 4: Transferred their remaining limited partnership interests to a **678 Trust** which benefits the client as well as his family.

Stage 5: With the children's and grandchildren's inheritances now secured, created a **Family Foundation** and directed anything remaining in their estates at death to go to it.

The end result is a zero estate tax, saving the family at least $340 million of estate tax.

THE FIRST STAGE of their planning occurred seven years ago when the business was doing well and the founder saw major potential for growth. The clients were parents who created an **Intentionally Defective Grantor Trust ("IDGT")** to benefit each of their three children and transferred a portion of their company stock to the trusts—part gift and part sale.

An IDGT is a "grantor trust" with a purposeful flaw that allows the individual to personally pay income taxes incurred by the trust assets even though the assets are out of the individual's estate for estate tax purposes. Since the parents

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continue to pay the income tax on the IDGTs' income, the trusts grow faster, as the trusts are not depleted by payments of income tax.

The clients made a "seed gift" of company stock with a value of $1 million to each child's IDGT (half from the husband and half from the wife). The seed gifts provided the children's IDGTs with sufficient equity so that they could be used to support subsequent sales where the parents would <u>sell</u> company stock to the IDGT. A typical seed gift is an amount equal to 10% or more of the anticipated sale transaction. The total seed gifts of $3 million of company stock consumed $1.5 million of the husband's lifetime gift and generation skipping transfer ("GST") tax exemptions and $1.5 million of the wife's lifetime gift and GST tax exemptions.

The clients then <u>sold</u> $5 million worth of company stock to each child's IDGT in exchange for promissory notes. At this time, the company was worth $50 million. The shares of company stock received a 40% valuation discount, an appropriate discount for an operating business. Therefore, the discounted value of all of the outstanding company stock was $30 million ($50,000,000 less 40% discount). The transfer of a total of $6 million worth of company stock to each IDGT transferred 20% of the outstanding company stock to each of the three children's IDGTs.

Ownership of Company:	
Child 1's IDGT	20%
Child 2's IDGT	20%
Child 3's IDGT	20%
Husband & Wife	40%
	100%

Seven years pass, and their company is now worth $1 billion (20 times what it was worth at the time of the transfers to the IDGTs). During this time, the promissory notes for these sales are paid off. Each child's IDGT now has a value of $200 million—plenty of inheritance for the children.

The clients then entered into a contract to sell their company for $1 billion. Following the sale, a 15% capital gains tax was due which shrunk the proceeds by $150 million. Since the IDGTs were grantor trusts, all of the $150 million was paid out of the parents' share of the proceeds.

Net Proceeds from Sale:	
Child 1's IDGT	$200 million
Child 2's IDGT	$200 million
Child 3's IDGT	$200 million
Husband & Wife	$400 million less $150 million = $250 million

THE SECOND STAGE of their planning was the planning we recommended just after the sale of the company. The clients created a **Family Limited Partnership ("FLP")**—a limited partnership where all of the partners are family members.

Consolidating the family assets into an FLP provided: (i) lower asset management fees (economies of scale); (ii) a vehicle for the long-term management of the family's investment assets; and (iii) the creditor protection that a limited partnership provides.

The children's IDGTs and the parents contributed their net sales proceeds to the FLP in exchange for limited partnership interests.

Limited Partner	Contribution	Ownership
Child 1's IDGT	$200 million	23.53%
Child 2's IDGT	$200 million	23.53%
Child 3's IDGT	$200 million	23.53%
Husband & Wife	$250 million	29.41%
	$850 million	100.00%

With the children's inheritance established, **THE THIRD STAGE** of their planning created a fund to benefit grandchildren and future generations. The clients transferred a portion of their FLP units into a **Dynasty Trust** to benefit their grandchildren and future heirs—part gift and part sale.

A Dynasty Trust is a long-term trust created to pass wealth from generation to generation without incurring estate tax when transferred from one generation to the next. To establish a Dynasty Trust, the individual creates an irrevocable trust for the benefit of one or more beneficiaries (typically children or grandchildren). The trustee would be able to make distributions for the beneficiaries' support. At the death of a beneficiary, any remaining assets would flow into similar dynasty trusts for his or her descendants. The Dynasty Trust can be structured so that during the lifetime of the individual who created the trust, it is considered a grantor trust and the creator pays the income tax on the trust's income, allowing the trust assets to grow without reductions for income tax. The Dynasty Trust is structured to last for as long as state law allows, and, if created as a Delaware trust, it can be perpetual.

The clients made seed gifts to the grandchildren's Dynasty Trust of FLP units with a value of $7 million, using the husband's $3.5 million remaining gift tax exemption and the wife's $3.5 million remaining exemption.[1] The clients then sold FLP units with a value of $35 million to the grandchildren's Dynasty Trust in exchange for 9-year balloon promissory notes.

Limited partnership interests are less marketable than assets held outright or assets traded on an exchange, such as stock of public companies or bonds. By virtue of the partnership form and standard restrictions in partnership agreements, a partnership interest is worth less than the underlying assets of the partnership. Discounts for lack of marketability and lack of control are routinely recognized by the courts when the partnership is formed and maintained properly.

[1] The lifetime gift tax exemption is currently $5,430,000 per taxpayer. For simplicity, $5 million is used.

Assuming $850 million in underlying assets and that the FLP units received valuation discounts of 35% for lack of control and lack of marketability, the discounted value of all FLP units was $552,500,000 ($850,000,000 less 35% discount). The transfer of $42 million worth of FLP units transferred 7.6% of the FLP to the grandchildren's Dynasty Trust ($42,000,000 ÷ $552,500,000).

Ownership of FLP:	
Child 1's IDGT	23.53%
Child 2's IDGT	23.53%
Child 3's IDGT	23.53%
Grandchildren's Dynasty Trust	7.6%
Husband & Wife	21.8%
	100.00%

By the time balloon notes owed by Dynasty Trust come due, the FLP will have grown in value such that the Dynasty Trust can use an FLP distribution to pay off the notes and still have plenty of value left in the Dynasty Trust, providing an inheritance for the grandchildren.

THE FOURTH STAGE of their planning moved the clients' remaining FLP units out of their estates. The remaining FLP units were sold to a new trust for the clients' benefit. A relative of the clients created a **678 Trust** to benefit the clients and the clients' family by making a gift of $5,000.

A 678 Trust is a unique vehicle that combines asset protection, estate tax savings, and continued ability to benefit from assets. A 678 Trust is established by a third party with a gift of $5,000. This is the only gift that should ever be made to the 678 Trust. Since the 678 Trust is created by a third-party trustor, the individual can be the beneficiary and the trustee of the trust. As the beneficiary, the individual can receive distributions for health, education, maintenance, and support purposes. The Trust is structured as a "Crummey" trust, so the beneficiary has a period of time to withdraw the $5,000 gift. If the beneficiary does not demand the gift, their withdrawal right lapses after a certain period of time (e.g., thirty days). When the individual allows the withdrawal right over the initial $5,000 contribution to lapse, the 678 Trust becomes a grantor trust as to the individual (under the authority of Section 678 of the Internal Revenue Code). Thus, all income tax effects of the 678 Trust from that point forward are the responsibility of the individual, and the IRS would ignore any transactions between the individual and the 678 Trust. Therefore, the individual could sell assets to the 678 Trust without triggering an income tax gain. As a result of being treated as the owners of the 678 Trust for income tax purposes, the clients will be responsible for paying the income tax on the income generated by the trust's assets during his lifetime, allowing the trust assets to grow without being depleted by income taxes.

The clients sold their remaining 21.8% of the FLP to the 678 Trust in exchange for 9-year balloon promissory notes for $120,500,000. Because the new 678 Trust had only $5,000 of equity, a guarantor for the transaction was needed in order for the sale to be economically viable. The children's IDGTs had sufficient assets to pledge as the guarantor of the promissory notes.

Final Ownership of FLP:	
Child 1's IDGT	23.53%
Child 2's IDGT	23.53%
Child 3's IDGT	23.53%
Grandchildren's Dynasty Trust	7.6%
678 Trust for benefit of Husband & Wife	21.8%
	100.00%

The clients can use the promissory note payments received from the 678 Trust for living expenses and to pay the income tax generated by the trusts. If additional funds were ever needed, the clients can also receive distributions from the 678 Trust.

Now that the children's and grandchildren's inheritances were set aside, the clients wanted **THE FIFTH STAGE** of their planning to direct anything remaining in their estates at death to go to charity. They created a **Private Foundation** and included a provision in their Living Trust which leaves the remainder of their estates to their Private Foundation.

The result of the planning accomplished for this client is an estate tax savings of $340 million ($850 million in net sales proceeds x 40% estate tax rate)!