Freeborn *Your Future Is Our Purpose*

FREEBORN & PETERS LLP

REAL LIFE EXAMPLE:

Transferring Wealth with Business Interests

by Bill Russell, Partner

A FREEBORN & PETERS WHITE PAPER

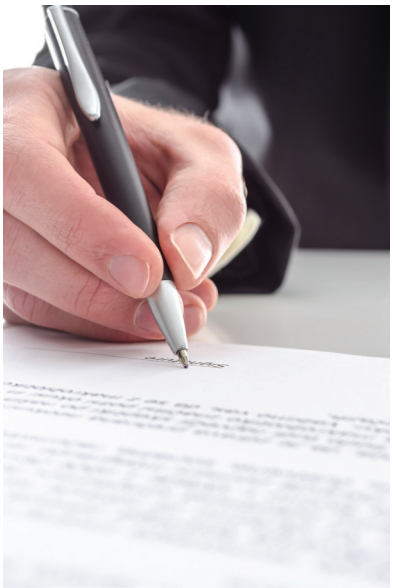
ABOUT THIS WHITE PAPER:

Despite the easing of estate taxes on many taxpayers, many family-held businesses continue to be burdened with large potential transfer taxes. This article is a real-life story (with names changed) of how one family business successfully addressed this problem.

Years ago, Peter Patriarch started a business in pet supplies. Over time his business has continued to grow in value and has become quite successful. Sales continued to surge, rebounding from the 2009 recession, and, by 2012 the business had considerable value.

Peter's son, Paul, participates in the business as one of its leaders. In the very early years, Peter had given Paul 10% of the company when it was worth little. By 2012, Peter realized that he faced a significant estate tax burden in leaving the remaining 90% of the company to Paul and his family. That tax burden (40%) was increasing everyday with the ongoing growth of the business. In 2012, Peter decided to shift ownership so that this ongoing growth would be out of his estate. At the same time, Peter was not ready to give up control of the company.

The following is the actual steps that were taken by Peter to shift that wealth in a tax efficient manner. While the names have been changed, and the figures and structure have been simplified, the following example substantially reflects the real life facts.

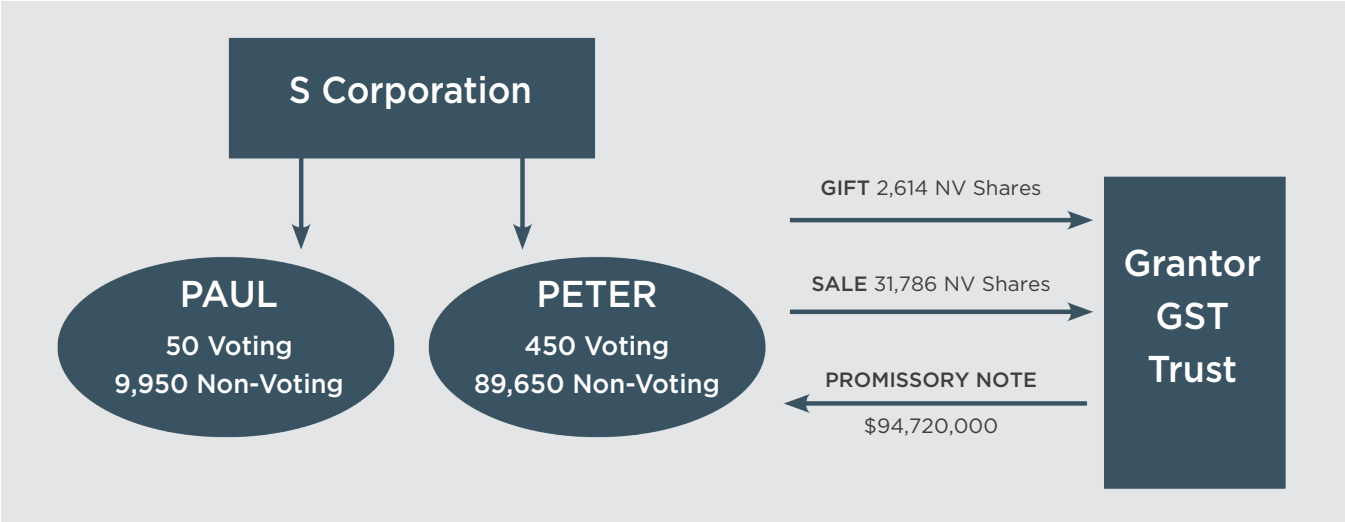


Peter's company is an S corporation owned 90% by Peter and 10% by his son, Paul. The first step was to recapitalize the corporation into voting and non-voting shares. While an S corporation may generally have only one class of stock, voting differences are permitted. Each share of stock was exchanged (tax-free) for voting and non-voting shares, resulting in Peter and Paul together having 500 voting shares and 99,500 non-voting shares (100,000 shares total). Peter owned 90% of each class and Paul owned the remaining 10%.

Peter then prepared a very special type of trust to be the recipient of the gifted assets. The trust was designed to benefit Paul's children and their descendants. Assets gifted to this trust would remain in trust indefinitely, potentially over several generations. Further, the trust was designed to be taxable to Peter as a "grantor trust" for income tax purposes meaning that he would receive all the taxable income from the trust assets as if he owned the trust assets directly, even though the trust actually owned the transferred stock. Note this only applied for income taxes. For gift and estate tax purposes, the trust was designed to be outside Peter's taxable estate. The trust, not Peter, received the cash distribution on the transferred stock.

Paul already owned 10% of this valuable company and was well provided for. He was one of the company leaders and had received considerable compensation and bonuses over the years. Peter did not see any need to add to Paul's estate. As a consequence, the trust was solely for Paul's children and their descendants. As long as the assets remained in trust, they are free of any estate or generation skipping tax. Additionally, because Paul is neither a beneficiary nor a donor, Peter gave him a "power of appointment" such that he may distribute the trust assets to anyone, other than himself or Peter, and had the power to revise the trust. Thus, even though Paul could not receive the trust assets himself, he had full control over their disposition.

The company was appraised. Based upon this valuation, the enterprise value of the company, net of debt, was valued conservatively at $424 million. Peter transferred about 34,000 non-voting shares, or 34% of the equity. However, the value of this transfer was much less than 34% of the net enterprise value due to substantial minority discounts. The net appraised value was reduced $144 million to about $102 million. Of this amount, Peter gifted 2,614 non-voting shares at a discounted value of $8,487,000. Peter also sold 31,786 non-voting shares at a discounted value of $94.7 million in exchange for a promissory note. The note paid interest only every year until the end of a nine year term, and could be prepaid by the trust any time without penalty.

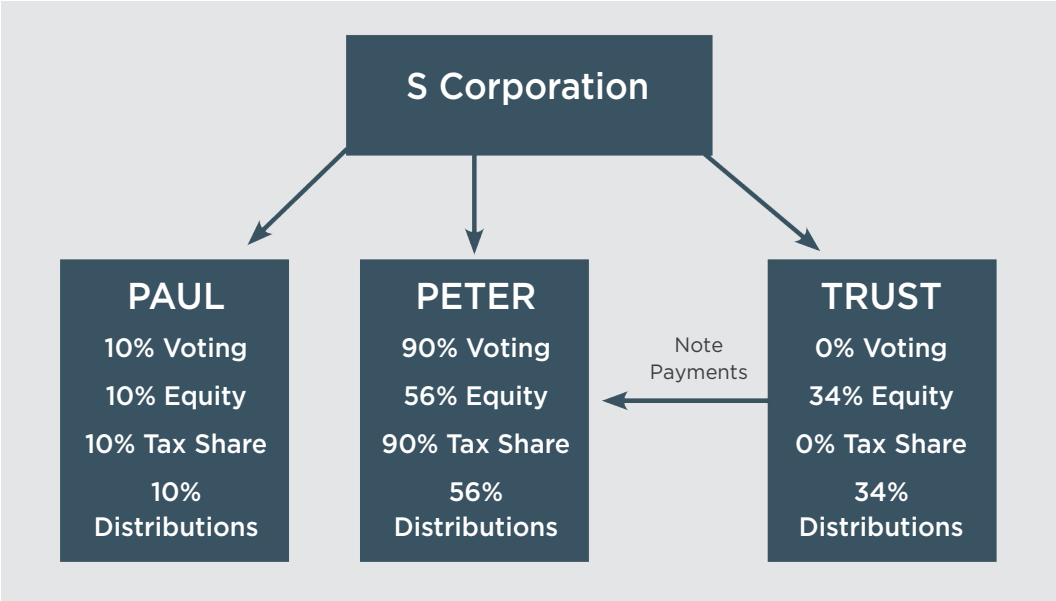


Peter split the $8,487,000 gift portion with his wife, so then the whole gift was covered by their gift tax exemptions as well as their generation-skipping exemptions. The balance of $94,720,000 was paid by the nine year note from the trust to Peter, secured by the stock. The note paid interest at 0.89%[1] every year until it is due in full in the ninth year.

While such a sale of stock would normally result in substantial capital gains, it did not in this case due to the "grantor trust" status of this trust. Because Peter is taxed on the trust assets as if he owned them, the sale by Peter to the trust is a sale to himself, and therefore not taxable. However, for gift and estate tax purposes, there was a completed transfer of the stock to the trust, and the stock was removed from Peter's taxable estate. The trust would receive all the economic benefits of the transferred stock, including company cash distributions or any proceeds upon the sale of the company. The grantor trust status also resulted in the income from this 34% share of stock going to Peter, not the trust. As an S corporation, the company taxable net income "flows through" to its shareholders. Each shareholder receives a K-1 form with his or her portion of that income. Peter received 90% of the company net income on his K-1 even though the trust owns 34% of the equity.

From the end of November, 2012 to the present, Peter received K-1 taxable income from the company with respect to the shares held by the trust. For December 2012 and for all of 2013, $25.5 million of trust taxable income was shifted from the trust to Peter, saving the trust approximately $11.5 million of federal and state income tax.

1 The minimum applicable federal rate at the time of transfer.



In the meantime, the company made distributions on its stock to all shareholders, both to pay income taxes and as earnings distributions.[2] From December 2012 through April of 2013, the trust received distributions of about $20.5 million. A small portion was applied to trust expenses. The rest, $20,148,000, was paid on the note as interest and to pay down principal. By April, 2014, the note balance was reduced from $94,720,000 to $74,373,000.

The company value continued to appreciate. By summer of 2014, the company conservatively estimated its enterprise value to be $500 million net of financial debt (and in reality, may be worth much more).

By the summer of 2014, remarkable results had been achieved:

1. Peter had removed about $98 million (34% x $500 million – $74,373,000 note balance) from his taxable estate, at a gift value of only $8,487,000. No gift tax was paid out of pocket. At a 40% estate tax rate, an estimated $39 million of potential estate tax was shifted out of Peter's taxable estate, plus all future growth on that transferred stock.
2. Peter had paid $11.5 million of income taxes on company income that otherwise would have gone to the trust (not including any 2014 income taxes), effectively making an additional $11.5 Million tax free gift.[3]

2 S corporations must make pro rata distributions to all shareholders based upon equity owned.

3 The tax basis of the transferred stock carried over. The stock basis will increase over time based upon flow through of S corporation income, even if the income tax is paid by Peter. This should be compared to the "step up" of tax basis that would occur if Peter retained the stock until his death and paid estate tax.

This income tax shifting would continue into the future, resulting in considerable tax free gifts. Meanwhile, the trust uses its tax distributions to pay down the note. The company tax distributions circulate back to Peter in the form of note payments.

3. Peter had placed $98 million of net equity in trust for grandchildren and their descendants, essentially pre-funding their inheritance while he is still alive. The trust assets remain protected from the creditors of the beneficiaries and avoid future gift and estate tax. No estate tax is paid on these trust assets with the passing of each generation. Meanwhile, through Paul's power of appointment, Paul has tremendous flexibility as to how these trust assets may be disposed of.
4. Peter retained voting control of the company.

The value of the company in this real life example is obviously very substantial. However, the structure is scalable up or down and may be adapted to a number of situations. Each closely-held business and family are unique and the planning options should be specifically customized. This example may not be appropriate for everyone. There are a number of tax and financial risks and issues that should be considered, and the various alternatives for structuring this type of wealth shifting should be compared. For the right situation, this structure provides a powerful means of shifting wealth at a very low tax cost and protecting ownership in trust, while maintaining control.

ABOUT THE AUTHOR

William E. Russell
Partner

311 South Wacker Drive
Suite 3000
Chicago, IL 60606

(312) 360-6373

brussell@freeborn.com

Bill Russell is a Partner in the Corporate Practice Group and advises closely-held businesses and professionals on business and tax matters. His practice consists of corporate transactions and business consulting, advanced estate planning and probate, and asset protection.

ABOUT FREEBORN & PETERS LLP

Freeborn & Peters LLP is a full-service law firm headquartered in Chicago, with international capabilities. Freeborn is always looking ahead and seeking to find better ways to serve its clients. It takes a proactive approach to ensure its clients are more informed, prepared and able to achieve greater success—not just now, but also in the future. While Freeborn serves clients across a broad range of sectors, it has also pioneered an interdisciplinary approach that serves the specific needs of targeted industries, including food, private equity and venture capital, transportation, and insurance and reinsurance. Freeborn is a firm that genuinely lives up to its core values of integrity, caring, effectiveness, teamwork and commitment, and embodies them through high standards of client service and responsive action. Its lawyers build close and lasting relationships with clients and are driven to help them achieve their legal and business objectives.

Call us at **(312) 360-6000** to discuss your specific needs.
For more information visit: **www.freeborn.com**

CHICAGO
311 South Wacker Drive
Suite 3000
Chicago, IL 60606
(312) 360-6000
(312) 360-6520 fax

SPRINGFIELD
217 East Monroe Street
Suite 202
Springfield, IL 62701
(217) 535-1060
(217) 535-1069 fax