



Frost Brown Todd Advises Manufacturing Business Owner Through Estate Planning

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Background

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Todd's client was the founder and sole owner of a manufacturing firm in the Midwest. His product was very popular, but he did not have the financial resources to expand the company to reach its full potential. The client entered into a deal with an investment banking firm to start positioning the company for a public offering. As a result of that deal, the investment banking firm owned a 52% equity interest in the company, and he retained a 48% equity interest in the company

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met with the client and his wife shortly after the deal with the investment banking firm was finalized. The client knew that the company would likely go public within the next two years, and wanted to start some estate planning, anticipating a significant increase in their wealth. This was somewhat unique, in that many business owners will not think of the estate planning aspects until after a sale or public offering is completed, when the wealth shifting opportunities are not as significant.

The client wanted to be sure they would have sufficient financial resources for

the rest
of their lives, but they also did not want to “spoil” their three
children, all
of whom were minors at the time. They
also had a significant interest in charitable causes.

The Plan

We suggested
that our client consider an installment sale of a portion of his equity
in the
company to an irrevocable “grantor” trust, which would be
consummated well in
advance of the public offering. We
explained the aspects of this Irrevocable Trust:

- The assets of the Irrevocable Trust would be sheltered from estate taxation at the deaths of our client and his wife. In order to assure that the assets would also be shielded from estate taxation for multiple generations, we retained the services of a corporate trustee in a state which would permit the Irrevocable Trust to continue for multiple generations.¹
 - We included certain features in the Irrevocable Trust which would cause the income generated by trust assets to be taxed on the client’s individual income tax return, rather than being taxed to the Irrevocable Trust. This was important so that the client would not have to recognize capital gain when he would sell the stock in the company to the Irrevocable Trust.
 - The trust assets would be sheltered from the claims of creditors of the client, his wife and the children and grandchildren.
 - The trust assets would be shielded from the claims of a divorcing spouse of a child or grandchild.
- Like most couples, they were almost more interested in this

feature than
the significant future estate tax savings!

After the client and his wife indicated that they liked the concept, we built a spreadsheet to assist them in understanding how the cash flow would work with this technique, and to decide how much of the client's remaining equity in the company should be sold to the Irrevocable Trust. After examining many different scenarios, they ultimately decided that they wished to transfer 20% of their 48% equity interest in the company to the Irrevocable Trust, and they would retain the other 28% of their 48% equity interest.

We started with drafting the Irrevocable Trust. The client and his wife agreed that we should have separate shares for each of the three children, because we didn't want the children to have to agree (or disagree) in the future on the investment of trust assets, the rate of spending, and similar issues.

- We included features which would allow the children to become trustees of their own separate trusts at appropriate future ages.
- We detailed where assets would pass if no grandchildren were born.
- We included a provision which would allow a child to include his or her spouse as a beneficiary at the child's death if the child so desired, but guaranteeing that the assets for the spouse would return to the family upon the spouse's death or remarriage.²

- We included provisions which would allow appropriate advisors to change the terms of the “Irrevocable” Trust in the future, as family circumstances, financial circumstances and tax laws change.³
- We included provisions which would permit the trustee to acquire the stock of the company, even if the trust assets consisted almost entirely of that one asset. We also permitted to trustee to acquire non-traditional investment assets in the future, including closely held businesses, artwork and vacation homes.

We hired an appraiser to determine the value of the 20% interest in the company that the client was going to sell to the Irrevocable Trust. Taking into account the fact that this was a minority interest in the company and was not liquid, the appraiser determined that the value of that 20% interest was \$4,000,000. Knowing that the IRS likes to see at least 10% equity in these transactions, we decided to have the client and his wife make an initial “seed” gift of cash to the Irrevocable Trust of \$600,000. We instructed the accountant to file gift tax returns for them, using \$300,000 of each of their lifetime gift tax credits to shield the gift from gift taxation. We also had the accountant allocate \$300,000 of each of their generation skipping exemptions to this gift, which would protect the trust assets from estate taxation and gift taxation for multiple generations.

The next step was the sale of the 20% interest in the company by the client to the Irrevocable Trust at a price of \$4,000,000. The Irrevocable Trust paid him a down payment

of \$500,000, and delivered to him its promissory note in the amount of \$3,500,000 requiring equal annual payments of principal and interest⁴ over a nine year period. The repayment of that note was secured with a pledge of the stock by the Irrevocable Trust in favor of the client. The Irrevocable Trust also had \$600,000 of equity from which the client could satisfy his claims if the Irrevocable Trust defaulted on the note. All of this made the transaction “commercially reasonable.” At the same time, the client’s cash reserves were only depleted by the \$100,000 cash which remained in the Irrevocable Trust after he received the down payment.⁵

Outcome

The company went public more than a year after we completed the sale transaction. After the company went public, the Irrevocable Trust was subject to a two year holding period for the stock. To everyone’s delight, during that two year period, the 20% stock position (which was diluted in the public offering) rose in value from the appraised value of \$4,000,000 to over \$35,000,000. After the two year holding period expired, the Irrevocable Trust began liquidating its position in the company, and some of the proceeds were used to repay the principal and interest on the promissory note.⁶

After the Note was paid and the client and his wife had a chance to review the results of the transaction, they grew concerned with their

children having too large an inheritance. They were very concerned that their children not be exposed to too much wealth, and that they have the incentive to work and be contributing members of society. The client and his wife also had some very significant charitable interests. Four years after we completed the transaction, the client and his wife created a family charitable foundation and requested that the trustee of the Irrevocable Trust use its discretion as trustee to transfer \$10,000,000 of its assets to the charitable foundation. This left about \$21,000,000 in the Irrevocable Trust, and they felt that \$7,000,000 for each of their children was enough for their children for the rest of their lives. Knowing that those funds would pass free of estate taxation to their grandchildren at their children's deaths, the client and his wife also changed their other estate planning documents to provide that the assets which they retained (approximately \$40,000,000) would also pass to the charitable foundation at the death of the survivor of the client and his wife, free of estate taxation.

- Each child has a separate trust with \$7,000,000 which will grow through the years, providing cash flow to the child for the rest of the child's lifetime. At the child's death, that child's separate trust will pass to that child's children free of estate taxation. The trust also protects the child from lawsuits, creditor claims and divorce during the child's lifetime.

- The client and his wife have \$40,000,000 that they fully control for the rest of their lives.
- At the death of the survivor of the client and his wife, the family foundation will be fully funded with \$50,000,000, and the children will run that foundation for the rest of their lives.
- What is the estate tax bill for this family? Zero!

The key to making this work effectively was early action by the client and his wife in getting us involved. If they had waited to implement this until after the company had gone public (or until after a letter of intent had been signed in a private sale of their company), the tax savings would have been far less.

Footnotes

[1] The state where the client and his wife live had a traditional “rule against perpetuities” at the time, which would not permit the trust to continue for multiple generations. This is not a problem for residents of Ohio, Kentucky and many other states.

2

Some clients like this feature and we include it, and other clients do not like this feature, and we exclude it.

3 None of the client, his wife or their children could hold this power.

4 Interest is determined in accordance with IRS tables. As an example, for a nine year note with annual payments in September 2011, the interest rate is 1.63%.

5 This \$100,000 cash reserve in the Irrevocable Trust was intended to assure that cash would be available to meet the interest obligation on the note in year 1 and to pay trustee fees.

6 The Note could have been kept in place, with the Irrevocable Trust meeting its payment obligations over the nine year term of the Note, but the client and his wife decided to prepay the entire balance due.

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