

**CRADLE TO GRAVE – THE IMPACT OF FAMILY ON THE
BUSINESS
CASE STUDY**

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CHAPTER 18.4

The information set forth in this outline should not be considered legal advice, because every fact pattern is unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein.

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CASE STUDY EXAMPLE

Creative Use Of Irrevocable Life Insurance Trust And Stock Purchase In Estate and Family Business Succession Planning

IRREVOCABLE LIFE INSURANCE TRUST

- **PURPOSES**
 - Exclude life insurance proceeds from taxable estate
 - Provide liquidity for estate taxes
 - Replace assets given to charity

- **FUNDING**
 - Normally Annual Exclusion gifts used to pay premiums

- **ATTRIBUTES**
 - Irrevocable
 - Life insurance proceeds in Grantor's estate if Grantor dies within three years of transfer of policy to trust
 - Not subject to Generation-Skipping Transfer Tax if exemption applied to trust

CASE STUDY EXAMPLE
FACTS

1. ABC Company is a “C” corporation owned by James Founder and Sally Founder. James Founder and Sally Founder have three children, James, Jr., William, and Carol. James, Jr. and William work in the business; Carol is not involved in the business. Each of the Founder children has three children of his/her own.
2. James Founder and Sally Founder are the 100% owners of ABC Company stock (very low tax basis) that has value of \$9,500,000.
3. James Founder and Sally Founder, each 65 years old, have combined estates worth \$15,000,000, \$9,500,000 (63%) of which is ABC stock. The remainder of their estates is illiquid, made up of (i) their home, a ranch, land and building on which ABC conducts business (from which they receive fair market value rental income) and profit sharing account of the Corporation, with a combined value of \$5,500,000.
4. Certain James and Sally Founder estate planning goals:
 - (i) During their lives:
 - (a) Take care of each other; and
 - (b) Continue to work in and control the business for the rest of their lives (earning salary and benefits during that time);
 - (ii) Upon the death of the survivor:
 - (a) Pass their interest in the family business to their two children participating in the business;
 - (b) Leave their estates in an equitable manner to their three children;
 - (c) Reduce their federal estate taxes; and
 - (d) Provide liquidity for the payment of their federal estate taxes.

The Founders currently have “Simple Wills”. A Simple Will leaves all of a person’s estate to his or her surviving spouse or to children equally (if spouse not surviving), with no transfer tax planning and no special allocation of ABC Company stock to the two sons working in the family business.

A PLAN

1. The Founders recapitalize ABC’s single class of stock (voting common) into voting and non-voting common stock and declare a stock dividend whereby 9 shares of non-voting common stock are issued for each share of voting common stock.
2. The Founders then begin a program of Annual Exclusion gifts of non-voting ABC common stock to each son participating in the business, making an equitable gift annually to their daughter of other property (probably undivided interests in the ranch-not equal gift because of the discount difference). The stock and the ranch interests will receive a valuation discount for both lack of marketability and lack of control. The Founder sons and ABC execute a Buy/Sell Agreement which places stock transfer restrictions on their stock under certain predetermined situations. This restricts the transferability of the stock of the sons and also creates a fair market value opportunity for their stock upon certain circumstances (i.e. death or disability funded with life insurance death benefit and cash value build-up). The Founders will execute a separate Buy/Sell Agreement with the Irrevocable Life Insurance Trust described in 4 below. The Buy/Sell Agreement will require the estate of the Founders (or their

successors in interests) to sell and the Irrevocable Life Insurance Trust to buy the shares of ABC owned by the Founders (or their successors in interest) at the survivor's death. Therefore their stock will not be subject to stock transfer restrictions except at death of survivor. This will create a market after the last to die but will avoid having a market created for it during life or at first death which would affect the valuation discount based on lack of marketability for lifetime or first death gifts/bequests.

3. The Founders execute new Wills to take advantage of the Marital Deduction (i.e. QTIP Trust) and Unified Credit (i.e. Bypass/Exemption Equivalent Trust) allowed to their estates. The Wills benefit only the survivor at the first spouse's death. The children receive the benefits under the Wills only upon the survivor's death. Any stock in the Corporation not gifted during life to the sons participating in the business will not be specifically bequeathed to the sons. The transition of #4 below will deal with stock in the corporation.
4. The Founders create an Irrevocable Life Insurance Trust (i.e. Trust) making their two children working in the business initial trustees and those two children and their children primary beneficiaries. The Irrevocable Life Insurance Trust will purchase a joint and survivor life insurance policy on Mr. and Mrs. Founder to be used by the Trust to purchase ABC stock owned by the estate planning trusts of the first to die and the estate of the survivor as well as provide funds to the estate of survivor by loan or asset purchase to pay estate taxes. The death benefit, if any, in excess of that necessary to purchase ABC stock will be equitably divided among the three children. This excess benefit can be distributed to the three children or maintained in separate trusts for each of the children and their descendants, of which each child is trustee of his/her own trust.

The death benefit in the Irrevocable Life Insurance Trust will not be subject to federal income or estate tax in the estate of either of the Founders or estates of children or children's children if left in Trust.

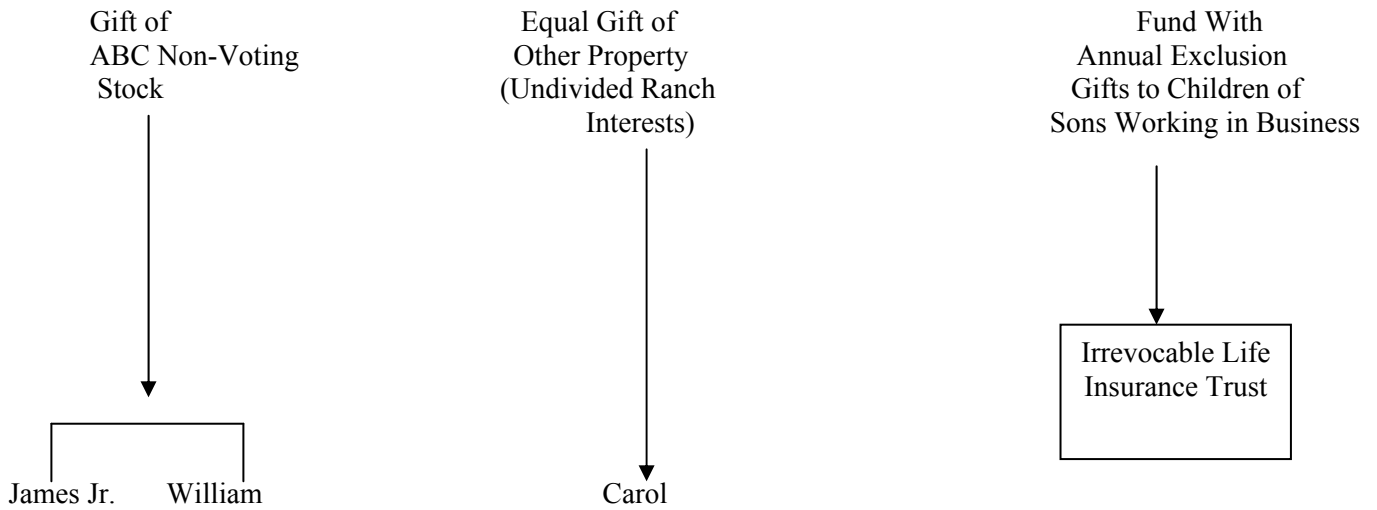
The premium on the joint and survivor life insurance policy will be paid by Annual Exclusion gifts by the Founders to the Irrevocable Life Insurance Trust using the Founders' grandchildren (who are children of the sons working in the business) as Crummey gift beneficiaries and income beneficiaries of Trust while insurance contract exists. The grandchildren are also contemporaneous and successor primary beneficiaries to their parents of the trust benefits from the life insurance (i.e. a Dynastic Trust). Use of some of the federal generation-skipping transfer tax exemption will be required because Dynastic Trust characteristics are desired.

5. Upon the death of the last to die of Mr. and Mrs. Founder, the Irrevocable Life Insurance Trust will use the life insurance proceeds to purchase the ABC stock owned by the estate planning trusts of the first to die and the estate of the survivor. Because of the federal income tax basis adjustment of §1014, no capital gains tax will be paid on the purchase from the Marital Deduction Trust of the first to die or the estate of the survivor. To the extent the purchase is from the Unified Credit/Exemption Equivalent Trust of the first to die, capital gains tax may be paid because §1014 basis adjustment is allowed only at the death of first to die and is not allowed at the survivor's death. The Irrevocable Life Insurance Trust will then own the stock of the corporation that was not gifted to the sons during the Founders' lives. The Founder sons will be co-trustees and equal beneficiaries of the Trust (and the later sole trustee of trust that owns such son's equal stock share) and thereby, along with the stock they each own individually, have equal control of the business. The life insurance proceeds that were paid to the estate planning trusts of the first to die and the estate of survivor will be used to pay the required estate taxes. Any remaining cash, along with the rest of the assets of the Founders, will be divided among the three children. The division will be done so as to provide overall equity in the distribution of the Founders' estates among the three children through a funding formula in the Marital Deduction and Unified Credit/Exemption Equivalent Trusts of the first to die and the Will of the survivor. The funding formula will not be in the Irrevocable Life Insurance Trust. These provisions allow balancing of assets among the Founder children, considering the value of the assets of the Marital Deduction and

Unified Credit/Exemption Equivalent Trusts of the first to die, the assets of the surviving parent's estate, the assets in the Irrevocable Life Insurance Trust and the lifetime gifts to the children.

CASE STUDY EXAMPLE

During the Lives of
James Founder and Sally Founder



Upon Death of Survivor of
James Founder and Sally Founder

