

Planning Ideas—Wealth Transfer with a IDGT

The economy has begun to recover, interest rates remain low, and it's a good bet that the Federal transfer tax is likely to remain with us given the current political environment and the increasing size of the federal deficit.

It couldn't be a better time to discuss business succession planning with your clients. A technique that takes advantage of currently low interest rates is an installment sale of the business to an "Intentionally Defective Grantor Trust" (IDGT)

How it Works

An IDGT is an irrevocable trust. The trust is intentionally designed to be "defective" for income tax purposes. When coupled with an installment sale of a closely-held business to the trust, the IDGT becomes a highly-effective business succession strategy. Consider the following example:

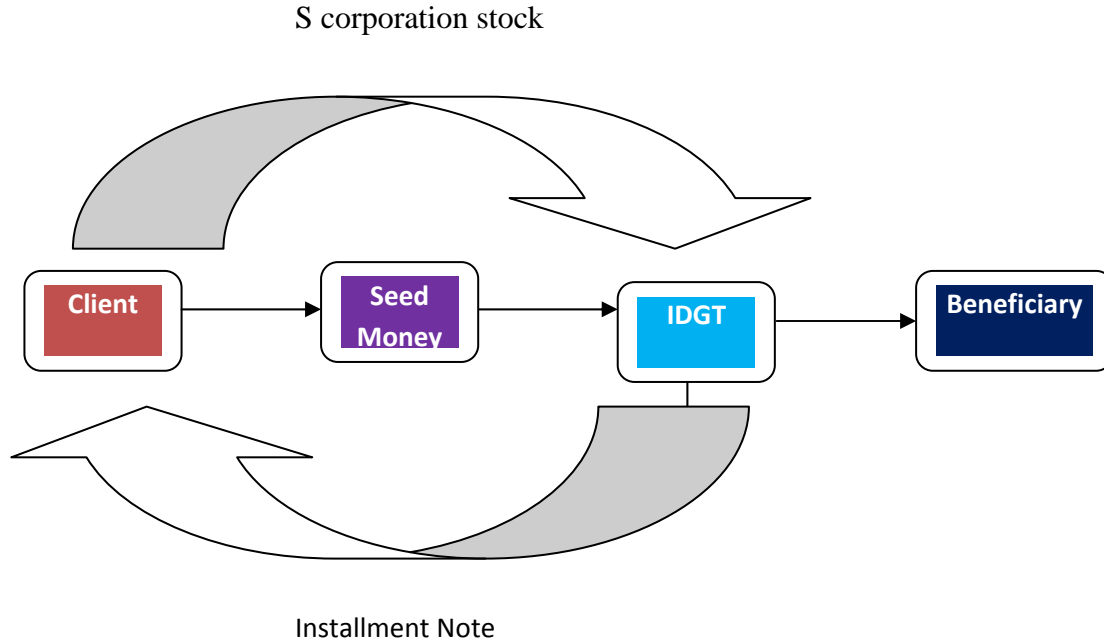
Example 1

Charlie W. is the sole owner a S corporation currently valued at \$12 million. He expects the company to come out of the current recession in good shape and believes it is poised for significant growth in the next 10-15 years. Charlie's son, Bill, is involved in every aspect of the business on a day-to-day basis. Charlie would like to retire and transfer the business to Bill but he's concerned about recognition of capital gains taxes, if he were to sell the business, and imposition of transfer taxes, if he were to give it to Bill outright.

Charlie's financial advisor, Nate S., recommends formation of a nine-year IDGT followed by an installment sale of Charlie's S corporation stock to the trust. The trust is funded with seed money of \$1.2 million, representing 10% of the stock value. The sale is evidenced in part by an installment note that calls for annual interest payments (on \$12 million) to Charlie of 2.87 % (the minimum mid-term rate for installment sales in September 2009) with a balloon payment of the principle in the ninth year. After the installment note is satisfied, the trust terminates and the S corporation stock is distributed to Charlie. Assuming, the stock appreciates at a 10% annual rate, the value of the stock received by Bill will be worth over \$28 million.

It is anticipated that stock dividends will source the payment of interest and principle on the installment note.

Figure 1



IDGTs are especially suited for use in the transfer of assets that are expected to appreciate rapidly such as closely-held business interests.

Federal Income Tax Considerations

Key to the success of this transaction is creation of an intentionally defective grantor trust. A grantor trust is a trust under which the trust income and loss flow through to the grantor by virtue of the grantor retaining certain powers under IRC Section 671-679. In general, it is advantageous to structure trusts so that the grantor is taxed on income and loss *for income tax purposes* yet avoids inclusion of the trust property in his or her estate *for estate tax purposes*. For example, assume the grantor retained the power to substitute trust property with property of equal value. Such power would be sufficient under IRC Section 675 to make the trust a grantor trust; however, the retention of such power would not cause inclusion of the trust property in the grantor's estate.

The IRS's position is that there is no gain or loss recognized in transactions between the grantor and the trust when the grantor is treated as the owner of the trust for income tax purposes. Rev. Rul. 85-13, 1985-1 CB 184; IRS Letter Rulings 9010065 and 9211026. Thus, the grantor is not taxed on the sale of assets to an IDGT.

Although the grantor is taxed on trust income used to make installment payments, it should be kept in mind that the payment of tax on such amounts further reduces the amount of the grantor's estate. Furthermore, the trust can be designed so that the grantor's power to substitute trust

property of equal value terminates in the event the grantor is financially unable to pay the tax due, for example, to increasing health or long-term care expenses. If the grantor no longer holds the Section 675 substitution power, grantor trust status is “toggled off,” and the grantor is no longer liable for the tax on trust income.

Federal Gift Tax Considerations

The sale of property to the trust for fair market value should not result in a taxable gift. However, valuation is undoubtedly an issue and hard-to-value assets such as closely-held business interests should be valued using a third-party appraiser. The gift of seed money to the trust is important to support the contention that the sale is an arm’s length transaction; however, so long as the gift is within the grantor’s annual exclusion or any unused gift tax exclusion equivalent there is no gift tax payable. The amount of the gift tax exclusion equivalent in 2009 is \$1 million per donor.

Federal Estate Tax Considerations

Because the grantor retains no beneficial interest in the trust, the trust property and all post-transfer appreciation should pass to the trust beneficiaries without being included in the grantor’s estate.

Federal Generation Skipping Transfer Tax Considerations

In general, the IDGT can be made effective as a generation-skipping vehicle by allocating the grantor’s GSTT exemption to the any taxable gift to the trust (for example, the seed money). The current (2009) GSTT exemption is \$3.5 million per donor.

Financial Considerations

In the example above, the grantor transferred a closely-held business interest worth \$12 million without imposition of income, gift, estate, or generation skipping taxes. The appreciation on the stock, estimated at upwards to \$16 million assuming 10% growth, passes transfer-tax free to the beneficiary. The financial benefits of an installment sale are maximized if the value of the transferred interest is discounted prior to the sale. For example, if Charlie’s closely-held business interest and other assets were transferred to a Family Limited Partnership in return for a 99 % limited partnership interest and a 1% general partnership interest, the financial benefits could be significantly enhanced.

Assuming the partnership was properly structured, the value of the limited partnership interests could receive a significant discount in value compared to the value of the underlying partnership assets. If the partnership assets were valued at \$12 million and the 99 % limited partnership interests received a 40% discount due to lack of marketability and transferability, the installment sale would be for only about \$7.2 million, not \$12 million. The amount of seed money required

to support the transaction would be only about \$720,000, not \$1.2 million, and the amount of the annual interest payments would be only about \$20,000 not \$34,000

Bottom Line

This is an excellent time for talking to your clients about business succession planning. Don't overlook an IDGT as a strategy for transferring closely-held business interests.

Planning Ideas and similar topics are covered in great detail in many of Cannon's professional development solutions. To find out more visit: www.cannonfinancial.com.

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