SOPHISTICATED PLANNING FOR BUSINESS SUCCESSION

An installment sale to an intentionally defective grantor trust is a technique that can have a positive impact on your business succession plan, provide cash flow in your retirement, and remove appreciating or income-producing assets from your estate for estate tax purposes.

Intentionally defective grantor trust (IDGT): A grantor – the person establishing the trust – purposefully sets up the trust so that he or she is treated as the owner of the trust assets for income tax purposes, but the assets in the trust are not included in the grantor's estate for estate tax purposes. An installment sale of assets to an IDGT is a powerful tool to remove appreciating or income-producing assets from the grantor's estate without the grantor having to make a large gift for gift tax purposes.

Jolie, the owner of a hotel in the Florida Keys, is proud to have something tangible to pass on to her three children when the time is right. And although she'd like to begin transferring her ownership in the hotel to her children, she isn't ready to give up control over how it is run. Instead, she wondered if she could recapitalize her S Corporation stock in the hotel into voting and non-voting shares, and then transfer the non-voting shares to a trust for the benefit of her children, with distribution provisions that limit her children's access to the trust assets. At the same time, by retaining the voting shares in her S Corporation, Jolie can retain control of the business.

Jolie worked with a financial advisor, tax professionals and a valuation expert to sell the non-voting S Corporation stock to an IDGT, designating all three of her children as beneficiaries of the trust. After recapitalizing the S Corporation into 1% voting shares and 99% non-voting shares, she gifted cash to the trust as a seed gift of 10% of the value of the S Corporation stock that she intended to sell to the IDGT.

Nine months later, she sold the non-voting S Corporation stock to the IDGT based upon the value of the professional appraisal of the non-voting shares in exchange for a balloon promissory note. Because the owner of non-voting shares does not have control over important business decisions such as making distributions to shareholders or selling the company, and the non-voting shares are stock in a closely held family company that cannot be readily sold on the open market, the appraiser applied minority and lack of marketability discounts to the appraised value of the non-voting shares. Under the balloon promissory note, the trustee of the IDGT was to pay her interest on the promissory note for nine years (the term of the balloon promissory note). At the end of the term, the trustee of the IDGT would pay her back any accrued and unpaid interest, as well as all of the principal.

Using this savvy technique, Jolie was able to transfer a significant amount of the hotel's current value and future appreciation out of her estate while maintaining control over the business. By transferring the stock to an IDGT and carefully drafting the trust distribution terms, she also limited her children's access to the trust's assets (the S Corporation stock).

An IDGT can be an ideal vehicle for business succession planning, generating cash flow in retirement and reducing estate tax liability.

Because the IDGT is "defective" for income tax purposes, no gain or loss is recognized by the grantor on the sale of the appreciated asset to the IDGT and the grantor does not recognize income on the interest payments received on the promissory note. The grantor is treated as if he or she sold the property to – and is paying interest to – himself or herself. There should be no gift tax consequences on the sale so long as the assets are sold to the trust for fair market value and the interest on the promissory note is based on the appropriate federal interest rate at the time of the sale.

By transferring assets to an IDGT, the grantor can immediately reduce the value of his or her estate for estate tax purposes because the grantor has relinquished control over the assets transferred to an irrevocable trust. The grantor can also leverage his or her lifetime generation-skipping transfer (GST) exemption by allocating his or her GST tax exemption to the trust to ensure that trust assets can be used for the benefit of future generations without incurring GST tax. GST tax can be imposed on distributions from a trust to grandchildren or younger descendants and to non-family members who are 37.5 or more years younger than the donor.

Finally, the grantor can leverage his or her annual gift tax exclusion for contributions through the use of Crummey powers (called so after a court case in which his or her use was approved). Gifts that qualify for the annual gift tax exclusion must be gifts of a "present interest," meaning the gift recipient must have an immediate right to use or enjoy the economic benefits of the gift. When the grantor makes a gift to a trust, he or she does not expect the beneficiaries of the trust to have an immediate right to use or enjoy the economic benefits of the gift. However, if the terms of the trust include language giving the beneficiaries the power, for a limited time period, to withdraw the gift, the gift will qualify as a gift of a present interest eligible for the annual gift tax exclusion.

It's also worth noting that by paying any income tax items associated with the IDGT assets (e.g., dividends, capital gains, ordinary income) the grantor is further reducing his or her estate for estate tax purposes and the grantor is making additional tax-free "gifts" to the beneficiaries by paying the income taxes associated with IDGT. This is because, by doing so, the trust assets do not have to be used to pay income taxes, leaving more assets in the trust available for the beneficiaries. The grantor also does not have to use his or her annual gift tax exclusion or lifetime gift tax exemption to pay those income taxes.

The payment stream on the installment note can provide a steady flow of retirement income. The payments on the note can be structured in a variety of ways, including interest-only payments for a term of years followed by a balloon payment, or as annual or more frequent payments of interest and principal.

Anyone considering a sale to an IDGT should keep in mind that the grantor must use a portion of his or her lifetime gift tax exemption or pay gift tax on a "seed" gift. A seed gift ensures that there are adequate funds in the trust to make payments on the promissory notes. Making a seed gift often requires the grantor to use a portion of his or her lifetime gift tax exemption.

The grantor risks inclusion of the present value of the remaining installment note payments in his or her estate if the grantor dies before the note is paid in full. Because the "defective" income tax status of the IDGT ends at the grantor's death, there are uncertain income tax consequences if the grantor dies before the promissory note is paid in full.

However, if a self-cancelling installment note ("SCIN") is used, the remaining installment note payments may not be included in the grantor's estate for estate tax purposes. With a SCIN, the promissory note is cancelled at the grantor's death.

Use of the SCIN technique includes a mortality risk premium to account for the risk that the note will not be paid in full at the grantor's death.

Unlike other kinds of estate planning techniques involving trusts such as Grantor Retained Annuity Trusts and Qualified Personal Residence Trusts, the installment sale to the IDGT is not explicitly approved by IRS rules. Finally, the grantor has no interest in and does not benefit from property transferred to an IDGT since the grantor gave up control over the assets transferred to the trust.

Installment Sale to IDGT

Grantor transfers appreciating assets as a "seed" gift to the IDGT and later sells appreciating assets to the trust

After the note is paid in full, the remainder beneficiaries receive the trust assets (and any appreciation after transfer) free of gift and estate tax

Trust makes interest and principal payments on the promissory note to the grantor. If the note is structured as a Self-Cancelling Installment Note, the value of any unpaid balance at the grantor's death will not be included in the grantor's estate for estate tax purposes

Grantor pays no income tax for sale and payments on the promissory note

An IDGT is an irrevocable trust that is "defective" for income tax purposes but effective for business succession planning, generating cash flow in retirement and reducing estate tax liability. Please speak with your financial advisor and tax professionals about this grantor trust, which can play an important role in your business succession plan.

Please note, changes in tax laws may occur at any time and could have a substantial impact upon each person's situation. While we are familiar with the tax provisions of the issues presented herein, as Financial Advisors of Raymond James, we are not qualified to render advice on tax or legal matters. You should discuss tax or legal matters with the appropriate professional.

Any examples are hypothetical and for information purposes only. Individual circumstances may vary. Every investor's situation is different. Please consult your financial advisor if you have questions about the example and how it relates to your own financial situation.

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