Opinion

Transferring business interest to an intentionally defective trust

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Lifetime gifts of closely held stock and real estate from business owners to children are a valuable way to shift assets to the next generation while minimizing estate taxes. There are several ways to implement a lifetime transfer. Sometimes an outright gift, although simple and straightforward, is not the most effective transfer technique.

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For example, when the proposed transfer exceeds the annual federal gift exclusion limits (currently $13,000 per donee per year); when a parent would rather use the annual gift exclusion for other purposes; or when the proposed transfer exceeds the $1 million lifetime gift exemption (or it has already been used), other techniques must be considered.

One common method is a gift and sale of assets to an intentionally defective grantor trust (IDGT). The IDGT beneficiaries are the children and often future generations. Because the IDGT may be designed as a dynasty trust, future estate tax is avoided.

IDGTs are beneficial because: assets transferred (and future appreciation) to the IDGT are removed from the business owner's estate; income tax to the grantor may be avoided on the sale of the assets; income on the assets inside the IDGT is paid by the grantor, thereby resulting in greater tax-free gifts; and the assets inside the IDGT are protected for future generations from creditors and failed marriages.

Why is an IDGT important?

It may be disconcerting to employ a trust called "defective," but the term merely refers to creating an irrevocable trust, where assets are transferred to the trust so they are removed for estate tax purposes but the income on such assets continues to be taxed to the transferor. Such a trust is called a "grantor trust."

The ability to work the income and estate tax consequences to the business owner's benefit arises because the income tax rules and estate tax rules do not dovetail perfectly. Because of this inconsistency, a trust can be drafted to give the business owner certain benefits or powers while avoiding others. In an IDGT, assets will be excluded from the business owner's estate for estate tax purposes, but the assets' income will be taxed for income tax purposes.

In effect, the business owner intentionally violates the rules designed to avoid the trust income from being taxed to

him. Transfers to such a trust are said to be "effective" for estate tax purposes, but "defective" for income tax purposes. This creates great opportunity for both income and estate tax planning.

Mechanics of an IDGT

To implement an IDGT, where the trust assets will not be included in the business owner's taxable estate, take the following steps:

(1) Fund the trust by making a "seed gift" to the IDGT. As a rule of thumb, it is often recommended that the value of this seed gift be at least 10 percent of the value of the sale transaction described in step 2 below. The seed gift can be cash, marketable securities, or a percent of the asset to be purchased. When the gift is made, the business owner would use some of his lifetime gift exemption to avoid paying gift taxes (or pay gift tax if the gift exceeds his lifetime gift exemption).

(2) Sell an asset, such as company stock, LLC interests, or real estate, to the IDGT in exchange for an installment note for the purchase price. The note would bear interest equal to the IRS rate that is published each month (the "Applicable Federal Rate" or "AFR"). This interest rate is locked in for the life of the loan. The AFR rate for a 9-year note in June 2009 was 2.25 percent. Because the IDGT is a grantor trust for income tax purposes, the sale of the asset would not result in any taxable gain to the business owner (for income tax purposes, the business owner is considered to be selling an asset to himself).

Assuming the business owner gifted company stock, dividends from the stock would pay for the purchase of additional stock. That is why it is important that the corporation is an S corporation.

An example

Below is an example of how the sale of stock worth $10 million by a business owner to an IDGT would work:

Step 1: Gift of $1 million in stock. The gift should be at least 10 percent of the total value of the sale.

Step 2: Sale of $9 million in stock to IDGT. The promissory note includes an interest ate of 2.25 percent, interest-only annual interest payments and a 9-year term balloon payment.

The $10 million of transferred stock will earn dividends which will pay the annual interest payments. The balance, if any, may be accumulated and reinvested by the IDGT; used to pay down principal; or disbursed to the IDGT beneficiaries.

-Assume the trust earns 7 percent income each year:
$10 million trust assets x 7% income = $700,000 annual income

-Annual interest payments:
$9 Million principal x 2.25% AFR interest rate = $202,500 annual interest

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