

New York Law Journal

Trusts and Estates Law

Utilizing Trusts to Transfer Business Interests

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November 10, 2008

In this article, we will discuss four topics of succession planning, incorporating the use of two different types of trusts in planning: advance planning for succession, using trusts in the plan, sale to an Intentionally Defective Grantor Trust (IDGT), transfer to a Grantor Retained Annuity Trust (GRAT), and a comparison of using a GRAT versus an IDGT.

Advance Planning for Succession

When planning for succession, the earlier the planning begins, the more options are available for both the transferor and the transferee of the business. The transferor and transferee should separately (and collectively, if possible) consider the effect of the planning on their own lives as well as on the business. Assessing the dynamics of the relationships among the transferor, transferee and the business is paramount to the success of the succession. Without advance planning, decisions for the succession of the business may be made without enough time to properly prepare all three parties noted above for the imminent changes.

The transferor must evaluate the current business structure. An important part of determining the proper planning is considering the type of entity (or entities) in which the business is contained. Subchapter S corporations require different vehicles and features of the plan than do partnerships and limited liability companies, largely as a result of the tax consequences of making transfers of interests in the entity.

As the transferor considers the dynamics of the relationships and the structure of the business, he or she can then develop the plan. Not surprisingly, the plan can be simple or complex in its execution. For example, the transferor may choose to transfer his or her interest in the business outright to one or more of his or her children in one fell swoop, or alternatively, transfer the business to the children in increments over time, so that the transferor can maintain control over the business while the children become



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increasingly active in the business. Often, the transferor does not want to relinquish any control, and, consequently, give control to the transferee.

This conflict between knowing that there are tax benefits to making these transfers and the transferor's emotional connection to the business presents its own set of problems, which the transferor must address, one of the many reasons to set out a reasonable time horizon for succession planning.

Using an IDGT or GRAT in the Plan

Now that the transferor has decided to make transfers to the transferee, the transferor often wants to retain some financial interest after the transfer. A good option is a set payment stream from the transferee. Inherent in the transferor's ambivalence in making the transfer is the lack of comfort that this payment stream will be continuous. To help ease the transferor's mind, he or she can transfer the business interest into a trust for the benefit of the person who is expected to succeed the transferor. There are two types of arrangements with trusts that are often used to receive the business interest from a transferor. The first is a gift to a grantor retained annuity trust (GRAT), which is discussed below. The other is a sale of the business interest to an intentionally defective grantor trust (IDGT).

IDGT

- ***Sale to Intentionally Defective Grantor Trust.*** An IDGT is a trust which provides no direct benefit to the transferor. It is a grantor trust under the income tax rules. A grantor trust is a legal trust under applicable state law that is not recognized as a separate taxable entity for income tax purposes because the grantor or other substantial owners have not relinquished complete dominion and control over the trust.

A transferor can use an IDGT to permit tax-free gifts of income tax on the trust's income. IRS Private Letter Rulings have approved this benefit. With a special clause in the trust document, the income tax paid by the grantor will not be a taxable gift to the trust beneficiaries.

Using an IDGT permits income tax-free transactions between grantor/transferor and trust. Complicated transactions can be effected without causing income tax. Further, some arrangements will permit the value of the grantor's net worth to be frozen, even though the trusts assets appreciate in value after the transaction.

A strong benefit to the IDGT over other types of trusts is the ability to hold S corporation stock. Only certain trusts can own S corporation stock. A grantor trust may own S corporation stock.

As to the structure of the sale of a business interest to an IDGT, there are certain considerations that must be examined. Further, the transaction must adhere to these formalities or risk losing benefits of the transaction. For example, the trust must be a wholly owned grantor trust. Under the federal income tax rules, certain provisions of the trust will cause the entire trust to be treated as a grantor trust. A recent Internal Revenue Service (IRS) Revenue Ruling has approved the nonfiduciary power of the grantor to reacquire trust property in exchange for other property which the grantor puts into the trust.

The transferor sells the business interest to the IDGT in exchange for a promissory note. In determining the face amount of the note, valuation discounts leverage the transfer. It is well-settled that a fractional interest in a business entity is worth less than the proportionate value of the underlying assets of the entity.

Example of Sale to IDGT. Assume a 60-Year-Old Grantor Sells \$3 Million of S Corporation Stock in the Grantor's Company to an IDGT in October 2007 for a Nine-Year Note.

The minimum interest rate (AFR) equals 4.35 percent. Using an interest rate of 4.35 percent, the note provides for annual payments of \$368,945. At the end of nine years, the note is fully paid and the trust holds the remaining assets for the benefit of the grantor's children. The taxable gift made to the trust is approximately \$300,000, as seed money.

- **Advantages and Disadvantages of a Sale to IDGT.** One major advantage of a sale to an IDGT is that there is no gain or loss on the sale. The assets sold and the appreciation are not included in the seller's taxable estate. The note carries a lower rate than that required for a GRAT since the AFR is lower than the §7520 rate. The grantor trust rules apply - grantor pays the income tax on the IDGT's income. There is no need to outlive the term of the note to assure its validity. There are generation-skipping transfer tax concerns, which can be addressed in the provisions of the IDGT.

A disadvantage of the sale to an IDGT is that there is little precedent on the usage of the IDGT - no regulations, or court opinions.

- **Grantor Retained Annuity Trust (GRAT)**

A GRAT is an irrevocable trust in which the grantor retains an annuity for a fixed term. At the end of the term, the trust's remainder is paid out to a family member of the grantor or held in further trust. A GRAT is a qualified trust under the Internal Revenue Code. As long as the grantor outlives the term of the trust, the assets inside the trust escape estate taxation. However, if the grantor dies during the term, the assets are included in the grantor's taxable estate. The trust is generally funded by a gift of cash or other property from the grantor. Valuation discounts can leverage the transfer, allowing more underlying property to pass into the trust at a reduced gift-tax cost.

Example of GRAT. Assume a 60- Year-Old Grantor Gifts \$3 Million of S Corporation Stock in the Grantor's Company to a Nine-Year GRAT in October 2007.

The IRS assumes a 5.2 percent return (§7520 Rate). The GRAT requires annuity payments of \$368,940, paid annually to grantor. At the end of nine years, GRAT pays the remainder to grantor's children or it is held in further trust for the benefit of the grantor's children. The taxable gift is approximately \$557,000.

GRATs, Low Interest Rates

Since 2001, the §7520 Rate has been under 6.5 percent and has even been as low as 3 percent. This low rate translates to a smaller gift needed to produce a desired annuity amount. Also, in the computation of the annuity, a lower rate provides a lower hurdle to overcome in terms of the cash flow of the trust. Specifically, the cash flow of the underlying asset in the trust is of paramount importance. When the rate hurdle is low, it will be easier for the trust to meet its annuity obligation.

- **GRATs: Advantages, Disadvantages**

Advantages: The grantor can make a large gift with little or no gift tax. Under *Walton v. Comm'r*, and the IRS' subsequent acquiescence thereto, a grantor can retain an annuity such that the actuarial value of the annuity is effectively 100 percent of the value of the transferred assets. Conversely, the gift is zero. GRATs are approved by statute. The grantor trust rules apply to GRATs, as noted above with IDGTs.

Disadvantages: The grantor must outlive the fixed term or the estate and gift tax benefits are lost. Also, the grantor receives much of the trust assets back as required by the annuity. This puts unnecessary pressure on the performance of the trust assets to generate enough cash flow to satisfy the annuity obligation. In the event the cash flow is insufficient to pay the annuity, the annuity must be paid in kind, adding a layer of administration to the trust. Of course, this may limit the choice of assets to put into the GRAT. Lastly, the GRAT is a complicated document, and some clients have difficulty understanding and implementing the GRAT.

Comparing IDGT to GRAT

As noted above in the two examples, a grantor has created a trust and transferred cash or other property to the trust. For nine years, the grantor will receive a stream of payments. In the IDGT example, the grantor's payment stream is based on the terms of the note. In the GRAT example, the trust contains those provisions regarding the annuity.

The interest rate required in the IDGT is 4.35 percent, and 5.2 percent with the GRAT. In order to compare apples with apples, we used the same stream of payments (\$368,940) in both examples. Then we determined the grantor's contribution to the trust, the terms of the trust and/or note necessary to produce that stream of payments. A transfer of \$3 million to a nine-year GRAT, with a 5.2 percent rate, and an annuity of \$368,940, produces a taxable gift of approximately \$557,000.

The transfer of the same \$3 million of property to an IDGT, with a nine-year, 4.35 percent note, will require the payment of \$368,940 annually for nine years. In the sale to the trust, the trust must produce a down payment to secure the payment of the note. The grantor must make a \$300,000 gift to the trust sufficient to cover the deposit (seed money). The taxable gift is thus smaller with the sale to an IDGT than with a GRAT.

Conclusion

While there are some disadvantages to using a sale to an IDGT, the advantages make this technique well worth the effort.

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