CONVERGENT | WEALTH
ADVISORS

{ Installment Sale to Intentionally Defective Grantor Trust }

In General

A time-tested and tax-efficient wealth transfer technique involves *selling* property to an irrevocable trust established for the benefit of a client's heirs (i.e., children or more remote descendants) in exchange for a promissory note. The result is that the asset(s) sold to the trust and any subsequent appreciation is removed from the client's taxable estate and replaced with the note. In addition, the sale of fractional and/or non-voting control interests in property can leverage the tax-free gifting of the asset through the application of valuation discounts.

The Mechanics

A key component to the sale transaction is to create an "intentionally defective grantor trust" (an "IDGT"), which is an irrevocable trust for the benefit of the Grantor's children or more remote descendants. The trust is generally structured to be intentionally "defective," meaning for federal income tax purposes the trust assets are deemed to be owned by the Grantor. The result is that income taxes on trust earnings are payable by the Grantor. This allows trust assets (which would have been used to pay the income taxes) to remain inside the IDGT, further enhancing the growth of the assets outside of the client's estate. In essence, the payment of the taxes is a *gift* to the beneficiaries without any associated tax.

Once the IDGT is established and appreciating assets have been identified, the Grantor sells an asset to the IDGT and in return receives a 10% cash down payment and a promissory note (the "Note") for the remainder of the purchase price. Typically, the Note is structured as an interest-only note with a final balloon payment of principal at the end of the Note term. A note term of between 3 to 9 years is most often selected. The Note must charge a minimal interest rate equal to the Applicable Federal Rate ("AFR") – also known as the "hurdle rate".[1] The IDGT will make interest payments to the Grantor annually and there is no penalty for prepayment of principal.[2]

One item to note with respect to the sale is that the IDGT must be able to show that it can meet its financial obligations under the issued Note. Consequently, if the trust was not previously funded or holds no other assets before the sale (as in the case of a newly formed IDGT) the Grantor must capitalize the trust with an initial gift, which may be taxable, and is referred to as "seed money" or "seed capital."[3] One alternative to avoid making a gift and paying any gift tax, if applicable, is to have the trust beneficiaries guarantee the note payments.

<u>Any excess performance above the hurdle rate in the underlying assets of the IDGT inures to the benefit of the trust beneficiaries transfer tax-free.</u>

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[1] The AFR rate will depend on the date and length of the note. Shorter notes have lower rates while longer notes have higher rates. Notes with terms of 3 years or less must use the short-term AFR, notes with terms over 3 years but less than 9 years must use the mid-term AFR, and notes with terms 9 years or more must use the long-term AFR prescribed for the month of the sale.
[2] The note can be refinanced if interest rates drop in subsequent years.
[3] A gift of seed capital in an amount equal to at least 10% of the purchase price of the property sold has generally been found as an acceptable rule of thumb within the legal community to avoid an IRC §2036 challenge by the IRS.

Leveraging Tax-Free Transfers through Application of Valuation Discounts

One way to increase the effectiveness of a sale to an IDGT is to sell assets that may be eligible for valuation discounts as a result of a lack of control and/or lack of marketability. Application of such discounts is effectively an *additional tax-free gift* to the beneficiary at the time of the sale. For example, assume the Grantor intends to sell a 10% non-managing member LLC interest worth $1 million. The value of the 10% LLC interest can be discounted (typically between 20%-35%) so that the asset may be sold for less than $1 million. If the discount applied is 25%, then the 10% LLC interest can be sold to the IDGT for the purchase price of $750,000 – successfully transferring $250,000 to the trust beneficiaries transfer tax-free upon the sale. Thus, using discounted assets with the sale technique maximizes wealth transfer benefits.

Tax Benefits

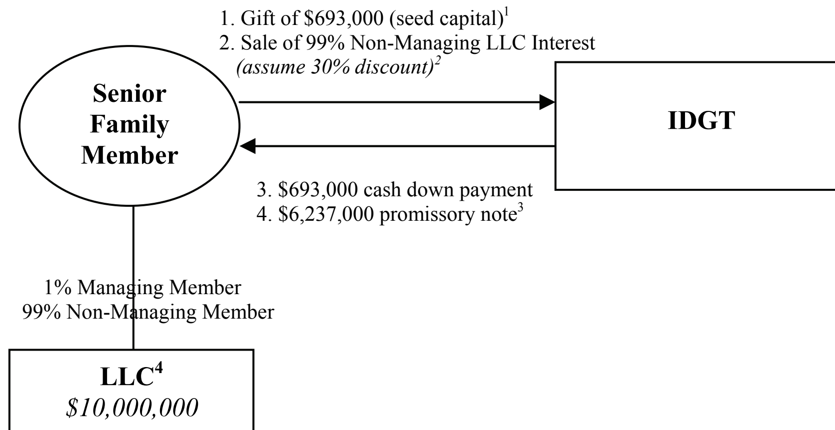
- If the Grantor dies during the Note term only the value of the Note will be included in his/her gross estate – in essence, the value of the asset sold has been "frozen" in the estate for estate tax purposes.
- All appreciation on the asset sold in excess of the hurdle rate grows transfer-tax free outside of the Grantor's estate for the benefit of the trust beneficiaries.
- The amount of the valuation discount is a gift tax-free transfer to the trust beneficiaries and all future growth attributed to that sum grows tax-free outside of the Grantor's estate.
- The consequence of the Grantor being deemed as the owner of the trust assets for federal income tax purposes is that:
    1. The sale of the property to the IDGT is a *non-taxable event* so that the transaction is disregarded for income tax purposes, meaning the Grantor will not recognize any gain from the sale[4]; and
    2. Annual interest payments payable to the Grantor by the IDGT are not taxable as additional income.
- Trust income is taxable directly to the Grantor on his/her personal income tax return. In effect, the income tax payments by the Grantor are *additional tax-free transfers* of wealth to the trust beneficiaries. *Note, however, that the trust may be converted at any time to transfer the taxability of the trust income to the trust beneficiaries.*
- Allocation of the Grantor's generation-skipping transfer ("GST") tax exemption to the gift of seed capital to the IDGT leverages the tax-free transfer of wealth because the assets continue to grow inside the trust GST tax-free for the benefit of grandchildren and more remote descendants.[5]

[4] The IDGT will take a carry-over income tax basis in the property. If the property is subsequently sold, gain will be recognized by the IDGT at that time. If the IDGT is a grantor trust at the time of the sale, the Grantor will pay the income taxes associated with the gain recognized at that time.

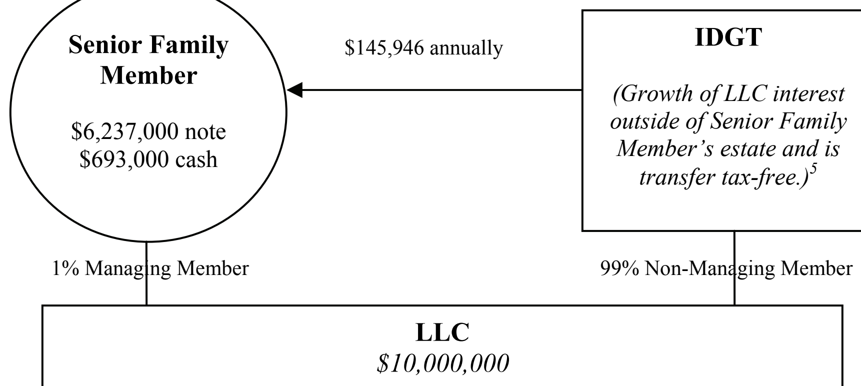
[5] Under current law, for year 2010, there is no GST tax and no GST exemption; therefore, any gift of seed capital to an IDGT cannot be allocated GST exemption until 2011 when the GST tax and exemption are brought back. In this case, any allocation of GST exemption in 2011 will be to the value of the trust at the time of allocation.

{ Installment Sale of LLC Interest to Grantor Trust }

SALE



RESULT



1. The Senior Family Member can use his or her $1 million lifetime gift tax exemption to shelter this gift.
2. The Senior Family Member transfers *$2,970,000 gift-tax free* solely from the 30% valuation discount - *savings of $1,039,500 in gift taxes (at the current 2010 gift tax rate)!*
3. The note will be for 9 years at 2.35% (July 2010 mid-term AFR), annual interest only.
4. While the sale of an LLC interest is illustrated here, any property can be sold in this manner.
5. Assuming a constant trust growth rate of 6% over 10 years, the IDGT will hold an LLC interest worth *$7,891,247 of asset appreciation – all of which has been transferred to the trust beneficiaries transfer tax-free!*

{ Notes and Disclosures }

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