



Leveraged Transfers of Business Assets

By Richard B. Gregory and William S. Forsberg

A business owner who is considering transferring a business to younger-generation family members faces a series of daunting obstacles. One obstacle is control. As entrepreneurs, business owners generally want to be in control of their business. Another obstacle is sibling rivalry. Old grudges die hard. A third obstacle is transfer tax. This article highlights the two primary methods of overcoming transfer tax problems and discusses the advantages and disadvantages of each method.

Gifts and Discounts

When transfer taxes are a factor, the client usually wants to transfer as much of the business as possible without incurring any out-of-pocket gift tax cost. This generally means “leveraging” the client’s transfer tax exclusions and exemptions (applicable, annual, and generation skipping) to pass the largest amount of underlying asset value at the least transfer tax cost.

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The value of property (whether real, personal, tangible, or intangible) for transfer tax purposes is usually its fair market value on the date of transfer. Fair market value is generally determined at the highest and best use to which the property could be put. If the property transferred is a minority interest in a business, however, substantial discounts may be available. Discounts ranging from 15% to 75% have been upheld in recent years. The use of discounts allows the transfer of current property value faster while at the same time transferring all future appreciation to junior family members.

The business entities most commonly used to obtain valuation discounts are the limited partnership and the limited liability company. Both entities exist under state law and allow senior family members to maintain control while allowing substantial value to be transferred to junior family members. Corporations can be used but are generally not the preferred entity because of income tax and other structural issues. Obtaining significant valuation discounts is the key to leveraging the transfer of business interests to junior family members effectively. If the business owner has already used his or her available transfer tax exclusions and exemption, or if the business is so valuable that it cannot be transferred by outright gift, then more sophisticated methods may be required.

Estate Freeze Overview

A commonly used technique to save estate taxes is to "freeze" the value of an asset while keeping control of it. The estate freeze does not allow property to escape the transfer tax system. Rather, it minimizes its effect. Although there are many variations on the basic estate freeze, they can be divided into two primary categories.

One category splits the business into different interests. The transferor gives away one interest in the business to junior family members while retaining another. The value of the transferor's retained interest would not be affected by any appreciation or depreciation in the value of the business entity as a whole. Appreciation or depreciation

would affect only the value of the transferred interest. A transfer of common stock while retaining preferred stock is an example of this type of transaction. A variation involves a special type of family limited partnership.

The other category includes transactions in which the transferor retains an interest in the transferred property for a period of time or places restrictions on the transferred property. As a result, the value of the transferred property is discounted for transfer tax purposes. For example, the property transferred might be a minority interest in a business entity or stock subject to restricted voting or liquidation rights.

Some transactions combine elements of both categories. For example, in addition to retaining preferred stock, a

and the remainder interest that passes to the beneficiaries at the inception of the GRAT using an interest rate factor under Code § 7520. If the GRAT performs exactly at the Code § 7520 rate, the assets passing to the beneficiaries at the end of the GRAT term will equal the amount of the initial gift. If the GRAT outperforms the Code § 7520 rate, the assets remaining at the end of the GRAT term in excess of the initial gift pass to junior family members free of any additional transfer tax. Unfortunately, the opposite result could occur, in which case the grantor's applicable exclusion amount will be wasted on gift tax. If the grantor dies during the GRAT term, the full value of the trust property should be included in his or her gross estate. If the grantor

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person might transfer common stock to a grantor retained annuity trust (GRAT) in order to further reduce the value of the interest that is to be transferred to junior family members.

During the last several years, the installment sale to an intentionally defective grantor trust (IDGIT) has become popular. Instead of a gift, the senior family members sell the business interest to a trust that is disregarded for income tax purposes but recognized for transfer tax purposes. The IDGIT technique both freezes value and allows for a discounted selling price.

The Grantor Retained Annuity Trust

The GRAT is a creature of statute and is controlled by Code § 2702. With a GRAT, the donor (grantor) transfers property to a trust and retains the right to a fixed amount (an annuity) paid at least annually for a fixed period of time. For gift tax purposes, the grantor values the retained annuity interest

survives the GRAT term, the entire value of the property remaining in the trust will be excluded from his or her estate.

When a GRAT is initially funded, the grantor creates and values two separate property interests. When valuing these interests, the IRS takes into account the following factors: (1) the Code § 7520 rate for the month of transfer (120% of the federal midterm rate, compounded annually, and rounded to the nearest .2%); (2) the term of the GRAT; (3) the amount of the transfer; (4) the annuity rate or amount; and (5) the age of the grantor. In its simplest form, the value of the annuity is the present value of the right to receive the annuity payments for the specified GRAT term, discounted using the Code § 7520 rate. The value of the remainder interest is the amount of the transfer minus the value of the retained annuity interest.

The Treasury Regulations under Code § 2702 attempt to add an additional factor. The Regulations state that

the possibility that the grantor may die before the end of the GRAT term should be taken into account when valuing these interests, thereby reducing the value of the annuity interest and increasing the amount of the remainder interest. An increase in the value of the remainder interest increases the amount of the current gift. This mortality factor does not significantly alter the computations for the younger client, but it greatly reduces the effectiveness of the GRAT for an older client. The practical effect of these Regulations, as interpreted by the IRS, is to make it impossible to structure a GRAT without generating some amount of gift. In other words, a GRAT cannot be “zeroed-out,” when the actuarial value of the remainder interest for transfer tax purposes equals zero. The IRS position was dealt a severe blow in *Walton v. Commissioner*, 115 T.C. No. 41 (2000). The Tax Court in *Walton* held that a fixed-term GRAT could be zeroed out if the annuity is payable to

transferred property will continue to be included in the grantor’s gross estate. Because a GRAT is generally included in the grantor’s estate under Code § 2036 until the annuity ends, the GRAT falls directly into the definition of a transaction that creates an ETIP. Accordingly, the grantor’s GST exemption cannot be leveraged, because it must be allocated to the assets remaining in the GRAT at the end of the annuity payment. To avoid the ETIP and GST issues, many GRATs are structured so that the remainder passes only to living children, excluding the issue of a predeceased child. An equalization clause is then inserted in the grantor’s will or revocable trust for the benefit of the predeceased child’s issue in order to equalize distributions along family lines.

A highly appreciating business interest is an ideal asset to transfer to a GRAT. A donor can transfer the S corporation stock to a GRAT if the GRAT is structured as a “wholly grantor

factor, especially for older clients. It can also add some precision to the planning when it is strongly believed that the assets transferred will substantially increase in value over the shorter term.

The grantor can use the annuity payments to create another short-term GRAT. This technique, called “rolling GRATs,” can continue year after year until the desired result is achieved. Rolling GRATs are an excellent way to hedge against the premature death of the grantor or poor market performance. Now that “anniversary year” GRATs are permitted, annual payment, short-term rolling GRATs can achieve favorable transfer tax results with reduced administrative cost and headache. One variation is a “graduated GRAT,” in which the GRAT starts with a lower payment and automatically increases each year, resulting in a smaller gift. Another variation is the “two-life GRAT,” in which the spouse has a contingent interest that only takes effect if the grantor dies before the end of the term. But two-life GRATs may no longer be viable, given *Cook v. Commissioner*, 115 T.C. 15 (2000), *aff’d*, 269 F. 3d 854 (7th Cir. 2001).

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the grantor or the grantor’s estate. The *Walton* case, although a victory for the taxpayer, raises other related issues. For a discussion of these related issues, see Deborah V. Dunn, *Coming to a Wal-Mart Near You: Tax-Free GRATs*, Tr. & Est., April 2001, and Carlyn S. McCaffrey, Lloyd Leva Plaine & Pam H. Schneider, *The Aftermath of Walton: The Rehabilitation of the Fixed-Term, Zeroed-Out GRAT*, 95 J. TAX’N 325 (2001).

Planners should consider the effect of the generation skipping transfer tax (GST) when structuring a GRAT. In most cases, the grantor cannot effectively allocate his or her GST exemption to a GRAT. The donor must wait until the end of the estate tax inclusion period (ETIP) to allocate his or her GST exemption to the GRAT. The ETIP period is the time during which the

trust” and qualifies as an S corporation shareholder. In times of rapid market appreciation, publicly traded stock is a good candidate for a GRAT. If the GRAT assets outperform the Code § 7520 rate, then the differential will be available to remainder beneficiaries at little or no gift tax cost. Many GRATs formed in the 1990s saw remarkable growth resulting in substantial value passing to junior family members. Because there is risk that the GRAT will not outperform the Code § 7520 rate or that it will actually perform below the Code § 7520 rate, most GRAT transactions should be structured to produce as small a present gift as possible. A *Walton* zeroed-out GRAT is certainly an option that should be explored with the client. Shortening the GRAT term is also a good idea, as the shorter term will reduce the effect of the mortality

Installment Sale to an Irrevocable Grantor Trust

The primary purpose of the installment sale to an IDGIT is to achieve an estate freeze without the complexity of Chapter 14 and, often, with better results for the client. The grantor sells an asset to an irrevocable trust that is owned by the grantor for income tax purposes but that is excluded from the gross estate for estate tax purposes. The consideration for the sale is an installment note (although some commentators suggest that the note should not finance the entire sales price). Because the note is considered “adequate consideration in money or money’s worth,” the transaction results in no or minimal gift tax cost.

If all works exactly as planned, the IDGIT will pay the note in full before the grantor dies. The only assets that will be subject to estate tax in the grantor’s estate after the note is paid will be the payments received that have not otherwise been spent by the

grantor during his or her lifetime. All increases in the value of the assets sold to the IDGIT (including the discount element of the purchase price, if any) will be excluded from the grantor's estate.

The IDGIT created by the grantor must be irrevocable to achieve the desired transfer tax result. For income tax purposes, it must be a "grantor trust," so that the asset sale does not cause income realization or recognition to the grantor. Many alternative provisions can be inserted into the IDGIT to make it a grantor trust. Commonly, the grantor retains the power to substitute his or her assets for IDGIT assets of an equivalent value. Because of its status as a grantor trust, the IDGIT is commonly referred to as a "defective trust." The name is misleading, however, because the IDGIT is anything but defective. In fact, it is a carefully drafted instrument that is intended to achieve these dual income and transfer tax results.

To avoid inclusion of the IDGIT assets in the grantor's gross estate, the grantor should not be a trust beneficiary, even with an independent trustee. The grantor should also not act as the trustee. Although it may be possible to structure the IDGIT to allow the grantor to act as trustee, the risk is too great. The grantor should not retain the power to remove and replace trustees. State law could cause a problem if creditors can access the IDGIT property to satisfy the grantor's claims. Finally, the trustee should be prohibited from using trust assets to satisfy the grantor's legal support obligations.

The sale to the IDGIT must be structured as a bona fide sale, rather than as a transfer by the grantor with a retained life estate. Obviously, all the formalities must be observed. These would include a formal, professional appraisal of the assets sold, a sale and purchase agreement, promissory note, security agreement, and any other commercially reasonable documents. The note interest rate should be the rate set under Code § 7872(f), which would be the applicable federal rate under Code § 1274. Installment payments on the note should have no direct relation

to the income generated by the IDGIT. The trustee should carefully monitor the IDGIT to ensure that it has sufficient assets to satisfy the note obligation. It is hoped that the assets sold to the IDGIT will generate the needed cash flow. If not, the grantor may have to transfer additional assets to the IDGIT. Guaranties by solvent beneficiaries could be used but may subject them to gift tax. All IDGIT income will be reported by the grantor because it is a grantor trust. But although no interest deduction is available to the IDGIT, the grantor does not need to report the interest received on note payments. In essence, the sale is ignored for income tax purposes. The note term should end within the grantor's life expectancy so that it will not be outstanding at the grantor's death. Otherwise, some portion or all of the outstanding note balance may have to be reported as income in respect of a decedent, although this result is not entirely clear.

The IDGIT sale is a great technique because no transfer taxes are paid and there is no or minimal use of the transferor's applicable exclusion amount. Finally, the grantor can allocate his or her GST exemption to the IDGIT, making it a dynasty or multi-generational trust.

IDGITs vs. GRATs

When contemplating the transfer of assets between generations, a planner needs to compare the strengths and weaknesses of GRATs and IDGITs. Both techniques freeze value and pass future appreciation to the second generation, but they can be quite different operationally.

One key question will be cash flow. In order for an IDGIT to work appropriately, it needs the wherewithal to support the current interest payments. If the asset does not produce sufficient income to make the interest payments on the note, the grantor will need to add a cash component up front or use a GRAT.

Valuation may also be an issue. With an IDGIT, the donor should appraise the asset at the time of the sale in order to determine the sale price. With a GRAT, it may be necessary to

re-value the asset more periodically if the annuity payment will be funded in kind with shares of stock or partnership interests. Therefore, it will be easier to administer a two-year, quarterly installment GRAT that holds publicly traded stock as opposed to an interest in a partnership that holds commercial real estate.

Time horizons may dictate which technique to use. GRATs are generally better for shorter time horizons, but most IDGITs will have a longer term.

Finally, one may also wish to consider the applicable interest rate that needs to be outperformed in order to achieve the desired results. The Code § 7520 rate, applicable to GRATs, will be different from the mid-term or long-term applicable federal rate on the note issued by the IDGITs. All other things being equal, the more favorable interest rate could govern.

Conclusion

Leveraged transfers of business assets can take on many forms. Some techniques, like the GRAT, are sanctioned by the Internal Revenue Code. Others, like the IDGIT, although based on sound income and transfer tax principles, have not yet achieved legislative sanction. With the gift tax applicable exclusion amount frozen at \$1 million until 2010, and with the uncertainty surrounding estate and gift tax repeal, leveraged transfers of business assets will become critical tools in the estate planner's arsenal. ■