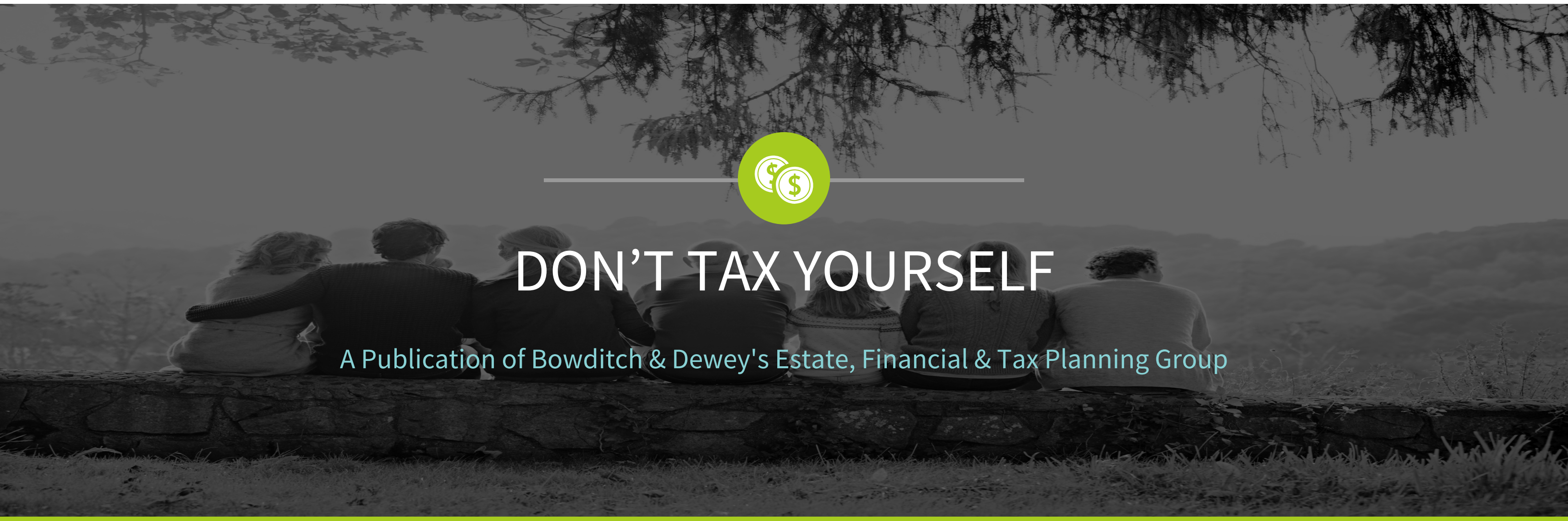

Using an IDGT in Succession Planning in Closely-Held Businesses

BY EILEEN Y. LEE BREGER • SEPTEMBER 23, 2019

Those who own closely-held family businesses may want to consider advanced estate planning strategies to pass on business interests to a younger generation, especially as the current $11.4 million federal gift and estate tax exemption is due to sunset at the end of 2025 and return to $5 million (adjusted for inflation). Now may be the opportune time to consider gift tax planning or the sale of business interests to an intentionally defective grantor trust (IDGT).

An IDGT is an irrevocable trust that is oftentimes established for the benefit of the grantor's descendants and can be drafted to provide creditor protection for the beneficiaries and help minimize the chance of a beneficiary's spouse obtaining any interest in the family business as the result of a divorce.

From a tax standpoint, an IDGT is designed to remove assets from the grantor's estate, but for income tax purposes will be a "grantor trust," a trust where the grantor continues to be responsible for the income taxes on assets transferred to the trust, even though the income is received by the trust. A grantor's payment of income taxes allows the assets in the trust to grow tax-free. Also, the trust can be drafted in a flexible way to allow the trust to reimburse the grantor for income taxes if the grantor does not have sufficient funds to pay the income taxes.

Gifting

A grantor can gift to an IDGT with assets that have a strong potential to appreciate and take advantage of today's high federal gift tax exemption. The future growth of assets transferred to the trust will be removed from the grantor's gross estate.

Sale to an IDGT

An alternative to gifting is the sale of business interests to an IDGT by the grantor in exchange for a promissory note. The interest on the note will be determined by the applicable federal rate (AFR) and may be structured as an installment note that calls for interest-only payments for a period of time and a balloon payment at the end, or it may require interest and principal payments. The IDGT may pay the note using cash distributions from the business or equity.

Additionally, in order for the transaction to be respected, the IDGT should be funded with “seed” money equal to at least 10% of the business interest to be transferred. Seeding the trust will use some of the grantor’s lifetime transfer tax exemption.

The sale with the trust will not trigger capital gains tax — as explained above, the trust is “defective” for income tax purposes, so the income of the trust is taxable to the grantor. For tax purposes, the grantor is transacting with himself.

The expectation is that the closely held business interest held by the IDGT will grow faster than the prescribed federal rate on the note. The value taken back by the grantor through the installment note will be far less than the appreciation of the assets owned by the trust, thereby allowing the grantor to transfer the growth on the business interests held by the IDGT tax-free to the trust beneficiaries.

If the grantor of the IDGT dies during the note’s term, the only item included in the grantor’s estate for estate tax purposes is the value of the installment note.

Valuation discounts can be used in conjunction with the sale of business interests to an IDGT for greater tax savings.