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Using a defective grantor trust in a business succession plan

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Small businesses fail at a very high rate. Only about 30 percent of family-owned businesses survive to the next generation. Of those, only one-half make it to the third generation. One of the reasons for this high failure rate is that the owner neglects to plan in advance for the smooth transition in the event that he or she retires, becomes disabled, or dies.

Without proper planning, the sale or transfer of a business can have significant adverse tax or financial consequences. What happens if the owner of a business fails to appropriately plan for his or her succession? The owner's unforeseen disability, death or retirement could trigger a forced sale or liquidation, netting the owner less money than the owner anticipated. Lack of planning could potentially increase his taxable estate by including the entire amount of the business in the estate.

Depending on the circumstances, an orderly succession plan could provide the owner with a reliable cash flow, a reduced estate tax burden, and the peace of mind knowing that he or she has done one's best to keep the business thriving.

One way to effectuate an orderly transition with significant tax benefits is to have the owner sell the business to an Intentionally Defective Grantor Trust (IDGT). An IDGT allows the grantor to freeze the discounted value of the asset at the time of the sale for estate tax purposes, but he continues to pay the tax on trust income. By having the grantor pay the income tax attributable to the trust, without such payment being regarded as a gift to the trust, the net worth of the trust is able to increase more rapidly outside of the grantor's estate. Part of the current value and all of the appreciated value of the assets of the trust will not be included in the grantor's estate. It is important that the trust include provisions that will cause the income to be taxed to the grantor, but not cause the principal of the trust to be included in the grantor's estate. Some examples of grantor trust provisions that would not cause estate tax inclusion are permitting the grantor the right to purchase non-life insurance assets from the trust for an asset of equal value, the right to borrow from the trust without providing adequate security, or authorizing the trust to use its income to pay life insurance premiums on the life of the grantor or the grantor's spouse.

How an IDGT works

In order to properly establish an IDGT, the grantor must gift to the trust liquid assets or cash equal in value to 10 percent or more of the value of the property being sold to the IDGT, in this case the grantor's business. The Grantor then sells the business at fair market value, less a valuation discount, to the trustee of the IDGT using an installment note. The grantor does not need to make any additional gifts to the IDGT.

Under this arrangement it is usual for the trustee to give the grantor an installment note providing for interest payments only for a set number of years with a balloon payment of principal at the end of the term.¹ Usually the note will be for a term less than the grantor's life. The interest rate of the note should be at or above the Applicable Federal Rate (AFR) published monthly by the IRS. The short term AFR can be used for notes of 1-3 years, the mid-term rate can be used for notes 3-9 years and the long term AFR can be used for terms longer than 9 years.

During the term of the note, the asset held in the IDGT generates income that is used to pay the interest on the note or to repay the note. The grantor is taxed on the income without the payment of said income tax being considered a gift, thereby allowing more money to accumulate in the trust. At the time of the grantor's death, only the principal balance of the note as of the date of death is included in the grantor's estate. All of the appreciation passes estate tax free to the heirs.²

How can an IDGT help business owners plan for a successful succession?

Assume that the Grantor, 65 years old, has an estate of 9 million dollars. The most significant asset of the estate is his 100% interest in an S Corp business valued at \$5 million dollars which generates 8% net cash flow. The Grantor, who is not married, has three

children, but only one of them is actively involved in the business. The Grantor wants to treat his children equally upon his death, and simultaneously, insure that the child active in the business is able to run the business without interference from his other children.

Without planning, the Grantor's estate would owe approximately \$4 million dollars in federal estate tax if he were to die in 2011 or later.³ After paying the estate tax, the only remaining asset is the business which would be owned equally by his three children. This would necessitate the active child to purchase two-thirds of the business in order to have complete ownership and fairly compensate his siblings, assuming that the non-active children, who now own a majority interest in the business, agree to sell. The business might not be able to afford the buyout, thereby, forcing a sale at a greatly reduced price. Or, the other children might have to remain owners of 2/3 of the business.

To avoid that situation the Grantor could, first, recapitalize the S Corp and establish two classes of stock, 10% voting shares which could be retained by him and 90% non-voting shares which could be sold and transferred to the IDGT.

The Grantor establishes an IDGT. Using part of his lifetime gift exemption. He would gift \$315,000 (10% of the value of the non-voting shares business after applying a 30% discount factor) to the trust. The Trustee would execute a promissory note in the amount of \$2,835,000⁴, payable, interest only, with a balloon payment due in 20 years.

Assuming the IDGT generates income of \$360,000 (8% x \$4,500,000) per year, it pays the Grantor \$123,322 in interest payments⁵. The Grantor pays income tax on the total trust income, but he receives the interest income tax free due to the defective grantor trust status. The balance of \$236,678 annually, remains in the trust, and can be used to purchase a life insurance policy that would be available to pay estate taxes and/or equalize the children's inheritance without

1. The terms of the note are flexible from interest only to fully amortized.
2. The heirs' basis in the property is the grantor's basis and they do not receive a stepped-up basis upon the death of the grantor.
3. Assumes no growth and the estate tax in effect in 2011 does not change.
4. \$5,000,000 x 90% (non-voting shares), discounted 30% is \$3,150,000. The grantor gifts \$315,000 to the trust, leaving a \$2,835,000 promissory note due to the grantor.
5. The long term AFR was 4.35% as of March 2010.

forcing the sale or refinancing of the business. A properly drafted will and trust is essential to implement the grantor's wishes. An estate plan must be consistent with the family's circumstances, and existing obligations, such as a buy/sell agreement among the children and the business. In the event the Grantor desires a greater income stream, the Grantor could receive more money by having the trust pay down the principal of the note.

A second benefit is that the Grantor retains control of the business, but any growth in the value of trust

over the Grantor's lifetime will not be included in the Grantor's estate. At a modest 2% growth per year capital appreciation (in addition to its 8% net cash flow), in twenty years, by using an IDGT, the grantor could shield approximately an additional \$2.2 million of value from estate taxes.

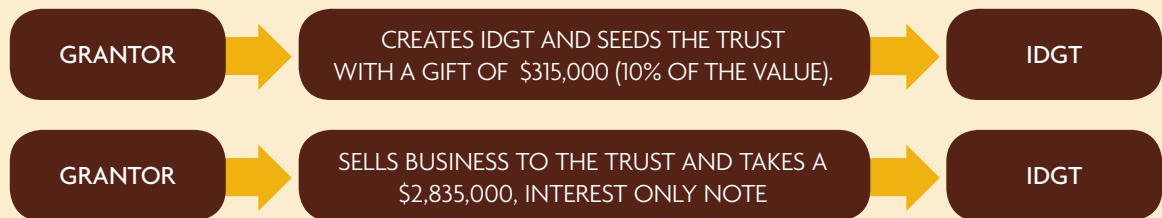
By understanding the client's desire to continue the business and equalize his estate among his children, using an IDGT and life insurance can help realize his goals.

PRE-TRANSFER

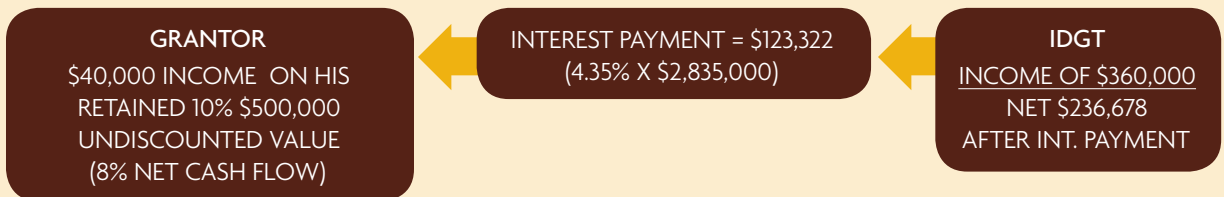
The Grantor, 65 years old, wishes to sell his business valued at \$5 million. He restructures the corporation such that he retains a 10% interest (voting shares) and intends to sell the remaining 90% (non-voting shares) to the IDGT. He has three children, only one of whom is active in the business. He wishes to have that child succeed him in the business, and to equalize his estate.

Applying a 30% discount factor to \$5 million business value the 90% share is valued at \$3.15 million allowing that portion of the business to increase in value and not be included in the grantor's estate. It is also assumed that the business generates 8% net cash flow and appreciates 2% per year.

THE TRANSFER



DURING LIFE



Pays income tax on IDGT income of \$360,000, (8% X \$4.5 MM real bus. Value), But not on the interest payment

AT GRANTOR'S DEATH



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