The Estate Planner

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A simple strategy

Pair an IDGT and an installment sale to pass on your business

Do you have a succession plan for your vacation home?

Helping a family member in need

Don't let your intrafamily loan run afoul of the IRS

Estate Planning Red Flag

Crummey powers provide for withdrawal of a specific dollar amount

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Pair an IDGT and an installment sale to pass on your business

For many people, a family business is a significant source of wealth, so passing it on to the next generation in a tax-efficient manner is an important estate planning goal. One of the simplest and most effective strategies available is an installment sale to an intentionally defective grantor trust (IDGT).

So long as the business generates sufficient cash flow to make the installment payments, a sale to an IDGT allows you to transfer the business free of capital gains and gift taxes. In addition, the business is removed from your estate, so that any future appreciation in value goes to your heirs estate-tax free.

A powerful combination

A straight installment sale for fair market value allows you to transfer the business to your children or other family members gift-tax free. Although this means the buyers will have to come up with the funds to make the installment payments, you have the flexibility to design a payment schedule that meets your family's needs.

An IDGT must be drafted carefully to ensure that it will be treated as a grantor trust for income tax purposes but that the sale to the trust will be considered a completed transfer for gift and estate tax purposes.

For example, you can structure payments to fluctuate over time to match expected cash flows from the business. Or you can provide for interest-only payments for a specified term, followed by a balloon payment of principal.

Future appreciation in the business's value is protected against estate taxes, but you're subject to income taxes on the portion of each installment payment you receive that represents capital gains or interest. This is where an IDGT comes into play.

An IDGT is an irrevocable trust that, with careful planning, is treated as a grantor trust for income tax purposes even though transfers to the trust are considered "complete" for gift and estate tax purposes. This is accomplished by retaining certain powers for yourself — such as the right to borrow funds from the trust without adequate security — that cause the trust to be a grantor trust without drawing the trust assets back into your estate.

The grantor trust rules provide two important benefits: First, any tax on trust income is paid by you, rather than by the trust, effectively providing your beneficiaries with tax-free gifts. Second, because the trust is considered your alter ego for income tax purposes, an installment sale to the trust is like a sale to yourself, so you're not liable for capital gains taxes or other income taxes on the installment payments you receive.

For a summary of the benefits and risks involved with this strategy, see "Pros and cons of selling to an IDGT" at right.

Pros and cons of selling to an IDGT

An installment sale of a business to an intentionally defective grantor trust (IDGT) offers many benefits, including the following:

- ✦ Selling to a trust rather than to your beneficiaries outright allows you to retain some control over the business.
- ✦ Because you're selling to a grantor trust, there's no sale for income tax purposes.
- ✦ The current value of the business, as well as all future appreciation, is removed from your taxable estate.
- ✦ As grantor, you pay the taxes on trust income, resulting in additional tax-free gifts to your beneficiaries.
- ✦ Unlike a grantor retained annuity trust (GRAT), if you die during the trust term the business probably will not be pulled back into your taxable estate (though the present value of any unpaid installments would be included in your estate).

This strategy isn't without its risks, however, including:

Lack of precedent. Unlike GRATs and certain other strategies, there's relatively little guidance on sales to IDGTs. Even though this technique is popular, its estate planning benefits aren't guaranteed. For example, there's some uncertainty about the tax consequences if you die during the trust term.

Possible elimination of "no sale" rule. Although IRS rulings confirm that there's no taxable gain when a grantor makes an installment sale to a grantor trust, the agency has criticized this rule in the past and there's no guarantee it won't revisit its position in the future.

Planning considerations

As previously noted, an IDGT must be drafted carefully to ensure that it will be treated as a grantor trust for income tax purposes but that the sale to the trust will be considered a completed transfer for gift and estate tax purposes.

In addition, the transaction must be structured to avoid an IRS challenge on grounds that it's a disguised gift. The first step is to ensure that the trust has sufficient assets so an installment sale of the business in exchange for a promissory note would be considered commercially reasonable.

Usually, this involves investing some "seed money" in the trust — which likely will be subject to gift tax. There's no bright-line rule about how much seed money will suffice, but typically it's at least 10% of the business's value.

Care should also be taken in drafting the installment note. Although there's some flexibility in designing the payment schedule, it's important to provide for a reasonable rate of interest and other commercially reasonable terms to ensure that the note is deemed to represent a legitimate debt.

Review your options

This is just one example of the many available estate planning strategies for transferring a family business to the next generation. Now that the federal gift tax exemption has been temporarily expanded (to $5 million for 2011 and 2012), there's an opportunity to make substantial gifts of business interests to your heirs tax free. Other options include grantor retained annuity trusts, self-canceling installment notes, family limited partnerships and family limited liability companies. The right strategy for you depends on your particular business, financial and tax circumstances. ✤

Do you have a succession plan for your vacation home?

Few estate planning issues are as emotionally charged as the disposition of the family home. And emotions may run even higher with vacation homes, which often evoke even more fond memories. So it's important to address your vacation home in your estate plan.

Keeping the peace

Before you do anything, talk to your loved ones about the vacation home. Simply dividing the home equally among your children or other family members can be an invitation to conflict and hurt feelings. Some may care more about keeping the home in the family than about any financial benefits it might provide. Others may prefer to sell the home and use the proceeds for other needs.

After determining who will receive your vacation home, there are several traditional estate planning tools you can use to transfer it in a tax-efficient manner.

One solution is to leave the vacation home to the family members who want it and leave other assets to those who don't. Alternatively, you can develop a buyout plan that establishes the terms under which family members who want to keep the home can buy the interests of those who want to sell. The plan should establish a reasonable price and payment terms, which might include payment in installments over several years.

You also may want to put together a usage schedule for nonowners whom you wish to allow to continue enjoying the vacation home. And to help keep the vacation home in the family, consider setting aside assets that will generate income to pay for maintenance, repairs, property taxes and other expenses.

Transferring the home

After determining who will receive your vacation home, there are several traditional estate planning tools you can use to transfer it in a tax-efficient manner. In light of the recent increase in the federal gift tax exemption (to $5 million for 2011 and

2012), it may make sense to transfer interests in the home to your children or other family members now, using tax-free gifts.

But if you're not yet ready to give up ownership, there are other strategies you can use, such as a:

Qualified personal residence trust (QPRT). With a QPRT, you transfer a qualifying vacation home to an irrevocable trust, retaining the right to occupy the home during the trust term. At the end of the term, the home is transferred to your beneficiaries, though it's possible to continue occupying the home by paying them fair market rent. The transfer is a taxable gift of your beneficiaries' remainder interest, which is only a fraction of the home's current fair market value.

You must survive the trust term, and the vacation home must qualify as a "personal residence," which means, among other things, that you use it for the greater of 14 days per year or more than 10% of the total number of days it's rented out.

Qualified terminable interest property (QTIP) trust. A QTIP trust can be an effective way to provide for your current spouse for life and preserve the trust assets for your children, while minimizing gift and estate tax. In blended families, a QTIP trust can provide a life interest in a vacation home to your spouse, while ultimately transferring ownership to your children from a previous marriage.

Discussing your intentions

Estate planning for a vacation home need not be complicated. The key is to sit down with your family to discuss the options. Only then can you put together a plan that meets everyone's needs. ✤

Helping a family member in need

Don't let your intrafamily loan run afoul of the IRS

George's son, Kevin, lost his job last year and is now having trouble paying his mortgage. George is happy to help his son by lending him six months' worth of mortgage payments. However, George may not be so pleased if his intrafamily loan triggers gift and income tax liability.

Because of the difficult economic times of the past few years, this fictitious scenario — or one similar — is likely playing out in many households. If yours is among them, it's important to understand how the IRS defines an intrafamily loan and know the rules surrounding such a loan.

A bona fide loan or a gift?

When lending money to family members, the first question to ask is: "Is this transaction truly a loan?" If the IRS concludes that the transaction isn't a bona fide loan, it will recharacterize it as a taxable gift. By formalizing the transaction and treating it as a loan, you can avoid negative tax consequences and have the necessary documentation to support a bad-debt deduction in the event the borrower defaults.

The IRS and courts look at several factors in determining whether a transaction is a loan or a gift.

Although no one factor is controlling, an intrafamily loan is more likely to be viewed as bona fide if there's a written agreement, interest is charged and there's a fixed repayment schedule. In addition, the borrower must execute a promissory note and actually make the payments.

Not all of these factors must be present, but, the more that are there, the better your chances of the loan withstanding IRS scrutiny. Yet regardless of how much you plan, no strategy is bulletproof. The IRS still can recharacterize a loan as a gift if it determines that the loan's purpose was to avoid taxes.

Is adequate interest being charged?

If an intrafamily transfer is a loan, the next question to consider is: "Are you charging adequate interest?" A loan is considered below market if you charge less than a minimum interest rate, which is determined by the applicable federal rate (AFR). The federal government periodically sets the AFR, and the rate varies depending on the type and term of the loan.

For example, the minimum rate for a demand loan (one that's payable on demand or has an indefinite maturity) is the short-term AFR, compounded semiannually. So, the minimum rate varies during the life of the loan. The easiest way to ensure that you charge enough interest for a demand loan is to use a variable rate that's tied to the AFR.

For a loan with a set term, use the AFR that's in effect on the loan date.

Type of loan affects tax impact

Below-market loans to family members have both income and gift tax consequences, and they differ depending on the loan type. For a demand loan, each tax year you're treated as if 1) you'd made a taxable gift equal to the amount of imputed interest, and 2) the borrower transferred the money back to you as an interest payment.

Imputed interest is the difference between the AFR and the amount of interest you actually collect, recalculated annually. Depending on the loan's purpose, the borrower may be able to deduct this interest.

The IRS and courts look at several factors in determining whether a transaction is a loan or a gift.

If interest is imputed to you, you'll owe income taxes on the fictitious payments. In addition, you may have to pay gift taxes if the imputed interest exceeds the $13,000 annual gift tax exclusion. There are two important exceptions that allow you to avoid the imputed interest rules — or at least lessen their impact. First, loans up to $10,000 are generally exempt. Second, loans up to $100,000 are exempt if the borrower's net investment income for the year is $1,000 or less. If net investment income exceeds $1,000, the imputed interest rules apply, but the amount of interest is limited to the amount of net investment income.

Term loans are treated essentially the same way as demand loans for income tax purposes. But the gift tax consequences are quite different. If you make a below-market term loan to a family member, your gift is equal to the excess of the loan amount over the present value of all future loan payments (using the AFR as the discount rate).

If you choose to make a low-interest or no-interest loan to a family member, try to avoid a term loan so you don't make a substantial upfront gift.

A positive outcome

Whatever your reason for lending money to a family member, be sure you understand IRS rules governing intrafamily loans. Working with your estate planning advisor to ensure that your loan won't incur income and gift tax liability will help result in a positive outcome for you and your loved one. ✤

Estate Planning Red Flag

Crummey powers provide for withdrawal of a specific dollar amount

A lifetime gifting plan that takes advantage of the $13,000 per recipient annual gift tax exclusion can be a powerful strategy for transferring wealth tax free. But the exclusion is available only for gifts of *present* interests. This can be a problem for contributions to trusts, which are generally considered gifts of *future* interests.

Crummey powers give trust beneficiaries the right to withdraw contributions (up to the amount of the annual exclusion) for a specified period after they're made (typically 30 days). Crummey powers, even if never exercised, convert a future interest into a present interest that qualifies for the annual exclusion (provided beneficiaries receive written notice of their rights).

When drafting Crummey powers in a trust, avoid providing for withdrawal of a specific dollar amount, such as $13,000. Doing so can create two potential problems:

1. After the annual exclusion is next increased to adjust for inflation, you'll lose out on valuable tax savings.
2. You'll risk violating the "5&5" rule. This rule provides that a beneficiary will be treated as an additional grantor to the trust (triggering a variety of tax complications) unless the beneficiary's Crummey powers are limited to $5,000 or 5% of the trust principal, whichever is greater. A straight $13,000 withdrawal right will violate this rule if the trust's value is less than $260,000.

To avoid these problems, a trust should provide for withdrawal rights up to "the annual exclusion amount permitted by Internal Revenue Code Sec. 2503(b)." It should also provide language that will allow flexibility when needed to avoid negative tax consequences from the 5&5 rule.