ADVANCED PLANNING

Premium paying strategies

Asset sale to an irrevocable grantor trust

IS AN ASSET SALE TO AN IRREVOCABLE GRANTOR TRUST (ASSET SALE) STRATEGY RIGHT FOR YOU?

An asset sale to an irrevocable grantor trust may be a helpful wealth transfer method for you if you want to reduce the transfer tax cost of passing your estate to your family and you:

- Are already making maximum use of your annual exclusion gifts and lifetime exclusion amounts (or don't want to use the full lifetime exclusion amounts).
- Have income-producing assets that are expected to appreciate in value over the next several years.
- Can afford not to rely on the income from those assets for a limited period of time.

WHAT IS AN ASSET SALE TO AN IRREVOCABLE GRANTOR TRUST STRATEGY?

- An asset sale to a trust strategy starts with an irrevocable grantor trust that you establish with your attorney.
- You sell assets to the trust and receive in exchange a promissory note providing fixed payments during the note term.
- The sale transaction does not result in taxable gain.
- The strategy allows you to transfer rapidly appreciating assets for the benefit of your heirs while minimizing or avoiding gift, estate, and generation-skipping transfer taxes.

BENEFITS TO THE GRANTOR AND HEIRS

- Illiquid assets such as limited partnership interests, non-voting LLC member interests, closely held nonvoting S corporation stock, etc. may be able to be sold at a discounted value.
- After the sale, any future appreciation of the assets sold to the trust is outside your taxable estate. The estate includes only the unpaid portion of the note, effectively "freezing" the value of the asset in the estate at that amount.
- Since you pay the income tax liability on any earnings on the assets in the trust, more assets remain in the trust to be invested for growth potential, shifting more wealth to your heirs.
- The estate freeze is income tax efficient as long as the note is repaid during your life.
- Trust income in excess of the required note payments can be used to purchase life insurance on your life, to repay principal on the note, or to pay estate taxes and other costs arising at your death.
- Provided you possess no incidents of ownership in the life insurance policy, the death proceeds payable to the trust will not be included in your taxable estate.

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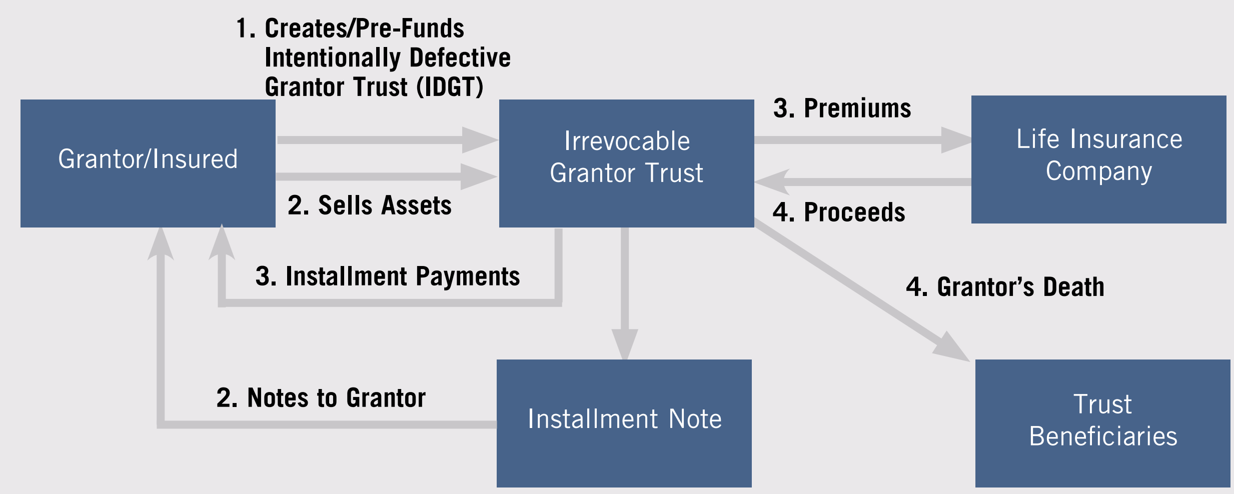
STRUCTURE OF THE ASSET SALE TO AN IRREVOCABLE GRANTOR TRUST



1. The grantor establishes an irrevocable trust structured as a grantor trust. The trust ensures that the assets are excluded from the grantor's estate but also gives the grantor certain powers under IRC §§671–679 that cause them to be treated as the "owner" of the trust for income tax purposes.

Prior to the asset sale, the grantor funds the trust to support the position that the trust has economic independence. At a minimum, the trust should be prefunded with assets or cash worth 10% of the value of the assets being sold to the trust.

2. The grantor enters into a bona fide arm's-length sales agreement with the trust, transferring assets to the trust in return for an installment note. Ideally, the transferred assets should be rapidly appreciating income-producing assets such as limited partnership units, nonvoting LLC member interests, S corporation stock, or real estate.

The sale transaction has no income tax consequences to the grantor (i.e., no gain is recognized) nor is the grantor taxed on the interest payable on the note.

3. The note can be structured as an interest-only note for a term of years with a balloon payment of principal at the end of the term. The interest rate is generally the appropriate applicable federal rate (AFR) at the time of the sale.

The grantor is taxed on the income generated by the trust. By paying this tax liability, more funds remain in the trust to be invested, potentially generating further value for the heirs.

Trust funds in excess of the required interest payments can be used to purchase a life insurance policy on the grantor's life.

4. At the grantor's death, only the value of the installment note (if outstanding) will be in the grantor's estate; the trust assets and any appreciation pass estate tax-free to the heirs.

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TAX CONSIDERATIONS

- There is no direct tax law guidance in support of the above described IDGT sales concept. It is clear that if the grantor dies with the note outstanding, the balance of the note and any accrued interest will be included in the grantor's estate and when the grantor dies, the IDGT ceases to be a grantor trust under IRC §§671-679. The income tax consequences of the grantor's death are less clear. There are several theories ranging from "no taxation" to taxable gain treatment based on the outstanding note balance at the date of death.
- There is no "safe harbor" approach to avoid the potential IRS position that the sale should be treated as the retention of an annuity subject to the rules of IRC §2702 or a retained life interest under IRC §2036.
- To avoid the risk of §2702 application or §2036 estate inclusion, it is critical that the sale be structured as a bona fide arm's-length sale. The grantor should not be the trustee, nor be placed in a position to make decisions regarding the trust's role in the transaction. The interest rate on the note should not be driven by the assets' income-producing potential. As previously noted, the trust should have economic substance and its own significant assets prior to the sale. And, to reduce the risk of an IRS challenge, some assets may require the use of a qualified appraiser.

SUMMARY

Sales to an irrevocable grantor trust may be highly effective in transferring wealth to the next generation with minimal transfer taxes. However, inadequate asset growth or income, potential IRS challenges, or premature death can impair the intended goals of the strategy.

These are complex planning techniques, so it is important that you seek the advice of your tax and legal counsel when considering and implementing this estate freeze technique.