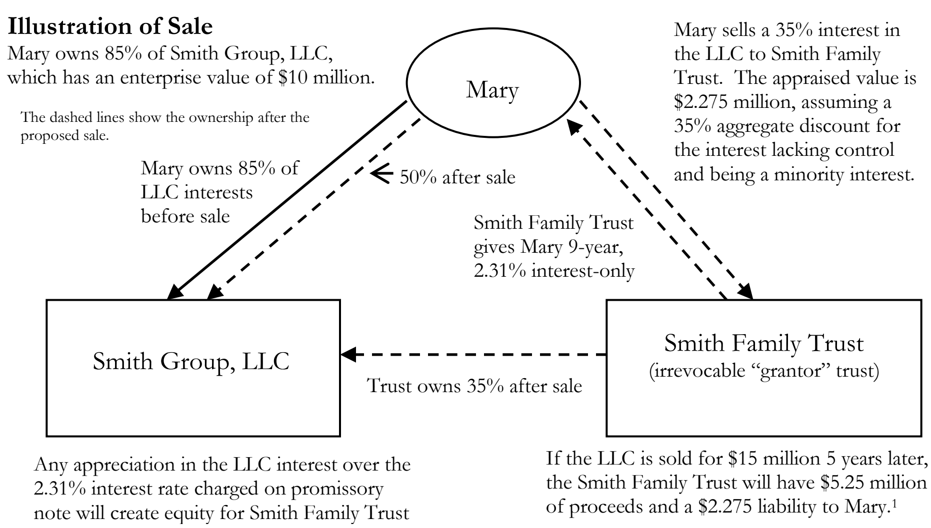
Sales of Interests in Family or Private Companies to Irrevocable "Grantor" Trusts

Would you like to mitigate the effect of estate taxes[1] on your business interests? We frequently suggest making sales ("Sale") of interests in closely held companies to an irrevocable "grantor" trusts for the benefit of younger family members. The Sale will freeze the value of the equity interest in the hands of the parent generation at today's value, while allowing most of the post-transfer appreciation to pass free of gift and estate taxes to younger generations. If (or more hopefully "when") the sold interest appreciates after the Sale, that appreciation will be removed from the transferor's estate for estate tax purposes.

This strategy works best in low IRS interest rate environments, such as the one we have been in recent years. In a Sale, the selling parent provides seller-financing at today's low Applicable Federal Rates ("AFR"). For example, the selling parent may take back an interest-only promissory note for the purchase price, with interest being charged at the mid-term AFR for February 2018 of 2.31% and with the principal being due at the end of 9 years.

Selling an asset to the children or a trust for their benefit "freezes" the value of asset for estate tax purposes. No gift tax is applicable because the transaction is a sale for fair market value, not a gift. With seller-financing, the children preserve their personal liquidity (because they are paying for the asset with a promissory note). If the asset appreciates faster than the interest rate under the promissory note, the excess appreciation belongs to the children and thereby escapes estate taxation in the parent's estate.



Assets may be sold outright to the children, but more often we suggest selling to an irrevocable "grantor" trust created by the parent for the benefit of a spouse and descendants (i.e., the irrevocable "grantor" trust). The sale to the irrevocable "grantor" trust can be made without income tax consequences. The grantor continues to pay the income taxes on the income generated by the asset sold to the trust, even though he or she does not receive income from the trust and is not entitled to be reimbursed for the tax expenses. The grantor's

[1] This is merely an illustration using certain assumptions. Actual results will vary.

payment of the income tax is the equivalent of making a tax-free gift to the trust each year. The interest payments each year on the promissory note are also ignored for income tax purposes. The trust assets and any future appreciation can also usually be exempted from the generation-skipping transfer ("GST") tax, too.[1]

A Sale permits a parent to sell a business interest, usually at a discounted value, to a trust for the benefit of younger family members, with the trust paying interest only at 2.31% for up to nine years, with no recognition of gain to the parent at the time of sale, and with the parent paying all of the income taxes on the trust assets, allowing the trust to build up its equity free of income tax.

Assuming no depreciation in value, the parent receives back the value of the sold interest (in the form of promissory note payments), plus interest. All of the post-sale appreciation over and above the applicable interest rate passes free of gift, estate and GST taxes to the trust for benefit of the younger family members.

It is important to consider, however, that the purchasing trust bears the investment risk of a decline in value after the Sale. Also, if the IRS could sustain a higher value for the sold interest, the IRS would argue that the parent has made a taxable gift for the difference between this higher value and the sales price used. However, a formula sale approach can be used to mitigate this gift tax risk.

The Sale is an intelligent way to transfer significant sums to younger generations free of gift, estate and GST taxes.

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