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Family Businesses Catch a Big Break

To recap: As part of the tax deal passed by Congress late last year, the gift-tax exemption jumps to $5 million from $1 million for individuals and to $10 million from $2 million for couples in 2011 and 2012.

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The Intentionally Defective Grantor Trust (IDGT) is one powerful vehicle that could eliminate estate taxes by transferring assets out of your estate. While low interest rate environments, like the one we are in are now, present certain challenges, they can enhance the benefits of IDGTs.

An IDGT is an irrevocable trust created by a person (the “grantor”), who gifts (“seeds”) assets (of at least 10% of the ultimate purchase price) to the trust, allowing the IDGT to then purchase the grantor’s assets in exchange for a promissory note with a specified term. Oftentimes, the note will require interest only payments with a balloon payment of principal at the end of the term. The grantor avoids gift taxes upon sale to the IDGT because the grantor and the trust are the same entity for income tax purposes. Because the grantor ‘intentionally’ violates just enough of the Internal Revenue Code 671-679 control rules the assets are removed from the estate – thus the name Intentionally Defective Grantor Trust.

The minimum interest rate on the promissory note is determined by the Internal Revenue Code 1274(d) Applicable Federal Rate (AFR), oftentimes called a “hurdle rate”. The current rate of 2.3% (for mid-term loans) is significantly lower than the 5.2% rate as recent as August of 2006, making the IDGT more appealing now than many periods over the last 10 years. The primary reason for establishing an IDGT is to remove net profits from the estate, with net profits defined as any excess return above the hurdle rate. The lower the hurdle rate, the easier it is to remove more assets from your estate. Translation: it is easier to earn more than 2.3% than it is to earn more than 5.2%.

The IDGT is ideal in situations where there are closely held businesses, where the goal is to transfer certain non managing stock (membership units) to a younger generation in the business without necessarily giving up the managing control. This can be ideal for S stock transfers. The corporation can be recapitalized to have voting and non voting shares. The non voting shares can then be transferred to the younger generation for value; whereby the older generation shareholder still has voting control given he/she owns the majority of voting shares.

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