

Sale to a Grantor Trust with Life Insurance

Current Situation

Jason, 65, and Joanne, 60, have built a successful closely-held business that, at their deaths, they want their two children to inherit. They are willing to enter into a strategy that would move a significant portion of the business's future appreciation outside of their taxable estates. They are currently making annual exclusion¹ gifts to their two children and plan to continue making cash gifts. Jason and Joanne have not used their \$5 million lifetime exemptions² and, as long as they retain control, are willing to transfer some of the company's shares for the benefit of their children.

The company has experienced a drop in its current market value, but Jason and Joanne are confident that the company is poised to recover with the economy and will continue to deliver strong growth and income. The business has a current market value of \$20 million.

Recommendation

1. Recapitalize the company into 10% voting and 90% non-voting stock. For valuation purposes, the non-voting stock is assessed a 30% discount for minority interest/lack of marketability.
2. Create an irrevocable grantor trust.^{3,4} A grantor trust is defective for income tax purposes, but not for estate tax purposes. As income is attributed to the grantors, they are responsible for income taxes on the trust assets, allowing the trust assets to grow unencumbered by income taxes. In paying income taxes for the trust, the grantors are effectively making tax-free gifts to the trust. At the grantors' second death the trust assets pass outside of their taxable estates.
3. Gift a combined \$2 million lifetime exemption in cash and discounted non-voting stock to the grantor trust. This is known as "seed" money and should be at least 10% of the value of the assets being sold to the trust.
4. Sell the balance of \$10 million in fair market value in non-voting stock to the grantor trust for a 20-year note at the long-term Applicable Federal Rate (AFR) of 3.58% (May 2009).
5. The trustee purchases a survivorship policy on Jason and Joanne in the amount of \$36,642,322, which is guaranteed for their lifetimes.⁵ For underwriting purposes, John is a standard smoker and Joanne is a standard nonsmoker. Premiums are payable from trust assets' cash flow. The first year's premium is paid with cash gifted to the trust.

Summary of Transaction – Year 1		Asset Sale to Trust	Asset Gift to Trust	Cash Gift to Trust	Total Gift to Trust
Nominal Asset Value	\$10,000,000	\$7,969,743	\$2,030,257	\$578,820	\$2,609,077
Discounted Asset Value @ 30%	\$ 7,000,000	\$5,578,820	\$1,421,180	\$578,820	\$2,000,000

Potential Benefit

Combining an installment sale to a grantor trust with life insurance reduces their taxable estates and provides the funds to purchase the remaining business assets from the estate at the second death. The cash proceeds from the purchase are available for estate liquidity.

Net to Heirs		
Assumptions: Estate A/T Growth – 4% Income Tax – 40%, Estate Tax – 45% Asset Growth – 5%, Income – 8% Other Trust Assets – 5%	Current Estate	Sale to a Grantor Trust
Non Business Assets – Yr. 28 Joint Life Expectancy (JLE)	\$45,964,149	\$ (15,447,003) ⁶
Nominal Asset Value	\$39,201,291	\$39,201,291
Estate Taxes	(\$38,324,448)	0
Other Trust Assets Outside Estate	\$0	\$32,404,099
Net Insurance Proceeds	\$0	\$29,545,139
Net to Heirs @ JLE	\$46,840,992	\$85,703,526
Increase Over Current		\$38,862,534

Source: NFP Insurance Services, Inc.

¹ Under Internal Revenue Code (IRC) § 2503(b), the gift tax annual exclusion amount is \$13,000 per recipient per year (2011) and \$26,000 per year if a married couple splits their gifts under IRC §2513(a).

² Under the Tax Relief, Unemployment Insurance Authorization and Job Creation Act of 2010, the lifetime gift and generation skipping tax exemption is \$5,000,000 per individual for 2011 - 2012.

³ Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds.

⁴ The grantor trust takes advantage of the differences between the estate tax rules of IRC §2036-2042 and the grantor trust rules of IRC §671-678.

⁵ Guaranteed death benefits are subject to the claims paying ability of the insurance carrier.

⁶ The estate is depleted by income taxes paid.

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