**ESTATE FREEZE DUE DILIGENCE**

**OVERVIEW OF AN ESTATE FREEZE**

* **Definition:**

Strategies which are used to transfer appreciating assets to the next generation and which freeze the value of the taxable estate.

* **Goals of an Estate Freeze:**

Decrease the future value of the taxable estate

Take advantage of valuation discounts which may be limited in the future

Shift future appreciation to beneficiaries

Provide a stream of income for the donor of the assets

**TYPES OF ESTATE FREEZES**

* Grantor Retained Annuity Trust (GRAT)
* Installment Sale to a Defective Grantor Trust (IDGT)
* Partnership Freeze Strategies
* Annual Gifting

**GRANTOR RETAINED ANNUITY TRUST (GRAT)**

* **GRAT 101:**
	+ The donor transfers property into an irrevocable trust and retains the right to receive an annual payment for a fixed period of years, which includes an imputed rate of interest.
	+ If the assets outperform the interest rate, any growth of the assets passes to the beneficiaries gift and estate tax-free.
	+ Only a minimal gift is incurred when making the transfer to the GRAT so very little lifetime gift exemption and estate tax exemption are used.
* **Example:**
	+ Ben transfers $5 million into a GRAT with a fixed term of ten years, and an annual payment of $539,300 every year back to Ben at a 7520 rate of 1.4%.
	+ If the rate of growth is equivalent to the 7520 rate (1.4%), then there will be no remaining property to go to the beneficiaries.
	+ However, if the rate of growth is higher than 1.4%, for example, 3%, then over the course of ten years the remainder will be in excess of $675,000, which will pass to the beneficiaries’ estate and gift tax free.

**GRATS: Advantages and Disadvantages**

* **Advantages**
	+ Minimal use of gift tax exemption.
	+ Gets appreciation of assets out of your estate.
	+ Even if the assets do not perform well, the worst that happens is that the Grantor loses out on the legal and administrative fees involved with setting up the trust.
	+ It is a technique that is statutorily permitted pursuant to 2702.
* **Disadvantages**
	+ Success depends on the market. Assets must outperform the Section 7520 rate for funding a GRAT to make sense – otherwise the beneficiaries get nothing.
	+ If the Grantor dies during the term, all the trust assets are clawed back into the estate.
	+ Any GST exemption may not be allocated to the GRAT until the end of the GRATs term; unwise therefore to include grandchildren directly as beneficiaries.

**TYPES OF GRATS**

* **Single GRAT**

Grantor retains the right to receive an annual payment for a fixed term using one GRAT.

* **Rolling GRATs**

The annual payments received by the grantor each year from the first GRAT are used to fund subsequent new GRATs as a way to continuously move appreciation tax free to the next generation.

* **Staggered GRATs**

The terms of several GRATs are staggered to utilize the present lower rates: a two-year GRAT is coupled with a mid-term GRAT of 7 to 9 years.

* **Diversified GRATs**

Focuses on separate sectors of the economy to allow the sector in favor to accelerate up so that the sector out of favor will not drag down the overall return.

* **Immunizing GRAT**

Involves selling a position within the GRAT to avoid the exposure of losing the overall gain at that point in time, i.e., parking the funds in cash for the remainder of the GRAT since the desired yield has been achieved.

**GRAT: ESCALATING ANNUITY PAYMENTS**

Under the IRS Regulations, the GRAT annual amount does not have to be the same amount for each year.

Variations in the annuity amount from year to year may not exceed 120 percent of the amount payable in the previous year.

If it is expected that the trust property will appreciate over the term of the trust at a uniform rate, increasing annuity payments will produce more value for the beneficiaries at the end of a term than would constant annuity payments.

**BAILOUT ON A FAILING GRAT**

If the grantor originally had believed that a stock position was going to explode and increase in value, but the liquidity event never happened, the stock position can be purchased out of the GRAT.

A new GRAT with a longer term should be funded with a more favorable asset that is expected to increase in value.

**CHARITABLE LEAD TRUST**

**CLT 101**

* A Charitable Lead Trust is an irrevocable trust that generates an income stream for one or more charities of the Grantor’s choice, with the remaining assets going to the Grantor’s family.
* A fixed amount or percentage of trust assets are paid to the charity pursuant to the IRS rate of return.

The remainder interest can either be retained by the Grantor or given to a non-charitable beneficiary.

* The initial transfer (if the remainder beneficiaries are non-charitable) will be subject to gift tax by discounted by the value of the income stream going to the charity.
* If the assets perform better than the IRS rate, then the beneficiaries will receive assets in excess of that which was reported to the IRS as a gift.

**Example:**

* Ben gifts $3 million to a CLT with a 20-year term, paying an income stream of $187,050 per year to a charity.
* The amount of the taxable gift would be zero.
* If the IRS rate is 2.2%, and the actual rate is 5%, then $2,795,275 would be left at the end of the 20-year term which will pass to the beneficiaries.

**Advantages:**

* If Grantor does not need the income stream, Grantor can transfer appreciation outside of his estate and
	+ 1) provide an income stream to a charity of his or her choosing
	+ 2) provide beneficiaries with a lump sum of the growth free of estate and gift tax
* Income tax deduction for non-grantor trust; also deduction for grantor of grantor trust if guaranteed annuity or unitrust interest and other requirements.

**Disadvantages:**

* If the assets do not outperform IRS rate, then beneficiaries could get little to nothing and effectively the charity is the only beneficiary.
* Strategy is not good if the Grantor needs access to an income stream, where a GRAT would be more suitable.

**INSTALLMENT SALE TO AN INTENTIONALLY DEFECTIVE GRANTOR TRUST**

**(IDGT)**

* **IDGT 101:**
	+ Assets gifted to a IDGT are completed gifts and outside the Grantor’s estate for estate tax purposes, but the Grantor continues to be characterized as the owner for income tax purposes.
	+ Instead of gifting assets and using the Grantor’s exemption to do so, the Grantor can sell the asset to the IDGT instead, which avoids the transfer being deemed a gift.
	+ Since the Grantor is the income tax owner of the Trust, no capital gains are realized at the time of the sale.
	+ Grantor would hold an interest bearing promissory note in exchange for putting assets into the trust, effectively being a sale and not a gift.
* **Example:**
	+ Ben owns a brokerage account worth $30 million with an annual 7% growth rate, resulting in about $2.1 million of returns per year.

* + As Ben is already above the federal exemption amount, the more the brokerage account grows the more estate tax he will have to pay.
	+ However, Ben also does not want to gift either the account whether in whole or in part, as doing so would exhaust a substantial part of his exemption.
	+ Instead, Ben sells the brokerage account to a IDGT in exchange for a promissory note that makes interest only payments of 2% a year for the next 20 years, followed by a balloon payment of principal.

* + The trust pays Ben about $600k (2%) per year in interest, but since the trust is making ~2.1m (7%) a year, a total of $1.5 million a year continues to grow in the trust estate and is gift tax free.
	+ The promissory note of $30 million – which was the initial value of the brokerage account, will be included in Ben’s estate, but the difference between the growth of the brokerage account and the interest payments every year back to Ben will be outside of his estate.

**IDGT: Advantages and Disadvantages**

* **Advantages**
	+ Sale does not use much or any of a client’s exemption (although an initial seed contribution/gift of 10% of the assets is advisable as a conservative approach to avoid gift tax treatment as to the entirety of the assets).
	+ It allows you to lock in the value of an asset for estate tax purposes and shelter all future growth from estate tax indefinitely from the time of transfer.
* **Disadvantages**
	+ Cost to initially set up. Not only does a trust need to be drafted and established, a promissory note and gift tax return for the initial seed of 10% are also necessary.
	+ Complexity; continued administration for annual interest payments required.
	+ Asset must continue to grow in value at a rate higher than that of the promissory note interest payments.
	+ The danger could be that the interest payments make it such that the value included in your estate might be higher than the actual value of the asset if it performs poorly.

**IDGT: PASS THROUGH TAX-FREE ENTITY**

* A IDGT is “defective” for income tax purposes – the Grantor continues to pick up the income on his or her personal return for the trust.
* Therefore, the Grantor pays the income tax on the assets’ growth, which allows the Trusts to continue to accelerate in growth without bearing the burden of contributing to the tax payment.

**IDGT: GENERATION-SKIPPING TAX FREE**

As long as the grantor allocates his or her generation skipping tax (“GST”) exemption to lifetime gifts to the IDGT, the trust assets will be exempt from the GST tax.

The GST exemption does not need to be applied if there is a sale to the IDGT.

**GST-EXEMPT DYNASTY TRUST BUYOUT REMAINDER INTEREST IN GRAT**

A GRAT cannot allocate any generation skipping tax exemption to the transfer to the GRAT until the end of the GRAT term; the rules pertaining to the estate tax inclusion rules preclude any GST allocation.

One solution is to have the GRAT remainder beneficiaries sell their remainder interest at the fair market to a GST exempt dynasty trust to avoid the estate tax inclusion rules.

**GRATs AND INSTALLMENT SALES: CURRENT INTEREST RATES**

These planning techniques should be emphasized now since they function well in today’s low interest rate environment.

**GRATs AND INSTALLMENT SALES: DISCOUNTS**

Valuation discounting provides greater equity in the trust and shrinks the value that is paid back to the grantor.

**2704 REGULATIONS**

In 2016, the US Treasury had offered temporary regulations that would eliminate discounting for nonoperating business such as a family limited partnership.

President Trump’s April 21, 2017 Executive Order 13789 directed the Treasury Secretary to reduce regulatory burdens by identifying any regulations issued after 2015 that: impose undue financial burdens on taxpayers; add “undue complexity” to federal tax laws; exceed the IRS’s statutory authority.

The IRS found eight that it believes satisfy the criteria in either (1) or (2) above. The proposed §2704 valuation discount regulations are included in this group of eight. These regulations have been controversial since their issuance in August 2016.

Section 2704(b) of the Internal Revenue Code provides that certain restrictions on the ability to dispose of or liquidate family-controlled entities should be disregarded in determining the fair market value of an interest in that entity for estate and gift tax purposes. These proposed regulations would create an additional category of restrictions that also would be disregarded in assessing the fair market value of an interest. Commenters expressed concern that the proposed regulations would eliminate or restrict common discounts, such as minority discounts and discounts for lack of marketability.

**IDGT: SALE OF BUSINESSES INTERESTS**

Sell business interests when value is modest so that growth takes place outside of estate.

Selling a business interest allows for valuation discounts, with greater equity going into Trust and less payments to the transferor.

Installment sale of a business interest in exchange for a promissory note allows the client the opportunity to continue to receive revenue from the business.

**EXAMPLE:**

 Ben is the founding owner of a business worth $20 Million, which generates about $1.5 Million to $2Million per year in profit distributions. As a result, Ben has a significant estate tax problem (he is far above the $5.45M exemption amount), which will only get worse as the business distributes ongoing profits (and especially if the stock appreciates further). Ben could gift about 25% of the business to family members or an irrevocable trust, eliminating that portion of the business value and its subsequent growth from his estate, but he’d still be stuck with the other 75%.

Instead, Ben could *sell*the business to the IDGT instead, in exchange for a promissory note from the trust that agrees to make interest-only payments of 2% per year for the next 15 years (followed by a balloon payment of the principal). At this interest rate, the trust will only need to make $400,000 per year of interest payments, which is easily covered by the available cash from the business’ $1.5 Million + profit distributions.

Immediately after the transaction, Jeremy’s net worth and estate tax exposure have not changed. He’s simply swapped from a family business worth $20 Million, to a promissory note worth $20 Million instead. Since he’s sold the business to “himself” for income tax purposes, there are no capital gains taxes due on the transaction, and cost basis of the business simply carries over into the trust.

However, going forward, the promissory note will “grow” by its simple 2% yield, while the business is already producing almost 4X that amount of cash flow, *plus*the potential for the business to appreciate further (while the promissory note’s principal value is fixed).

For instance, if at the end of the first year, the business appreciated to $21M (e.g., by getting a big new customer), plus generated profits of $1.5M, and then paid out $400k in interest, its value would be up to $22.1M. By contrast, the grantor’s estate would still be $20M, plus the $400k of interest, but reduced by the income tax liabilities it must pay. The end result is that the trust’s value is over $22M, while the grantor’s estate will be slightly lower than $20M, producing a $2 Million shift in value to the trust – and outside the grantor’s estate. At a 40% top estate tax rate, that’s an $800,000 estate tax savings.

**IDGT AND GRAT TRUST DESIGN:**

* Spousal access trusts for flexibility to use transferred assets for needs that arise in the future
* Borrowing and swapping powers to allow grantor to access the assets in the absence of the spouse

**IDGT AND GRAT TRUST DESIGN (CONTINUED):**

* Trustee removal and replacement in the event the grantor is not married
* Decanting to a new trust

**INABILITY TO MAKE ANNUAL PAYMENT**

* Asset swap for liquid or income-producing investment
* Fund GRAT initially with cash reserve
* Amend and re-structure promissory note payments

**LIFE INSURANCE AS HEDGE FOR UNEXPECTED DEATH**

* Death before completion of term of GRAT or promissory note causes inclusion in estate of the assets in
* Cost-efficient term insurance (which is only in effect during the term of GRAT or note) provides wealth replacement or liquidity to cover the expense of increased taxes.
* Life insurance owned by an Irrevocable Life Insurance to ensure it passes estate tax free

**PARTNERSHIP FREEZE STRATEGIES**

* **Description of the strategy:**
	+ Through this strategy, older and higher net worth clients can shift the growth of assets to the next generation while ensuring income to themselves to live on.
	+ Client creates a new LLC or partnership, and then transfers assets into the partnership in exchange for a preferred interest.
	+ The preferred interest’s value is frozen and pays out a fixed preferred return (similar to a bond).
	+ The client also receives a liquidation preference entitling the client to a priority return of his or her capital contribution upon liquidation of the partnership.
	+ Client’s children (or trusts for the children) transfer assets into the trust in exchange for a non-preferred, common interest. Must be at least 10% of the total value of the partnership.
	+ Freezing the value of the preferred interest allows the holders of the common interests to benefit from the appreciation of the assets without estate or gift tax.
	+ If the growth rate of the assets exceeds the preferred return rate, resulting growth of the common interest is excluded from the client’s estate and inures to the benefit of the children.
	+ Provided that the 2701 requirements are satisfied and the client receives an adequate coupon rate for his or her qualified payment right, there are no gift tax implications for the initial transfer of the property. The initial contribution of capital is considered a retained interest.
* **Example:**
	+ Ben owns assets worth $20 million. Ben transfers these assets into an LLC. The initial contribution of $20 million would be frozen in value upon the issuance of common interests to Ben’s children (or trusts for his children).
	+ A fixed rate of return of 7.5% would yield $1.5 million in annual payments.
	+ Assuming asset growth is 10%, every year there is a 2.5% difference ($500k) between the fixed rate and the actual growth, and this growth increases the value of the common interests and is not part of the client’s taxable estate.
	+ Ben now has a steady income stream from the fixed rate of return, while also making sure that the growth above that amount is being accumulated for the benefit of his children.

**Partnership Freezes: Advantages and Disadvantages**

* **Advantages**
	+ Although 2701 requirements must be navigated, potentially no gift tax exemption is used.
	+ Not only does this strategy transfer asset growth to the next generation, it also ensures a stream of income for the client indefinitely.
	+ Prevents the appreciation of the assets from being included in the client’s estate.
	+ There is no claw back upon death like with a GRAT.
* **Disadvantages**
	+ Very complex. Requires attorneys, accountants, and appraisal professionals to value the preferred interest and corresponding rate of return in order to avoid gift tax implications. Requires interest transfers and partnership documentation.
	+ Annual preferred coupon must be properly determined or client will be deemed as making a partial gift upon contribution of the assets into the partnership.

**Partnership Freezes: Other Issues**

* **Valuation Issues**
	+ To avoid a deemed gift when a contribution is made to the partnership in exchange for a preferred interest that pays a fixed, annual return, the preferred interest must be structured as a qualified payment right, i.e., the preferred interest will be valued under traditional valuation principles.
	+ Therefore, it is very important to make sure that the annual preferred coupon amount is correctly determined. This requires obtaining a valuation appraisal from a qualified appraiser.
* **Retained Interest**
	+ When structuring the rights associated with the preferred interest, it is critical that the preferred holder not retain any extraordinary payment rights outlined in the IRS regulations which would affect the value of the transferred interest, e.g., conversion rights or rights to compel liquidation.

**ANNUAL MAINTENANCE FOR ESTATE FREEZES**

* Ensure Annuity/Note Payments are made and monitor the progress of the strategy.
* Insulate growth by locking in success of strategy by selling positions and going to cash or swapping assets for other investments.
* Gift Tax Return and GST Allocation
* Information-only Income Tax filing for Trusts
* Monitoring Investment Performance

**CLOSING AND QUESTIONS**

Estates continue to compound and failing to do planning today with modest appreciation and longevity means problems will continue to expand.

While the current taxing scheme permits discounting, the “alpha” in your estate planning is the immediate tax free growth that is taking place off of your balance sheet.

The immediate impact is up front by transferring discounted assets (and from the compounding down the road) into a protected vehicle, i.e, a Trust which still can enable you to have access through borrowing or distributions to a spouse.

**MCMANUS CONTACT INFO**