INSTALLMENT SALE TO GRANTOR TRUST ("ISGT")

General Planning Memorandum

This memorandum outlines estate planning considerations involved in an installment sale to a grantor trust ("ISGT"). Essentially, an ISGT is a sale transaction in which the owner of a closely held corporation (or LLC) transfers a substantial portion of the corporation to a trust created by the owner where most of the consideration which the owner receives is in the form of a promissory note under an installment sale.

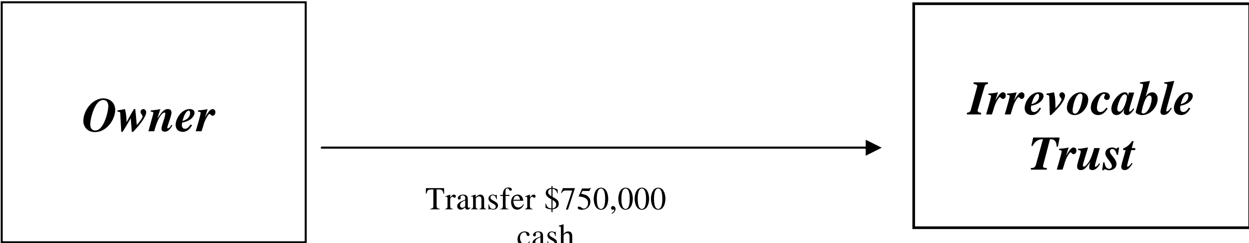
What is an ISGT? - Central bullet points summarizing this technique include the following.

- By transferring the non-voting stock to the trust, owner is able to maintain control of the corporation (or LLC).
- The value of the stock is frozen for estate and gift tax purposes at a value which is substantially less than its true proportionate fair market value of the underlying property held by the corporation.
- Because owner is liable for the income tax of the trust, owner is able to make what effectively amounts to additional gifting to owner's descendants (i.e. paying income tax) with no additional gift tax consequences.
- Owner does not incur any additional income tax consequences and is not required to file a gift tax return reporting the installment sale.

Mechanics of an ISGT - To illustrate this technique, the following assumptions are made, with the transaction to be implemented in three distinct steps shown below. Importantly, each step should be done separately, with a decent interval of time (e.g., a month or more) after the first step is completed. The record should be made clear that there is no obligation or prearrangement that the owner is committed to follow through and complete the transaction after the first step is completed.

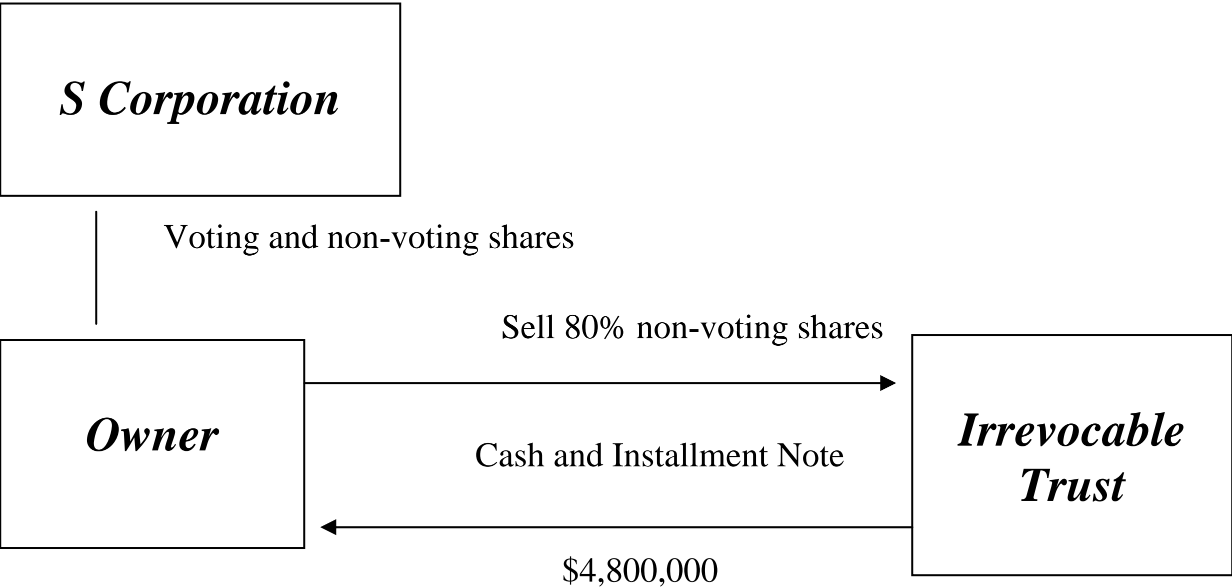
- Owner is sole shareholder of S Corporation which owns appreciated real estate valued at over $10,000,000.
- Owner has previously recapitalized the S Corporation into voting (1%) and non-voting (99%) stock. The shares of non-voting stock have identical economic rights (i.e. the right to receive dividends and share in the proceeds of liquidation).
- The non-voting shares represent $9,900,000 of the underlying pro rata value of the S Corporation's real estate.
- Owner wishes to transfer 80% of the equity in the S Corporation into trust for the benefit of owner's descendants.

Step One: Form and Fund Trust



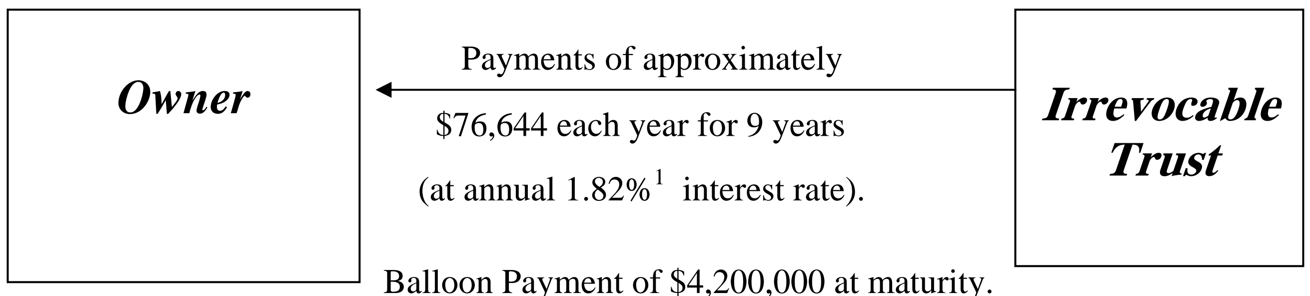
- Owner creates a trust which is designed to be effective to transfer property out of owner's estate for estate tax purposes but which is not recognized for income tax purposes and as treated as a so-called "grantor trust."
- Owner funds the trust with cash in an amount ($750,000) which is at least sufficient to be used as a down payment for the purchase of the stock. The minimum amount should be at least 10% of the purchase price, and an amount somewhat higher than that (e.g.15%) is preferable.
- The beneficiaries of the trust are one or more of the owner's descendants as specified under the trust terms.
- Income and principal of the trust may be accumulated or distributed among owner's descendents in the Trustee's discretion.
- Upon termination of the trust, the principal and accumulated income will be distributed among children's descendents pursuant to the trust terms.

Step Two: Sale of S Corporation Stock to Trust



- Owner subsequently sells 80% of the non-voting stock to the trust for $600,000 cash and a $4,200,000 9-year interest only balloon promissory note. The cash portion should exceed 10% of the purchase price and should not fully deplete the initial trust cash property.
- Due to valuation discount for lack of marketability and/or lack of control and/or for minority interest, the purchase price should be significantly less than the underlying proportionate fair market value of the real estate. Assuming a 40% valuation discount, the purchase price is $4,800,000. The valuation discount must be set by a valuation report issued by a qualified business appraiser.
- Because owner is considered the trust taxpayer for income tax purposes, owner will not incur a gain on the sale of stock to the trust.
- If the applicable IRS interest rate is used for the note and the stock is valued properly, there will not be a gift or an obligation to file a gift tax return.
- The applicable IRS mid-term interest rate (for a promissory note of 9 years or less) from June 2005 forward at times has been at times higher than 5% and at other times in more recent years lower than 1% annually. The current (July 2014) rate is at the lower end of that range -- 1.82 percent.

Step Three: Trust Makes Annual Note Payments



- Owner receives interest payments each year from the trust, which must receive cash distribution from the corporation in order to make the interest payment.
- Because owner is considered the trust taxpayer for income tax purposes, owner will not recognize interest income upon receipt of the payments.
- Owner will be required to pay 100% of the trust's income tax. As a result, owner's descendants receive an additional "gift" in the amount of the income tax payment with no additional gift or estate tax liability. There is

[1] Represents annual mid-term AFR for July, 2014

flexibility to change this tax treatment as may be appropriate in future years (i.e. owner may direct instead for the tax liability to be shifted to the trust).

- Even though the owner has transferred 80% of the equity ownership in the corporation in trust for owner's descendants, owner may still control the corporation though the voting stock retained by owner. However, it is preferable for estate tax purposes for owner also to divest himself or herself of the voting stock (or at least a control portion of it) before death. It is also preferable for owner to arrange for the note to be fully discharged (either by repayment, or by cancellation – see below) during owner's lifetime, so as to avoid any estate tax claim by the IRS after death that the transaction should effectively be ignored for estate tax purposes.

Additional planning issues for an ISGT. Some additional considerations include the following

- If in the future the owner wishes to cancel a portion or all of the installment sale note principal, this may be done by gift. The entire amount of the installment note principal may be cancelled without gift tax being incurred, assuming the owner has not made substantial prior taxable gifts using up owner's available gift tax exemption ($5,340,000 in 2014, and adjusted for inflation in future years).
- If the owner is married, planning may also include so-called "split-gift" planning for gifts made by both spouses. Also, the spouse may be made a trust beneficiary during his or her lifetime, and separate trust planning may be done for any portion of the stock owner by the spouse.
- Instead of a corporation funded with real property (as illustrated above), an ISGT transaction may be implemented for other types of assets, such as a closely-held business (or one of its principal assets or subsidiaries), or for an LLC funded with marketable securities holdings.

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For more information, please contact Hollis F. Russell, Esq. or Lauren E. Touchard, Esq. at (516) 829-6900, or any of our firm's other attorneys.

July 2014

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