BARBER EMERSON, L.C.

MEMORANDUM

ESTATE FREEZING THROUGH THE USE OF INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

I. INTRODUCTION AND CIRCULAR 230 NOTICE

A. **Introduction**. This Memorandum discusses how an estate freeze may be achieved through the sale of assets, particularly ownership interests in a family entity such as a family limited liability company, to an intentionally defective grantor trust ("IDGT"). The Memorandum first presents a brief substantive discussion of family wealth transfer techniques and illustrates the advantages of using gifts of fractional ownership interests in a family limited liability company ("**L.L.C.**") to defer or reduce transfer taxes. The Memorandum then illustrates the additional advantages of using a combination of the IDGT and the family limited liability company to effectuate an estate "freeze."

An estate "freeze" describes any estate planning technique that attempts to shift the future expected appreciation in the value of assets to the next generation in such a way that the expected increase in value escapes liability for estate tax in the senior generation member's estate. An estate freeze should be contrasted with various gifting techniques such as transferring ownership interests in family limited liability companies, which are designed to remove all economic interests in the gifted property, including current income, from the donor's ownership and therefore from the donor's taxable estate.

Because the implementation of an estate freeze using a sale to an IDGT requires careful computational planning to meet the various tax rules that must be followed for a successful estate freeze to occur, the scope of this Memorandum is general. The implementation of a sale to an IDGT should be accompanied by a spreadsheet illustrating the specific economic and tax benefits of such a sale. This Memorandum, however, discusses only general economic and tax benefits of a sale to an IDGT.

B. **Circular 230 Notice**. Pursuant to Internal Revenue Service Circular 230, Barber Emerson, L.C. is required to advise you that this memorandum involves a discussion of various tax matters and an analysis of one or more significant tax issues. We believe the conclusions reached in this memorandum are based on substantial authority and relate to tax benefits in a manner consistent with applicable statutes and Congressional intent. Our conclusions, however, are not intended to be relied on and cannot be relied on for the purpose of avoiding penalties that may be imposed by the Internal Revenue Service. In addition, the ideas described in this letter should be considered merely preliminary tax advice. If the reader of this memorandum determines to proceed with any of these ideas, or if the reader wants more information before deciding on proceeding with any of these ideas, we will provide you with a more complete and formal description of the tax effects of the specific transaction you might wish to consider. Because preparation of that more formal tax advice may require additional facts and research regarding the reader's individual situation, the reader should not rely on the preliminary ideas described in this memorandum as a basis for implementing a transaction based on those ideas.

II. GOALS OF FAMILY WEALTH PLANNING

A. **Wealth Disposition**. Wealth disposition techniques include the following: wills; revocable trusts; life insurance; life insurance trusts; joint tenancy; payable upon death accounts, transfer on death under Uniform Transfer on Death Security Registration Act; annuities; qualified pension and profit sharing plans; individual retirement accounts; and similar arrangements that cause the transfer of assets from one person to another, usually upon death. Wealth disposition can also occur during lifetime, principally through gifts and various transfers for value, such as installment sales, private annuities, grantor retained annuity trusts ("CRATS"), grantor retained unitrusts ("CRUTS"), split-interest charitable gifts, and similar arrangements.

B. **Wealth Preservation - General Concepts**. The preservation of one's wealth, both during lifetime and at death, may involve the following:

1. **Protection Against Creditors**. Protection against claims of creditors through trusts, exempt assets, mortgaging assets, creating corporations and other limited liability entities, and transferring assets to children or other third parties.

2. **Management of Assets**. Preservation of assets during one's lifetime involves prudent financial and investment planning, together with planning for management during times of disability through durable powers of attorney, revocable trusts, family corporations, partnerships, or limited liability companies.

3. **Transfer Tax Reduction**. Preservation of assets at death involves protecting, reducing, and deferring death taxes, and providing adequate liquidity to pay such taxes.

III. WEALTH PRESERVATION THROUGH GIFTING OF ASSETS

A. **Transfer Tax Reduction Through Lifetime Gifts**. Lifetime gifts as a way to avoid or minimize estate tax are favored for the following reasons:

a. A $12,000 per donee annual exclusion is available under I.R.C. Code § 2503(b).

b. Post-gift appreciation is shifted to the donee, and no value is returned to the donor as occurs with GRATS and sales to IDGT's.

c. Valuation opportunities through discounts are now more readily available as a result of Rev. Rul. 93-12, as discussed in more detail below.

d. Income from the gifted property is removed from the donor's estate and is shifted to the donee. Occasionally, however, tax planning objectives can be furthered if the principal is transferred and income remains taxed to the donor, thus further reducing the donor's estate, as will be the case for the IDGT, discussed in more detail below.

e. The unified transfer tax system is not truly unified, as the gift tax is tax exclusive, whereas the estate tax is tax inclusive, i.e., the gift tax itself is not subject to gift taxation, in contrast to the estate tax. This will be illustrated in an example below.

Lifetime gifts, however, have several disadvantages, including the following:

a. The donor loses control of the gifted property, as the donnee generally has complete independence regarding the use and disposition of the gifted property.

b. Outright gifts in excess of the $12,000 per donnee annual exclusion reduce a portion of the donor current $1,000,000 lifetime gift tax exemption and also reduce the total exemption that may be available at death, which is currently $2,000,000. Any gift that might involve a payment of gift tax must consider that the gift tax exemptions may increase in the reasonably near future and that the gift and estate tax may be repealed completely.

B. **<u>Traditional Gifting Strategies</u>**. Traditional gifting strategies involve encouraging persons with potential estate tax exposure to make gifts of cash or other property to their children, grandchildren, or other beneficiaries in order to take advantage of the $12,000 annual exclusion under Code § 2503(b). However, in many cases, the transfer of $12,000 per year will not be sufficient to reduce significantly the estate tax exposure of a senior generation member because his or her other assets continue to increase at a faster rate than assets can be given away. In these cases, the senior generation member should consider making additional gifts that will make lifetime use of his or her current $1,000,000 gift tax applicable credit amount. The major advantage of making lifetime use of the applicable credit amount is that the future appreciation in the gifted property will escape gift and estate taxation, and that no value will be returned to the donor as occurs with GRATS and sales to IDGTs. A major disadvantage of making lifetime use of the applicable credit amount is that the subject of the gift is no longer within the donor's control unless the gift is an interest in a family entity in which control remains with the senior family members.

C. **<u>Gifting Strategies Involving Family L.L.C.s</u>**. More sophisticated gifting strategies require considering whether to use a family limited liability company in order to "leverage" gifts to the next generation.[1] The leverage is created by valuation discounts that apply to gifts of interests in a family L.L.C., as explained in greater detail below:

1. **"<u>The Sum of the Parts Does Not Equal the Whole</u>"**. For transfer tax purposes, the value used in determining the amount of a gift is fair market value, generally defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the facts. Ownership of an interest in an entity such as a family L.L.C., whether a majority or minority interest, generally will result in a lower valuation for transfer tax purposes than the outright ownership of assets outside of the entity. Lower valuations result because minority interest and lack of market-

[1] A discussion of all of the advantages and disadvantages of using a family L.L.C., and a comparison to use of family limited partnerships, is beyond the scope of this memorandum. This office has prepared materials, available on request, that discuss the advantages and disadvantages of establishing a family L.L.C.

ability valuation discounts are allowed for transfers of interests in closely held corporations and limited partnerships.

2. **Valuation Discounts**. The primary valuation discounts are for minority interests and lack of marketability. A minority interest is any ownership interest in an entity such as a family L.L.C. that lacks voting control over the entity, such that the member has no unilateral power to determine the timing of distributions, force a liquidation of the L.L.C., or control the management of the L.L.C. Although minority interest discounts must be based on each individualized case, such discounts may reach thirty percent or more, but are more often in the twenty percent range. A marketability discount generally applies to majority and minority interests in a L.L.C. due to the illiquid nature of such interests. Such discounts may reach fifty percent or more.

3. **Impact of Rev. Rul. 93-12**. Recent developments have created an opportunity to use a family L.L.C. to transfer substantial wealth to the next generation on a discounted basis. In Rev. Rul. 93-12, the I.R.S. reversed its long-standing position that minority discounts would not be allowed for transfers of interests in family controlled businesses. Previously, the IRS had argued that family interests should be treated as a single interest for valuation purposes. This argument was rejected by a number of courts in which the IRS raised the issue. The fact that discounts are now more readily allowed provides taxpayers with an opportunity to transfer a significant amount of wealth to the next generation on a discounted basis.

D. **Example of Gifting Using a Family L.L.C.** Suppose Mom and Dad own real estate worth $1,000,000. They wish to make partial gifts of this real estate to their four children to take advantage of the $12,000 annual exclusion under Code § 2503(a). Mom and Dad decide to establish a L.L.C. to own the real estate. Each receives a 50% interest in the L.L.C. upon contribution of the real estate to the L.L.C.[2] Mom and Dad are appointed managers, which gives them the power to make all decisions regarding the management and operation of the L.L.C. After establishing the L.L.C. for substantial business reasons, and after the L.L.C. has been in existence for some time, Mom and Dad make a gift of 19.2% of their interests in the L.L.C., by giving a 4.8% interest to each of their four children.

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[2]There are no income tax consequences upon the contribution unless any mortgage on the real estate exceeds the basis of the real estate, or only marketable securities are contributed. *See* I.R.C. § 721(b).

Each gift of an interest in the L.L.C. is entitled to a minority interest discount, because each child lacks control of the entity. Each gift is also entitled to a lack of marketability discount because each interest in the L.L.C. is highly illiquid, and no child has the power to liquidate the L.L.C. Assuming for purposes of this example a total discount of fifty percent, the fair market value of the gift made to each child is only $24,000.[3] Thus, the gift tax exclusion has been "leveraged" using the L.L.C. because $48,000 in underlying asset value has been transferred to each child without gift tax cost and without using any unified credit.

As the real estate owned by the L.L.C. increases in value, such increase in value will be reflected in Mom and Dad's estate only to the extent of their remaining interest in the L.L.C. Furthermore, Mom and Dad now each owns only a 40.4% minority interest in the L.L.C. Each such interest lacks the power to liquidate the L.L.C., and would also be entitled to minority interest and lack of marketability discounts. Thus, significant gift and estate tax savings can be achieved by using a family L.L.C., although at the "cost" to Mom and Dad of foregoing the income that otherwise would have been received on the 19.2% that has been given away to the children. As discussed below, the advantages of making highly leveraged gifts of interests in a family limited liability company can be combined with the "estate freezing" advantages of the IDGT, to achieve significant reductions in estate and gift taxes. Moreover, a sale to an IDGT has the further advantage of permitting Mom and Dad not only to keep the future appreciation in value out of their estates, but also to retain all of the current income from the property, thus avoiding the loss of income inherent in gifts of L.L.C. interests.

Because of many recent court cases involving the use of family limited liability companies and family limited partnerships, a careful analysis in each instance is needed before interests in a family entity are gifted. Moreover, in most situations a professional appraisal is needed to value both the company’s underlying assets and the fair market value of the interests gifted. The cost of such appraisals must be considered when a decision is make to implement the use of family entities as a part of one’s estate plan.

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[3]When an entity owns non-operating assets such as real estate or investments, courts will generally analyze the underlying value of the assets owned by the company, and then apply appropriate discounts to arrive at the value. *See, e.g.*, *Estate of Ray A. Ford v. Commissioner*, 66 T.C.M. 1507, 1511, (1993) ("In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company the appraiser may accord the greatest weight to the assets underlying the security to be valued.").

IV. THE CONCEPT OF ESTATE FREEZING

As discussed above, gifting of interests in a family L.L.C. or freezing assets in an estate involves shifting future appreciation of an asset to the donor's family members at the lowest transfer tax cost. The general summary of transfer tax reduction through lifetime gifts of interests in a family L.L.C., as described in Section III, above, illustrates how appreciation can be shifted, and therefore reduce the ultimate estate tax burden to the donor. A gift of an interest in a family L.L.C. or an estate freeze using an IDGT, however, will be beneficial only if the transfer taxes saved from removing the value of the property and the post-gift appreciation from the effect of these taxes is greater than the cost of losing the income tax step-up in basis available if the donor held the assets until the time of his or her death. The loss in the step-up in basis occurs because generally, a donee takes the donor's income tax basis, whereas if the donor held the asset until the time of death, the asset's basis would be "stepped-up" to its date of death value. The loss in step-up in basis will be significant, however, only if and when the asset is sold. Thus, if the asset is one not likely to be sold by the donee, the loss of the step-up in basis is not particularly significant. This concept will be illustrated by the following example which is based on a gift of an interest in the family L.L.C. Suppose the property transferred to the family L.L.C., which is worth $1,000,000 in the above example, has an adjusted basis (original cost less depreciation deductions) of $100,000. Each 4.8% interest transferred to a child would have a basis of $4,000. If the property owned by the family L.L.C. were sold immediately following death of the surviving senior generation member, the child would generally recognize capital gain with respect to his or her interest as follows:

Amount Realized (4.8% of $1,000,000)	$48,000
Less: Adjusted Basis	4,000
Gain Recognized on Sale	44,000
Maximum Federal Capital Gains Tax Rate	15%
Total Tax Liability	$ 6,600

If, instead, Mom and Dad had retained all of the property until death, the property's basis would have been stepped-up to its fair market value at the time of the survivor's death. The property would therefore escape capital gains tax except with respect to post death appreciation. Mom and Dad would have, however, increased estate tax exposure related to the failure to remove the value of this property from their estates. In this case, if we assume that the surviving spouse was in a marginal estate tax bracket of 45%, the transfer to the family L.L.C. saved the family approximately $21,600 ($48,000 x 45% estate tax rate) in estate taxes, which more than compensates for the higher potential capital gains tax liability of $6,600. This example illustrates the benefit of sacrificing the stepped-up basis for lower estate taxes that may result from gifts of LLC interests. Although this discussion regarding the potential loss of step-up and basis emphasizes the importance of considering not only the estate tax, but also the income tax consequences of estate freezing, there may in many instance be tax elections that can ameliorate the consequences of the loss of the step-up of basis. Although discussion of these elections is beyond the scope of this memorandum, such elections generally involve the use of Code Section 754 that permits certain adjustments that would significantly reduce the potential capital gains tax described in the proceeding example.

V. THE USE OF AN IDGT IN AN ESTATE FREEZE

A. **Grantor Trust Rules**. A grantor trust under the Code is a trust that, because of a power retained by the grantor, causes the trust's income to be taxed to the grantor as if the trust did not exist. A revocable trust is the most common example of a grantor trust. An IDGT is a trust that is intentionally drafted to cause the income to be taxed to the grantor, even though the grantor does not retain rights of revocation over the trust or the right to control its ultimate disposition. Because the grantor does not retain these rights, the trust is irrevocable. Ordinarily, an irrevocable trust is prepared to remove the trust's income from the grantor's annual income return; however, a defective grantor trust is one that causes the trust's income to be taxed to the grantor, but is also irrevocable, and thus not included in the grantor's estate for federal estate tax purposes.

B. **IDGT Tax Consequences**. Because an IDGT is not recognized as a separate entity for income tax purposes and yet is irrevocable and therefore not includable in the grantor's estate for federal estate tax purposes, the following results occur:

1. **Income and Expenses Shown of Personal Return**. All of the trust's income and expenses must be shown on the grantor's personal income tax return. Because the grantor pays income taxes on income earned and generally retained by the trust, the grantor has indirectly made a tax free gift to the trust's beneficiaries. The gift, however, is not recognized for tax purposes as a gift by the grantor of the trust.[4] Moreover, the payment of income tax by the grantor on the trust's income removes the income tax from the grantor's estate. If, however, the trust requires that the grantor be reimbursed for the income tax the grantor must pay because of the trust’s income, negative tax

[4]Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

results may occur, including the disastrous result of causing the entire trust to be included in the grantor's estate under Code Section 2036. Although paying income tax would seldom seem to be a tax planning benefit, because income tax on the income earned by the trust must be paid by someone, to have that income tax paid by the senior generation member and thereby reduce his or her estate, is a significant wealth transfer.

2. **Payment of Income Taxes**. The IDGT pays no income taxes during the grantor's lifetime. Therefore, the trust's assets accumulate income tax free, in much the same manner that the assets in a qualified plan grow tax free. Assuming a combined state and federal income tax bracket, each dollar of income remains in the trust to accumulate instead of only sixty cents as would occur after a forty percent income tax reduction. Because the trust grows tax-free, substantially more value will be transferred over the trust's term to children and grandchildren than if the trust paid tax on its income. On the other hand, the payment of income taxes by the grantor will create a potential liquidity problem for the grantor, and the grantor will need to plan to pay this income tax liability from other assets or other sources of income. This problem is magnified if the primary asset held by the trust is a membership interest in a family entity and assets held by the entity, for example, appreciated real estate, sold and a substantial capital gain occurs. Because the grantor will be taxed on the gain from the sale he receives no portion of the sale proceeds because they are held in the trust, the grantor may have a significant tax liability. Consequently, a sale to an intentionally defective grantor trust that may involve potential significant income or capital gains tax to the grantor should be undertaken only by persons who have adequate income and wealth and the potential for payment of such taxes is not a concern

3. **Transactions between Trust and Grantor**. Because the trust is not recognized as a separate entity for income tax purposes, transactions between the grantor and the trust are disregarded. Therefore, if a grantor sells assets to the IDGT, the grantor is considered as making a sale to himself or herself. Because sales to oneself are not recognized for federal income tax purposes, no gain is recognized on the sale to an IDGT.

4. **Filing of Federal Gift Tax Return**. Although a sale to an IDGT is not treated as a gift for federal gift tax purposes if the sales price is for full and adequate consideration, we generally recommend that at least some property

be transferred to the IDGT for no consideration (i.e. gifted to the trust).[5] This gift to the IDGT, as discussed below, will require filing a federal gift tax return, and will use a portion of the grantor's applicable credit amount. Because the gift to the IDGT is a gift of a "future" interest, the gift will not qualify for the $12,000 annual exclusion. The reason for transferring property to the IDGT is to ensure that the trust not only has substance by having initial assets, but, also, and more importantly, to address an issue raised by the Internal Revenue Service that the note from the trust to the grantor, as described below, would be characterized as an equity investment by the grantor in the trust, rather than as a debt. The likelihood of this characterization as equity instead of debt is heightened if the trust does not have the reasonable ability to repay the debt. If the note is characterized as equity, the possibility exists that under several Code sections, the IRS would argue that the assets in the trust would be includable in the grantor's estate for federal estate tax purposes and would also be considered a substantial gift for gift tax purposes.

VI. SALE TO AN IDGT

A. **<u>Tax Consequences of a Sale to an IDGT</u>**. Because, as discussed in Section V, above, a sale to an IDGT is treated as a sale to oneself, it is not taxable. If, therefore, highly appreciated stock in a family corporation or an interest in a family L.L.C. were sold, no capital gain should result to the grantor. Even if there is no step-up in basis to the trust, as would usually be available when one buys an asset, an estate freeze has been effected. If the transfer taxes saved from eliminating post-gift appreciation from the asset are greater than the loss of the income tax step-up in basis, an intergenerational wealth transfer has occurred. Moreover, as previously discussed, the cost of losing the step-up in basis may not be important if the asset sold to the IDGT is one that will probably not be sold by the children or grandchildren.

B. **<u>Sale of Family L.L.C. Interest to an IDGT</u>**. The benefits of selling a highly appreciated asset to an IDGT can be substantially increased if the asset sold is an interest in a family L.L.C., or other closely-held family business interest. If the sales price of the asset, such as stock in a closely held family corporation or a family L.L.C., can be discounted for either a minority interest or lack of marketability, a

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[5]In contrast to a grantor retained annuity trust ("GRAT"), which treats the remainder interest of property transferred in trust as a gift, there is no gift if property is sold to the IDGT for its fair market value, even though at some time in the future the IDGT will terminate upon the death of the grantor, and the ownership of the family L.L.C. interests (or other property either transferred or sold to the trust) will be distributed to the beneficiaries of the IDGT.

transfer tax benefit results and additional leverage is gained through the sale. For example, in the above example, if Dad decides to sell the remaining 40.4% interest that he owns in the family L.L.C. to an IDGT, the fair market value of the interest would be $202,000 (40.4% x $1,000,000 x 50% valuation discount). Because the 40% interest represents a minority interest and lacks marketability, Dad would be able to use these discounts to dramatically lower the value of the transaction for estate and gift tax purposes.

C. **<u>Sale Structured as Installment Sale</u>**. The sale to the IDGT could be structured as an installment sale, with interest only paid until the principal balloons at the end of the term, for example, nine years. The Code allows interest to be charged at the applicable federal rate, rather than at 120% of the applicable federal rate as is the case with other asset freezing transfers such as a GRAT. Because interest must be paid by the trust to the grantor, the grantor will receive additional taxable income as a result of the interest paid by the trust. A shift of wealth to the next generation occurs, however, if the percentage growth of the trust's assets and its income that accumulates tax-free exceeds the percentage interest rate paid to the grantor. Similarly, the end loading, or balloon installment payment, further enhances the wealth transfer to the next generation. The interest paid will, however, reduce the trust's taxable income that is taxed to the grantor, as described above.

E. **<u>Tax Traps to Avoid</u>**. Although the concept of asset freezing and family wealth transfers seems reasonably straightforward, there are numerous tax shoals to avoid in the creation and implementation of the IDGT. One of those shoals is Code Section 2702, which is designed to avoid transfers in which the grantor retains certain interests in the property transferred. If Section 2702 is not avoided, the entire value of the asset may be treated as a gift and immediate gift taxation imposed. The path around the Section 2702 shoal requires the initial contribution to the trust of assets having a fair market value of at least ten percent of the value of the asset the grantor intends to sell to the IDGT. Thus, for example, if the asset sold in our example has a discounted value of $202,000, the trust should initially be funded with cash or marketable securities having a fair market value of at least $21,000.

F. **<u>Risks of the IDGT</u>**. There are certain tax risks that are impossible to avoid with the use of an IDGT. Sales to IDGTs are not blessed by any statutes, and instead owe their existence to IRS rulings and court cases. Consequently, they may be eliminated by an act of Congress or a change in IRS position. Moreover, if the grantor dies before the entire installment obligation is paid, the balance of the promissory note is an asset in the grantor's estate. This result may be avoided by the use of a self-cancelling installment note (**"SCIN"**), but the use of the SCIN requires adroit planning to avoid a gift when the sale is made. A more detailed discussion of the use of SCINs is beyond the scope of this Memorandum, although it should be considered in planning for a sale to an IDGT. In addition, the grantor's death prior to installment payments being completed may require gain recognition, whereas payments during the grantor's lifetime would avoid gain recognition because during the grantor's lifetime, the sale is treated as a sale from the grantor to himself or herself.

A further risk exists that an inadvertent gift could be made if the price set for the sale of property to the IDGT is less than its true fair market value. Should that occur, the value above the sales price may be a gift.

Finally, if the value of the assets sold to the IDGT declines significantly in value, a risk exists that the transaction may fail in that the purchase price will exceed the value of the trust's assets. Consequently, instead of shifting value to the next generation, the reverse has occurred and the value of the payments to the grantor under the note, together with interest, will exceed the value of the assets transferred to the younger generation by the trust.

VII. ILLUSTRATION OF A SALE TO AN IDGT

A. **Steps for Implementation of IDGT**. The following illustrates the steps necessary to implement an estate freeze using an IDGT to transfer an interest in a family L.L.C. This illustration assumes that if the grantor is not married, the grantor previously made gifts of interests in the family L.L.C. so that when the sale of the 40% interest to the IDGT is made as described below, grantor will have only a minority interest remaining, or in the case of married grantors, they have previously made gifts of interests in the family L.L.C. so that at the time of the sale to the IDGT occurs, each spouse owns 50% of the family L.L.C. and each sells 20% of the interest in the L.L.C. (or 40% of his or her 50% interest) to the IDGT.

1. **Creation and Gift to IDGT**. The grantor creates an IDGT naming an independent trustee, and transferring cash and marketable securities having a value of $20,000 to the trust. Because the transfer of the cash and marketable securities is a completed gift for gift tax purposes, but is a transfer of a future interest, a gift tax return will be required. If, however, the grantor has not used all of his or her applicable credit amount no gift tax will be due.

2. **Sale of Interest**. Within a reasonable period of time following the creation of the trust, the grantor enters into a sales agreement with the trustee to sell a 40% minority interest in the family L.L.C. to the trust. Thus, if the fair market value of the family L.L.C.'s property is $1,000,000 a 40% interest

discounted by 50% for minority and lack of marketability would be valued at $200,000.

3. **Execution of Promissory Note**. The trustee would transfer to the grantor the trust's promissory note in the amount of $200,000, with interest only for nine years at which time the principal balance would balloon. Interest would be at the Code Section 1274 applicable federal mid-term rate in order to avoid an imputed gift under Code Section 7872. If the applicable mid-term federal rate were 5%, annual interest would be $10,000 per year.

B. **Analysis of Results**. Based on the above-described example and assuming that the value of the underlying property owned by the family L.L.C. appreciates at the rate of 8% per year and earns annual income of 6%, the following results occur:

1. The $20,000 initial contribution to the trust (the **"Seed Money"**) earns interest at 6% per year, thus yielding income to the trust of $1,200 per year.

2. The income from the 40% family L.L.C. interest sold to the IDGT generates annual taxable income of $24,000 ($1,000,000 x 40% x .06) [Note: the income would not be reduced by the marketability and minority interests].

3. The grantor's taxable income from the IDGT is thus $25,200 ($1,200 + $24,000).

4. Grantor's income tax at 40% on $25,200 equals $10,080.

5. Grantor would receive interest of 5% per year payable to the grantor from the promissory note, which equals $10,000 per year. This amount could be used by the grantor to pay the grantor's tax liability.

6. The annual wealth transferred is $44,000, which is a combination of (1) the annual appreciation in the value of the underlying assets owned by the family L.L.C. ($32,000 [$1,000,000 x 40% x 8%]), and (2) the excess of the trust's annual income over the interest paid to the grantor ($2,000 [$12,000 - $10,000]).

7. Estate tax savings arising from the use of this strategy may be substantial. If we assume that Mom and Dad have estate tax exposure arising from their ownership of assets other than the property contributed to the family

L.L.C., then the transfer of the 40% interest in the family L.L.C. will result in one-half of the value of 40% of the L.L.C.'s property (the valuation discount multiplied by the value of the underlying property) escaping estate tax exposure. In addition, because Mom and Dad's remaining interest in the family L.L.C. has now dropped to less than fifty percent (Mom and Dad each has a 30% interest remaining), their remaining ownership interest in the family L.L.C. also qualifies for the same valuation discounts. As a result of the sale to the IDGT, the value of the property remaining in their estate has decreased from $1,000,000 to $500,000 ($300,000 value of the family L.L.C. (60% x $1,000,000 x 50% valuation discount) plus $200,000 balloon payment owed by the IDGT). This results in a net decrease in their estate of $500,000, which assuming a 45% marginal estate tax rate means that the family will immediately save $250,000 in federal estate taxes through the use of this technique, in addition to additional savings that result from the exclusion of the future growth in the value of this asset from their estates. The benefit of this technique can be increased significantly by or in combination with gifts of minority membership interest in the family L.L.C., as previously described in this memorandum, particularly if those gifts are used in connection with Mom's and Dad's $12,000 annual per donnee gift tax exclusion.

VIII. CONCLUSION

As illustrated in this Memorandum, the wealth transfer benefits of a sale of an interest in a family L.L.C. to an IDGT using a favorable Code Section 1274 interest rate are substantial. These benefits may be increased by annual sales to an IDGT, so long as each sale is accompanied by the contribution of at least ten percent seed money to the trust. These advantages are, however, tempered by various tax risks, and the discomforting fact that little case law has developed to support the tax benefits discussed in this Memorandum. Adequate authority does, however, exist to support the conclusion that a carefully planned sale to an IDGT can result in substantial income and transfer tax savings. Such savings permit passing family assets to the next generation that could otherwise be reduced by as much as 45% (the current maximum Federal Estate Tax rate).

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