An Underutilized Tool for Transferring the Family Business

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Owners of family-owned businesses have several concerns that limit their ability to engage in estate planning: most of their wealth often consists of interests in the closely-held businesses that are not readily marketable; they do not want to give up ultimate control over their businesses; they do not want their descendants to waste or misuse any assets transferred to them or allow their creditors to receive the assets; and they are very concerned about developing qualified management to take over the business when they die or retire. An intentionally defective irrevocable trust, or IDIT (aka a defective grantor trust or income tax defective trust) can help resolve many of these concerns. The IDIT can provide unmatched flexibility to owners of closely-held businesses.

The IDIT – What Is It?

An IDIT is an irrevocable trust (one that the creator cannot directly terminate) that satisfies two conditions. First, the trust is effective for gift and estate tax purposes (i.e., assets owned by the trust will not be included in the transferor's taxable estate). Second, for income tax purposes, the transferor is treated as still owning the trust assets (this is why the trust is referred to as "defective").

For income tax purposes, the transferor to such a trust is treated as owning trust assets if the transferor or the transferor's spouse has certain powers over the trust. Those powers are listed in Internal Revenue Code (IRC) sections 671 – 677. Although many of those powers also cause the assets to be included in the transferor's taxable estate, there are some that do not have that effect. Many planners believe that the powers not resulting in estate tax inclusion include:

- the power to reacquire trust assets by substituting other property of equivalent value;
- the power to borrow without adequate security; and
- certain powers if held by the transferor's spouse.

The Advantages of an IDIT

There are several often-mentioned advantages of IDITs.

First, the transferor's payment of the taxes on the trust's income is the economic equivalent of an additional transfer to the trust, but is not a taxable transfer. This reduces the size of the transferor's taxable estate and increases after-tax family wealth.

In addition, transactions between the transferor and the trust are ignored for income tax purposes. This means that assets can be sold to, or exchanged with, the trust without causing a taxable event. Assets are often sold to IDITs on long-term notes at the applicable federal rate (AFR) as a way of freezing the value of the estate and shifting the appreciation in excess of the AFR to the trust beneficiaries. Often, a minority interest in a closely-held business is sold. This allows additional leverage through the use of minority-interest and marketability discounts.

Moreover, because a properly drafted IDIT is an irrevocable trust, the beneficiaries and their creditors will have the ability to access the trust assets only to the extent provided in the trust instrument. This means that trust assets will not be subject to the claims of divorced spouses (although courts may consider the trust assets in determining how to divide the other property of the beneficiary and divorced spouse) and creditors of the beneficiaries. In addition, the trustee can be given discretion to structure or limit distributions to reduce the chance that the beneficiaries will squander their shares of the trust assets and to encourage them to use their resources more wisely.

Finally, another important advantage of IDITs that is often overlooked is the retained power to substitute assets of equivalent value. This provides the transferor with flexibility that is not found in most estate planning tools:

The "substitution" power allows the transferor to change the specific assets that each beneficiary ultimately receives. This power can be used to change the transition of the business to deal with later events, such as a child's mid-life crisis, death or disability, or a family disagreement. For example, if separate trusts are funded for the benefit of each of two children and later only one of the children shows an interest in being involved in the family business, the transferor may substitute, for the child who is not interested in the family business, other assets for the business interests held by the trust. The family business interests could then be transferred to the trust for the benefit of the child with an interest in running the family business.

Alternatively, if neither child is interested in running the business, the transferor could substitute other assets for the business interests owned by both trusts and then locate buyers for the business or seek to transition the business to key employees. This can greatly simplify the process of transferring the business because the trustee does not have to be as involved in the decision making process.

As the transferor nears death, the transferor can exchange high-basis assets (like cash) for low-basis trust assets. This allows the assets to receive a step-up to a fair market value basis, reducing future income taxes, with no additional estate or income tax cost.

If the transferor no longer wants to pay tax on the trust's income, the transferor can relinquish the power to substitute assets (and any other powers that make the trust income-tax defective). Once the powers are relinquished, the trust (or its beneficiaries to the extent to which income is distributed) will pay tax on the trust's income. Such a relinquishment does not result in a taxable gift.

This ability to later change trust asset allocations gives many closely-held business owners the comfort to allow them to begin the gifting process early. By beginning early, a business owner is able to achieve additional estate tax savings. Additional estate tax savings are achieved by utilizing annual gift tax exclusions that otherwise would have been unused and because the appreciation in earlier years on transferred assets stays out of the transferor's estate. Also, the transfer of business interests to a trust for the benefit of a beneficiary may provide an incentive to the beneficiary to become actively involved in learning how to run the business and, thereby, increase the chance that the business will survive into the next generation.