

## Using A Defective Trust For Business Succession Planning

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When prospecting in the high net worth market, planners often come across situations where a large part of the prospect's estate is held in his or her business. A planner's first instinct may be to ask about the prospect's business succession plan, only to find that the business is owned 100% by the family.

In these situations, typical buy-sell arrangements, such as a cross-purchase or entity purchase, will probably be inappropriate, especially when the intention of the estate/business owner is to pass the business to children. In cases where not all the children are involved in the family business, estate equalization will usually be another major planning objective of estate owners. The challenge here is to incorporate the succession plan into the estate plan.

Estate owners with this profile may have already begun using their annual exclusion gifts (\$12,000 per person in 2008) to pass ownership interests to their children. But when a business is valued in the millions of dollars, the owners can not live long enough to pass the entire value of the business to their children.

Where owners want to maintain control of the business, they may wait until death to pass the firm to the next generation. This tactic can cause problems for the children, as there may be insufficient liquid assets in the estate to cover the estate tax and other settlement costs.

One technique found to be successful in generating sales to clients with this profile is an asset sale to an intentionally defective grantor trust: a vehicle that is "defective" for federal income tax purposes (the grantor continues to be taxed on trust income for federal income tax purposes). But assets transferred by the grantor to the trust also avoid estate and gift tax.

Using this technique, planners can show the estate owner how their business interest can be sold to an intentionally defective grantor trust and how children, being the trust beneficiaries, will receive the business interests at the death of the estate owner without the business being subject to estate taxes.

Let's look at a typical estate owner who holds 100% of the Family S Corp.

Sale to a Defective Grantor Trust  
Estate Freeze Benefit

This technique allows the estate owner/grantor to enter into a sale agreement to the trust—in this case, an irrevocable life insurance trust or ILIT that is also an intentionally defective grantor trust—in exchange for a promissory note. The trust will act as a “stockholder” of the company and be responsible for the repayment of the loan to the grantor.

S Corp. distributions will be allocated to the ILIT as if it were an individual stockholder. The trust realizes the growth of the business and excess retained capital. Therefore, this technique will freeze the growth of the asset in the grantor’s estate (the note receivable) at the loan interest rate.

#### Estate Equalization

The trust has an income-generating asset: the stock in the S Corp. Income can be used to pay loan interest back to the grantor and to pay life insurance premiums. The same trust that owns the S Corp stock can apply for and own a policy on the live(s) of the estate owners, with the trust being the beneficiary. The children would be the trust beneficiaries and, at the death of the estate owner/grantor, the S Corp. stock would pass to the named children.

The life insurance proceeds will be used to repay the estate for the loan and any excess death benefit retained can be used to acquire additional estate assets. The estate would now be liquid for the payment of estate taxes and the trust would have additional estate assets that would be distributed to other non-involved children to equalize the inheritance.

#### Immediate Estate Reduction

##### Discounted Assets

The business interests sold usually represent a minority or non-voting interest. As a result, the actual proportion of the interest sold can qualify for a discount due to lack of marketability/control. While the amount of the discount can vary and represents only the “opinion” of the parties involved, we restrict for illustrative purposes the amount of the discount to a maximum of 1/3 (33.33%). This is still a significant amount and has a meaningful impact to the grantor’s estate.

For example, if a \$10 million asset can qualify for a 30% discount, the grantor would take a note back for \$7 million. This provides an immediate estate reduction of \$3 million and an estate tax savings of about \$1.5 million.

#### Case Study

Let’s consider this scenario:

- Mr. Smith is age 72 and in standard health.
- Mrs. Smith is age 71 and in preferred health.
- Their total net worth is about \$18 million.
- The business (an S Corp.) is appraised at about \$6.7 million
- They own commercial real estate that generates about 8% percent net cash flow and grows at 2% annually.
- The Smiths have 3 children, one of whom works in the business.
- The couple has not used any of their lifetime exemption.

##### Objectives

- Have the business pass to the child who is already working in the business and distribute the remaining estate assets equally to the other 2 children.
- Minimize the growth of the estate, while continuing to manage and grow the business.

- Create liquidity in the estate to equalize the inheritance to all 3 children. The life insurance need is established at \$8 million with an annual premium of \$151,427.

#### The Process

(1) The grantor agrees to sell 90% of the non-voting S Corp. stock to the intentionally defective grantor trust and the grantor retains the remaining 10% voting stock, enabling the grantor to retain control of the S-Corp. This 90% is valued at \$6 million. (\$6.7 million times .9 = \$6 million).

(2) The advisors agree to apply a 30% discount to the sale.

(3) To make the trust economically viable, the grantor “seeds” the trust with a 10% minimum gift, the grantor’s lifetime exemption and/or crummy gifts being used to offset potential gift taxes. In our scenario, the grantor seeds the trust with cash equal to the first year’s premium, the balance being discounted stock. The chart shows the seeding.

#### Leverage Cash Flow with Life Insurance

The above sale provides a valuable estate tax reduction and tax savings. A \$6 million asset that provides a 10% return to the estate owner is replaced by a \$3.9 million promissory note carrying a 4.46% applicable federal rate, the AFR based on long-term notes made in February 2008. The estate is reduced by \$1.8 million and the growth of the estate is reduced by 5.12%.

Now that the excess growth and income has been transferred from the estate to the trust, the trustee has cash flow by which life insurance can be purchased. The insurance will pay off the loan to the estate and the excess death benefit will be used to acquire additional estate assets at death.

If we assume the \$6 million of real estate provides for a net cash flow of 8%, the trust would receive \$480,000 per year as the S-Corp distribution. The trustee must make annual loan interest payments to the grantor at the fixed AFR rate of 4.46% or \$175,342 per year. That would leave about \$304,658 in excess cash flow that can be used to pay the annual premium on the \$8 million universal life policy of \$151,427. After premiums and interest are paid, there remains \$153,251 of excess cash flow the trustee can retain in trust.

#### Benefits at Life Expectancy

If planners project out these numbers to life expectancy (15 years), the \$6 million assets, growing at a 2% rate compounded annually, would grow to more than \$7.9 million. The excess cash flow retained by the trust, growing at a compounded rate of 4%, would increase to over \$4.5 million. The trust would own the \$8 million life policy on the lives of the estate owners.

In total, the trust would have assets on hand totaling more than \$20 million. The loan to the estate would need to be repaid in the amount of \$3,931,427, leaving net assets in the trust totaling \$16.6 million.

This \$16.6 million would now pass to the trust beneficiaries estate-tax-free. From the standpoint of estate equalization, remember that one child gets the business (\$8 million); and other two children would share the remaining estate and trust assets equally.

## Summary

As planners prospect in the high net worth market, keep in mind the family business can make up the bulk of the estate. Passing the business to an owner's children can be the objective. Combining the family buy-sell agreement with estate planning can be accomplished with this powerful technique.

Planners can show their client that estate growth can be frozen at currently low AFR rates. And excess cash flow from the asset can be used by the trustee to buy the life insurance needed to create the liquidity in the estate needed to repay loans and estate settlement costs.

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