**8823.01. How can a grantor retained annuity trust be used in family business succession planning?**

Trust entities can be useful in business succession planning, whether the trusts are revocable or irrevocable. The two forms of trust are not mutually exclusive, a revocable trust can become irrevocable upon the death of the person who set it up. In many instances, a succession plan may contain more than one trust entity. The decision to have one or more types of trusts depends on the business owner’s goals, how much control the senior generation wants, when the assets will be disposed to the heirs and other restraints that are imposed.

A grantor retained annuity trust (GRAT) is an irrevocable trust to which the business owner transfers shares in his business while retaining the right to a fixed annual annuity payout for a stated term of years. At the end of the term, the property remaining in the GRAT (the appreciation and income in excess of the annuity amount that is to be paid to the business owner) will pass to the trust beneficiaries (often the owner’s children or grandchildren). Only the value of the remainder interest is subject to gift tax.

Since the value of the gift is based upon the value of what is going to be left over at the end of the Trust, the amount of the taxable gift to the beneficiaries can be reduced by structuring the trust with a larger annuity payout or a longer stated term. Further, the value is dependent on the IRS Section 7520 1 interest rate in effect at the time the trust is established—a lower interest rate can also reduce the value of the taxable gift.

A GRAT may be structured so that there is little or no gift tax payable on the value of the remainder interest that passes to the trust beneficiaries. For gift tax purposes, this is known as a “zeroed-out” GRAT or “Walton GRAT” 2. If the zeroed-out GRAT produces a return in excess of the annuity amount payable to the business owner, the GRAT will succeed in passing on the reminder interest (the trust’s excess income and appreciation) to the trust beneficiaries at little or no gift tax cost to the business owner. If the zeroed-out GRAT fails to produce a return in excess of the annuity amount and the remainder beneficiaries receive nothing, there is minimal downside risk since there was little or no gift tax cost to the business owner upon establishing the zeroed-out GRAT. The primary risk of using a GRAT (especially a short term GRAT) to transfer business interests is that if the business owner fails to survive the stated term, the GRAT may be included in his estate and subject to estate taxes.

See Q8823.02 for a discussion of the use of intentionally defective grantor trusts in family business succession planning.

1. IRC. Sec. 2702(a)(2); Sec. 7520

2. Walton v. Com., (2000) 115 T.C. 589

**8823.02. How can an intentionally defective grantor trust be used in family business succession planning?**

A trust structure called an intentionally defective grantor trust (IDGT) is another trust structure that can be used by a small business owner to transfer business interests to the next generation. In using this strategy, the business owner actually sells his interests in the business to the IDGT, naming his children or other heirs as beneficiaries of the trust.

An IDGT is an irrevocable trust that is valid for estate tax purposes, but “defective” for income tax purposes. This means the business owner (as the grantor of the IDGT) is the owner of the IDGT for income-tax purposes, but is not treated as the owner of the IDGT for estate tax purposes. Since the business interests are sold to the IDGT, there are no gift taxes.

Further, there are no capital gains taxes to the business owner because sales between a grantor and an IDGT are disregarded for income tax purposes. Typically, the business owner will structure the sale so that there is no down payment by the IDGT, annual interest payments are at the lowest rate permitted by the IRS, and a balloon principal payment is due in nine or more years. This technique is similar to a GRAT, but without the mortality risk. The value of the business is taken outside of the business owner’s estate for estate tax purposes, because future appreciation and interest are sheltered within the IDGT. The business owner’s estate is also reduced by the income and capital gains taxes he must pay on the IDGT’s income. In other words, the business owner is not taxed separately on the interest payments but instead is taxed on all of the capital gains and income realized by the IDGT. The taxes paid by the business owner on the IDGT’s income and capital gains are effectively tax-free gifts to the beneficiaries of the IDGT.