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When Frozen Assets are a Good Thing

by Brian Luster and Steven Abernathy

The phrase “frozen assets” is one that strikes fear into the heart of many a wealthy citizen. The inability to sell an investment or take a withdrawal at a time when cash may be most crucial is indeed stomach-turning, often evoking thoughts of bankruptcy, fraud, political corruption, terrorism, or perhaps, an unsavory business deal. Yet, for investors interested in protecting and passing on their wealth, there is a way to re-appropriate the concept of “frozen assets” in a beneficial and advantageous way.

An investors’ wealth is typically diversified across multiple accounts, securities and assets. Sometimes these investments are personal and closely-held assets or businesses. At some point, an investor may begin to contemplate the future of these assets. When the time comes to hand them down, not all wealth transfer techniques are created equal. Estate freezing, under the right circumstances, can become a vital component of an intelligent wealth preservation strategy. To affect this change at a low tax cost, a closely-held “value freeze” could be an option. How does it work?

Suppose Daisy wants to hand down her small consulting firm to her three college-educated sons, Huey, Dewy, and Louie. For three years they’ve worked for their mom, and, it’s clear someday they’ll run the show. At the onset, Mom holds 100% of the stock, valued at approximately $2.5 million. She then opts to exchange $2.5 million worth of common stock for $2.4 million of preferred, non-growth stock, as well as $100,000 of common. Mom then gifts the $100,000 common stock to her three sons.

Now, this recapitalization, followed by the transfer of the common stock, accomplishes several things:

1. Daisy has moved the enterprise’s growth to her sons by splitting her common stock into equity (common stock) and debt (preferred stock)

2. The value of Daisy’s interest is “frozen” at the time of the recapitalization and will remain in her estate at death

3. The preferred shares allow Daisy to retain control of the company (and enjoy cumulative dividends and liquidation rights).

4. Notably, the growth shares have now been transferred out of the estate,

thus escaping estate tax.

Now, the $100,000 of common stock provided to the sons is going to result in gift tax; however, Daisy can most likely use her lifetime unified credit to shelter this amount. If the company flourishes (perhaps it triples in value, which is likely considering the sons' performance is tied to stock value), the common stock would be worth $5.1 million ($7.5 million minus $2.4 million). This subsequent stock appreciation will escape gift tax altogether.

Another great way to pass on a business or other growth-assets to family members through a "freeze" technique is An Intentional Defective Grantor Trust, (IDGT). The IDGT is structured as a Grantor trust that purposefully runs afoul of specific income tax rules. By retaining certain powers, including the right to borrow funds, the grantor ensures that he or she will be responsible for paying income tax on the trust's income. This is not as bad as it sounds: because the trust is considered an "alter-ego" of the grantor, there will be no taxable gain when assets are "sold" to the trust or when the grantor receives interest payments from the trust.

Now, suppose Daisy has invested well and owns several thousand shares of high growth equities (worth $5 million) that she wants to pass to her daughter, Minnie. She sets up an IDGT, names Minnie as the beneficiary, and contributes $500,000 (cash) to the trust. Daisy later sells the trust—all of her shares—in exchange for a fair market value note with an arms-length interest rate, as well as the $500,000 in cash as a down payment.

By doing so:

1. Daisy "freezes" the value of her shares at the moment of contribution. Because she is receiving a fair market value note in exchange for the shares, there is no gift. In addition, because the trust is a Grantor trust, Daisy will not recognize gain on the sale of the stock to the trust.

2. Any stock appreciation will inure to the beneficiaries. While Daisy will have to pay tax on the trust's income, this cost can be thought of as an additional gift to Minnie and one that, according to the IRS, is not treated as a gift for tax purposes.

3. The interest Daisy receives on her note is tax-free on account of the Grantor trust.

4. The income of the IDGT can be used to fund other vehicles, such as a life insurance policy. Should Daisy pass on before paying off the note, the unpaid value will be included in her estate. These taxes can then be paid off from the life insurance policy's death benefit.

5. The $500,000 "seed" money is put into place to avoid IRS challenges that the IDGT is a disguised gift to Minnie. Doing such increases the likelihood that the transaction will have economic substance independent of the sale (that it has enough assets to pay the note outside of the stock).

6. The IDGT provides asset protection: while Daisy is treated as the owner for income tax purposes, she is not considered the legal owner of the trust. As such, creditors will be unable to touch the securities.

Another effective way to minimize gift and estate tax by employing a value freeze uses a Grantor Retained Annuity Trust (GRAT). While GRATs are complex, their basic premise is fairly simple; they allow the investor to take advantage of the ability to separately value different interests of a single asset. These interests are typically: 1) the cash flow from the trust's asset (usually in the form of an annuity), such as the rent from an apartment building; and, 2) the trust's asset itself (i.e. the apartment building).

The trick is in the valuation. The asset placed into the trust is valued at less than its fair market value because the annuity cash stream, also called retained interest, is still held by the grantor. This minimizes gift tax; more importantly, by allowing the retained interest to equal the value of the asset (plus an assumed growth rate provided by the Treasury Department). The retained interest value is "frozen" at the time it is placed in the trust. Assuming the asset increases in value faster than the assumed growth rate (note: the grantor, not the trust, is paying taxes on the growth), any appreciation is passed on tax-free.

This technique was dramatically illustrated by the Walton Family. Audrey Walton, wishing to give $100 million worth of stock to her daughters, transferred 7.2 million shares to a GRAT. The trusts were to terminate in just two years, with the remaining shares to be transferred to her daughters. The trust stipulated that for the first year, Audrey was to be paid an annuity equal to 49.35% of the initial trust, and 59.22% for the second year. Payments could be made in-kind with the Wal-Mart stock. Using the voodoo of actuarial tables, the daughters' remainder was valued at only $6,195—not a bad gift tax to pay on 10% of $1 billion. Why so low? The amount Mrs. Walton received, in the form of an annuity, equaled the value of the stock at the time it was arranged.

What would have happened if the value of the stock increased at the end of the two years?

In what was a surprise at the time, the value of the Wal-Mart stocks declined, thereby exhausting the trust corpus, so the daughters were left with nothing from it. What would have happened had the shares appreciated (even 15%– certainly possible in a volatile market): the girls would have received approximately $15 million for the bargain price of a gift tax on $6,195, plus relatively minimal administrative and legal costs.

The use of such value freeze techniques is useful and complex. Like all issues involving the Internal Revenue Code, many considerations must be taken into account. When structured properly, these trusts can accomplish wealth transfer goals with maximum precision and efficiency. Value freezes are about asset appreciation, and, using these techniques today may result in millions of dollars in tax savings years down the road.

Steven Abernathy and Brian Luster co-founded The Abernathy Group II Family Office which counsels affluent families on multi-generational asset protection, wealth management, and estate and tax planning strategies.

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