Valuation Freezes

The planning objective in any valuation freeze is to make a gift of property during the grantor's lifetime and allow the transferred property to appreciate outside the grantor's estate. The property can be given to an irrevocable trust or to individuals outright. By giving the property during the grantor's lifetime, the value of the property can be frozen for transfer tax purposes and any appreciation that occurs after the gift is made is not included in the grantor's estate.

Valuation freezes can be accomplished by making lifetime gifts through a number of different planning vehicles, such as the vehicles discussed below.

Grantor Retained Annuity Trusts. The Grantor Retained Annuity Trust ("GRAT"), the Grantor Retained Income Trust ("GRIT"), and the Grantor Retained Unitrust ("GRUT") involve an immediate gift of a remainder interest in property, thereby freezing the value of the remainder interest for transfer tax purposes. For all three trusts, the grantor retains an interest in the trust for a term of years. The remainder interest is transferred to the beneficiaries of the trust after the grantor's retained interest expires. By making a gift of the remainder interest in trust during the grantor's lifetime, the grantor can freeze the value of the remainder interest at the date the trust is established. The remainder interest appreciates outside the grantor's estate and is transferred to the remainder beneficiaries without any further gift or estate tax, provided the grantor dies after the expiration of the retained interest.

The grantor retains the right to an annuity amount with the GRAT, the right to an income interest with the GRIT, and a right to a fixed percentage of trust assets with the GRUT.

Qualified Personal Residence Trust. A Qualified Personal Residence Trust ("QPRT") freezes the value of a personal residence or a second/vacation home. The grantor transfers the residence to an irrevocable trust and retains the right to occupy the residence rent-free for a term of years. The remainder interest is given to the beneficiary of the trust, usually the grantor's children. The amount of the gift is the present value of the remainder interest using the applicable remainder factor in Table B. By making a gift of the remainder interest during the grantor's lifetime, the value of the gift is frozen for gift tax purposes. The property can appreciate for the benefit of the children outside of the grantor's estate and be transferred to the children without any further gift or estate tax, provided the grantor dies after the expiration of the term.

- ➔ **Planning Point:** A non-partition agreement can be used with a QPRT to significantly reduce the value of a jointly-owned residence and thereby reduce the amount of the remainder gift to the beneficiaries.

Family Limited Partnerships and Limited Liability Companies. Family Limited Partnerships ("FLPs") and Limited Liability Companies ("LLCs") are planning vehicles used to freeze the value of assets. A variety of different types of properties can be transferred to an FLP or LLC. Due to the restrictions embodied in the FLP or LLC agreement, substantial valuation discounts often are taken on gifts of FLP or LLC interests. The value of the FLP or LLC interest transferred is determined on the date the gift is made and any appreciation that accrues thereafter on the gifted property is outside of the grantor's estate.

Sale to an Intentionally Defective Grantor Trust. In a sale to an intentionally defective grantor trust ("IDGT"), the grantor sells property at its fair market value to the IDGT in return for an installment note. At the end of the note term, any income and appreciation on the trust assets that exceed the payments required to satisfy the promissory note pass to the beneficiaries of the trust free of estate, gift and GST taxes.

A promissory note bearing interest at the applicable federal rate ("AFR") under Section 1274(d) is deemed to have a fair market value equal to its face amount. Therefore, the sale of assets to the IDGT in return for a promissory note will not be a gift as long as the promissory note equals the value of the property transferred and bears interest at the AFR. An accurate appraisal is essential to support the fair market value claimed in the transaction.

Gift tax concerns may arise if the property that is the subject of the sale is a hard-to-value asset, such as closely held stock. A taxable gift will occur if the value of the property transferred is later determined to be greater than the sale price. Section H. below discusses the most common methods used to minimize the risk that the IRS will increase the value of the property transferred.