ADVANCED PLANNING

Wealth Strategies

GRATs and Sale to IDGTs: Estate Freeze Techniques

FREQUENTLY ASKED QUESTIONS
ESTATE PLANNING

How do two of the techniques used by wealthy clients—grantor retained annuity trusts (GRATs) and intentionally defective grantor trusts (IDGTs)—work?

The estate process places a premium on techniques that leverage the use of annual exclusion gifts and/or lifetime gift tax applicable exclusion amounts. For wealthier grantor clients who are already gifting and have little or no exclusions and applicable exemption amounts left, the next step is often a technique known as an "estate freeze." The goal is to freeze the value of the asset to be included in the grantor's estate at its current value while minimizing or avoiding current gift or income tax. Grantor retained annuity trusts (GRATs) and intentionally defective grantor trusts (IDGTs) are two effective estate freeze techniques.

GRATS IN GENERAL. To establish a GRAT, the grantor creates an irrevocable grantor trust in which he or she retains the right to a fixed payment for a specific term (an annuity). At the end of the annuity term, any remaining assets in the GRAT (the remainder interest) are typically passed outright or in trust to the grantor's heirs. However, should the grantor die during the annuity term, the transferred assets will be included in his or her estate.

The GRAT technique allows the grantor to transfer substantial value to the trust with low immediate gift tax consequences since the grantor is treated as having made a completed gift at the time the GRAT is established equal to the value of the property transferred less the value of the retained annuity interest. The value of this annuity interest is determined by: (1) the length of the annuity term; (2) the amount of the retained annuity; and (3) the interest rate used to determine the present value of the annuity payments. This interest rate is equal to 120% of the midterm applicable federal rate (AFR) and is reset monthly according to the rules in IRC §7520. An asset that is transferred to a GRAT that outperforms the Section 7520 rate can pass tremendous wealth to younger generations with transfer tax savings. The lower the 7520 rate, the more attractive GRATs are as an estate freeze technique.

Three factors serve to reduce the value of the remainder interest to the family:
- an increased GRAT term
- a greater retained interest
- lower federal midterm rates

Minimizing the value of the "remainder interest" gift passing to family members is important because the transfer of the property to the GRAT at its creation produces a future interest gift equal to the remainder value and does not qualify for the gift tax annual exclusion.

ZEROED-OUT OR WALTON GRAT. By adjusting its various components, a GRAT can be structured so that there is no gift when the trust is created (i.e., the GRAT has a high enough stated annuity interest and/or a long enough term of years that the gift tax value of the remainder interest is "zeroed out").

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For years, commentators argued that a zeroed-out GRAT was allowed by IRS code. However, the IRS, relying on Reg. §25.2702-3(e), Ex. 5, took the position that there always has to be some gift when a GRAT is created. The IRS reasoned that the possibility of the grantor's death had the effect of reducing the value of the annuity and that, together with other valuation requirements, made it impossible to create an annuity in a GRAT with a value equal to the property transferred.

Finally, in *Walton v. Commissioner*, 115 T.C. 589 (2000), the tax court settled the dispute by invalidating the regulation on which the IRS had been relying. The IRS did not appeal the Walton case and three years later issued Notice 2003-72, 2003-44 IRB 964, in which it acquiesced in the case and agreed to revise the gift tax regulations. The Treasury subsequently issued proposed regulations addressing GRAT valuation issues.[1] These new regulations reflect the holding of the Walton case permitting zeroed-out GRATs and clarify regulations relating to revocable spousal annuities. While the proposed regulations are effective for trusts created after July 26, 2004, the IRS has indicated that it will not challenge any prior application of the Walton decision.

The zeroed-out Walton GRAT is a great gift technique. It allows the grantor to transfer significant amounts of property out of his or her estate with minimal or no taxable gift. If the grantor survives the term of the trust but dies while the estate tax is in effect, the GRAT can significantly reduce any tax that might be owed. There are no lost dollars because the transfer did not result in the payment of any tax.

A GRAT works best with assets that are appreciating rapidly. A zeroed-out GRAT effectively returns to the grantor, in the form of an annuity, all the property originally transferred to the trust. Any excess appreciation stays in the trust and passes to the remainder beneficiaries. This makes the GRAT a great tool for transferring closely held stock, rental real estate, and even some marketable securities. It works particularly well with S corporation stock where there are distributions to shareholders of appreciation and for taxes.

The tax savings from making a gift to a GRAT can be further maximized through the use of discounted assets, such as limited partnership units or closely held stock. This is because the discount has the effect of increasing the effective rate of return on the GRAT assets.

The main risk with using a GRAT is that the grantor must outlive the annuity term for assets to be excluded from the estate. The risk of estate inclusion can be mitigated by selecting an annuity term that the grantor is likely to survive; by using a series of shorter GRATs; or by purchasing life insurance on the life of the grantor to offset the impact of the estate tax if inclusion should occur.[2]

SALE TO AN INTENTIONALLY DEFECTIVE GRANTOR TRUST (IDGT). An estate freeze technique that bears similarities to a GRAT is the sale to an IDGT. Using the sale to an IDGT technique, a wealthy individual looking to rid his or her estate of future appreciation and income without incurring gift tax could sell property to an IDGT for an arm's-length installment note.

Here's a quick step-by-step summary:

- **Step 1: Create an IDGT.** The grantor creates a trust that is structured so that it is excluded from the grantor's estate for federal estate tax purposes, but is considered owned by the grantor for income tax purposes—that is, an IDGT. This is accomplished by properly drafting the trust provisions so that the trust constitutes a grantor trust under one or more of the grantor trust rules found in IRC §§671-679 whereby the grantor will be taxed on all trust income whether or not it is distributed to him or her. But, at the same time, the grantor is not given sufficient control over the trust assets to cause the trust property to be included in the grantor's gross estate under the retained interest rules found in IRC §§2036-2038. Essentially, the grantor needs to retain enough control for grantor trust status but not enough to cause the transferred assets to be included in his or her estate.

[1] Reg-16379-02, 69 F.R. 44476-44480 (July 26, 2004); 2004-35 IRB 390 (August 30, 2004).
[2] Rev. Proc. 2007-3, 2007-1 I.R.B. for proposed regulations dealing with the includibility of a grantor trust under IRC §§2036 and 2039.

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The benefit of creating an IDGT is that any tax paid on the trust income by the grantor is essentially a gift tax-free transfer to the trust beneficiaries to the extent the grantor is not reimbursed.[3] Of course, these payments further reduce the grantor's estate for estate tax purposes.

- **Step 2: Pre-Fund Trust.** Before the installment sale occurs, the IDGT should be funded with significant assets to support the position that the trust has economic substance independent of the sale (i.e., the trust has sufficient assets so that it can repay the loan). The seed money can be transferred through gifts to the trust or through the use of a GRAT. In Private Letter Ruling (PLR) 9535026, the IRS found that trust equity of at least 10% of the installment price was sufficient to create a valid arm's-length transaction.

- **Step 3: Sell for an Installment Note.** The grantor sells property to the wholly owned grantor trust in return for an installment note for fair market value with appropriate valuation discounts where applicable. The note is secured by the sold asset(s) but is a full recourse note. The note can be structured many ways but is often designed so that it provides for interest-only payments with a balloon payment of principal at the end of the note term.

  To avoid the application of the below-market interest rules found in IRC §7872, the note is generally structured to bear interest at the applicable federal rate (AFR) under IRC §1274(d).

  To avoid gain recognition on a sale to a grantor trust, the grantor must be treated as wholly owning the assets of the trust. The IRS takes the position that when the trust is treated as a wholly owned grantor trust, the grantor and the trust are treated as the same entity and transactions between them have no income-tax consequences. As a result, no gain or loss is recognized when assets are sold to the IDGT, and the grantor is not taxed on the interest payments made on the note.[4]

- **Step 4: Trustee Pays Note Interest Annually to You, the Grantor.** Due to the nature of the trust, interest is not taxable income to you.

- **Step 5: Plan to Repay the Note During the Grantor's Lifetime.** Provisions should be made to make it "more likely than not" that the note will be repaid before the grantor's death. It is clear that if the grantor dies with the note outstanding, the balance of the note and any accrued interest will be included in the grantor's estate. What isn't clear is the income-tax effect of the grantor's death. Commentators agree that when the grantor dies, the IDGT loses its grantor tax status. But precisely when does this occur? Depending on when the deemed transfer occurs, gain might be recognized at this time. Presumably, the amount of gain would be based on the outstanding note balance at the date of death. Lack of clarity on this issue emphasizes the need to extinguish the note before the grantor's death.

  Some advisors substitute a self-canceling installment note (SCIN) or a private annuity for the basic promissory note to avoid the possibility of estate tax inclusion.

  If the grantor dies during the term of the SCIN, the value of the note is zero for estate tax purposes. He must, however, recognize any unrealized gain, as there has been a cancellation of the installment obligation. In addition, uncertainty still exists on how much of a premium on interest or principal is needed to compensate for the self-canceling feature of the note. Similarly, a private annuity ensures that there is nothing to include in the estate should the grantor die during the term of the note. The trade-off is that if the grantor lives longer than his actuarial life, payments continue, and more assets accumulate in his estate than under either the promissory note or the SCIN approach.

[3] The IRS confirmed this position in Rev. Rul. 2004-64, 2004-27 IRB 7.
[4] Rev. Rul. 85-13, 1985-1 C.C. 184. Subsequently reaffirmed in PLR 9535026.

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- **Step 6: Buy Life Insurance.** Finally, a portion of the income generated by the trust assets can be used to pay premiums for a life insurance policy on the grantor's life. The policy can be used to repay the balance of the note and/or to help defray estate taxes and costs at the grantor's death.

IDGT VS. GRAT. While the GRAT and the IDGT approaches are very similar in what they intend to accomplish, there are important differences between the two techniques.

Consideration of the following factors is important in determining which technique is more appropriate for a particular scenario:

- **Actual Life Expectancy.** In the case of the GRAT, the grantor must survive the term of the trust to prevent the assets from being pulled back into his estate for purposes of the estate tax. Life expectancy is also important for the IDGT scenario, because of the risk of gain recognition if the grantor dies during the term of the note.

- **Assumed Interest Rates.** The sale to the IDGT mirrors the GRAT in that it transfers appreciation in excess of a given rate. The lower the assumed rate, the more leverage is possible. For GRATs, the assumed rate of return as established by IRC §7520 is 120% of the midterm AFR for the length of the note, while the assumed rate of return for sales to an IDGT is the AFR. Thus, sales to an IDGT maximize the opportunity for leverage.

- **Required Payments.** With a GRAT, the annuity payments cannot increase more than 120% in any year, and substantial annuity payments must be paid in each and every year. However, an installment note can be structured as an interest-only note with a balloon payment of principal at the end. The IDGT approach allows appreciating assets to remain in the trust and accumulate for the heirs' benefit for the maximum period, again generating greater leverage.

- **Income Tax Advantages.** The estate freeze is completed without having to recognize any income tax on the sale of the assets to an IDGT as long as the note is repaid during the seller's lifetime. In addition, the interest payments will not have to be reported as income by the grantor/seller.

- **Gift Tax Avoidance.** As previously discussed, minimizing any gift to the trust becomes an issue where the grantor has already made maximum use of exclusions and exemptions. Proposed regulations now support the position that a GRAT can be zeroed-out. If the sale to the IDGT is structured as a bona fide sale, there will be no gift tax when the assets are transferred. However, to support the position that the trust has economic substance (i.e., is capable of repaying the loan), the grantor may need to fund the trust with cash or other assets prior to the sale. This pre-funding could result in a taxable gift if gift tax exclusions and exemptions are not available.

- **GST Avoidance.** If the ultimate heirs are grandchildren, the sale to an IDGT is favored because the generation skipping transfer (GST) exemption can be allocated immediately, exempting all future appreciation following the sale from GST tax. In contrast, with the GRAT, the annuity term qualifies as an estate tax inclusion period (ETIP) since death during this time results in the inclusion of assets in the grantor's estate. Under the GST rules, the GST exemption can be allocated only at the end of the ETIP period.

- **Valuation Issues.** If limited partnership interests or other discounted assets are used in these estate freeze techniques, there is always the possibility that the IRS will try to revalue the assets. A GRAT can minimize this risk of revaluation if the annuity is expressed as a percentage of the initial trust assets. Should the assets be revalued, the annuity payment will change, but no additional gift tax (or a minimal amount of gift tax) will be owed.

  If the IRS is successful in its revaluation of IDGT assets, the seller would be deemed to have made a gift of the difference between the sales price and the value of the assets sold as determined by the IRS. This can result in substantial gift tax being owed.

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- **Statutory Guidance.** The rules for GRATs are well defined under IRS regulations, rulings, and case law. IRC §2702 is intended to prevent the use of trusts to artificially reduce the value of interests passing to younger generations. This is generally accomplished by not recognizing the value of a parent-grantor's life estate interest for tax purposes, so that the full value of the transfer to the trust becomes a gift to the ultimate beneficiaries (i.e., the life estate [retained annuity] is valued at zero). There is less risk that the Section 2702 rules will be applied to a GRAT because the Code provides a road map (qualifying trust rules) that explicitly outlines how to structure the retained annuity to achieve gift tax certainty.

  There is no statutory road map for an IDGT sale. Without this "safe harbor," the risk remains that the IRS may argue that what looks like a sale is really the retention of an annuity subject to the rules of IRC §2702 or a retained life interest under IRC §2036. To avoid the risk of Section 2702 application or Section 2036 estate inclusion, it is critical that the sale be structured as a bona fide arm's-length sale. The grantor should not be the trustee nor be placed in a position to make decisions regarding the trust's role in the transaction. The interest rate on the note should never be driven by the income produced by the assets. As previously noted, steps should be taken to give the trust economic substance. To reduce the risk of IRS challenge, some assets may require the use of a qualified appraiser.

- **Life Insurance Sale.** The life insurance need is present with either technique. For the GRAT, life insurance provides the certainty that, should the grantor die during the GRAT term, funds will be available to help pay the estate taxes resulting from the asset inclusion. Similarly, where the sale to the IDGT is the favored technique, life insurance not only provides additional leverage but also can be used to help repay the balance of the note and/or to help defray estate taxes and costs at the grantor's death.

Summary

GRATs and sales to IDGTs are techniques that can be highly effective in transferring wealth to the next generation with minimal transfer taxes. However, a failure of the transferred assets to withstand an IRS challenge or a premature death can create havoc with the intended results. These are complex techniques. It is important that clients seek the advice of their tax and legal counsel when considering these estate freeze techniques.

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