Sale to an IDGT vs. Grantor Retained Annuity Trust

A GRAT offers similar transfer tax saving opportunities as a sale to an intentionally defective grantor trust, in that they both result in tax savings when the trust assets outperform (from an investment return perspective) the applicable interest rate. Following is a discussion of how GRATs and sales to an IDGT compare on several important issues.

<u>Inclusion in the Grantor's Gross Estate</u>. If the sale to an IDGT is structured correctly, no portion of the IDGT will be included in the grantor's gross estate for federal estate tax purposes. If the grantor dies before the promissory note is fully paid, only the unpaid balance of the note is included in his or her gross estate. Any appreciation in the value of the assets in the grantor trust escapes taxation. In contrast, if the grantor of a GRAT dies during the GRAT term, most or all of the GRAT property, including any appreciation in the value of the GRAT property, will be included in the grantor's gross estate for federal estate tax purposes. Therefore, there is a mortality risk with a GRAT that is not an issue with a sale to an IDGT. The mortality risk of a GRAT, however, can be eliminated by use of the guaranteed GRAT approach discussed above.

<u>Annual Payments</u>. The IRC § 7520 rate, which is used to value the retained annuity interest in a GRAT, equals 120% of the federal mid-term rate under IRC § 1274. As such, the IRC § 7520 rate is almost always higher than the interest rate on the note (the short-, mid-, or long-term AFR). Thus, the annual annuity payments under a GRAT almost always will be greater than interest payments required under the promissory note used in a sale to an intentionally defective grantor trust. In addition, the GRAT annuity payments often result in a portion of the underlying trust assets being returned to the grantor at a time that is often earlier than would be the case where a sale to an IDGT is used. As a result, with a GRAT, more property will be returned to the grantor in the form of an annuity payment (to be subject to estate tax if not consumed by the grantor), and less property will pass to the beneficiaries. Thus, more property usually will pass to trust beneficiaries free of transfer taxes under the sale technique than under a GRAT.

<u>Backloading Payments</u>. By structuring the transaction as a sale to an intentionally defective grantor trust, it is possible to use a balloon note in which the repayment of principal is deferred until the end of the term of the note. Thus, it is possible to delay payments to the grantor, which has the effect of causing more growth to occur inside the irrevocable trust. With a GRAT, however, the extent to which annuity payments may be postponed is limited because the annuity for a given year cannot exceed 120% of the preceding year's annuity amount. Treas. Reg. § 25.2702-3(b)(1)(ii). Thus, a sale to an IDGT allows the greatest compounding of appreciation inside the trust.

<u>Amount of the Gift</u>. The sale of assets to an IDGT, if structured correctly, will not be a taxable gift. The only gift will be the gift upon contributing the "seed" money to the IDGT. As discussed above, a gift can be avoided entirely if the sale is to an existing funded grantor trust or if the beneficiaries guarantee payments on the note. In light of *Walton*, discussed in the section on GRATs above, a GRAT can be structured as a zeroed-out GRAT so that there is no gift upon creation. Before *Walton*, a sale to an IDGT was considered to have the advantage on this point because it could be structured to avoid any gift.

<u>Planning Point</u>: If the sale is not to an existing funded trust, the creation of a new trust will require the transfer of "seed" money to the trust. Such a transfer may result in the payment of gift tax. Thus, a sale to a newly created IDGT may not be as attractive as a gift tax-free *Walton* GRAT in light of the possibility of estate tax repeal. That is, clients may be less likely to pay gift tax now to save estate taxes later if there is a possibility that estate taxes may never be paid. Therefore, techniques that do not involve the payment of gift tax, such as a *Walton* GRAT, may be preferable.

Post-Sale Adjustment of Sale Price. As discussed above, if the value of the property sold to the IDGT is later increased on audit, the grantor will have made a taxable gift. Valuation concerns may be addressed by a price adjustment clause, but such provisions may be subject to attack by the IRS under the holding in *Procter*. With a GRAT, however, the regulations in effect sanction a post-transaction adjustment clause by permitting the annuity amount to be payable as a fraction or percentage of the fair market value of the GRAT assets. If the value of the assets increases, so will the amount of the annuity, which, in turn, results in no, or a minimal, increase in the taxable gift.

EXAMPLE: Grantor transfers $10,000,000 to a 10-year, zeroed-out GRAT when the IRC § 7520 rate is 5.4%. The annuity is expressed as 13.20323% of the initial value of the property transferred to the GRAT. As such, the annual annuity amount is $1,320,323, and the taxable gift is $6.00. If the value of the GRAT property is increased to $13,000,000, then the amount of the annuity will increase to $1,716,420. The value of the taxable gift will, however, only increase to $7.00.

Planning Point: Because of the possibility that the revaluation of the property sold to an IDGT could result in gift tax liability, and because the risk of revaluation of the property transferred to a GRAT is minimized if the annuity is expressed as a percentage of the value of the property, a sale to an IDGT may not be as attractive as a gift tax-free *Walton* GRAT in light of the possibility of estate tax repeal.

Although the sale technique has a number of advantages over the GRAT, the GRAT has one significant advantage over the sale technique in that it is a creature of statute. There is a provision of the Code, along with associated regulations, that explicitly states what a GRAT is, what the rules are for creating and operating a GRAT, and what the transfer tax consequences will be upon creating a GRAT. In contrast, no such certainty exists with respect to the sale to an intentionally defective grantor trust. The sale technique has been created based on a number of previously unconnected legal principles (*i.e.*, the technique was created based on logical connections and inferences that were drawn from court cases, published and private rulings by the IRS, Treasury Regulations and Code provisions). Thus, there is a risk that if the IRS, in litigation involving the viability of a sale to an intentionally defective grantor trust, is able to successfully dislodge any of the key premises upon which the sale technique is built, the technique could lose its advantage (*e.g.*, the entire value of the trust property could be brought into the gross estate of the grantor for federal estate tax purposes). Despite this risk, the sale technique is a viable planning tool for attorneys and their clients who understand the benefits and potential pitfalls involved.