No Better Time for GRATs and IDGTs

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The precipitous drop in the real estate and securities markets has certainly been painful for many, yet there is a silver lining. Depressed asset values, low interest rates, and the likelihood of continuing federal estate taxes make certain federal estate tax planning strategies extremely attractive. Two such strategies are transfers to grantor retained annuity trusts (GRATs) and sales to intentionally defective grantor trusts (IDGTs). Both are "estate freeze" techniques, with each permitting the transfer of an asset’s future appreciation without significant use of federal estate and gift tax exemptions. Both have rarely been more attractive than they are now.

Transfer to a GRAT

The GRAT is a creature of IRC Section 2702, whereby a taxpayer may transfer assets to a GRAT in return for the right to receive annuity payments for a term of years. The amount of the annuity is determined by IRS-prescribed rates, which are at historic lows. Assume a Mr. Jones created a nine-year GRAT, funding it in January 2009 with $1 million worth of XYZ LLC units. The Section 7520 rate is 2.4 percent. Based upon IRS annuity factors, the annuity payments are calculated to be $124,866. The value of the remainder interest is then computed to be $0 - or an amount slightly greater than $0 - and that becomes the value of the taxable gift. If over the nine-year term the GRAT’s assets grow by 10 percent annually, the GRAT will have outperformed the Section 7520 rate. The GRAT would have $662,336 in assets at the end of the GRAT term to distribute to the GRAT’s remainder beneficiaries. This amount would be transferred without any gift tax.

Note that if Mr. Jones, the grantor, does not outlive the trust term, then the GRAT’s assets are includible in Mr. Jones’ estate for federal estate tax purposes. Further, it is advisable not to completely zero-out a GRAT. The best practice is to calculate a very small remainder for the GRAT to preserve the applicability of IRC Section 2702.

Sale to an IDGT

Through this method, a grantor could set up a trust for the benefit of his or her children and sell the XYZ LLC assets to an IDGT. The IDGT would be drafted so the gift to the trust would be a completed gift for federal estate and gift tax purposes. However, the trust would also be drafted to obtain grantor trust for federal income tax purposes. Because the grantor is treated as the owner of the trust for income tax purposes, no gain or loss would be recognized on the sale of the XYZ LLC units from the grantor to the IDGT. The grantor would be deemed to have made a sale to himself or herself.

The grantor would take back a promissory note requiring repayment over a term of years. To maximize the benefit of the IDGT, some will use a balloon payment of the full principal amount at the end of the repayment term. The interest rate on the note must be no less than the applicable Section 1274 rate, which is currently 2.06 percent for midterm notes - those with maturities between four and nine years - and is lower than the Section 7520 rate applicable to GRATs. At the end of the note term, the remaining assets pass for the benefit of the trust beneficiaries - those that would have been remainder beneficiaries under the GRAT. The grantor would be deemed to have paid the income taxes on the IDGT income.

Assume that Mr. Jones, in January 2009, creates an IDGT instead of a GRAT for the benefit of his children. He sells the XYZ LLC units to the IDGT and takes back a promissory note. The note provides for interest-only payments for nine years, and a balloon payment of $1 million at the end of the period. This would result in the applicable Section 1274 rate being 2.06 percent, which is used as the interest rate on the promissory note. Again, assuming a return of 10 percent on the XYZ LLC units, the value of the IDGT assets at the end of nine years is $1,078,210, which represents the value that passes to the trust beneficiaries with no further tax consequences.

The illustration does not contemplate one important component of selling assets to IDGTs, and that is the suggested practice of giving "seed money" to the IDGT to provide economic substance. As a result, there will need to be some use of Mr. Jones’ federal gift tax exemption to effectively use an IDGT. Further, if a balloon note is used, the grantor will need to have sufficient liquidity to pay the income taxes on the IDGT income.

Advantages of the IDGT
Greater Overall Return - As the two illustrations show, the IDGT may bring a greater overall return. Above, the IDGT returned roughly 60 percent more to the beneficiaries than the GRAT. The deferred repayment of principal allows IDGT assets to generate a better return over time, as the GRAT is not able to defer payments. Also, IDGTs generally have a better IRS prescribed rate than a GRAT.

Easier to Use with Difficult to Value Assets - Because payments can be back-end loaded, IDGTs may be easier with low-income producing business interests or those interests that are difficult to value. This is because the repayment demands are not as difficult, and therefore it is less likely that the trustee will need to make payments in-kind, thus reducing valuation costs and freeing up cash flow.

Lower Estate Inclusion Value - In the IDGT scenario, the value of the installment note is all that will be included in the grantor/seller’s estate if he or she dies before the note is repaid. On the other hand, if the GRAT trust grantor dies during the term, the entire value of the business interest may be includible in the grantor’s estate.

Allows for Leverage of the GST Exemption - A GRAT generally does not allow for the effective leverage of the GST exemption, due to the application of the "estate tax inclusion period." An IDGT is not saddled with those issues, so full leverage of the GST exemption may occur.

Grantor Need Not Outlive Term - Whereas a GRAT will only be effective for federal estate and gift tax purposes if the grantor survives the term of the GRAT, sale to an IDGT will be effective even if the grantor does not outlive the term of the note.

Advantages of the GRAT
Clear Legislative Authority - A GRAT is a statutorily created planning technique, and therefore has clear legislative authority. IDGTs, on the other hand, have not been endorsed by statute, though recent revenue rulings have given some comfort to practitioners.1

Post-Transaction Flexibility - A GRAT has the ability to adjust to adverse valuation examination by the IRS, while an IDGT is not as flexible in dealing with such issues.

Conclusion
Both GRATs and IDGTs can be used with virtually any asset class. Closely held business interests are particularly attractive, especially if minority and lack of marketability discounts can be applied to reduce the value of the transferred asset. Real estate interests are also attractive, especially where there are solid rental income prospects for funding annuity or note payments. Note that S corporation shares can be incorporated into either strategy. C corporation shares present some challenges, since taxable dividends will be required to get cash to fund payments. Given the current economic and legislative environment, serious consideration should be given to GRATs and IDGTs as federal estate tax planning strategies.

1 See Rev. Rul. 2008-22, for example.

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