Estate Planning in a Low Interest Rate Environment – Grantor Retained Annuity Trusts ("GRATs") and Installment Sales to Intentionally Defective Grantor Trusts ("IDGTs")¹

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Background

For wealthy families who have accumulated assets in excess of what is needed to provide for the lifetimes of senior generation family members, the goal often becomes transferring assets to children and grandchildren while minimizing federal and state transfer taxes. The top current federal estate tax rate is 45%, so for an individual whose gross estate exceeds the federal exemption at death, 45 cents of every additional dollar is paid to the federal government in the form of taxes.² With interest rates at historic lows and many asset values being depressed, now is a great time for estate planning techniques such as GRATs and installment sales to IDGTs. Such techniques can transfer substantial wealth from senior generation family members to children and grandchildren while reducing transfer tax costs. Financial planners should understand these techniques and consider initiating discussions with wealthy clients now.

Grantor Retained Annuity Trust

Overview

A GRAT is a type of irrevocable trust to which a senior generation family member transfers assets and retains the right to receive an annuity payment for a specified period of time. The ultimate goal of a GRAT is to transfer assets from the senior family member to a trust for beneficiaries (e.g. spouse and/or children and/or grandchildren) with little or no transfer tax costs. A GRAT works as follows:

1. The senior family member (the “grantor”) establishes an irrevocable trust.

2. The grantor transfers assets to the trust and retains the right to receive an annuity payment for a fixed term.³

¹ Note that this article is not intended to be a comprehensive discussion of these techniques but rather an overview. Individuals and advisors interested in such transactions should consult their own legal counsel. For an excellent discussion, see Blatmachr and Zeydel, GRATs vs. Installment Sales to IDGTs: Which is the Panacea or are They Both Pandemics? 41st ANNUAL HECKERLING INST. ON EST. PL. (2007).

² The federal exemption equivalent is $3,500,000 in 2009. The 45% rate ignores any deduction for state transfer taxes.

³ The annuity must qualify as a “qualified interest” under Code §2702 to avoid the interest retained by the grantor being valued at $0 when the trust benefits the grantor’s family members. If the retained interest were valued at $0, then the entire value of the assets transferred to the trust would be a gift for gift tax purposes.
3. The value of the assets transferred, less the present value of the annuity payments retained by the grantor, is a gift to the trust for gift tax purposes. In most circumstances, the annuity payments back to the grantor are “solved for” such that the gift is equal or close to $0.

4. The IRS assumes that the assets in the GRAT produce a total return equal to a prescribed interest rate under Code §7520. For July 2009, the §7520 rate is 3.40%.

5. The trust assets (or cash flows generated from the trust assets) are used to make the annuity payments after the trust is funded. If the trust assets produce a total return over the term in excess of the §7520 rate, then there may be assets remaining in the trust after the last annuity payment is made. If so, then the remaining assets are available for the grantor’s beneficiaries and are not subject to federal estate taxes or state inheritance taxes at the grantor’s death.

The key to making a GRAT “successful” (i.e. having assets left in the trust after the term ends and after all annuity payments have been made) is to transfer assets that produce a total return in excess of the interest rate assumption required by the IRS at the time the GRAT is funded (i.e., the §7520 rate or 3.40% for July 2009).

Example 1 - GRAT

Assume $1,000,000 in marketable securities is transferred to a nine (9) year GRAT in July 2009 when the §7520 rate is 3.40%. The GRAT is “zeroed out,” meaning that the value of the assets transferred is equal to the present value of the annuity payments to be received by the grantor based on the §7520 rate, resulting in a gift to the trust of $0.

The yearly annuity payment required to zero out the GRAT in this circumstance is $130,840. The trust cash flows and assets are shown below, assuming an eight percent (8%) total return each year.

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4 References to the “Code” are to the Internal Revenue Code of 1986, as amended.

5 This amount is solved for. The present value of these annuity payments at 3.40% equals $1,000,000 (assumes end of year payments).
In this example, at the end of nine (9) years, the GRAT will have resulted in the transfer of assets having a value of $365,133 from the grantor to the beneficiaries of the GRAT. These assets are not subject to estate or inheritance taxes in the grantor’s estate, so the GRAT strategy will have resulted in a tax-free transfer to the beneficiaries of this amount.

**Keys to Structuring a GRAT**

1. **Selection of Assets.** Assets that generate significant cash flow relative to their fair market values or assets that are expected to appreciate significantly in value over a relatively short period of time should be used. While marketable securities may work, other assets such as closely held business interests or rental real estate have the potential to perform even better. Closely held business interests often receive discounts for lack of marketability and control for transfer tax purposes, which may increase their effectiveness when used with a GRAT. Stock in a closely held business that may have an initial public offering in the not too distant future may be an especially good choice.

2. **Volatility of Returns.** Volatility of asset returns and cash flows must also be considered. In the simplified example above, the GRAT successfully transfers assets to the GRAT beneficiaries based on an 8% annual return. However, a GRAT that produces an average return of 8% over the term, but has negative returns in early years may not be successful. Negative returns combined with the annuity payments may deplete the trust such that there are no assets remaining after the annuity term, even when the trust earns the assumed rate over the entire term. Modeling the expected cash flows based on realistic assumptions is an important part of GRAT planning.

3. **GRAT Term.** The term must be carefully considered when setting up a GRAT. If the grantor dies before all annuity payments are made, most or all of the property in the trust is included in the grantor’s estate for federal estate tax purposes. Thus, the trust term needs to be short enough that the grantor is likely to survive the term. If the usual goal of “zeroing out” the GRAT is important, however, then a shorter term results in higher required annuity payments, which means the trust assets need to generate more cash flow. Balancing longevity risk with the usual goal of “zeroing out” the GRAT by extending the term is one of the greatest challenges in GRAT planning.
4. **Grantor Trust Status.** For income tax purposes, the GRAT is a “grantor trust,” meaning that trust income is taxed to the grantor rather than the trust. This is an added benefit from an estate tax perspective, because the grantor’s payment of income taxes on assets that benefit family members is essentially a tax-free gift to the family members. The payment of taxes by the grantor rather than the trust can have a substantial positive impact over time.

5. **Selection of Trustee.** As with any trust, selection of the trustee is important. The grantor may serve as trustee during the annuity term, but it is very important that the trustee selected comply with the GRAT provisions and requirements, such as making annuity payments on time. The grantor cannot be trustee after the annuity term, so careful thought should be given to the selection of a successor trustee.

**Downsides**

What happens if the GRAT is not successful? If the GRAT assets do not generate sufficient total return to leave assets remaining in the trust at the end of the annuity term, then the GRAT “fails,” meaning that all assets in the GRAT are returned to the grantor and no assets have passed to the grantor’s beneficiaries. However, with the exception of the costs incurred in setting up and administering the GRAT, which are minimal compared to the potential savings, there is no downside. Because of this, it is often most beneficial to use short-term or “rolling” GRATs (at least two years) and “try again” if the GRAT is not successful at the end of the term. This may be particularly true for speculative or volatile assets, such as pre-IPO stock.

Because assets in the trust are not included in the grantor’s estate if he survives the trust term, there is no step-up in the basis of the trust assets upon the grantor’s death. This reduces the savings from a GRAT, but with the substantial disparity in estate tax rates (45%) versus long-term capital gains rate of (15%), the partial offset does not eliminate the advantages of GRAT planning.

**Installment Sales To An Intentionally Defective Grantor Trust**

An alternative to a GRAT is an installment sale to an IDGT. This technique works as follows:

1. The grantor establishes an irrevocable trust.

2. The trust includes provisions causing it to be treated as a “grantor trust” for income tax purposes, meaning that all trust income is taxed to the grantor.6 Such a trust is often referred to as being “intentionally defective”.

3. The grantor “seeds” the trust with a small gift (usually at least ten percent (10%) of the value of the property in the trust after the sale).

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6 There are several ways to make a trust a grantor trust for income tax purposes, however, this discussion is outside the scope of this article. See Code §671 et seq.
4. The grantor sells property to the trust in exchange for a promissory note.

5. The IRS assumes that the trust assets earn a rate equal to the applicable federal rate (“AFR”) under Code §7872 based on the term of the note. The AFR rates for July 2009 are as follows:

<table>
<thead>
<tr>
<th>Note Term</th>
<th>7872 Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 years or less</td>
<td>0.82%</td>
</tr>
<tr>
<td>&gt; 3 years to 9 years</td>
<td>2.76%</td>
</tr>
<tr>
<td>&gt; 9 years</td>
<td>4.36%</td>
</tr>
</tbody>
</table>

6. The trust assets (or cash flows generated from the trust assets) are used to make the note payments after the trust is funded. If the trust assets produce a total return in excess of the AFR over the note term, then there may be assets remaining in the trust when the note is fully paid off. If so, then the remaining assets are available for the grantor’s beneficiaries and are not subject to federal estate taxes or state inheritance taxes at the grantor’s death.

As with the GRAT, the key to making an installment sale to an IDGT “successful” (again, this means having assets left in the trust after the term ends and after the note has been paid off) is to transfer assets that produce a total return substantially in excess of the prescribed interest rate. With an installment sale, however, the rate generally used is the AFR instead of the §7520 rate, which is lower than §7520 rate for short-term and mid-term notes. Therefore, the installment sale has the potential to produce a better result than the GRAT if a short-term or mid-term note is used, because the lower interest rate results in a lower required payment back to the grantor, which, in turn, results in more assets remaining in the trust after the note is paid off.

**Keys to Structuring an Installment Sale to an IDGT**

All of the factors discussed above with respect to GRATs are also important with installment sales. However, there are some differences and additional considerations.

1. **Note Term.** One difference between the GRAT and the installment sale is that the trust assets should not be included in the grantor’s estate if the grantor dies during the term.8 Instead, the remaining obligations on the note would be included.9 However, consideration of the term is important from a cash flow standpoint (i.e., will the trust assets generate sufficient cash flow to make the note payments?) and because the

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7 Assumes annual compounding.

8 With an installment sale, there is some risk that the IRS might try to reclassify the interest in the note as a retained interest in the trust assets, which would cause estate tax inclusion. This can be minimized to the extent there are other assets in the trust and the term of the note is less than the grantor’s life expectancy. The risk can be lessened further if the note is paid off during the grantor’s lifetime.

9 There is some uncertainty as to the income consequences if the grantor dies while the note is outstanding. The IRS may argue that capital gain on the sale to the IDGT is accelerated upon death.
prescribed interest rate varies depending on the term of the note. Often, it is desirable to structure the IDGT with a nine (9) year term to take advantage of the lower mid-term AFR (2.76% mid-term AFR for an IDGT sale vs. a 3.40% §7520 rate for a GRAT in July 2009).

2. **Structuring the Sale.** The terms of the sale to the IDGT need to be commercially reasonable. Questions to consider include whether the installment note will be collateralized and whether anyone will guarantee the note payments.

3. **Grantor Trust Status.** As with the GRAT, the trust used for an installment sale is structured as a “grantor trust” for income tax purposes. Because the trust is a grantor trust, transactions between the grantor and the trust have no income tax impact. As a result, no gain or loss is triggered when the grantor sells assets to the trust in exchange for a note or when note payments are made to the grantor from the trust.

4. **Selection of Trustee.** Unlike the GRAT, the grantor would not be the trustee of the trust, to avoid estate inclusion if the grantor died during the term.

5. **SCIN Note.** The note given in exchange for the assets sold to the trust can be structured as a self-cancelling note, meaning that any payments remaining on the note are cancelled at the death of the grantor. However, there is an additional amount that must be paid by the trust to the grantor for this feature (a premium).\(^\text{10}\)

**Example 2 – Installment Sale to IDGT**

Assume the grantor has $1,000,000 in marketable securities to transfer as in Example 1. With an installment sale to an IDGT, the grantor would first gift $100,000 to the trust. The remaining $900,000 would be sold to the trust in exchange for a nine (9) year note. Assuming annual note payments and the current mid-term AFR of 2.76%, the annual note payments would be $114,300 per year. The trust cash flows and assets are shown below, assuming an eight percent (8%) annual total return.

<table>
<thead>
<tr>
<th>Year</th>
<th>Beg. Yr. Trust Balance</th>
<th>8% Trust Growth &amp; Income</th>
<th>End Yr. Note Payment to Grantor</th>
<th>End Yr. Trust Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1,000,000</td>
<td>80,000</td>
<td>(114,300)</td>
<td>965,700</td>
</tr>
<tr>
<td>2</td>
<td>965,700</td>
<td>77,256</td>
<td>(114,300)</td>
<td>928,656</td>
</tr>
<tr>
<td>3</td>
<td>928,656</td>
<td>74,292</td>
<td>(114,300)</td>
<td>888,648</td>
</tr>
<tr>
<td>4</td>
<td>888,648</td>
<td>71,092</td>
<td>(114,300)</td>
<td>845,440</td>
</tr>
<tr>
<td>5</td>
<td>845,440</td>
<td>67,635</td>
<td>(114,300)</td>
<td>798,776</td>
</tr>
<tr>
<td>6</td>
<td>798,776</td>
<td>63,902</td>
<td>(114,300)</td>
<td>748,378</td>
</tr>
<tr>
<td>7</td>
<td>748,378</td>
<td>59,870</td>
<td>(114,300)</td>
<td>693,948</td>
</tr>
<tr>
<td>8</td>
<td>693,948</td>
<td>55,516</td>
<td>(114,300)</td>
<td>635,164</td>
</tr>
<tr>
<td>9</td>
<td>635,164</td>
<td>50,813</td>
<td>(114,300)</td>
<td>571,677</td>
</tr>
</tbody>
</table>

\(^\text{10}\) There is no generally accepted guidance on how to determine the premium.
In this example, at the end of nine (9) years, the sale to the IDGT will have resulted in the transfer of assets having a value of $571,677 from the grantor to the beneficiaries of the IDGT. These assets are not subject to estate or inheritance taxes in the grantor’s estate.

**Downsides**

The “downsides” to an installment sale to an IDGT are basically the same as those with a GRAT. If the trust assets do not generate sufficient total return to leave assets remaining in the trust when the note is paid off, then no assets have passed to the grantor’s beneficiaries and legal and administrative costs have been incurred. In addition, the trust assets are not included in the grantor’s estate, so there is no step-up in basis upon the grantor’s death, which partially offsets the estate tax savings.

**Comparison of GRATs and Installment Sales**

Note that there are more trust assets left in the trust at the end of the term with the installment sale than with the GRAT in the examples above, but the comparison is not “pure” -- for one thing, there is a $100,000 gift upon formation of the IDGT, but no gift upon formation of the GRAT. This causes the IDGT sale to transfer more wealth, but at the expense of using more of the grantor’s lifetime gift tax exemption (or, for large IDGT sales, causing gift tax to be paid). Additional considerations when evaluating a GRAT and an installment sale to an IDGT include the following:

1. Some practitioners view GRATs as less risky because they are described in statutes and Treasury regulations. The “qualified annuity” retained by the grantor is provided for under Code §2702. In contrast, there is no statutory authority for installment sales to grantor trusts.

2. Allocation of generation skipping tax (“GST”) exemption may not be made with a GRAT until the term of the annuity payments ends. With an installment sale, GST exemption can be allocated when the trust is formed.

3. If the IRS determines that the value of the assets sold to the trust through an installment sale exceeds the note, then there would be a gift. In contrast, with a GRAT, there is a statutory “safe harbor” savings clause in that the initial annuity amount can be defined as a percentage of the trust assets. Therefore, if the value of the trust assets is increased upon audit by the IRS, the amount of the annuity is increased accordingly. As a result, GRATs present less gift tax valuation uncertainty.

**Conclusion**

With interest rates at historic lows and depressed asset values, estate planning techniques such as GRATs and installment sales may provide substantial benefit to wealthy clients. However, because any such transaction has benefits and risks, careful consideration must be given by clients and their advisors to ensure that the transaction is properly structured.