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ADDING GRATS TO YOUR ARSENAL OF TRUSTS

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INTRODUCTION. This Outline will address the general rules regarding the creation of a Grantor Retained Annuity Trust (hereinafter, "GRAT"), the income, gift and estate tax consequences of a GRAT and the planning considerations in connection with the use of a GRAT.

I. WHAT IS A GRAT?

A. A GRAT is a trust that pays an annuity to the grantor for a specified period of time. At the end of the term, the beneficial interest in the trust shifts to another beneficiary or group of beneficiaries.

Example 1: D, age 50, transfers $1,000,000 to a trust that requires the trustee to pay D an annual annuity of 23.86918% of the initial principal ($238,692) for 5 years. At the end of the 5 year term, any remaining assets are to be paid to D's daughter. If the qualified interest rules are met, the zero value rule does not apply and the value of D's retained annuity interest will be determined under Code Sec. 7520. Assuming a 7520 rate of 6.2%, on a straight term basis, the value of the life annuity interest is 999,999.30 ($238,691.80 x 4.1895 [base term certain annuity factor]), resulting in a taxable gift of only 70 cents. Any growth in excess of the Section 7520 rate will be shifted to D's daughter.

B. General Rule and Exceptions to General Rule. If a transferor makes a transfer of an interest in trust to or for the benefit of a member of the transferor's family, for gift tax purposes, the interest retained by the transferor (or an "applicable family member") is valued at zero (the "zero-value rule"). Sec. 2702(a)(2)(A) of the Internal Revenue Code of 1986, as amended (hereinafter "I.R.C."). For purposes of the aforesaid general rule, "member of the transferor's family" means the transferor's spouse, any ancestor or lineal descendant of the transferor or the transferor's spouse, any sibling of the transferor and any spouse of any of the aforesaid individuals. An "applicable family member" means the transferor's spouse, an

ancestor of the transferor or the transferor's spouse and the spouse of any ancestor. The zero-value rule does not apply if the retained interest is an annuity or unitrust interest or a non-contingent remainder following an annuity or unitrust interest ("qualified interest"). I.R.C. Sec. 2702(a)(2)(B), 2702(b).

C. Governing Instrument Requirements. To satisfy the requirements of a "qualified interest", Treasury Regulations Sec. 25.2702-3 specifically set forth requirements to be included in the governing instrument.

1. Annuity Amount.

a. The trust must require that the annuity amount be payable for each taxable year of the trust. If a GRAT is created on a date other than January 1 and is on a calendar year, the first annuity payment will be payable within the first full year of its existence. The IRS interprets "payable" to mean actually "paid". The annuity cannot be paid with a note or by giving the annuitant the annual right to withdraw the annuity amount.

b. Consideration should be given to the use of a fiscal year instead of a calendar year to make annuity payments. Treas. Reg. Sec. 25.2702-3(b)(3) states:

> The governing instrument must contain provisions meeting the requirements of Sec. 1.664-2(a)(1)(iv) of this chapter (relating to the computation of the annuity amount in the case of short taxable years and the last taxable year of the term). Solely for purposes of this paragraph (b), the governing instrument meets the requirements of this section with respect to short taxable years, if any, and the last taxable year of the term if the governing instrument provides that the fixed amount or a pro-rata portion thereof must be payable for the final short period of the annuity interest.

The regulation was modified in 1992. Treasury explained: "The amendment, pertaining to the treatment of short taxable years, simplifies the valuation of an annuity or unitrust interest by eliminating the need to prorate the first year's payment in the case of a short taxable year." T.D. 8536, 1994-1 C.B. 261, 263. In addition, the Number Cruncher program assumes payment on a fiscal year basis with a year ending on the anniversary of funding. A benefit to providing for a fiscal year payment is the deferral of the payment allowing for more appreciation in the GRAT. If a fiscal year is selected, notwithstanding the regulations, there may not be a payment in the first calendar year. By using a fiscal year payment, it does not require that a fiscal year trust return be filed for the GRAT.

c. The trust must require proration of the annuity payment in taxable years of less than 12 months.

d. The annuity must be actually paid to the annuitant whether or not the trust has produced income equal to the annuity. (If the income is insufficient, the trustee must be required to invade principal to pay the annuity.) The annuity may be paid in the subsequent year so long as it is paid by the date on which the trustee must file the trust's income tax return.

e. The annuity may be paid in kind.

f. The annuity must be fixed in the trust instrument either in terms of a fixed dollar amount or in terms of a fixed percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes. Treas. Reg. Sec. 25.2702-3(b)(1)(ii).

g. The regulations do not require that the fixed amount be the same for each year; but the amount payable in one year cannot exceed 120% of the amount payable in the prior year.

h. The regulations permit the trustee to distribute amounts in excess of the annuity amount; but the value of any rights to receive payments in addition to the annuity interest has a zero value for gift tax purposes.

i. The trust instrument must contain an adjustment clause. If the annuity has been defined as a percentage of or as a fraction of the value of the trust's assets, the trust instrument must contain a provision requiring adjustment of annuity amounts previously paid if an error was made by the trustee in determining the value in accordance with the requirements of Treas. Reg. Sec. 1.664-2(a)(1)(iii). This aspect of the GRAT is an advantage over other gifting techniques because it provides a mechanism for self correction for valuation adjustments on audit of the gift tax return. For planning purposes, a GRAT is a strong candidate for a client who is considering an initial private offering or is contemplating a sale of stock.

2. Additional Contributions to GRAT. The trust must prohibit additional contributions to the trust.

3. Commutation. The trust must prohibit commutation. This means that the trustee cannot pre-pay the annuitant's annuity interest.

4. No Amounts to Other Persons. The trust must prohibit payments from the trust before the expiration of the qualified interest to or for the benefit of any person other than the annuitant.

5. Term. The term must be fixed and be for the life of the annuitant, a specified term of years, or the shorter of those two periods.

II. GIFT TAX CONSEQUENCES

A. How to Value a Qualified Annuity Interest. Pursuant to I.R.C. Sec. 2701(a)(2)(B), the value of a qualified annuity interest will be determined under Sec. 7520. The value of the gift to the trust will be determined by the subtraction method. Pursuant to the subtraction method, the value of the gift will be determined by subtracting from the value of the property transferred an amount equal to the actuarial value of the retained annuity. The relationship between the value of the property transferred to a GRAT and the taxable gift resulting from the transfer depends upon the Sec. 7520 rate, the length of the annuity term and the size of the annuity in relation to the value of the property transferred. The Sec. 7520 rate is published on approximately the twentieth day of the preceding month. Generally, assuming that the other factors remain constant, a decline in the Sec. 7520 rate produces a smaller taxable gift. It is generally advantageous to minimize the value of the remainder so that there is only a nominal taxable gift. The effectiveness of the GRAT is enhanced when the small amount of gift tax is compared to the relative value of the ability to shift future appreciation to the grantor's heirs. Moreover, a low taxable gift GRAT avoids the risk that gifted property could decline in value but continue to be reflected in the grantor's adjusted taxable gifts at the original value.

Example 2: To illustrate that a decline in the Sec. 7520 rate produces a smaller taxable gift, consider D from Example 1. If we use the same assumptions, that is, that D is age 50 and that D transfers $1,000,000, assuming a 7520 rate of 5.4%, the taxable gift based on a straight term basis is only 56 cents as compared to 70 cents in Example 1 assuming a 6.2% Sec. 7520 rate.

B. On April 29, 1999, the IRS issued proposed, final and temporary regulations (REG-103851-99, T.D. 8819) updating the actuarial tables used in valuing annuities, interests for life or terms of years, and remainder or reversionary interests. The final and temporary regulations revise tables used for the valuation of partial interests in property under I.R.C. Sec. 7520 to reflect the most recent mortality experience. The regulations provide transitional rules: for gift tax purposes, if the valuation date of a transfer is after April 30, 1999, but before July 1, 1999, the donor may determine the value of the gift (and/or any applicable charitable deduction) based on the new table or the prior table.

C. Zeroing-Out the Gift. “Zeroing-Out” refers to the concept that GRATs can theoretically be structured so that there is a relatively small gift at the time of funding. The Treasury and the IRS, however, have made it difficult for planners to rely on that theory. The Regulations take the position that the value of the retained annuity interest is not the actuarial value of the right to receive an annuity for a term, but rather the right to receive income for a term or until the prior death of the grantor.

1. Example 5 of Treas. Reg. Sec. 25.2702-3(e) provides as follows:

> A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A’s estate for the balance of the term. A’s interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years or until A’s death.

2. The effect of Example 5 is to reduce the value of A’s 10-year annuity to the value of an annuity payable until the earlier to occur of A’s death or the expiration of the 10-year term. This seems to eliminate the option of having a term for a specified term of years as noted above. For this reason, many estate planners believe that Example 5 is wrong.

Example 3: Consider the same facts as in Example 1. If the annuity is valued for the shorter of the term or the life of D, the taxable gift increases to $15,444. Valued on a straight term basis, the gift is only 70 cents.

3. Because there is always a chance that the grantor will die during the term, the value of the retained interest will be reduced regardless of the grantor’s age. The impact is greater, however, with older grantors since it is more likely that an older grantor will die during the term.

Example 4: Let us assume that D in Example 1 is age 65 rather than age 50, assuming all other factors remain constant. On a straight term basis, as in Example 1, the taxable gift based on a straight 5 year term is 70 cents. Taking into consideration that the grantor may die during the term and following Example 5 of the Regulations, the taxable gift increases to $52,203. For a donor age 75, the gift pursuant to Example 5 of the Regulations jumps to $111,207.

D. Drafting in Light of Example 5. It is advisable to draft the GRAT to take advantage of the possibility that Example 5 will be withdrawn or invalidated by the courts.

1. The trust generally should not provide for a reversion if the transferor dies within the specified term. If the trust provides for a reversion rather than a continuing annuity, the transferor will have lost the opportunity to treat any part of the post-death value as part of the transferor's retained value for purposes of measuring the amount of the gift. Consider giving the transferor a limited or general power of appointment that can be exercised to control how the trust will be distributed after the annuity term if the transferor desires to control the disposition of the trust remainder if he or she dies before the expiration of the term.

2. The trust could direct that the annuity payments be made to the grantor's spouse commencing on the grantor's death if the grantor dies before the end of the term. Pursuant to Treas. Reg. Sec. 25.2702-2(a)(5), an annuity payable to the spouse of the grantor will be treated as an annuity retained by the grantor if the grantor has retained the power to revoke it. However, the IRS is currently taking the position that a spouse's revocable interest in a GRAT following a grantor's initial interest does not reduce the value of the gift upon the creation of the GRAT. Recently, in TAM 9848004 (November 27, 1998), husband (age 71) and wife (age 65) each transferred property to separate GRATs. Under each GRAT, an annuity was payable to the grantor for seven years. If the grantor dies during the term, the payments are to be paid to the grantor's spouse for the balance of the term or prior death of the spouse. The grantor retained the right to revoke the spousal interest. In determining the amount transferred to each GRAT for gift tax purposes, each grantor deducted from the amount transferred the present value of the grantor's retained interest, plus the present value of the spouse's revocable annuity interest. The IRS rejected the position that the spouse's revocable annuity interest in the trust is a qualified interest on the basis that the spouse's interest is contingent on the grantor's death prior to the termination of the annuity period and because the commencement date for the spousal interest is uncertain.

COMMENT: Notwithstanding the IRS' current position expressed in TAM 9848004, including a spousal survivor annuity in the trust instrument maintains flexibility in the event the IRS alters its position. In addition, if it is intended that the GRAT qualify for the marital deduction if the assets are includable in the estate of the grantor who dies during the term, there is no downside to including the contingent survivor annuity. To qualify for the marital deduction, consider a QTIP trust for the spousal interest. A survivor annuity qualifies for the marital deduction under I.R.C. Sec. 2056(b)(7)(C) if the GRAT is includable in the grantor's estate under I.R.C. Sec. 2039.

3. If the annuity amount is increased so that its actuarial value is equal to the amount the grantor wishes to retain (which will have the effect of decreasing the amount of the gift to the remainder beneficiary), because the annuity amount may exceed the predictable

ability of the trust fund to produce the annuity, the IRS could take the position that the gift tax value of the annuity is reduced to the actuarial value of the right to receive the annuity amount until the fund is exhausted. In Rev. Rul. 77-454, 1977-2 C.B. 351, the Internal Revenue Service determined the value of an annuity interest in a trust for a grantor's lifetime. Because the annuity would have exhausted the trust prior to the grantor's death, however, the IRS determined that in valuing the trust, the possibility that the trust would be exhausted would have to be taken into account. This had the effect of reducing the value of the retained interest and increasing the gift.

COMMENT: The exhaustion argument does not seem tenable. The argument is that because the annuity is large enough that the trust assets will be exhausted before the expiration of the term (e.g. with respect to a 6-year GRAT, in year 4), a higher gift results than if the possibility of exhaustion was not taken into account. In the case of a GRAT that exhausts prior to the term, the beneficiaries would receive nothing. Why should the gift be increased if it is more likely that the remainder beneficiaries receive nothing?

4. Where should the annuity be set in light of the uncertainty? The answer depends, in part, on whether the client has more or less tolerance for risk and the size of the gift. If the annuity is set at a straight term rate, the annuity payment will be lower. By setting the annuity at a straight term rate, it is more likely that there will be assets left to pass to the remainder beneficiaries. Alternatively, the annuity can be increased to decrease the gift to the remainder beneficiary. The GRAT will have to out perform the 7520 rate more to have assets left at the end of the term.

Example 5: D, age 50, transfers $20,000,000 to a GRAT assuming a 6.2% Sec. 7520 rate. Assume the principal grows at an annual rate of 7%. On a straight term basis, the annual percentage payout is 23.86919% ($4,773,838). On a shorter of term or life basis, the annual percentage payout is 24.24359% ($4,848,718). At the end of the five-year term, with respect to the smaller annuity payout, there is $597,938 remaining to pass to the beneficiaries. With respect to the larger annuity payout, only $167,323 remains to pass to the beneficiaries.

E. Reporting the Gift on the Gift Tax Return (Form 709). Once the advisor and client determine whether and how much to pay for gift tax purposes, the transaction must be reported on Form 709.

1. Adequate disclosure rules. The IRS issued Proposed Regulations, NPRM REG-106177-98 proposing amendments to Treas. Reg. Sec. 20.2001-1, 25.2504-2 and 301.6501 regarding the valuation of prior gifts in determining estate and gift tax liability and the period of limitations for assessing and collecting the gift tax. With respect to gifts made after August 5, 1997, the proposed regulations provide that the value of prior gifts that were

adequately disclosed on a gift tax return can not be adjusted for purposes of calculating either estate or gift taxes if the gift tax assessment period has expired. The statute of limitations for purposes of adjusting the gift runs from the date the trust is funded rather than from the end of the annuity period. The proposed regulations include specific requirements for the satisfaction of the adequate disclosure standard. Essentially, the gift tax return must completely describe the transaction and disclose any facts that would apprise the IRS of any potential controversy regarding the gift tax treatment of the transfer.

2. If the donor does not satisfy the adequate disclosure requirement, the statute of limitations does not run, leaving the transferor exposed to possible revaluation of the gift.

COMMENT: If the gift consists of assets that are not publicly traded, it is advisable to obtain and attach a complete appraisal and a copy of the computation of the remainder factor.

3. Because the gift made on the creation of a GRAT is a gift of a future interest, it cannot be protected from gift tax by the gift tax annual exclusion. Consider a cushion, depending on the grantor's available applicable exclusion amount.

F. At the End of the Term.

1. At the end of the annuity term, no additional gift tax is imposed on the transferor. The IRS cannot assess an additional tax in the event the assumptions were inaccurate.

2. This is the key to the tremendous opportunities of a GRAT: If the trust property outperforms the 7520 rate at the time of the gift, any excess value passes to the remainder beneficiaries free of gift tax. In addition, GRATs are generally risk-free. If the value of the gifted asset decreases, the GRAT may be exhausted but the grantor is no worse off. When funding a GRAT, consider funding with a single asset. This approach protects against underperformers.

III. ESTATE TAX CONSEQUENCES

A. What if the Grantor Dies During the Term?

1. The IRS takes the position that if the grantor dies during the term, the value of the <u>entire</u> trust is includible in the grantor's gross estate under I.R.C. Sec. 2039. See PLRs 9451056 (December 23, 1994) and 9345035 (November 12, 1993). Section 2039(a)

provides that a decedent's gross estate includes the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement if, under the contract or agreement, an annuity or other payment was payable to the decedent.

2. The better view is that Section 2039 does not apply and that if the grantor dies during the term of the annuity, Section 2036 will apply to cause a portion of the trust in the grantor's estate to be included for federal estate tax purposes. Section 2036 requires that a transferor include in the transferor's gross estate the value of property transferred during the grantor's life if he or she has retained for life or for a period that did not end before his or her death, the right to the income from the transferred property. The included portion is equal to that fraction of the principal which would be required to be invested at the Code Sec. 7520 rate in effect on the date of the grantor's death to produce annual income equal to the required annuity payment. Rev. Rul. 82-105, 1982-1 C.B. 133.

3. If the terms of the GRAT provide that the grantor's estate is entitled to the balance of the annuity payments, the actuarial value of the payments will be includible in the grantor's gross estate under I.R.C. Sec. 2033. Section 2033 includes in the value of a decedent's gross estate all property to the extent of the decedent's interest therein at the time of the decedent's death. To the extent trust assets revert to the grantor's estate, they are includible in the grantor's estate under Sec. 2033.

B. Credit for Gift Tax Paid. To the extent that all or any portion of the GRAT is includible in the grantor's estate if the grantor dies during the term, the grantor should be entitled to an adjustment in the estate tax determination under Sec. 2001(b)(2) for the gift tax payable on the transfer to the trust. The adjusted taxable gifts under Sec. 2001(b) do not include any portion of the GRAT that is includible in the grantor's gross estate. Thus, if only a portion of the GRAT is included in the grantor's gross estate, presumably only the portion that is not included in the grantor's gross estate is added as an adjusted taxable gift for purposes of determining the decedent's estate tax. There is no similar adjustment for the nondonor spouse if the grantor and the grantor's spouse elect to split gifts for gift tax purposes. For that reason, it is not recommended that the spouses split gifts in the year of funding.

C. For planning purposes, a short-term GRAT has advantages. A short-term GRAT minimizes the chances that a period of poor performance will impact the general effectiveness of the GRAT. In addition, a short-term GRAT reduces the likelihood that the grantor may die during the term.

IV. INCOME TAX CONSEQUENCES

A. Grantor Trust Rules. I.R.C. Secs. 671-679 generally apply to trusts that are required to or are permitted to pay trust income and principal to the trust's grantor. If a trust is deemed to be a wholly grantor trust for income tax purposes, all of the trust's items of income, deduction, and credit are taken into account by the grantor in calculating the grantor's taxable income and credits. Thus, a grantor who receives a distribution from a grantor trust will not be taxed on the distribution and the grantor will be taxed on the trust income, whether or not it is actually distributed to him or her.

B. A GRAT as a Grantor Trust.

1. Because payments from the GRAT may be made from income or principal during the annuity term, the GRAT should be a grantor trust for income tax purposes under I.R.C. Sec. 677(a)(1). It is possible that the IRS could treat the grantor as the owner of the income portion of the trust, but not necessarily the corpus portion unless another provision of the trust causes the grantor to be treated as the owner of trust corpus. For this reason, it is advisable to include another provision to make the trust a grantor trust as to the entire trust, especially if the GRAT will hold Subchapter S stock.

2. Following the term, it is usually desirable for the trust to be treated as a grantor trust for income tax purposes. One way to achieve grantor trust status is to grant a nonadverse party the power to add to the class of possible beneficiaries. I.R.C. Sec. 674(a), 674(b), 674(c) and 674(d). Under Sec. 674(a), the grantor is considered the owner of a trust in respect of which the beneficial enjoyment of the income or principal is subject to a power of disposition exercisable by a nonadverse party (e.g. a disinterested trustee). There is an exception under Sec. 674(c). Under Sec. 674(c), 674(a) does not apply to a power exercisable solely by the trustee (none of whom is the grantor or the grantor's spouse) and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor or the grantor's spouse to distribute or accumulate income or pay principal to or for a class of beneficiaries. The exception under 674(c), however, does not apply if any person has a power to add to the class of beneficiaries (other than after-born children).

COMMENT: Consider the inclusion of a power in the trust instrument appointing a "Selector" to exercise the power to add charitable organizations as additional beneficiaries. Neither the grantor nor any trust beneficiary should serve as the Selector. The Selector should act in a non-fiduciary capacity so as to distinguish the Selector's power from a trustee's power to sprinkle assets among beneficiaries, thereby treating the class of persons the Selector can add as if such persons were already beneficiaries. In addition, it is important to grant the Selector the power to irrevocably release the power to add beneficiaries so that the grantor trust status can be "turned off" in the event the income tax consequences become onerous to the grantor.

C. Benefits to Grantor Trust Status.

1. The grantor's transfer of assets to the trust will not cause the recognition of gain or loss for income tax purposes. No gain or loss is recognized when a grantor trust sells an asset to or buys an asset from the grantor. Thus, a GRAT can use appreciated trust assets to satisfy the annuity obligation without recognizing gain.

2. Because grantor trust status causes the grantor to pay all taxes on trust income and gain, the trust assets can grow on an after-tax basis. The IRS has taken the position that it will not issue a favorable ruling regarding a contemplated GRAT unless the trust agreement includes a provision requiring the trust to reimburse the grantor for the excess of the grantor's personal income tax liability over his or her income tax liability computed as if the trust were not a grantor trust. See, e.g. PLRs 9416009 (April 22, 1994) and 9352007 (December 30, 1993).

3. In Private Letter Ruling 9444033, the IRS suggested that the payment of income tax by the Grantor on income of a grantor trust may result in an additional gift to the trust. In Private Letter Ruling 9543049 (October 27, 1995), however, the IRS deleted the discussion of that issue in the prior ruling.

4. The grantor may make an interest-bearing loan to the GRAT without being required to include the interest in his or her gross income.

5. The trust is a permitted shareholder of an S corporation. Dividends paid by an S corporation to the GRAT as the shareholder can be accumulated to the extent the dividends exceed the annual annuity.

V. GENERATION-SKIPPING TRANSFER TAX CONSEQUENCES

A. The Estate Tax Inclusion Period ("ETIP") rule. Code Sec. 2642(f) prohibits the allocation of generation skipping transfer tax ("GST") exemption to an inter vivos transfer if the transferred property would be included in the gross estate of the transferor if the transferor died immediately after the transfer. With respect to a GRAT, if the grantor died after establishing a GRAT, some portion of the trust property would be included in the transferor's gross estate. The ETIP rule prevents allocation of GST exemption to a GRAT until the termination of the grantor's retained interest.

B. Allocation of GST to a GRAT is not an efficient use of the GST exemption because the exemption will be allocated at the time of the termination of the annuity term. This is not a recommended use of the exemption because it would not leverage the exemption.

C. Consider providing that the remainder interest in a GRAT be divided among the transferor's living children and make compensating gifts under the client's Wills for grandchildren or more remote descendants of a deceased child.

D. A technique to consider in connection with GST planning is the creation of a trust in which the remainder beneficiaries (the children of the grantor) have a vested remainder interest and which includes provisions authorizing the remainder beneficiaries to assign their vested remainders. (The spendthrift clause should be drafted to permit assignment of beneficial interests to descendants.) To achieve maximum benefit from this technique, the child's vested interest could be assigned to a dynasty trust for the child's descendants. Although there is no direct case law or IRS rulings clearly addressing the tax consequences, the technique should work. The theory behind the technique is that because the remainder interests are vested in the child's estate, the child becomes the transferor for GST purposes. Following this theory, the child will allocate his or her GST exemption to the gift to the child's dynasty trust. Because the theory behind the assignment of a vested interest is that the child becomes the transferor, the child should be able to allocate GST when the child's interest still has a low value. (As stated above, the portion of the annuity trust protected from GST is determined by applying the GST exemption to the value of the trust at the time of termination of the annuity interest rather than at the creation of the trust.)

The client should be aware of the uncertainty and the possible results if the technique is rejected by the IRS. There are two possible results. First, the termination of the annuity period of the GRAT and the distribution to the children might result in a 55% GST tax due at that time. Second, if no GST is due at that time, it is possible that GST might be due when a child dies and the property passes to the child's children.

VI. GRATS V. SALES TO GRANTOR TRUSTS

A. Sales to intentionally defective grantor trusts ("IDGTs") have become popular among estate planning commentators as an alternative to the GRAT. A thorough discussion of the income and transfer tax consequences of the use of sales to IDGTs is beyond the scope of this outline, but a comparison of the two techniques is warranted.

B. The sale to an IDGT technique is generally used to sell non-controlling interests in entities such as limited partnerships and S corporations to defective dynasty trusts, taking advantage of valuation discounts in exchange for an installment note. The value of the asset is frozen at the value of the note received in the sale so that future appreciation in the value of the asset sold to the IDGT will be transferred to the beneficiaries of the IDGT without gift or estate tax. Because the IDGT is a grantor trust for income tax purposes, the sale will not trigger an income taxable event.

C. Advantages of a sale to an IDGT over a GRAT. There are several advantages of a sale to an IDGT over a GRAT.

1. There is no gift tax on the sale transaction (unless the sale transaction is combined with a gift component), so long as the sales price is for full and adequate consideration.

2. The seller can allocate his or her generation skipping tax exemption to the trust at the outset because, unlike a GRAT, there is no ETIP problem.

3. The assumed rate of return that can be used for the sale transaction is often lower than the 7520 rate used for a GRAT. If the note has a term between three and nine years, the federal midterm rate will be used; the 7520 rate for a GRAT is 120 percent of the federal midterm rate. The lower rate reduces the amount paid back to the estate owner.

D. Advantage of a GRAT over a sale to an IDGT. A primary advantage to a GRAT over a sale to an IDGT is that there is a fairly clear roadmap outlined in I.R.C. Sec. 2702 and administrative guidance in the regulations and rulings regarding the requirements for a GRAT and the income and transfer tax consequences. The GRAT is thus appealing to a more conservative client.

The foregoing outline does not attempt to offer specific advice with respect to a particular individual's estate plan but rather to provide general information about the use of GRATs in estate planning. Editorial comments or inquiries can be directed to Christina Mesires Fournaris, Morgan, Lewis & Bockius LLP, 1701 Market Street, Philadelphia, PA 19103 (Tel.: 215-963-5649; E-mail: four5649@mlb.com). The author wishes to gratefully acknowledge the assistance of Ellen K. Harrison, a partner in the Tax Section of Morgan, Lewis & Bockius LLP in its Washington, D.C. office. Her comments and guidance have been invaluable.

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