The Wealth Counselor

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GRATs vs. Sales to Grantor Trusts

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Advisors frequently ask which is "better," a sale to a grantor trust or a GRAT (Grantor Retained Annuity Trust). The answer (no surprise) is, "It depends." Both are excellent planning tools for the right client in the right circumstance. This issue of *The Wealth Counselor* explores the advantages and disadvantages of each in particular situations.

When Do These Strategies Apply?
GRATs and sales to grantor trusts are two techniques that accomplish the same planning objective - transfer of assets to beneficiaries, often children, in a way that affords asset protection to the beneficiaries. Both are also "freeze" transactions in which future growth in the value of the transferred assets inures to the beneficiaries' benefit without estate or gift tax on the increase in value. Finally, both can create a steady income stream to the client without forcing the family to sell assets that the client would prefer the family to hold on to.

What Is a Grantor Trust?
"Grantor trust" is a term defined in the Internal Revenue Code. Basically it means that, for tax purposes, a grantor trust is the "alter ego" of the taxpayer who created or has certain powers relative to it, and so it is disregarded for tax purposes. One common kind of grantor trust is the revocable living trust. A client with a revocable living trust reports all income tax events inside the trust on his or her own personal income tax return and typically does not file a tax return for the trust.

Interestingly, the Internal Revenue Code defines "grantor trust" one way for income taxes and a different way for gift and estate taxes. It is because of the differences in the sets of

rules that, with careful design, the use of a grantor trust can yield surprising and beneficial results for the client in the right circumstance. These two different sets of rules are not new; they have been in the Code and well known for decades.

NOTE: Whenever we use the term "grantor trust" in this issue of *The Wealth Counselor*, unless otherwise explained, it means a trust that is a grantor trust for income tax purposes but is not a grantor trust for gift and estate tax purposes.

Installment Sales to Grantor Trusts

By using this long-standing wrinkle in the Code, the transfer of assets in trust to beneficiaries can all be virtually "supercharged." Here's how. The client creates a trust that is a grantor trust for income taxes, but not for gift or estate taxes, and makes a gift to the trust. Later, the client sells assets to the trust in a commercially reasonable way, taking back an installment note (which can be a balloon note). To ensure that the sale is commercially reasonable, clients often secure the note by the assets sold plus the other assets previously donated to the trust.

Planning Tip: There is no "bright line" test for commercially reasonable security for an intra-family note, but many lawyers feel that assets valued at 110% of the amount of the note is commercially reasonable. Alternatively, a third party, such as a beneficiary, who has sufficient net worth can guarantee the note to provide commercial reasonableness.

Making the trust a grantor trust for income tax purposes but not for estate tax purposes fixes the value of the assets for gift and estate taxes at the moment of its transfer by sale or gift to the trust. The "supercharging" results because, when the grantor/trust maker pays the tax, the tax payment is not an additional gift to the trust. Said another way, inside the trust there is tax-free income and, outside the trust, paying the taxes on that income depletes the estate of the donor/seller.

Planning Tip: A client sometimes tires of paying taxes on income not received or the client's economic situations changes such that he or she is no longer able to pay the extra taxes. To address such contingencies, good planning includes having a "spigot" provision in the trust to allow turning off grantor trust status.

When Is a Sale Not a Sale?

Generally, when someone sells an asset, he must recognize income to the extent the net sale price exceeds his "basis" in the property. In its most simplified sense, basis is the amount the client paid for an asset when he purchased it or its value when he inherited it. If he received it by gift, his basis is carried over from his donor's basis in the property. However, you can't sell property to yourself or buy property from yourself.

Therefore, if a trust is a grantor trust for income tax purposes, the IRS ignores any sale by the grantor to or purchase by the grantor from the trust. For gift and estate tax purposes, however, the asset is no longer the taxpayer's once transferred to the trust (by gift or sale).

The Installment Sale
With an installment sale, the client transfers assets to the trust in exchange for a promissory note. Promissory notes are short-term (not over 3 years), mid-term (over 3 but not over 9 years) or long-term (over 9 years). To avoid the attribution of a phantom gift, the note must bear at least the Applicable Federal Rate (AFR) for that term of note in effect for the month in which the note is given. Oftentimes the note is a balloon note; i.e., the trust pays only interest for a fixed number of years and the principal is due only at maturity.

Planning Tip: Sales to grantor trusts are particularly useful where the client desires to sell appreciated assets without immediately incurring income tax.

Current near historically low interest rates make the sale-to-grantor-trust strategy even more attractive. A sale to a grantor trust for up to a 9-year promissory note requires interest payments at not less than the mid-term AFR. In September 2009, the mid-term AFR is only 2.83% per year.

GRATs Generally
A GRAT is a type of trust specifically authorized by the IRS regulations interpreting the Internal Revenue Code. With a GRAT, the donor makes a lifetime gift of assets to an irrevocable trust in exchange for a fixed payment stream for a specified term of years.

At the end of the term of years, after making the final payment to the donor, all of the trust property that is left, if any, goes to the remainder beneficiaries - typically one or more trusts for the benefit of the donor's children or grandchildren.

The value of the remainder interest is determined for federal gift tax purposes at the inception of the GRAT by discounting future payments to present value using the "Section 7520 rate," which is 120% of the mid-term AFR. The presumption is that the combined income plus appreciation of the GRAT assets during each period in the term of the GRAT will be equal to the 7520 rate in effect at its inception. The trust maker can reduce the value of the remainder to zero by making the presumed present value of the income stream equal to the value of the gift to the GRAT. Such a GRAT is called a "Walton" GRAT after the case in which the court upheld its use by one of the Wal-Mart heirs.

The term of years, the frequency of payments (not less frequently than annually), and the amount of the payments are all fixed at the time of establishment of the GRAT. Under the GRAT regulations, each of the periodic payments cannot exceed 120% of the prior payment.

Planning Tip: By "back-end loading" the GRAT payments, the donor can typically transfer more wealth to the remainder beneficiaries.

The donor can be the GRAT's sole trustee or a co-trustee with complete control over all decisions of the GRAT and the assets in the GRAT. Alternatively, the donor can appoint a financial advisor to manage GRAT assets.

A way to explain how a GRAT works to your clients is "heads you win, tails you tie." If the performance of the assets in the GRAT *exceeds* the applicable 7520 rate, the excess value is transferred without estate or gift tax. If the performance of the assets in the GRAT equals or falls below the 7520 rate, the donor gets all the GRAT assets back.

A similar result is obtained with the installment sale. If the investment growth doesn't pan out, the Trustee, who is not personally liable, defaults on the note and the seller forecloses on the security. If the seller's "seeding" the trust with assets has used up some of the seller's gift tax exemption, foreclosure does not reverse that use.

Planning Tip: GRATs are particularly suited for transfers of assets that are expected to grow in value at a rate in excess of the 7520 rate, like many clients' current portfolio assets.

Planning Tip: Both GRATs and installment sales to grantor trusts are particularly well suited to use for the transfer of assets that have been the subject of downward value adjustments, such as those represented by minority interests in FLPs and FLLCs.

Since GRATs are grantor trusts, during the GRAT term all of the GRAT's income, losses, etc., appear on the donor's personal income tax return. However, and this is a difference from installment sales to grantor trusts, GRATs are also grantor trusts under the gift and estate tax laws. Therefore, if the donor dies during the GRAT's term, the IRS will include the GRAT property in the donor's estate for tax purposes. Note that if that happens, the donor will be no worse off than had he not created the GRAT at all.

Interest Rates

With the exception of long-term GRATs, the minimum interest rate for a GRAT is higher than the minimum interest rate for an installment sale of the same assets to a grantor trust. This is important because this is the rate at which trust assets must grow if the planning tool is to "succeed" by passing additional assets to the beneficiaries. (This success is aided by valuation discounts as well as the grantor paying the income tax on trust income.)

Planning Tip: An installment sale to a grantor trust over a period of less than 9 years generally can have a lower interest rate component than an equivalent GRAT. Therefore, mid- and short-term sales to grantor trusts typically require lower growth of the assets transferred, thereby increasing their likelihood of success. This advantage can reverse for long-term sales. In September 2009, the 7520 rate is 3.4% versus the long-term AFR of 4.29%.

IRS Guidance

Some advisors prefer GRATs because of the relative certainty provided by guidance promulgated in the form of Treasury Regulations. Alternatively, while there are no regulations interpreting sales to grantor trusts, there are several cases and IRS pronouncements that give us significant guidance as to these transactions.

Planning Tip: There is arguably more certainty with GRATs because guidance comes in the form of Treasury Regulations. Thus, more conservative clients may prefer GRATs to installment sales to grantor trusts.

GSTT Planning
A disadvantage of GRATs is that the donor cannot do generation-skipping transfer tax (GSTT) planning at inception. Because the GRAT assets will be pulled back into the donor's estate if the donor dies during the GRAT term, the donor cannot allocate GSTT exemption until the end of the GRAT term, at which point the exemption required will be based on the fair market value of the remaining GRAT assets. Thus, for example, with a 10-year GRAT, the donor must wait 10 years before he or she can allocation GSTT exemption - during which time the GRAT assets likely will have appreciated, requiring the use of more GSTT exemption. There is no GSTT associated with a sale of assets to a grantor trust.

Planning Tip: If the beneficiaries are grandchildren or of similar age, the installment sale to a grantor trust is advantageous because the trust maker can allocate GSTT exemption to the "seed" gift to the trust at inception and there is no GSTT on any sale on which the IRS does not impute a gift (e.g., for using too low an interest rate).

Complexity
Both GRATs and installment sales to grantor trusts are complex transactions, particularly if the transaction includes transfers of assets to an LLC, FLP, or closely held business. Some clients perceive GRATs to be less complicated given there is one fewer step to complete during the planning process (gift alone versus gift then sale).

Example
Suppose Mr. Client is contemplating a transfer of stock in a closely held business received in exchange for $10,000,000 of assets. Suppose, too, that between appreciation and dividends, the assets' value is growing at 10% per year. With a 30% discount on internal asset value, the gift to the GRAT or the stock sold has a fair market value of $7,000,000. Assume the required interest rates are the September 2009 rates:

Sec. 7520 Rate: 3.40%
Mid-term AFR: 2.83%
Long-term AFR: 4.29%

If Mr. Client enters into a 9-year transaction, the total wealth transferred would be:

- Installment sale to grantor trust = $13,889,383 transferred using $0 gift tax exemption and $0 GSTT exemption.
- GRAT (with payments increasing by 20% annually) = $12,030,168 transferred using $9 of gift tax exemption.

If Mr. Client enters into a 10-year transaction, the total wealth transferred would be:

- Installment sale to grantor trust = $14,151,416 transferred using $0 gift tax exemption and $0 GSTT exemption.
- GRAT (with payments increasing by 20% annually) = $13,941,579 transferred using $9 of gift tax exemption.

These differences are simply a function of the interest rate differential between the two strategies at the given time horizon and the fact that the GSTT window remains open for the term of the GRAT whereas it is never open for the installment sale.

Conclusion

Installment sales to grantor trusts appear to be advantageous for the reasons set forth above, but GRATs continue to offer viability, particularly for those more conservative clients who seek the assurance of the "safe harbor" provided by the regulations and, for younger clients, where longer time horizons are reasonable.

Thus, it is important that the planning team works together closely to ensure that it selects the strategy that best meets the particular client's needs and circumstances.

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