Morgan Stanley

WEALTH MANAGEMENT

GRATs versus Sales to Grantor Trusts

Estate Planning Strategies

General

An outright gift removes the gifted property and all future income and appreciation on that property from the donor's gross estate for federal estate tax purposes. If, rather than making an outright gift of property, assets are transferred to an intentionally defective grantor trust, the trust assets will not be included in the donor's estate but the donor (the "grantor") will continue to be taxed on trust income.

By paying taxes on trust income, the donor, in effect, can transfer additional wealth to the beneficiaries of the intentionally defective grantor trust without federal gift tax consequences.

Grantor Trust Status

A grantor trust is a trust that is not a separate taxpayer for income tax purposes. Instead, the grantor of the trust is deemed for federal income tax purposes to own the trust assets and therefore, all income, deductions and credits attributable to the trust property will be reported by the grantor on the grantor's personal federal income tax return. Non-grantor trusts are separate taxpayers. In the case of an intentionally defective grantor trust, the transfer of assets to the trust is a completed gift for federal gift and estate tax purposes. The assets held in the intentionally defective grantor trust are not included in the estate of the grantor.

Grantor trust status can be established in many ways. For example, if the grantor, the grantor's spouse or other persons have certain interests or powers with respect to the trust, such as: (i) naming the grantor's spouse as a beneficiary eligible to receive distributions; (ii) naming the

Wealth and Estate Planning Strategies

Family Office Resources

grantor's spouse as trustee with the power to "sprinkle" income and principal among trust beneficiaries; (iii) authorizing the trustee to lend to the grantor or grantor's spouse for less than adequate security or interest; and (iv) giving the grantor or another person the power to reacquire trust property by substituting other property of equivalent value.

Sale to an Intentionally Defective Grantor Trust

Grantor trust status also allows the grantor to transact with the grantor trust without federal income tax consequences. The grantor can sell to or purchase assets from a grantor trust, but such transaction is not a taxable event: In other words, there is no gain or loss recognition because from a federal income tax perspective, there is only one taxpayer.

A common planning technique is for a grantor to sell assets to a grantor trust in exchange for the trust's interest-bearing promissory note of equal value so that there is no gift element. The note must bear interest, at a minimum, equal to the applicable federal rate published monthly by the IRS to avoid a taxable gift.

The note may be structured as interest only with a balloon payment at maturity so that assets remain "at work" in the trust. Interest paid to the grantor on the note is not subject to federal income tax because of the grantor trust's federal income tax status.

The grantor trust promissory note sale produces federal estate and gift tax savings if the grantor trust has a total return on the purchased assets in excess of the interest rate on the note. Such savings can be enhanced by the sale of highly appreciating assets to the grantor trust, as the value of the assets sold or transferred is "frozen" in the grantor's estate as of the date of the sale or transfer.

GRAT

A sale to an intentionally defective grantor trust is often compared to a Grantor Retained Annuity Trust (GRAT), another type of estate freeze transaction. With a GRAT, a donor transfers property to an irrevocable trust for a term of years. The GRAT is required to pay the grantor an annual annuity during the term. Any value remaining in the trust after the annuity is paid may pass to children (or other beneficiaries) without incurring federal gift tax. GRATs generally are structured so that the present value of the annuity payments (valued using an IRS prescribed discount rate) is equal in value to the assets transferred to the trust so that there is no gift to the remainder beneficiary at inception.

The GRAT produces federal estate and gift tax savings if trust property's income and appreciation exceed the total annuity payments, since the excess value will go outright to or remain in trust for the remainder beneficiaries after the expiration of the GRAT term.

Comparison of Grantor Trust Sale to a GRAT

- Each technique allows for a federal gift tax-free transfer of appreciation and a freeze of the estate tax value of the transferred assets in the grantor's estate.
- The discount rate for determining the value of the donor's retained interest in the GRAT usually is higher than the interest rate, which must be charged on the promissory note in the sale to the intentionally defective grantor trust. The lower the rate, the less that must be paid to the grantor and, therefore, the lower the hurdle for transfer tax savings.
- If the grantor of a GRAT dies during the term of the annuity, most or all of the trust property - including post-transfer growth in value - generally will be included in the grantor's gross estate for estate tax purposes. With a sale to a grantor trust, whenever death occurs, only the promissory note, at the original asset value, is included in the grantor's estate so that post transfer growth of the trust property is removed from the grantor's gross estate for federal estate tax purposes.

- GRATs generally do not provide an efficient manner of making gifts to grandchildren because the exemption from the generation-skipping transfer (GST) tax (a tax imposed on property passing to a beneficiary who is at least two generations younger than the transferor) cannot be allocated to the trust until the expiration of the grantor's annuity. With a transfer to an intentionally defective grantor trust, GST exemption can be allocated at inception before any growth of the trust property. Further, the GST exemption only has to be allocated if there is a gift portion of transaction, but not to the sale portion.
- In general, the longer that property can be retained in a GRAT or an intentionally defective grantor trust before paying the required amounts to the grantor, the more that ultimately will pass to the remainder beneficiaries because of compounding of returns. In the GRAT, annuity payments in any year may not exceed 120% of the payment made in the preceding year. There is no such limitation on payments by the grantor trust. The promissory note can be repaid with a balloon payment at the end of a term allowing more property to be retained in the trust (compounding the leverage).

Risks

- Some commentators argue that employing a high ratio of debt to equity with the sale to an intentionally defective grantor trust may support an IRS argument that the debt is in fact an equity interest in the trust. If the grantor is deemed to have retained an interest in the trust, the trust will be included in the grantor's estate for federal estate tax purposes, which would defeat the purpose of the transaction. Commentators suggest that making a gift to the grantor trust prior to the sale of assets equal to at least 10% of the amount of the installment note may help to avoid this result. Alternatively, some argue that a guarantee of the note by the trusts beneficiaries obviates the need for a 10% seed gift.
- If the transferred property declines in value, other trust assets if any (i.e., those already out of the grantor's estate) may be returned to the grantor in satisfaction of the note and, thus, be brought back into the grantor's estate.
- If the grantor dies while the trust exists and the note is outstanding, the grantor trust becomes an irrevocable trust, which is a separate legal entity for income tax purposes. Some commentators argue that the change in federal income tax status triggers a sale of that part of the property with a value equal to the outstanding amount on the note possibly resulting in a taxable gain on the appreciation.

	SALE TO INTENTIONALLY DEFECTIVE GRANTOR TRUST	GRAT
Advantages	• Can be generation-skipping • Can have a lower interest rate (growth hurdle) than GRAT • Lower annual payments (interest only) • No mortality risk for federal estate tax benefits	• Statutory guidance for technique • No downside if assets underperform beyond initial administrative and legal costs • Potential to not use federal gift tax exemption
Disadvantages	• Valuation risk • Can put assets back into grantor's estate if transferred assets underperform • Often requires "seed gift" • Federal income tax risk if death occurs while note is outstanding • Must comply with strict terms of the note regarding payment of interest and principal	• Higher growth (hurdle rate) compared to short term and mid-term notes • Mortality risk: death within the annuity term generally results in federal estate tax inclusion of transferred assets and all appreciation • Not effective for generation-skipping transfers • Requires annual annuity payments equal to a percentage of trust assets (rather than an interest only approach)

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