Report #11

A complete listing of the proceedings and speakers is available on **the Institute's Web site**

As we have done in January for the last ten years, and again with the permission of the University of Miami School of Law Center for Continuing Legal Education, we will be posting daily Reports to this list containing highlights of the proceedings of the 41th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 8-12, 2007 at the Orlando World Center Marriott Resort and Convention Center in Orlando, Florida, a new venue for the Institute this year. A complete listing of the proceedings and speakers will be published here later and is also available on the Institute's Web site at http://www.law.miami.edu/heckerling.

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EDITOR'S COMMENT: This is a supplement to our final Report #12, as the Special Session Report that was missing then has finally arrived and is being published here. There also is a technical note from EstateWorks at the end.

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This Report contains coverage of Special Session 2-E on GRATs vs.

Installment Sales to Grantor Trusts vs. Direct Gifts and a note from EstateWorks

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Special Session 2-E GRATs vs. Installment Sales to Grantor Trusts vs.

Direct Gifts: What Do the Numbers and Theory Say?

Wednesday afternoon, January 10, 2007

Presenters: Jonathan Blattmachr, Robert Weiss and Diana Zeydel

Reporter: Jason Havens Esq. of Havens & Miller PLLC in Destin, Florida

Diane S.C. Zeydel discussed certain legal aspects of grantor-retained annuity trusts (GRATs) and installment sales. Robert then discussed the financial impact of doing a GRAT and an installment sale, using various modeling techniques. Jonathan stayed in the background and offered his insight as each person proceeded with their presentation.

There were no additional special session materials beyond those found in the general session materials prepared by Jonathan and Diana. However, mention was made in the special session that if anyone wanted the extensive slide show prepared by Robert, he could be contacted at robert.weiss@alliancebernstein.com. Some of these slides are very compelling in illustrating the benefits of these techniques to your clients.

Diana started the presentation by pointing out that although attorneys can identify the legal risks attendant to GRATS, she cannot identify the potential economic risks in a way that the financial world can. On the other hand, the financial world sometimes has difficulty understanding the strategies being proposed by attorneys. As a result, there is a disconnect between the legal and financial worlds. Her goal was to try to bring the two disciplines together and get them to start talking to each other.

They used as their model a nearly zeroed-out, two-year GRAT. They thought that you could zero out but maybe you had better not. Although they think that there is no minimal term, it is better not to do something out of the ordinary. Diana then proceeded to finesse the legal issues.

First issue: Qualifying for the marital deduction (pages 12-14 of main

materials): You do your GRAT, and grantor dies during term. The IRS thinks that the entire GRAT is includible in the estate. You want the GRAT to qualify for the marital deduction to delay the tax event. Query: How many interests do you have? The IRS might say that you have more than one interest and not just one GRAT. In other words, they might say you have an annuity interest and a remainder in a GRAT. If that is the case, then you cannot solve the marital deduction issue because you cannot get the remainder in the GRAT to become a QTIP because the remainder interest in the GRAT does not mature until the GRAT term ends. Thus, the remainder interest cannot be paid to the surviving spouse or the QTIP.

In a Walton GRAT, you have to have the annuity interest paid to the estate if the grantor dies prior to the term so that the GRAT does not collapse. To qualify the annuity payment for the marital deduction, all the income of the GRAT must be paid to the spouse. Therefore, to the extent the annuity payments consist of income, the income must be paid to the spouse. If the annuity payment falls short of the GRAT's income, the shortfall must be distributed to the surviving spouse from the GRAT -- but through the grantor's estate. Finally, the GRAT remainder must be paid to the surviving spouse.

Second issue: Zeroing out the remainder: TAM 200245053, issued after Walton but before the IRS announced its acquiescence, indicated that a zeroed-out formula for a gift could violate Proctor if you set the annuity payment so you always zero out the GRAT. To avoid this risk, always have a minimal gift of the remainder interest. In structuring a minimal remainder, the IRS will not rule unless you use a five-year term and a ten percent remainder interest, which comes from the charitable remainder trust area; however, the analogy does not fit in the GRAT area.

Diana stated her formula in the main materials, which provides a minimal remainder interest and avoids an unanticipated technical disqualification by providing formula language that would adjust the retained annuity to produce whatever remainder value may be legally required, and likewise to adjust the fixed term to whatever duration is necessary in order to have a tax-qualified GRAT. The following provision may accomplish those two goals:

(A) The "Annuity Amount" shall be determined as provided below, and shall be paid to the Grantor [specify payment terms, such as annually during the Fixed Term on the date immediately preceding the anniversary of the Funding

Date]:

(1) In the first year of the Trust, the Annuity Amount shall be a Fixed Percentage of the Gift Tax Value of the assets contributed to the Trust on the Funding Date; and

(2) In each subsequent year of the Trust during the Fixed Term, the Annuity Amount shall be one hundred twenty percent (120%) of the Annuity Amount payable in the preceding year.

(B) The "Fixed Percentage" shall be that percentage that will cause the Gift Tax Value of the taxable gift to the Trust (taking into account the determination of the Fixed Term as provided in Paragraph (D)) to equal the greater of:

(1) [specify the percentage of the fair market value of the assets contributed to the GRAT that the value of the remainder will represent, such as one one-hundredth of one percent (.01%)] of the Gift Tax Value of the assets contributed to the Trust on the Funding Date rounded up to the nearest whole dollar; and

(2) The smallest amount such that Annuity Amount will constitute a qualified annuity interest within the meaning of Internal Revenue Code

§2702(b)(1) and Treas. Reg. §25.2702-3(b)(1).

(C) The "Funding Date" shall be the date of the initial assignment, conveyance transfer or delivery of property to the Trustee.

(D) The "Fixed Term" shall commence on the Funding Date and end on:

(1) [specify the date upon which the annuity payments to the Grantor will end as an anniversary of the Funding Date, such as the second anniversary of the Funding Date]; or

(2) such later anniversary of the Funding Date as shall be necessary in order that the Annuity Amount shall constitute a qualified annuity interest within the meaning of Internal Revenue Code §2702(b)(1) and Treas. Reg.

§25.2702-3(b)(1).

(E) The "Gift Tax Value" of any property shall be the fair market value of such property as finally determined for Federal gift tax purposes.

She stated that there should not be a Proctor problem with this formula because an actuary can determine the value of the remainder on day one using the formula.

The Adkinson case was discussed in which a CRAT was not administered properly and determined to be void ab initio and the importance of making the annuity payments as required.

Third issue: The situation where the annuity payments have not been paid:

Jonathan resolves this problem by saying that payments vest in the grantor-beneficiary even if not paid and trustee acting as agent for grantor. This might not work, but at least you have something to say. In another case which Jonathan has where annuity payments were not made, he is arguing if the grantor is the trustee, then under Delaware law there might be constructive receipt of the payment even if not made. However, Jonathan mentioned there is a trend where the IRS is looking to see if the payments are made.

Fourth issue: How do you deal with GST exemption? As a general rule, if you have an ETIP (and that is the IRS position at least with a GRAT), you cannot allocate GST exemption until the ETIP expires. Remember if the possibility of the payments reverting to the grantor's estate is so remote to be negligible and that percentage is five percent, then you do not have an ETIP and in a two-year GRAT, this might be possible and you might have possible automatic allocation -- but then how much? Is it for the entire amount in the GRAT? This would be a disaster. Nevertheless, you have to elect out and then try allocating GST exemption. How? Use a formula with a ceiling: "so much as necessary but not more than the value of the remainder."

Jonathan mentioned the concept of "deference" in the Supreme Court case of Auer v. Robbins, which held that the federal courts must follow the proposed construction of the IRS as in the regulations unless the proposed construction is unreasonable. The chance of allocating GST exemption in light of the Auer doctrine is extremely remote.

Fifth issue: Funding of the GRAT: You cannot make additions to the GRAT. The presenters mentioned the idea of the revocable GRAT proposed by Manigault and Hatcher in a recent Probate & Property article. The idea is to make it revocable until all the funds are retitled in the name of the GRAT to avoid an argument that you made an addition. Once you have them all titled, at that point you revoke your revocation right.

Sixth issue: Do you have one asset for each GRAT? This could be administratively impossible because hedge fund managers might not want to do it. One solution is to use a single-member LLC for 50 different LLCs, which is disregarded for tax purposes. In the LLC, you specifically provide that the owner can assign interests in the LLC attributable to specific assets in the LLC. To GRAT one, you assign hedge fund A. To GRAT two, you assign hedge fund B. As far as hedge fund managers are concerned, there is only one LLC and no change of ownership.

Diana next discussed legal issues with installment sale to Grantor trusts. Jonathan said that there is no gain recognition at death. What about 2701, 2702, and 2703? The issue is whether you have equity or debt? If you have debt, you do not come under these sections. If payments are not tied to income in the assets, then you do not have a tie in and thus avoid 2036. You are looking for true debt and not something that looks like an income interest. The Dallas and Rosen cases, as mentioned in the general materials, were discussed as indicia of whether you have debt or a retained interest characterized as equity. Jonathan said practically speaking if you pay off the debt, you do not even have to face the IRS questioning whether you have equity and not debt.

The duration of the note should require payment within the grantor's life

expectancy. Use of discounting is easier with sale vs. the GRAT.

An informal survey was conducted in Florida on a marketable securities vs.

primarily marketable securities FLP, and the survey revealed 2/3 of cases indicated a discount of at least 30% on audit.

Diana said that Robert will say that discounting is not the most important factor in determining the success of GRAT and sale strategies. The most important component in the success of a strategy is grantor trust status, second most important is asset performance, and third is discounting.

Robert was next. He has slides which were inexplicably excluded from the materials, but see the e-mail address above (where they can be obtained). These slides are critically important in understanding his presentation.

He stated the legal and financial world should work together to "turbo-charge" the strategies.

Without discussing the means in which he came to the following conclusions, these were his conclusions.

GRAT conclusions: You should do a rolling GRAT with each annuity payment coming out creating a new GRAT, and you should do asset-splitting GRATs in which you put different stocks based upon asset allocation into separate GRATs. You do rolling asset-splitting GRATs by having the international GRAT annuity payments go back into the same instrument which created the original international GRAT, but have separate internal bookkeeping with each GRAT and thus in reality have any number of GRATs. In other words, if you start out with four GRATS, you only have four documents but are administering any number of rolling GRATs. The accountants are happy even if the legal draftsman is not. When looking at GRAT success, it is important to look at the estate taxes saved.

The beauty of the math of GRATs is that the children never get hurt -- only benefitted. The shorter the GRAT, the more you capture the dynamics of a volatile market.

Jonathan stated that when he does a GRAT or a sale, he will often have the spouse named as a beneficiary when the GRAT ends. The spouse can also make a guarantee if it is necessary. He will also define the spouse as the person “to whom you are married at any given time.”

The risk for short-term rolling GRATs is that you stop the strategy and do not fully account for the volatility of the market.

Installment sale conclusions: Discounting is important. If interest rates go down, you can reset the AFR and increase the chances of it being successful. Also, if you have a profit, you can capture the profit by prepaying the note and then start another installment sale. Mortality risk is better managed with GRATs. Long-term structure with sales will not

capture market volatility as well as GRATs. Also, the seed money is at

risk in sales when there is a falling market.

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Note From a Vendor - EstateWorks 1/17/07

Get 3 Months of Free Service - Extended by Popular Demand!

Thanks to the overwhelmingly positive response at the 41st Annual Heckerling Institute, EstateWorks is extending the offer for 3 months of free service. To take advantage of this offer, email sales@estateworks.com or call 978-461-1204 before the end of January.

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Our on-site local reporters who are present in Orlando this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Herb Braverman Esq.

of Walter & Haverfield, LLP in Cleveland, Ohio, Merry Balson Esq.of Wade, Ash, Woods, Hill & Farley in Denver, Colorado, Paul Hood Esq. of L. Paul Hood Jr. (APLC) in Mandeville, Louisiana, Joanne Hindel Esq. of Fifth Third Bank in Cleveland, Ohio. Jason Havens Esq. of Havens & Miller PLLC in Destin, Florida, Alan Rothschild Esq. of Hatcher, Stubbs, Land, Hollis and Rothschild, LLP in Columbus, Georgia, and Kimon Karas Esq. of McCarthy, Lebit, Crystal and Liffman Co., LPA in Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado, who also is the Chief Moderator of the ABA-PTL List.

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