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GRATS – UNRESOLVED ISSUES, POTENTIAL PITFALLS AND RANDOM OBSERVATIONS

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GRATS – UNRESOLVED ISSUES, POTENTIAL PITFALLS AND RANDOM OBSERVATIONS

I. It's just a GRAT!

True story. I received a phone call from an individual I had never met before. He was interested in some estate planning - for his father. The conversation went something like this:

> *My father wants to do some estate planning for my benefit. He wants to give me a portion of his closely held business. I therefore already know that I need a GRAT, and that doing a GRAT is pretty simple. Can you please tell me your flat rate cost to set up a GRAT? Also, do you charge for phone calls?*

Since the prospective client did not seem to believe me that a review of the nature of the company (including any restrictions on transfer) was relevant, and since he had already received an estimate from a competitor of $3,000, I was happy to decline the invitation to bid. When I told the gentleman that I would estimate a range higher than he suggested, he incredulously responded, "How can it cost that much? It's just a GRAT!"

II. What is a GRAT?

A "GRAT" is a "grantor retained annuity trust" created under Code § 2702 and the regulations thereunder. It is beyond the scope of this presentation to thoroughly discuss GRAT basics.[1] Simply put, a GRAT is a gifting strategy whereby taxpayers may shift wealth with little or no gift tax liability, regardless of the outcome of any IRS attempts to revalue assets contributed to the GRAT, and without risk of wasting lifetime gift tax applicable exclusion amounts when assets decline, rather than appreciate, in value.

> ***Example***. *Client in September 2006 contributes $10 million to a 2 year GRAT in exchange for two equal annuity payments of $5,454,369. If the $10,000,000 appreciates by a certain rate of return (generally thought to be the then-prevailing Code § 7520 rate of 6%),[2] then value will be shifted to the GRAT remainder beneficiaries without gift tax liability. For example, if the rate of*

[1] For excellent discussions of GRATs, *see* McCaffrey, *The Care and Feeding of GRATs -- Enhancing GRAT Performance Through Careful Structuring, Investing and Monitoring, in* 39TH ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (Portuondo ed., 2005) (hereinafter "McCaffrey, *2005 Miami Institute*") and Akers, *Update of Transfer Planning Issues*, 1 A.B.A. SEC. REAL PROP., PROB. & TRUST LAW PROB. & TR. LAW SYMP. 3 (2004) (hereinafter "Akers, *2004 RPPT Symposium*").

[2] Actually, and as discussed below, a return of only slightly higher than 5% can result in a shift of wealth for a GRAT created in September of 2006. *See* Exhibit H.

return is 10%, the GRAT remainder beneficiaries will share more than $645,000.[3]

For a checklist of GRAT requirements, *see* Exhibit A.

III. GST Planning

A. GRATs and GST planning – oil and water? It is often said that GRATs are poor choices for GST planning (because of the "ETIP" rules, described below). This is most likely an overstatement, at least given the current differences between the gift tax and GST tax exemptions.

1. Excellent technique for GST planning. Many clients may have exhausted their lifetime gift tax exclusions but may not want to wait until they die to use their GST tax exemption (or the remaining portion thereof). They may also not want to pay gift taxes now to allocate GST tax exemption. The use of a GRAT may be an optimum way to use a client's GST tax exemption, as the remainder can be transferred in a GST favored format, without gift taxes.[4]

> *Client has used all of her lifetime gift tax exclusion, but is projected to have $3,500,000 of GST tax exemption remaining in 2009. She contributes property to a GRAT, and following the expiration in 2009 of the annuity term, any remaining assets will be distributed to her grandchildren (or to a trust for their benefit). To the extent the GRAT remainder is equal to or less than $3,500,000, those assets will pass to (or for the benefit of) her grandchildren without GST tax.*

2. Hidden dangers? What if the GRAT instrument includes the following remainder provision?

> *Following the end of the annuity period, any assets which are exempt from the Federal GST tax shall be distributed to the then serving trustee of the Dynasty Trust, and the remaining assets shall be held in further trust for the benefit of my daughter, subject to her general power of appointment.*

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[3] $10,000,000 grows to $11,000,000, then the first annuity payment of $5,454,369 is distributed to the grantor, leaving $5,545,631. After another year, the assets appreciate again by 10%, to $6,100,194. After the second and final annuity amount of $5,454,369 is distributed, $645,825 remains to be distributed to the remainder beneficiaries.

[4] *See* Janes, *GRATs: Avoiding the Petards in an Otherwise Safe Harbor – Part 2,* 33 EST. PLAN. 3, 10 (June 2006) (hereinafter "Janes – *Part 2*").

a. Assets distributed from a GRAT following the expiration of the annuity period are not likely to be exempt from GST taxes absent the affirmative or automatic allocation of GST exemption to the GRAT/Dynasty Trust.

b. The allocation of the GST exemption may require the affirmative action of the grantor (depending upon the terms of the receptacle trust), or in any event could effectively be overridden by the grantor's exhaustion of her GST exemption by other allocations, or by "opting out" of the deemed allocations under Code § 2632(c).[5] Does the language therefore mean that the funding of the GRAT is an incomplete gift (because the grantor may be able to determine how the remainder is distributed)? Or could this language cause potential estate tax inclusion by reason of Code § 2036(a)(2) or 2038(a)?

c. Practitioners should carefully consider and draft for such GST-favored distributions. Consider the following alternative. The GRAT remainder could "pourover" to another trust without regard to the amount of the remainder or the grantor's remaining GST tax exemption. If the remainder exceeds the grantor's remaining GST exemption, the grantor could allocate GST exemption to the receiving trust and then divide the receiving trust into GST-exempt and non-exempt trusts by in a qualified severance under Code § 2642(a)(3)(B).

B. Do ETIPs apply only to old grantors? It is almost universally stated that a taxpayer cannot allocate GST exemption to a GRAT until the expiration of the annuity term because of the "estate tax inclusion period" or "ETIP" rules.[6] The ETIP is the time during which, should the grantor die, the assets in the trust would be includible in the estate of the grantor or her spouse, other than by reason of Code § 2035. A GRAT would normally be includible in the grantor's estate, under Code § 2036 and/or 2039, and would therefore be subject to the ETIP rules, if the grantor dies during the term of the annuity period.

1. Five percent inclusion exception. There is an exception to the ETIP rules, however, for transferred property if the possibility that such

[5] Code § 2632(c)(5)(A)(i).

[6] Kwon & Loewy, *GRATS: On a Roll*, 144 TR. & ESTS. 33, 43 (June 2005) (hereinafter "Kwon & Loewy").

property is includible is "so remote as to be negligible," which is defined to mean less than a 5% actuarial chance of inclusion.[7]

a. Based upon the 90CM Unisex Table, a 68 year old grantor has only a 4.7% chance of dying within a 2 year period.[8] Does this mean that a 68 year old can contribute $10,000,000 to a 2 year GRAT that is structured to create a $10 gift, and insulate from GST tax the remainder by merely allocating $10 of GST exemption?

b. If this is an incorrect interpretation of the regulation, what would the harm be if one allocates GST exemption by formula (perhaps with a cap), and the client is aware of the implications and otherwise will have some assets that will be subject to the GST tax?

2. Not so fast? Although it appears that some GRATs should clearly fall outside of the ETIP rules – depending upon the age of the grantor and the term of the annuity period – it is not clear how much GST exemption would need to be allocated to the GRAT in order to provide for a zero inclusion ratio.

a. If the amount to be allocated necessary to produce a zero inclusion ratio was tied to the taxable *gift* amount, then using a nearly zeroed-out GRAT would seem to permit the allocation of an amount only equal to the minimal taxable gift.

b. Unfortunately, the provisions for allocation of GST exemption seem to be tied to the *amount of the property transferred*, not the amount of the taxable gift.[9] This method is consistent with the determination of the applicable fraction (for purposes of calculating the inclusion ratio), which has as its denominator the value of the property transferred to the trust.[10]

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[7] Treas. Reg. § 26.2632-1(c)(2)(ii)(A). The author is not the first to notice this provision. *See* Harrington and Acker, 850 T.M., *Generation-Skipping Tax*, A-36-37. The authors discuss the exception in the context of spousal transfers, but specifically offer a 2 year GRAT as an example possibly fitting within the literal language of the regulation. The authors suggest that this result is probably a mistake and not intended by Treasury. Surprisingly, there apparently has been nothing else written on this issue.

[8] By way of comparison, a 45 year old has only a 4.8% chance of dying within a 10 year period, a 37 year old has only a 4.7% chance of dying within a 15 year period, and a 30 year old has only a 4.8% chance of dying within a 20 year period.

[9] *See* Treas. Reg. §§ 26.2632-1(b)(1)(i), -1(b)(2)(i) and (ii), and -1(b)(4).

[10] *See* Treas. Reg. § 26.2642-1(c)(1).

IV. Calculating and Structuring the Annuity Payments – Stated Dollar Amount, Fixed Fraction/Percentage or Formula?

An annuity payment can either be a stated dollar amount, or a fixed fraction or percentage of the amount contributed to the GRAT, as finally determined for federal tax purposes.[11]

A. Fixed fraction/percentage vs. stated dollar amount. Much has been written about the advisability of defining the annuity payment by using a fraction or percentage of the initial fair market value (as finally determined for federal tax purposes) of the assets contributed, as opposed to a stated dollar amount. In fact, one of the most attractive features of a GRAT is the ability to counter an increase in the initial fair market value of the contributed assets via the automatic increase in the annuity payments produced by a fixed fraction. The author therefore believes that the use of a stated dollar amount is not common, and should be avoided.

B. What "fixed fractions" work, and which is best? According to the regulations, if the annuity is not a stated dollar amount, the annuity may be expressed as a "fixed fraction or percentage of the initial fair market value" of the property contributed, "as finally determined for federal tax purposes."[12] What types of annuity amount fractions work, and if more than one is permissible, which works the best?

1. An express percentage. The author believes that most practitioners use commercial software to calculate either the regular or graduated annuity payments as a fixed percentage, and then draft their GRAT trust agreements to require the trustee to multiply the percentage(s) by the initial fair market value of the contributed assets.

> ***Example - 2 Year Regular GRAT****. "Annuity Amount" for each year shall be an amount determined by multiplying the initial fair market value of the property transferred to the Trustee, as finally determined for federal tax purposes, by 54.54345%.*[13]

> ***Example - 2 Year 20% Grad GRAT****. "Annuity Amount" for each year shall be an amount determined by multiplying the initial fair market*

[11] Treas. Reg. § 25.2702-3(b)(1)(ii).

[12] Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

[13] This percentage is produced by commercial software using the September 2006 Code § 7520 rate of 6%.

value of the property transferred to the Trustee, as finally determined for federal tax purposes, by the following percentages: 49.7166% for the first year; and 59.65992% for the second year.[14]

2. A defined value-type formula. It has been suggested that, instead of using express percentages in the GRAT trust agreements, a formula can be used to define the annuity payments.[15]

   Example. *"Annuity Amount" for each year shall be the minimum amount necessary for all of the Annuity Amounts payable to the Annuitant to have a fair market value, as determined using the Code § 7520 rate in effect for the month the trust is created and based on the tables thereunder, equal to the initial fair market value of the property transferred to the Trustee as finally determined for federal tax purposes.*

3. What about a mathematical formula? What if, instead of defining the amount of the annuity payments by directing one to do a calculation similar to a defined value-type formula, a mathematical formula is used to produce a fraction stated in the terms of the GRAT instrument?

   Example - 2 Year Regular GRAT. *"Annuity Amount" for each year shall be an amount determined by multiplying the initial fair market value of the property transferred to the Trustee, as finally determined for federal tax purposes, by the fraction,* $\boldsymbol{(1+R)^2 / (2+R)}$, *where "R" shall be equal to the Code § 7520 rate, expressed as a decimal, for the month in which the trust is created.*[16]

   Example - 2 Year 20% Grad GRAT. *"Annuity Amount" for each year shall be an amount determined by multiplying the initial fair market value of the property transferred to the Trustee, as*

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[14] These percentages are produced by commercial software using the September 2006 Code § 7520 rate of 6%.

[15] *See* Kwon, McCaffrey & Hesch, *Deciding Upon the Appropriate Estate Freeze Technique and Enhancing Its Performance Through Careful Structuring, Investing and Monitoring*, 2 A.B.A. SEC. REAL PROPERTY, PROBATE & TRUST LAW PROB. & TR. LAW SYMP. 665, 679 (2005) (hereinafter "Kwon, McCaffrey & Hesch"); McCaffrey, *2005 Miami Institute*, *supra* note 1 at ¶ 703.3A.

[16] For September of 2006, this fraction produces a percentage equal to 54.543689%.

finally determined for federal tax purposes, by the fraction, ***(1+R)***^{2} ***/ (2.2+R)*** *for the first year, and 120% of the first year amount for the second year, where "R" shall be equal to the Code § 7520 rate, expressed as a decimal, for the month in which the trust is created.*[17]

NOTE: these formulas *exactly* zero-out the respective GRATs. The author recommends, however, that at least some minimal taxable gift be generated, if only to have reason to file a gift tax return to commence the running of the statute of limitations. Additionally, some commentators have expressed concern that *exactly* zeroing-out a GRAT may be challenged by the IRS. (Both of these issues are discussed at V.A. below.)

The derivations of the formulas for the two year Regular GRAT and the 20% Grad GRAT are shown on Exhibit B and Exhibit C, respectively.

4. Which approach is best?

a. Stated dollar amount. Using a stated dollar amount provides no protection for an increased value of the contributed assets. Avoid using a stated dollar amount.

b. Benefits of express percentage over formula. An express percentage stated in the GRAT trust agreement is simple and straightforward. Anyone who reviews the GRAT trust document should be able to figure out how much to pay to the annuitant. The advisor who prepares the gift tax return should also be able to easily input the information into software in order to produce a gift tax valuation calculation to attach to the grantor's Form 709.

c. Benefits of mathematical formula. An express percentage must be updated in every GRAT. If a mathematical formula works, in theory one need never to recalculate it again, even because the Code § 7520 rate changes due to the passage of time.

(1) How many people obsess over checking, and re-checking, the percentages in the GRAT? What if there is a typo?

[17] For September of 2006, these fractions produce percentages equal to 49.716814% and 59.660177%.

(2) What if the assets are thought to be contributed in one month, but are actually not legally transferred (at least for gift tax purposes) until a later month? The use of express percentages could result in excessive annuity payments, or worse, insufficient annuity payments and a taxable gift. The use of a mathematical formula should, however, minimize (or at least mitigate) this risk.

d. Problem with mathematical formula. The problem with mathematical formulas is that they can get complicated. For example, compare the formula for a 2 year, 20% Grad GRAT $[(1+R)^2 / (2.2+R)]$ to the formula for a 3 year, 20% Grad GRAT $[(1+R)^3 / (3.64+3.2R+R^2)]$.

V. Can You Really Zero Out? What is the Shortest Term Permitted?

In the time that it has taken the author to prepare this outline, and after thinking that the author was alone in reconsidering some of the forgotten or ignored issues related to GRATs, several highly respected commentators have raised interesting questions about GRATs, including whether a GRAT can really be "zeroed-out" and whether a 2 year GRAT (or even a 3 or 4 year GRAT) is too short for the IRS.

A. Why can't we zero out – or can we? Many, if not most, advisors have concluded that after the *Walton*[18] decision, advisors are free to structure GRATs so that the gift portion is zero, or close to it.[19]

Some commentators, however, have cautioned against completely zeroing-out a GRAT, and have instead recommended that GRATs be structured to produce at least a nominal taxable gift (1% of the contribution has been suggested) so that the IRS cannot argue the application of the *Procter* doctrine.[20]

1. Authority supporting required taxable gift. There is some support for the view that the IRS would not permit a complete zeroing-out of a GRAT.

a. No ruling position. The IRS has since 1999 refused to rule on whether annuity interests are qualified annuity interests

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[18] *Walton v. Commissioner*, 115 T.C. 589 (2000), *acq.*, Notice 2003-72, 2003-2 C.B. 964.

[19] The author recommends creating at least some minimal gift to be able to report the creation and funding of the GRAT on the federal gift tax return in order to commence the running of the statute of limitations. *See* XV., below.

[20] *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). *See* Kwon, McCaffrey & Hesch, *supra* note 15, at 679; McCaffrey, *2005 Miami Institute, supra* note 1, at ¶ 703.3A, n.21.

under Code § 2702 if the value of the remainder interest is less than 10% of the initial net fair market value of the property transferred to the trust.[21] It has therefore been suggested that the IRS believes that a GRAT is invalid if it has a remainder interest of zero.[22] On the other hand, however, the IRS may have implemented this no-ruling position for practical purposes – if only to preserve limited resources that might otherwise be overburdened with many requests for rulings on zeroed-out GRATs.

b. <u>TAM 200245053</u>. It has also been suggested that the IRS has made public its view, at least in the past, that a GRAT could not be zeroed out, citing TAM 200245053.[23] This 2002 ruling, which actually involved an installment sale to a thinly capitalized grantor trust, and not a GRAT, contains the following statement:

> Further, this regulation should not be viewed as sanctioning the utilization of the formula to "zero-out" a gift, as is the case in the situation presented here. The preamble accompanying the promulgation of this regulation explicitly expresses concern regarding the use of [GRATs] that are structured such that the value of the remainder interest (and thus, the amount of the gift) is zero or of nominal value relative to the total amount transferred to the trust. The preamble states that the Service and Treasury view these gift arrangements as contrary to the principles of §2702. See, Preamble to T.D. 8395, 1992-1 C.B. 316, 319.

The Preamble to the 2702 regulations, however, is inconsistent with the IRS characterization thereof in TAM 200245053.

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[21] Rev. Procs. 2006-3, I.R.B. 2006-1, 122, § 4.01(50), 2005-3, I.R.B. 2005-1, 118, § 4.01(50), 2004-3, I.R.B. 2004-1, 114, § 4.01(50), 2003-3, I.R.B. 2003-1, 113, § 4.01(49), 2002-3, I.R.B. 2002-1, 117, § 4.01(51), 2001-3, 2001-1 C.B. 111, § 4.01(51), 2000-3, 2000-1 C.B. 103, § 4.01(48), and 99-3, I.R.B. 1999-1, 103, 4.01(48).

[22] *See* Blattmachr & Zeydel, *Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth*, 31 TAX MGMT. EST. GIFTS & TR. J. 115, 124-25 (2006) (hereinafter "Blattmachr & Zeydel").

[23] *See id.* at 124.

> In response to comments requesting that increases in the annuity and unitrust amounts be permitted throughout the term, the final regulations provide flexibility to taxpayers by permitting the annuity or unitrust amount to be 120 percent of the annuity or unitrust amount paid for the preceding year. The proposed regulations prohibited increases to prevent transferors from "zeroing out" a gift while still effectively transferring the appreciation *on all the property* during the term to the remainder beneficiary, (*e.g., by providing for a balloon payment in the final year of the term*). The Treasury Department and the Service believe that such a result would be inconsistent with the principles of section 2702. *The final regulations, with minimal complexity, strike a balance between the government's policy concerns and taxpayers' desire for planning flexibility*.

(Emphasis added.) It therefore seems that the Treasury's concern was with complete back-loading (not "zeroing out" the gift) via a single, lump-sum balloon payment at the end of the term, and that such concern was alleviated by permitting graduated payments of up to 120% of the prior year's payment. The GRAT discussion in TAM 200245053 is also dictum.

c. *Procter* doctrine. The taxpayer in the *Procter* case conveyed property subject to a provision which would return to the donor any property to the extent a court ultimately concluded the property was subject to a gift tax. The Fourth Circuit's decision held that such a scheme was a condition subsequent and void because contrary to public policy, citing three reasons for the conclusion: (1) the scheme discouraged tax collection by the government; (2) the scheme obstructed justice by requiring courts to rule on moot cases; and (3) effectively, the condition, if operative, would operate to void a final court judgment.[24]

Some commentators have expressed concern that the IRS will allege that a GRAT cannot be zeroed out because of the

[24] *Procter*, 142 F.2d at 827-28.

Procter doctrine.[25] However, it is this author's opinion that "public policy" considerations should not operate to incorporate a minimum gift requirement to Code § 2702. Unlike *Procter*, zeroing out a GRAT does not require a court to rule on moot cases, or operate to void a final court judgment. Following the clear language of Code § 2702 and the regulations thereunder may, however, discourage the collection of tax in cases involving zeroed-out GRATs, but that is as a result of the statutory and regulatory provisions – not some contrivance or scheme of a taxpayer. It seems that since Congress can completely repeal the entire gift tax, it can certainly permit structures which might, in some cases, have the effect of limiting taxpayer exposure to gift taxes. Even the IRS has apparently acknowledged, in TAM 200245053, that such a structure has been approved by Congress.

> Similarly, the formula for defining a retained annuity contained in §25.2702-3(b)(ii)(B) sanctions a practical method which, when utilized in a bona fide manner, enables a donor to take advantage of a *Congressionally approved mechanism* for transferring a remainder interest in trust property, in situations where assets that may be difficult to value, such as real estate or stock in a closely held business, are transferred to the trust.[26]

If Congress has approved the mechanism without any concern over the possibility of a zeroed-out remainder interest, almost 50 years after the *Procter* decision, and Treasury itself has created the ability to counter revaluations by its own regulation, then public policy arguments should be left to the floors of Congress, not to be made by an agent in an audit.

2. <u>Authority and analysis supporting zeroed-out GRATs</u>. This author believes that the better position is that zeroed-out GRATs are permissible.

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[25] *See, e.g.*, McCaffrey, *2005 Miami Institute*, *supra* note 1, at ¶ 703.3A, n.21; Kwon, McCaffrey & Hesch, *supra* note 15, at 679, n.23.

[26] TAM 200245053 (emphasis added).

a. Treasury silence. If the IRS or Treasury thought that a zeroed-out GRAT should be or is invalid, it has had numerous opportunities to make that argument.

(1) The argument was not made in *Walton*.[27]

(2) The argument was not made in the Notice in which the IRS acquiesced to the result of the *Walton* decision.[28]

(3) The Treasury has not even hinted at this argument in recently promulgated Code § 2702 regulations, including those which corrected Example 5 (Treas. Reg. § 25.2702-3(e), Ex. 5) following the *Walton* decision.[29]

b. Legislative or regulatory changes. If the IRS or Treasury believed it could eliminate zeroed-out GRATs by promulgating regulations, it has failed to take the opportunity to do so.[30]

(1) A legislative change seems very analogous to the 10% minimum charitable remainder required for charitable remainder trusts by passage of Code §§ 664(d)(1)(D) and 664(d)(2)(D), and to a lesser extent, to the 10% minimum value for junior equity interests under Code § 2701(a)(4)(A).

(2) It would not surprise the author that Treasury has concluded that it cannot impose a minimum gift by regulation. If the Tax Court ruled that Example 5 was an unreasonable interpretation and invalid extension of Code § 2702, how would the Tax Court characterize a regulation that imposed a minimum gift?

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[27] *Walton v. Commissioner*, 115 T.C. 589 (2000).

[28] Notice 2003-72, 2003-2 C.B. 964.

[29] T.D. 9181, 70 Fed. Reg. 9222 (Feb. 25, 2005). This Treasury Decision also clarified the regulations addressing revocable spousal interests that were in issue in *Schott v. Commissioner*, 319 F.3d 1203 (9th Cir. 2003), *rev'g* T.C.M. 2001-110, and *Cook v. Commissioner*, 269 F.3d 854 (7th Cir. 2001), *aff'g* 115 T.C. 15 (2000).

[30] There have been rumors from time to time that Congress might be willing to impose a minimum taxable gift requirement on GRATs as part of the effort to achieve a compromise on federal estate tax reform. The rumor may have arisen based in part upon a suggestion in the Task Force on Fed. Wealth Transfer Taxes, *Report on Reform of Federal Wealth Transfer Taxes*, § 18.B.2, Tax Notes Today, Sept. 21, 2004, available at http://www.abanet.org/rppt/section_info/tttf/TTTF-Report.pdf.

c. *Procter* response. The author is not personally aware of any case in which the IRS has argued that the *Procter* doctrine prevents the creation of a GRAT without a more than a *de minimis* taxable gift, but the author has been informed that a nationally recognized practitioner has stated that he is defending such a case based on TAM 200245053. *Procter* was decided in 1944, long before the enactment of Code § 2702. If Congress wanted to make certain that GRATs resulted in some level of taxable gift, at least upon a successful revaluation, then it could have easily provided for such a result within Code § 2702 itself. Also, the ability pursuant to Treas. Reg. § 25.2702-3(b)(1)(ii)(B) to adjust the annuity payments upon a subsequent revaluation of the property contributed to a GRAT seems directly contradictory to the argument that a zeroed-out GRAT should not be permitted based upon the *Procter* doctrine.

It is this author's belief that the only authority arguably supporting a potential argument against a zeroed-out GRAT is *Procter*, and based on what the IRS and Treasury have done (and not done), that the more sound conclusion is that zeroed-out GRATs are valid.

3. Still worried about zeroing out a GRAT? If you are concerned that there is a risk that the IRS will attack a zeroed-out GRAT, there are several ways to structure your GRATs so as to not zero-out the remainder.

a. Manipulate the express percentage. An advisor can simply manipulate the commercial software program to produce an express percentage which yields a gift of a certain amount. For example, assume $1,000,000 is contributed in September 2006 to a 2 year Regular GRAT paying an annuity of 54.489%.[31] Based upon commercial software, this GRAT produces a taxable gift of almost $1,000. If the IRS successfully argues that the value of the contributed asset is instead $5,000,000, the taxable gift increases proportionally to slightly less than $5,000.

b. Defined value-type formula solve for a percentage. If an advisor uses a formula and is concerned about a *Procter* argument, she can choose to solve for a taxable gift based upon a percentage, such as 1%, of the initial value of the property contributed to the GRAT.

[31] By comparison, a zeroed-out payment would be 54.54345%, according to the commercial software, and 54.543689% by mathematical formula.

> ***Example***. *"Annuity Amount" for each year shall be the minimum amount necessary for all of the Annuity Amounts payable to the Annuitant to have a fair market value, as determined using the Code § 7520 rate in effect for the month the trust is created and based on the tables thereunder, equal to 99% of the initial fair market value of the property transferred to the Trustee as finally determined for federal tax purposes.*[32]

This approach is similar to the defined value-type formula noted in IV.B.2., above.

c. Mathematical formulas. Following the discussion at IV.B.3. above, an advisor could structure a GRAT with a mathematical formula to create an approximate 0.01% taxable gift.

> ***Example – 2 Year Regular GRAT***. *To produce an approximate 0.01% taxable gift, the 2 year Regular GRAT payment fraction would be* $\boldsymbol{0.9999(1+R)^2 / (2+R)}$.

> ***Example – 2 Year 20% Grad GRAT***. *To produce an approximate 0.01% taxable gift, the first year annuity payment for a 2 year 20% Grad GRAT would be* $\boldsymbol{0.9999(1+R)^2 / (2.2+R)}$, *and the second year annuity payment would be 120% of the first fraction.*

d. Solve for a dollar amount gift. If an advisor is concerned that a fixed percentage gift might be too large on a revaluation, can he or she instead choose to solve for a taxable gift based upon a dollar amount, such as $1,000?

> ***Example – 2 Year Regular GRAT***. *To create an approximate $1,000 taxable gift, the 2 year Regular GRAT payment fraction would be* $\boldsymbol{(V - \$1{,}000) \times [(1+R)^2 / (2+R)]}$.

[32] *See* Kwon, McCaffrey & Hesch, *supra* note 15, at 679. Presumably the level of materiality needed to counter a *Procter* argument can be varied based upon the amount of assets contributed to the GRAT. A 1% gift *may* be palatable for taxpayers when the contributed assets are worth $1,000,000, but may be too much for many taxpayers at contribution levels of $100 million, even for those with sufficient assets to fund such GRATs.

Example – 2 Year 20% Grad GRAT*. To produce a $1,000 taxable gift, the first year annuity payment for a 2 year 20% Grad GRAT would be* ***(V - $1,000) x [(1+R)² / (2.2+R)]***

(In each case where "V" is the initial fair market value of the Contributed Assets as of the Funding Date, as finally determined for federal tax purposes.)

However, if one's concern is based upon the *Procter* doctrine, then arguably the same policy reasons behind *Procter* are still present if the formula is designed to produce a gift of a specific dollar amount, even after a revaluation. If there is a subsequent revaluation of the contributed assets, the taxable gift amount remains unchanged.

B. How short is too short? Commentators for some time have expressed concern that a GRAT with a one year annuity term would be too short and not permitted by the IRS.[33] This concern is based primarily upon the language in Code § 2702(b)(1) that defines a qualified interest as the right to receive "fixed *amounts* payable not less frequently than *annually*" (emphasis added) and Treas. Reg. § 25.2702-3(d)(4), which requires that a GRAT trust instrument fix the term of a GRAT "for the life of a term holder, for a specified term of *years*, or for the shorter (but not the longer) of those periods." (Emphasis added.) The thought is that a single year term is not a term of *years*.

Commentators have raised the question of whether a GRAT of only two years may be too short.[34]

1. IRS Position. There is arguably some support for the view that the IRS would not permit a GRAT with a very short term.

a. The IRS has since 1999 refused to rule on whether annuity interests are qualified annuity interests under Code § 2702 "if the amount of the annuity *payable annually* is more than

[33] McCaffrey, *2005 Miami Institute*, *supra* note 1, at ¶ 703.2A, n.18; Akers, *2004 RPPT Symposium*, *supra* note 1, at 22.

[34] *See* Blattmachr & Zeydel, *supra* note 22, at 125.

50 percent of the initial net fair market value of the property transferred to the trust."[35]

(1) This position clearly means that the IRS would not rule upon a normal, zeroed-out 2 year GRAT with level payments (as such a GRAT will always have annual payments in excess of 50%).

(2) It is not clear, however, how this no-ruling position applies in the case of a 2 year Grad GRAT, as the initial payment is almost always less than 50% (as long as the Code § 7520 rate is less than 6.4%), while the second payment will always be greater than 50%. Does a single annuity payment in excess of 50% literally fall outside of the wording ("payable *annually*") of this no-ruling position?

(3) However, a two year GRAT produces annuity payments of less than 50% in each year, if a minimum gift of 10% is generated, so the IRS would apparently rule on even a 2 year GRAT.

2. GRATs with variable terms and percentages. It has been suggested by two experienced and respected commentators that a possible solution to concerns about minimum taxable gift amount and minimum term can be addressed by use of language which both adjusts the annuity percentage to produce an increased taxable amount (if the stated amount does not produce the minimum gift amount so that the annuity is a qualified annuity interest), and extends the annuity term (if the stated term is determined to be too short).[36]

a. Does this work? Does a provision that might change the annuity percentage or the annuity term satisfy:

(1) The requirement that an annuity be "an irrevocable right to receive a *fixed amount*"?[37] A "fixed amount" must either be

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[35] Rev. Proc. 2006-3, I.R.B. 2006-1, 122, § 4.01(50) (emphasis added.) *See also* I.R.B. 2005-1, 118, § 4.01(50), 2004-3, I.R.B. 2004-1, 114, § 4.01(50), 2003-3, I.R.B. 2003-1, 113, § 4.01(49), 2002-3, I.R.B. 2002-1, 117, § 4.01(51), 2001-3, 2001-1 C.B. 111, § 4.01(51), 2000-3, 2000-1 C.B. 103, § 4.01(48), and 99-3, I.R.B. 1999-1, 103, 4.01(48).

[36] *See* Blattmachr & Zeydel, *supra* note 22, at 125-26.

[37] Treas. Reg. § 25.2702-3(b)(1)(i).

(a) a "stated dollar amount.",[38] or

(b) a "fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes."[39]

(2) Does this language meet the requirement that the annuity "be payable in any event to or for the benefit of the holder for *the fixed term* of that interest"[40] and that the governing instrument "must *fix* the term of the annuity ... and the term of the interest must be fixed and ascertainable at the creation of the trust"?[41]

b. How are these GRATs administered in practice? What if the IRS were to successfully challenge the minimum term of a GRAT, but only following the expiration of the planned initial term after the remainder has been distributed? How are the payments restructured? Is there then an argument that the GRAT was improperly commuted if the terms of the document require the extension of the term?[42]

VI. The Power of Deferral

Treas. Reg. § 25.2702-3(b)(4) provides something rather unique in tax law – a giveaway. GRATs that have annuity payments based on the anniversary date of the creation of the GRAT may defer making payments until up to 105 days after the anniversary date. GRATs which have payments based upon the calendar year may defer payments until the deadline for filing the GRAT income tax return, or if the GRAT is a grantor trust reporting under Treas. Reg. § 1.671-4(b), until the deadline that would be imposed if the trust were reporting pursuant to Treas. Reg. § 1.671-4(a), (in either case, without regard to any extensions).[43]

A. The hurdle rate is not the Code § 7520 rate. The use of this deferral period can provide very material benefits. The "free" deferral period, at least

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38 Treas. Reg. § 25.2702-3(b)(1)(ii)(A).

39 Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

40 Treas. Reg. § 25.2702-3(d)(2).

41 Treas. Reg. § 25.2702-3(d)(4).

42 *See Focardi v. Commissioner*, T.C. Memo. 2006-56, at 23 (where the Tax Court ruled a "savings clause" could not effectively eliminate an invalid spousal interest).

43 One might assume that because a calendar year GRAT can provide for deferral of the final payment in excess of 105 days, that a calendar year GRAT would be even better. As discussed at VII.B., below, however, this assumption does not appear to be correct.

conceptually, can reduce the actual hurdle rate for a GRAT to significantly below the applicable Code § 7520 rate. For example, for September 2006, the Code § 7520 rate is 6%, so most practitioners would conclude that GRAT assets would have to appreciate at greater than 6% to produce a positive remainder. The "real" hurdle rate for 2 year GRATs, however, is almost a full percentage point below that rate (just more than 5% for a Regular GRAT and just in excess of 5.01% for a Grad GRAT). *See* Exhibit H for a list of some of the real hurdle rates for 2 year GRATs, assuming full use of the 105 day deferral for an anniversary date GRAT. The difference between a 5% and a 6% return may be insignificant on most GRATs. However, the difference could be material on very large GRATs.

B. GRATs could beat installment sales. Note that in some cases, a short-term GRAT can actually outperform an installment sale to a defective grantor trust if complete deferral is used, at least for the applicable annuity period.

1. In September 2006, the mid-term applicable federal rate is 5.05%, so the mid-term rate is in excess of the "real" hurdle rate of a 2 year anniversary date GRAT created during the same month.

2. As mentioned above, if the rate of return does not beat the Code § 7520 rate, a Regular GRAT can outperform a Grad GRAT, as evidenced by the differences in the real hurdle rates of return in Exhibit H.

C. Calendar vs. anniversary date. As discussed more fully below, GRATs can either be based upon the anniversary date or calendar year.

1. An anniversary date GRAT payment can be deferred up to 105 days after the anniversary date.[44]

2. A calendar year GRAT payment can be deferred until the filing deadline (without regard to extensions) of the GRAT's income tax return, which will usually also be 105 days.[45]

[44] Treas. Reg. § 25.2702-3(b)(4).

[45] *Id*. In a non-leap year, and assuming April 15th is on a weekday.

a. A calendar year GRAT payment could, however, be deferred up to 108 days.[46]

b. A final calendar year GRAT payment, however, could apparently be deferred for up to 469 days.[47]

Example. *A 2 year calendar year GRAT created on January 2, 2006 will have three annuity payments: an initial, partial year payment due on or after December 31, 2006, but not later than April 16, 2007; a second annuity payment due on or after December 31, 2007, but not later than April 15, 2008; and a third annuity payment due on January 2, 2008, but which could apparently be deferred until April 15, 2009.*

VII. Regular or Grad GRAT? Calendar or Anniversary Date?

GRATs can be distinguished based upon the type of annuity payment (regular or graduated), and the timing of the annuity payment (based upon the calendar year or anniversary date of the creation of the GRAT). What should you use?

A. Grad GRATs and Regular GRATs. There are two types of GRAT payments: level payment (or "Regular") GRATs (which, as the names suggest, have annuity payments which are the same every year); and increasing payment (or "graduated") GRATs (which are sometimes called "Grad GRATs", and as the names suggest, have annuity payments which increase during the term of the annuity). Many commentators have recommended that GRATs be structured to have "graduated" annuity payments.[48] The annuity amounts can increase up to 20% per year and still be considered "fixed amounts" and thus a "qualified annuity interest". (Increases in excess of 20% are permissible, *at least if paid from income*, but are ignored for valuation purposes.)[49] Other commentators have, however, argued that, or at least questioned whether, the use of Regular GRATs

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[46] Leap years add another day. If April 15th falls on a Sunday, another day is added, and if it falls on Saturday, two days are added. If April 15th falls on a Saturday, in a leap year, then the payment can be deferred 108 days. This will next occur in 2028.

[47] Or perhaps 472 days, if the final payment is due in a leap year, such as 2028, in which April 15th falls on a Saturday.

[48] *See* Kwon & Loewy, *supra* note 6, at 44, n.1; McCaffrey, *2005 Miami Institute*, *supra* note 1, at ¶ 703.3B; Akers, *2004 RPPT Symposium*, *supra* note 1, at 12-13.

[49] Treas. Reg. § 25.2702-3(b)(1)(iii). One might wonder why anyone would ever draft a GRAT to have increasing payments in excess of 20%. The author knows of no logical reason to do so – although providing for the payment of the greater of income or the annuity amount (for marital deduction purposes) pursuant to Treas. Reg. § 25.2702-3(b)(1)(iii) could result in an annual increase in excess of 20%.

might in some circumstances be more advantageous than Grad GRATs.[50] Who is right?

1. Grad GRATs - proven winner. Most commentators who favor Grad GRATs have offered the elegant and simple justification that Grad GRATs permit more "backloading" of the payments, which permits more assets to appreciate within the GRAT for the benefit of the remainder beneficiaries.[51] This explanation is accurate, with one exception discussed below, but some advisors have trouble believing something so straightforward. It is easy enough to compute the different projected remainder values using Regular versus Grad GRAT annuity payments, but some have stated that those projected or even actual results calculations do not *prove* that Grad GRATs always beat Regular GRATs.

> The premise that Grad GRATs outperform Regular GRATs can, however, be proven mathematically, at least for a 2 year GRAT, when the rate of return exceeds the Code § 7520 rate.[52]

a. Constant rate of growth. GRAT performance is often projected using assumed constant rates of growth. (The author has been guilty of this practice.) Providing such projections is clearly unrealistic, and does not reflect one of the great benefits of GRATs (capturing volatility swings, with upsides favoring the remainder beneficiaries and the downturns reducing the grantor's estate), but it is simple and easy for many clients to understand.

If, for the sake of argument, you assume that a GRAT will have a constant rate of growth (*i*), and that rate of growth is expected to exceed the Code § 7520 rate, then the 2 year

[50] There was an active debate on this issue on the ABA-PTL (Probate & Trust Law) listserv. *See* posting of Douglas W. Stein, dstein@bsdd.com, to ABA-PTL@MAIL.ABANET.ORG (May 16, 2005) (on file with author).

[51] Indeed, *total* backloading, via a balloon payment, was the Treasury's concern cited in T.D. 8395.

[52] Much has also been written about what seems to be the consensus that a shorter term GRAT is generally better than a longer term GRAT. The author agrees with the consensus. The author does not dispute that longer term GRATs may make sense in certain situations, such as if structured so that cash flow from the GRAT assets are likely to satisfy (or largely satisfy) the annuity payments and thereby eliminate annual appraisal costs. The author does, however, admit to a short-term bias.

Grad GRAT will outperform the 2 year Regular GRAT - *every time*.[53]

If you are so inclined, see the proofs to calculate the annuity payments for a zeroed-out Regular and zeroed-out Grad GRAT (*see* Exhibit B and Exhibit C, respectively), then review the proofs to calculate the remainder in a zeroed-out Regular GRAT (Exhibit D) and in a zeroed-out Grad GRAT (Exhibit E). If you are still conscious, Exhibit F demonstrates that a Grad GRAT beats a Regular GRAT any time the constant rate of growth exceeds the Code § 7520 rate.

Note - If you assume that a GRAT will have a constant rate of return, but that rate will be less than the Code § 7520 rate, then both 2 year GRATs will *likely* "lose," in that both will *likely* produce a zero remainder amount (but the Regular GRAT will not underpay by as much). Presumably no one will do any type of GRAT if they do not expect (or at least hope for) a return in excess of the Code § 7520 rate.

HOWEVER, *see* VI.A. above. If a grantor takes full advantage of the deferral permitted under Treas. Reg. § 25.2702-3(b)(4), a GRAT can produce a positive remainder value, *even if the return is not as high as the Code § 7520 rate in effect upon the creation of the GRAT*. If the rate of return is less than the Code § 7520 rate, a Regular GRAT can "beat" a Grad GRAT.

b. Varied rates of growth. Since it is more likely that a GRAT will not have constant growth, even over just a two year period, it is more appropriate to compare mathematically the results of a Regular and Grad GRAT assuming two annual growth rates. Perhaps surprisingly, it can be proven that a 2 year Grad GRAT will outperform a 2 year Regular GRAT whenever the *second* year rate of return exceeds the Code § 7520 rate – *regardless of the rate of return in the first year*.

See Exhibits A-E, and then Exhibit G.

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[53] For purposes of comparing the Regular and Grad GRATs, "outperform" means only that one GRAT does better than the other, and in the case when both types of GRATs fail, only that the better GRAT would just not fail as miserably.

This means, at least for a 2 year GRAT, and relative to comparing Regular and Grad GRATs, that the first year's performance does not matter, at least as long as the second year's return exceeds the Code § 7520 rate. (Admittedly, if the first year performance is significantly below the Code § 7520 rate, the GRAT may never recover, but a Grad GRAT will not perform as poorly, at least until both reach zero.)

2. A Regular GRAT can win, under one scenario. If you assume varying growth rates, the 2 year Regular GRAT will outperform the 2 year Grad GRAT in only one scenario - when the second year growth rate is *less than* the Code § 7520 rate.

   One might think that such a "win" between two GRATs which do not beat the Code § 7520 rate is meaningless (as one would likely assume both GRATs would not produce positive remainders), but that is not the case. As discussed at VI.A. above, the deferral permitted under Treas. Reg. § 25.2702-3(b)(4) effectively reduces the "hurdle rate" below the Code § 7520 rate, and can make a Regular GRAT outperform a Grad GRAT.

3. First year irrelevant, and Grad GRAT upside exceeds Regular GRAT upside. There are a few other interesting things that can be concluded about 2 year GRATs based upon these mathematical formulas.

   a. The first year performance is basically irrelevant, on a relative basis.

   b. The second year performance alone will determine whether the Regular GRAT wins (if the second year return is less than the Code § 7520 rate), or the Grad GRAT wins (if the second year return is more than the Code § 7520 rate).

   c. Because the winner is determined based upon the difference in the second year return and the Code § 7520 rate, it is clear that the comparative upside potential of the Regular GRAT is limited to the range between zero and the Code § 7520 rate. (The benefits of a Regular GRAT therefore are reduced relative to the Grad GRAT as the Code § 7520 rate decreases.) On the other hand, the comparative upside potential of the Grad GRAT is unlimited because it is based upon the range of any return in excess of the Code § 7520 rate.

   d. It is actually possible to solve to determine by how much a 2 year Regular GRAT beats a 2 year Grad GRAT (when the second year return is less than the Code § 7520 rate), or by how much a 2 year Grad GRAT beats a 2 year Regular GRAT (when the second year return is more than the Code § 7520 rate). In the following formula, Z is multiplied by the amount of the assets contributed to the GRAT:

$Z = (1+R)^2 \times [0.2y/(2+R)(2.2+R)]$, where y = the difference between the Code § 7520 rate (R) and the second year return (i_2).

B. Anniversary date vs. calendar year GRATs. GRATs can also be distinguished by the *timing* of the GRAT payments. GRAT payments can either be made on a calendar year basis or on the basis of the anniversary date of the creation of the GRAT.

1. Anniversary date GRAT. An anniversary date GRAT has a number of annuity payments equal to the number of years in the annuity term. As discussed above, the payment of the annuity from an anniversary GRAT may be deferred for up to 105 days after the anniversary date.[54]

2. Calendar year GRAT. A calendar year GRAT, however, has a number of annuity payments equal to the number of years in the annuity term, *plus one*. The payments can be deferred until after the close of the year and until the trustee is either required to file the federal income tax return for the GRAT, or when it would have been required to do so had it reported pursuant to Treas. Reg. § 1.671-4(a), in both cases without regard to extensions.[55]

> ***Example***. *A 2 year calendar year GRAT created on June 30, 2006 will have three annuity payments: an initial, partial year payment due on or after December 31, 2006, but not later than April 16, 2007; a second annuity payment due on or after December 31, 2007, but not later than April 15, 2008; and a third annuity payment due on June 30, 2008. (As discussed at VI.C.2 above, although it is not entirely clear, however, the last payment may apparently be deferred until April 15, 2009.)*

3. Which is better? There seems, to this author, not to be any reason to use a calendar year GRAT instead of an anniversary GRAT.

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[54] Treas. Reg. § 25.2702-3(b)(4).

[55] *Id*.

a. Extra payment and pro-ration. The calendar year GRAT requires an additional payment, which is one additional requirement that might be missed by the trustee and/or grantor. Additionally, two of the annuity payments (regardless of the length of the term of the GRAT) will have to be pro-rated, either based upon a 365 day year, or a 366 day year during a leap year. (Forgetting that a year is a leap year is another thing that can be missed.) These factors weigh in favor of an anniversary GRAT.

b. Grad GRAT and calendar year - huh? How do you calculate the pro-rated amount for a calendar year Grad GRAT?[56]

Treas. Reg. § 25.2702-3(b)(3): "If the payment is made based on the *taxable year*, pro-ration of the annuity amount is required *for each short taxable year* of the trust during the grantor's term."

(1) In a Regular GRAT, the first year is pro-rated, the full years are not pro-rated, and the last short year is pro-rated.

Example. A 2 year Regular GRAT is created on June 30, 2006. The GRAT is funded with $1,000,000 and the annuity is set at 54.54345% (using commercial software) to zero-out the remainder. A complete annuity payment is therefore $545,434.50. The first annuity payment of $274,958.76 (representing 184 days) is due on December 31, 2006. The second payment of $545,434.50, however, is for the entire year of 2007, is therefore not pro-rated and is due on December 31, 2007. The final payment of $270,475.74 (representing 181 days) is pro-rated and due on June 30, 2008 (or perhaps not until April 15, 2009).

(2) It is not clear, however, what to do with a calendar year Grad GRAT, at least in full taxable years.

Example. A 2 year, 20% Grad GRAT is created on June 30, 2006. The GRAT is funded with $1,000,000 and the annuity is set at 49.7166% for the first year, and 59.65992% for the second year (using commercial software) to zero-out the remainder. A complete first year annuity payment would

[56] *See* Janes, *Grantor Retained Annuity Trusts: Avoiding the Petards in an Otherwise Safe Harbor*, 33 EST. PL. 10, 16 (May 2006) (hereinafter "Janes – *Part 1*").

therefore be $497,166, and a complete second year annuity payment would be $596,599.20.

The first year calculation should be fairly easy to determine, as it should be pro-rated, presumably based upon what the payment would be in a full year for a Grad GRAT based upon the anniversary date, or $250,626.15 (representing 184 days), and due on December 31, 2006.

Is the second year payment the rest of the first payment ($246,539.85), plus a pro-rated amount of the second payment based on an anniversary date (181/365 x $596,599.20, or $295,847.82)? And the final payment the difference between what would have been paid using a anniversary date and what has been paid to date ($300,751.38)? Treas. Reg. § 25.2702-3(b)(3) does not *require* pro-ration in a full year, but doing so seems to be the only thing that makes sense.

This unanswered question of how to calculate Grad GRAT payments on a calendar year basis weighs in favor of anniversary GRATs.

4. Anniversary date seems better.

a. At first glance, a calendar year GRAT would seem to be about the same as an anniversary date GRAT because the maximum deferral period of 105 days for an anniversary date GRAT is roughly the equivalent to the time between January 1 and April 15, which is the maximum time for deferral of the payments in a calendar year GRAT (other than for the final payment).

b. However, unless the anniversary date GRAT is funded on January 1, the first payment will necessarily be slightly accelerated, at least in comparison to an anniversary GRAT.

c. ***Example***. Assume that in June 2006 a grantor contributes $1,000,000 to a 2 year, completely zeroed-out GRAT, with level payments when the (June 2006) Code § 7520 rate is 6%.

(1) For an anniversary date GRAT, the present value of the remainder is exactly zero, assuming no deferral, and with complete deferral, the present value increases to $16,623.

(2) For a calendar year GRAT, the present value of the remainder depends upon the date on which it is formed.

Date created	**Present value – no deferral**	**Present value – full deferral**
January 1	$0	$16,525
March 31	-$5,454	$11,179
June 30	-$7,391	$9,292
September 30	-$5,735	$10,940
December 15	-$1,181	$15,434

d. As can be seen above, a calendar year GRAT will almost always have a negative present value, unless annuity payments are deferred. Even if the annuity payments are deferred, however, a calendar year GRAT will apparently always have a present value lower than that of a comparable anniversary date GRAT.

VIII. Funding and Payment Issues and Problems

A. Short/long and negatively correlated GRATs. One minor imperfection with GRATs, as with almost all estate planning freeze techniques, is that the results are based upon investment performance. What if one could create a GRAT, or multiple GRATs, and be certain that some appreciation would be shifted to the remainder beneficiaries?

1. Short/long GRATs. Assume that a client creates two different GRATs and contributes to one a long position in a stock, and to the other a short position in the same stock.[57]

a. At the end of any particular period, one GRAT would be "in the money" and the other GRAT would be out of the money by the same amount.

b. While the grantor's total position would be the same as prior to the creation of the GRATs, one GRAT would be

[57] Assume for the sake of illustration that there are no practical difficulties with funding an otherwise empty GRAT with a short position in a stock. In reality, this may not be feasible because of institutional securities lending requirements.

guaranteed to have a positive remainder (ignoring the possibility of subsequent losses).

c. Assuming this structure would pass muster for gift tax purposes, a potential problem could be mismatched income tax results, as the loss may not offset the corresponding gain, possibly depending upon the nature of other investments held by the grantor outside of the GRATs.[58]

2. Negatively correlated GRATs. What if instead of using short and long positions, a grantor creates two GRATs and funds each with a stock that is negatively correlated to the other?

a. As one stock appreciates, the other stock is likely to depreciate, and vice versa.

b. This structure has the benefit of likely not raising straddle and wash sale issues, and may be quite attractive if the grantor already has the assets in his or her portfolio.

c. The problem, of course, is that there is no guarantee that even stocks which have had a historic negative correlation will perform similarly in the future.

B. Assets subject to restrictions. It should be quite elementary to most, but the grantor needs to have the ability to transfer the assets in question to the GRAT, the GRAT trustee needs to be able to transfer the assets to the remainder beneficiaries – and do not forget – also to the grantor as the annuitant. Therefore, any sorts of restrictions (such as restrictions in limited partnerships, buy-sell agreements, or imposed on stock which has not been registered) need to be considered and reviewed, and if necessary, consents need to be obtained.

1. Hedge fund problems. Funding a GRAT with an interest in a private equity or hedge fund investment can be especially problematic.

a. Some funds require legal opinions, consents and even transfer fees for transfers of interests.

b. These assets are also extremely difficult to value – especially on a timely basis. Some hedge funds, for example, only provide financial information on what can generously be said to be a "periodic" basis.

[58] *See* Code §§ 1091 and 1092.

c. While a lack of information can be irritating if the GRAT is funded early in a year, it can be a real problem for gift tax reporting if the GRAT is funded late in the year, and can be a nightmare for purposes of determining the amount of an in-kind annuity payment.

2. Annuity payments can also be hindered. Do not forget, that transfer restrictions may apply even to the annuity payments.

a. If hedge funds and private equity funds charge a fee for transfers, they often charge a lower fee for a transfer back from an entity to the original owner, but do not assume this is the case, and in any event, the necessary steps must be taken to effect the transfer.

b. Interestingly, some stock option plans permit certain intra-family transfers (including to certain trusts) by the original owner, but do not expressly permit a re-transfer back to the original option holder.

C. Date of contribution of assets? Many advisors are aware that the Code § 7520 rate is published around the third week of each prior month. This advance notice allows practitioners to make a determination of whether it is better to fund a GRAT in the current month, or a later month, depending upon the prevailing Code § 7520 rate (all else being equal). Pushing this timing too far could result in problems.

1. What if the intent is to fund the GRAT in a current month (because the next month Code § 7520 rate will increase), but assets are in fact not contributed until the following month, because of delayed receipt of transfer consents or other logistical problems?

2. The chance that the date of funding may differ from the date of the agreement may suggest that the use of a formula (*see* IV.B.3., above) be considered.

D. Valuation issues -- marketable securities. It seems clear that marketable securities contributed to a GRAT should be valued using the mean of the high and low trading price for the date on which the securities are contributed.[59] If the stocks did not trade on the date of funding, then a more complicated formula is used with an inverse weighted average of mean prices of trading dates before and after the date of the contribution,

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[59] Treas. Reg. § 25.2512-2(b)(1). *See also, Walton v. Commissioner*, 115 T.C. 589, 590 (2000) (the Wal-Mart stock was said to have a fair market value of $27.6875 per share on April 7, 1993, which equals the mean between the high of $28 and the low of $27 3/8 for Wal-Mart on April 7, 1993).

assuming the trades occurred within a reasonable period before and after the date of contribution.[60]

1. It is not clear that this same rule applies to calculate the value of marketable securities distributed to the grantor/annuitant (either directly, or as underlying assets in another entity).[61]

2. If, however, you do choose to distribute assets using the same valuation principle, how do you know how much to distribute until after the close of trading on the day in question?[62] Presumably a formula distribution, or an instrument that is irrevocable after the close of trading, should suffice, even if the securities are not actually distributed until a few days later.

3. Note – the funding instrument should clearly state whether declared but unpaid dividends should be included in the stock transferred.

E. Due date values vs. date of distribution values. It is not clear when to value assets distributed in-kind during the grace period. Should assets be valued as of the due date of the payment, or as of the date of payment? The closest authority is arguably only analogous – the rules for funding marital deduction trusts.[63]

F. Valuation and revaluation. As it is often noted, GRATs provide for valuation protection because, as long as the GRAT uses a "fixed percentage" or "fixed fraction" to define the annuity amount, a subsequent revaluation of the contributed assets should not result in an appreciable increase in the resulting taxable gift.

1. Short-term GRATs. What if the term of the GRAT is only two years with the remainder to be distributed outright to the children? The IRS may choose to attack the value of the contributed assets within three years of the filing of the gift tax return, but well after the assets have been distributed to the children.

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[60] *Id*.

[61] Treas. Reg. § 25.2512-2 appears to be limited to the value "on the date of the gift." Treas. Reg. § 25.2512-2(a).

[62] *See* Janes – *Part 2, supra* note 4, at 6.

[63] Rev. Proc. 64-19, 1964-1 C.B. 682. At least one commentator has suggested that any valuation date on or after the due date but not later than the expiration of the grace period should be permissible, but he has also cautioned of the risks of a routine practice of distributing only assets which have appreciated during the grace period. *See* Janes – *Part 2, supra* note 4, at 6.

a. This issue may warrant continuing the remainder in further trust, at least until the statute of limitations has run.

b. Alternatively, the trustee may obtain a reimbursement agreement from the remainder beneficiaries in which each agrees to return assets to the GRAT trustee in the event of a successful revaluation.

2. Valuation protection for annuity payments? GRATs can provide protection on revaluation of the *contributed* assets.[64]

a. There is, however, no provision in the regulations which provides the same sort of valuation protection for the annuity payments.[65]

b. What happens if the IRS successfully challenges the value of assets distributed in-kind to the grantor/annuitant? If too much value was distributed, do you have a commutation risk? If too little was distributed, is there a risk the grantor made an impermissible additional contribution to the GRAT or that the GRAT does not meet the annuity distribution requirements and is thus not qualified?[66]

c. Can these risks be mitigated or eliminated through use of a formula distribution provision from the GRAT?

G. Planning suggestions.

1. Revocable GRAT. Advisors may wish to consider structuring a GRAT that is expressly revocable by the grantor.

a. The grantor can then fund the GRAT, make sure title to all assets has been transferred, and then amend the GRAT to be irrevocable. The Code § 2702 rules should not apply during the period in which the trust is revocable, as the funding of the revocable trust should not be a completed gift.[67]

b. A revocable GRAT may also facilitate the funding of a GRAT on short notice, at least with some advance planning.

[64] Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

[65] *See* Janes – *Part 2, supra* note 4, at 4.

[66] *Id*.

[67] Code § 2702(a)(3)(A)(i); Treas. Reg. § 25.2511-2(c). *See also* Treas. Reg. §§ 25.2702-1(c)(1) and 25.2702-2(d), Ex. 4.

(1) The GRAT can be revocable and provide that if the grantor dies prior to being made irrevocable, it will serve as a will substitute.

(2) The grantor can choose to make the GRAT operative, by making it irrevocable, by merely signing a single sheet of paper.

(3) A revocable GRAT might necessitate the use of a mathematical formula to eliminate the need to make last-minute annuity calculations.

(4) A revocable GRAT might also be used in anticipation of incapacity, as it might be easier to give an attorney-in-fact the authority to make irrevocable a revocable GRAT (perhaps especially if the attorney-in-fact has the authority while the GRAT is revocable to withdraw assets from the GRAT for the benefit of the principal), as opposed to giving an attorney-in-fact the power to create and fund a GRAT from scratch.

c. A revocable GRAT might also allow a settlor of a GRAT to grant to the GRAT an option on property.

(1) Some have sought to fund GRATs with options, as doing so can effectively result in a very short term GRAT (as the option is either in the money and exercised, or expires worthless). Those seeking this result may have considered it impossible to grant an option to a GRAT because a gifted option might not be considered enforceable under state law, thereby making the issuance of an option to a GRAT an incomplete gift.[68]

(2) Because a GRAT may not receive multiple contributions, the settlor cannot solve this issue by contributing funds and then having the GRAT purchase the option from the settlor (at least without a valuation risk).

(3) By making the GRAT revocable, the grantor could fund the GRAT with cash. The GRAT trustee could then use funds to purchase from the settlor the option, which should therefore make the option

[68] *Compare* PLR 9501004 (Sept. 29, 1994).

enforceable under state law. The grantor could then make the GRAT irrevocable.

2. Single member LLC. Advisors may also want to consider the use of a single member LLC to facilitate both transfers into and distributions from a GRAT.

a. A single member LLC may facilitate funding a GRAT with multiple positions in publicly traded securities, or assets the title to which is difficult to transfer.

b. A single member LLC may be the only reasonable and practical way to fund a GRAT, and to make in-kind annuity payments, with private equity and hedge fund investments – assuming the funds permit such forms of ownership and transfers.

c. The use of a single member LLC will not, however, eliminate the valuation complications attached to private equity and hedge fund investments, and may actually result in additional valuation issues due to discounts. Practitioners should consider drafting the LLC operating agreement to provide for rights of withdrawal to eliminate the discount (or at least permit the position that discounts do not apply), especially if distributions are not likely, so as to eliminate the need (hopefully?) for appraisals.

IX. GRATs and Circular 230

A. Covered opinions. As most practitioners should now be aware, under Section 10.35 of Circular 230[69], written advice in the form of a "covered opinion" must satisfy a litany of requirements, which most have agreed go beyond what has historically been provided for full-blown legal opinions. It is not clear to what extent that the covered opinion requirements apply to "normal" estate planning, but it is very clear there are no absolute exceptions that are unique or applicable in the estate planning context.

B. Principal purpose transaction. Written advice, including e-mails, concerning one or more Federal tax issues arising from "any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, *the principal purpose of which is the avoidance or evasion*

[69] 31 C.F.R. Part 10 (hereinafter "Circular 230").

of any tax imposed by the Code" must be in the form of a covered opinion.[70]

1. Practitioners should first understand that written advice in principal purpose transactions *must* be in the form of a covered opinion – the despicable Circular 230 legend will not insulate the practitioner. (Legends only provide protection in "a significant purpose" transactions, as described below.)

2. After many complaints, "the principal purpose" was defined[71] to make clear that a purpose is "the *principal* purpose" if it exceeds any other purpose.

3. More importantly, the definition was defined to state that the purpose "is not to avoid or evade Federal tax if the partnership, entity, plan or arrangement has as its purpose the claiming of tax benefits *in a manner consistent with the statute and Congressional purpose*."[72]

4. Analysis of "the principal purpose" in the GRAT context.

    a. It is commonly believed that a GRAT is created pursuant to a statute, so is therefore not a "the principal purpose" transaction.

    b. Can practitioners always be sure that the goal of transferring wealth, or some other non-tax goal, is the principal purpose, and not tax avoidance?

    c. Can practitioners always be sure that the use of a GRAT is consistent with Code § 2702 and "Congressional purpose"? As set forth above, the IRS has at least at one time taken the position that zeroing-out GRATs is inconsistent with Code § 2702.

    d. Would the following examples of GRATs be consistent with Congressional purpose?

        (1) Football. Assume that 2 GRATs are funded with $1,100,000 each. GRAT #1 bets $1,000,000 on the Cincinnati Bengals to win against Cleveland, and GRAT #2 bets $1,000,000 on the Cleveland Browns

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[70] Circular 230 § 10.35(b)(2)(i)(B).

[71] *Id*. at § 10.35(b)(10), as added by T.D. 9201, I.R.B. 2005-23, 1153.

[72] *Id*.

to beat Cincinnati. The Bengals win decisively (covering the point spread), so GRAT #1 ends up with $2,100,000 (the $1,000,000 bet, plus the $1,000,000 won on the bet, plus the remaining $100,000 that was not bet). GRAT #2 pays the casino and is left with nothing (it paid the $1,000,000 bet, plus 10% to the casino.) GRAT #1 therefore has $1,000,000 of appreciation towards a positive remainder at the cost of 10% -- the $100,000 paid on the losing bet.

(2) Poker. A grantor creates 10 GRATs, each funded with $1,000,000. The GRATs then enter into a winner-takes-all Texas Hold 'Em tournament, with a $1,000,000 buy-in. One GRAT ends up with $10,000,000 in winnings, minus the cost of the game paid to the casino. That GRAT is therefore $9,000,000 of appreciation towards a positive remainder.

(3) Roulette. A grantor creates 38 GRATs, with each one funded with $1,000,000. Each GRAT bets $1,000,000 on a different number on the roulette wheel (1-36 red and black, plus green 0 and 00). One GRAT wins $35,000,000 and the other GRATs all lose. The result is that the winning GRAT is immediately "in the money" by $34,000,000, at a cost to the grantor of $3,000,000.

C. Significant purpose transaction. The practitioner may be satisfied that written advice concerning a GRAT is not subject to the covered opinion requirements because it is not a "the principal purpose" transaction. However, the practitioner must also be careful to analyze whether written advice concerning a GRAT could still be a covered opinion. This result would occur if the GRAT is "a significant purpose" transaction.

1. A "significant purpose" transaction is "any partnership or other entity, any investment plan or arrangement, or any other plan arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code" if

2. the written advice is

a. a *reliance opinion*,

b. a *marketed opinion*,

c. subject to *conditions of confidentiality* or

d. subject to *contractual protection*.[73]

3. The most likely pitfall for an estate planning practitioner in the "a significant purpose" area is when an advisor provides written advice containing phrases which exceed "more likely than not" comfort (thereby making the written advice a "reliance opinion").[74] Language such as "this *should* not be a gift", and similar statements containing "will" "probably" should be considered carefully. In those instances, the written advice might need to be in the form of a full-blown covered opinion, unless an exception (including a disclaimer in some instances) applies.[75]

X. Remainder Provisions – To Whom? How Much Is Too Much?

A. Pot trust. It is very common for GRAT remainders to be held in further trust for family members. What if the grantor desires to remove appreciation from his estate, but he does not yet know how much to distribute to his children and how much to distribute to charity? The GRAT can be structured to provide for a "pot trust" for the benefit of children and other family members, potentially including the grantor's spouse. The grantor's spouse can then be given a power of appointment to redivide or redistribute the assets between descendants, and even charity, if it turns out that the circumstances warrant the change.[76]

B. Don't give away too much – use a cap. Several commentators have advised that grantors can impose a cap on the amount passing to the remainder beneficiaries, with the rest to be returned to the grantor.[77] The use of a cap can be easier than figuring out how to get a certain (or reasonably approximate) amount to beneficiaries based upon the amount

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[73] Circular 230 § 10.35(b)(2)(i)(C).

[74] A "reliance opinion" is defined in Section 10.35(b)(4)(i) as advice which "concludes at a confidence level of more likely than not (a greater than 50 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer's favor." A "Federal tax issue" is defined in Section 10.35(b)(3) of Circular 230 as a question concerning the Federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for Federal tax purposes. A Federal tax issue is "significant" if the IRS "has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion." *Id*.

[75] *See* Manigault & Akers, *Nuts and Bolts of "Covered Opinions" Under Circular 230*, 20 PROB. & PROP. 34 (Mar./Apr. 2006); Manigault & Akers, *Circular 230 – How It Changed Our Lives (Or At Least Our Practices)*, 20 PROB. & PROP. 32 (May/June 2006).

[76] Note, however, that if the spouse is a beneficiary and exercises a power of appointment, he or she may make a gift by the exercise.

[77] *See, e.g.*, McCaffrey, *2005 Miami Institute*, *supra* note 1, at ¶ 703.9; Akers, *2004 RPPT Symposium*, *supra* note 1, at 21-22.

of assets used to fund the GRAT. The cap also provides for a protection against a homerun, and is useful in lieu of a tax reimbursement provision. The cap can be a simple ceiling ("the remaining assets, if any, but not more than $10,000,000, shall be distributed to my daughter, Isabella"), or a more complicated waterfall:

1. the first $1,000,000 to my irrevocable insurance trust;

2. the next $9,000,000 to be divided between my daughter, Isabella, and my son, Drayton; and

3. anything over $10,000,000 shall be distributed to me.

C. Target cap subject to valuation discrepancies. One client desired to transfer assets to her child. She wanted the amount to be based upon a percentage of the net proceeds of any future sale of a business, net of all debts and income tax liabilities. One approach would have been to define the cap by this explicit goal ("the remainder, but not more than 20% of the net after-tax cash proceeds from the sale of Acme, LLC...").

1. However, a sale was not in the works when the GRAT was created, and the operating businesses were subject to lack of marketability and lack of control discounts, which might have been jeopardized by a formula which explicitly anticipated a sale for cash.

2. We therefore "backed into" a formula which would produce the desired results, with some minor variations depending upon the valuation of the operating businesses, the discounts applied to the transferred interests, and the ultimate sales proceeds.

3. The solution was to set the cap equal to a percentage of three components – the two annuity payments, and the remainder at the end of the GRAT. By using this approach, changes in the valuations and any sales proceeds were minimized, as the increases to the two annuity payments resulting from higher contribution values were largely offset by the lower remainder value (and vice versa).

D. Watch for cash flow issues. In using a waterfall or similar cap/formula, there may be a tendency to overfund the GRAT with the thought that any excess will be merely returned to the grantor. However, there may be timing differences, at least from a cash flow perspective, because the grantor may need to pay out of his pocket for the income tax liabilities prior to receiving the GRAT annuity payment for the corresponding year.

XI. Marital deduction

A. General. Since the *Walton* decision,[78] many practitioners have pointed out the complexities and esoteric issues of qualifying for the federal estate tax marital deduction the remaining annuity payments and remainder interest in a GRAT.[79] Treasury could have recently eliminated this complexity but chose not to do so.[80]

B. Just six steps? A very cogent and clear explanation, at least to this author, was provided by Michael L. Graham and Jonathan G. Blattmachr.[81] In that article, the authors state that following these six steps will suffice for marital deduction planning:

1. Term of years. Ensure that the annuity continues to be paid for the term of years, even if the grantor dies during the term, with any remaining payments to be payable to the grantor's estate. (Note – this should be mandatory for all *Walton*-type GRATs, even if the grantor is not married or concerned about the marital deduction.)

2. Greater of all income or annuity amount. The GRAT instrument should require that following the grantor's death, the GRAT pay to the successor annuitant (the surviving spouse or marital trust) the greater of the annuity amount or the income of the GRAT (at least if the successor annuitant is the surviving spouse or marital trust).

3. Marital deduction boilerplate. The GRAT instrument should include all of the customary marital deduction boilerplate provisions (such as the right of the surviving spouse to make unproductive property productive), and such provisions should apply during the annuity period.[82]

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[78] *Walton v. Commissioner*, 115 T.C. 589 (2000), *acq. in result*, Notice 2003-72, 2003-2 C.B. 964.

[79] *See* McCaffrey, *2005 Miami Institute*, *supra* note 1, at ¶ 703.6; Janes - *Part 1*, *supra* note 56, at 12-14.

[80] When amending Treas. Reg. § 25.2702 to reflect the *Walton* decision, several commentators and members of the Real Property, Probate and Trust Law Section of the ABA, including this author, suggested that a GRAT could provide that annuity payments could be made to the grantor, then if the grantor were to die during the annuity term, to the grantor's spouse, subject to the grantor's right to revoke the spousal interest in favor of the grantor's estate. *See ABA Real Property[, Probate and Trust Law] Section Comments on Proposed Regs Amending Special Valuation Rules*, Tax Notes Today, 2004 TNT 218-17 (Nov. 1, 2004).

[81] Graham and Blattmachr, *Six Steps to a Marital Deduction for a Walton GRAT or How I Learned to Love the Bomb*, available at http://www.ilsdocs.com/docs/alerts/Six_Steps_to_Marital Deduction.pdf.

[82] Others have made the same point. *See Janes – Part 1*, *supra* note 56, at 13.

4. All income vs. annuity deferral. The mandatory distribution of income, for marital deduction purposes, should trump the allowance that GRAT annuity payments may be deferred for 105 days after the respective anniversary date for an anniversary date GRAT, or until the due date (without extension) for the federal income tax return of a calendar year GRAT.

5. Execute a codicil. The grantor should execute a codicil to bequeath the remaining annuity payments received by the estate to the surviving spouse. (As a possible alternative, the codicil could distribute the income portion outright to the spouse, with the remaining annuity payment to a QTIP trust.)[83]

6. Remainder to qualify for marital deduction. Finally, the authors point out that the remainder of the GRAT needs to be distributed in a form that qualifies for the marital deduction.

XII. Securities law issues

A. General. Clients who are "insiders" of publicly traded companies[84] often have a considerable amount of their wealth in a concentrated position in the publicly traded company with respect to which they are insiders. Estate planning for these assets is particularly complicated, especially when the assets are contributed to a GRAT. The main issues for consideration are:

1. Exposure to recovery of "short-swing" profits as a result of matching transactions under Section 16(b), which creates strict liability exposure for gains resulting from opposite-way trades (i.e., purchase/sale or sale/purchase transactions) made within 6 months of each other; and

2. Reporting issues under Section 16(a) of the Securities Exchange Act of 1934.

B. Section 16(b) – short swing profits. This issue carries the greatest potential exposure for the insider, and unfortunately the authority seems to be somewhat inconsistent. Get advice from competent securities counsel.

[83] Craig Janes also suggests one consider making a protective QTIP election with respect to the remaining annuity payments. *Id.*

[84] Directors, officers and the beneficial owners of 10 percent or more of a public company's shares are considered insiders subject to Section 16 of the Securities Exchange Act of 1934.

1. <u>SEC says funding the GRAT and annuity distributions are OK</u>. The SEC has taken the position[85] that funding a GRAT and making in-kind distributions to the grantor as annuity payments from a GRAT are exempt from Section 16 under Rule 16a-13 as mere changes in the form of beneficial ownership from direct to indirect, rather than a transaction that would constitute a potential matching disposition.[86] (Other transactions in the stock by the GRAT during the annuity period would, however, be considered as transactions by the grantor.)[87]

    a. Unfortunately the SEC interpretation is not necessarily binding on courts.

    b. *Query* whether or to what extent the SEC position is limited to the facts of the *Kight* letter. In that GRAT, the grantor served as the trustee, and the grantor's minor children were the remainder beneficiaries. Although the author has heard suggestions that the insider should *not* serve as the trustee of a GRAT, perhaps for reporting reasons, the safer course would be to try to follow the facts of *Kight* as closely as possible to ensure that the transfer to the trust is not viewed as a disposition at that time.[88]

2. <u>Exercising a right of substitution is *not* OK</u>. GRATs are often structured to be grantor trusts, often by the use of a "right of substitution" power.[89] An insider should be very careful, however, before exercising a right of substitution power in order to reacquire stock in the insider's company.

    a. In *Morales v. Quintiles Transnational Corp.*,[90] the court held that an insider's exercise of a right of substitution (by exchanging a promissory note for the stock) was a matching

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[85] Peter J. Kight, SEC No-Action Letter, Fed. Sec. L. Rep (CCH) ¶77,403 (Oct. 16, 1997) (hereinafter "Kight Letter").

[86] *See* Romeo & Dye, *Section 16 Treatise and Reporting Guide*, 312-13 (hereinafter "Romeo & Dye"). Note that the final distribution to the remainder beneficiaries should be a gift and exempt under Rule 16b-5, and not a potential matching transaction. Kight Letter, *supra* note 85.

[87] Kight Letter, *supra* note 85.

[88] Note that the Kight GRAT does not mention any power of the grantor/insider/trustee to defer the payments beyond the anniversary date. *Id*.

[89] *See* Code § 675(4)(C). A GRAT should be a grantor trust, at least during the annuity period, also by reason of Code § 677(a)(1) and/or (2). The addition of the right of substitution is a "belt and suspenders" approach during the annuity term, and may also be used to extend grantor trust status beyond the annuity period. *See* XIV., below.

[90] 25 F.Supp.2d 369 (S.D.N.Y. 1998).

transaction for purposes of Section 16(b). As a result, the insider had to disgorge $1,404,128 in profits to the company representing the difference in value at the time of substitution and time of sale, since the transactions occurred within 6 months of each other.

(1) It seems inconsistent, to this author, that one can transfer stock to and receive stock from a trust as a mere change of the form of beneficial ownership, but that an exchange of the same property for a promissory note is not a mere change in the form of beneficial ownership.

(2) The prudent response to *Morales* is to make sure that grantors either do not exercise a right of substitution power to reacquire the stock in the company, or if they do so, to make sure there are no potentially matching transactions within the 6 month period before or after the substitution.

(3) Some have suggested that such a power should not even be included in a GRAT created by an insider, but the author believes this is an overreaction.

3. *Dreiling ex rel. Infospace, Inc. v. Kellett*.[91] This case should give every estate planner pause. The defendant insider in the case was forced to pay $247,000,000 for trades involving a GRAT funded with insider stock, as the court ruled that the distribution of stock from a GRAT *was* a matching transaction under Section 16(b).

a. That case, however, involved an extremely unusual set of facts (the insider allegedly approved SEC filings which indicated that the stock, owned by a family trust, had been pledged in escrow as collateral for the grantor's individual obligation, giving rise to arguments that the grantor no longer had "beneficial ownership"[92] of the shares and therefore the loss of such ownership constituted a disposition).

b. That case was widely criticized by commentators but was settled before the decision on appeal to the Ninth Circuit.

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[91] 281 F.Supp.2d 1215 (W.D. Wash. 2003).

[92] Under SEC Rules 16a-1 and 13d-3, "beneficial ownership" requires either voting or dispositive control of the shares.

c. In response to *Dreiling*, insiders may wish to be ultra-conservative and consider any future distribution of stock from the GRAT as a potential Section 16(b) matching transaction and therefore refrain from any matching transactions within a period of 6 months before, and for 6 months after, such distribution.

C. Initial and ongoing reporting. The reporting for insider stock owned by a GRAT depends in part upon the identity of the trustee.

1. Funding of GRAT.

a. Grantor is trustee or controls stock. The transfer of shares need not be reported until the Form 5 is due (within 45 days after the end of the company's fiscal year), at which time the GRAT's ownership of the shares should be disclosed by indicating that such shares are held indirectly. If any Form 4 is filed earlier, however, the indirect ownership would be reported at that time.[93]

b. Grantor is not trustee and does not control stock. If the grantor is not the trustee, and does not otherwise control the GRAT's transactions in issuer securities, then the contribution to the GRAT is a disposition by gift that divests the insider of ownership, and subsequent trustee sales are not attributed to the grantor for Section 16 purposes.[94] The insider would be required to report the gift (a non-matchable transaction, however) on Form 5 within the timeframe specified above and subject to voluntary earlier reporting on the next Form 4.

c. GRAT is 10% owner. In the event that the grantor transfers to the GRAT more than 10% of the company's stock, the GRAT would then also become an "insider" subject to Section 16. As such, it would be required to file a Form 3 within 10 days of the funding of the GRAT. Any subsequent transactions would be reportable on Form 4 or Form 5. If the grantor continues to also have beneficial ownership of the same shares (due to control as a trustee), both the GRAT's and the grantor's filings would reflect such transactions.

[93] SEC Rules 16a-3 and 16a-8.

[94] SEC Rule 16a-8; Romeo & Dye, *supra* note 86, at 312.

2. Annuity payments from GRAT.

a. Grantor is trustee or controls stock. The transfer of shares back to the grantor should not need to be reported until the Form 5 is due (within 45 days after the end of the company's fiscal year), at which time the GRAT's ownership of the shares should be disclosed as a change of ownership from indirect to direct.[95]

b. Grantor is not trustee and does not control stock. Because the insider no longer has beneficial ownership of the shares in such a GRAT (as described above), the receipt of shares would constitute a gift to the grantor from the GRAT and would be reportable as a non-matchable gift on Form 5 or earlier Form 4. The GRAT would also be required to report the gift on Form 5 or earlier Form 4 if it has become an insider by virtue of holding 10% of the shares.

c. GRAT was 10% owner. Dispositions by GRAT reducing holdings by GRAT below 10%. Once the GRAT holds less than 10% by virtue of distributions of shares, it will no longer be an insider and its reporting obligations will cease. The final filing showing the gift by which it drops below this threshold should have the exit box on the Form checked.

3. Sales by GRAT.

a. Grantor is trustee and family has pecuniary interest. If the insider is the GRAT trustee, and either the insider or his family member has a pecuniary interest in the GRAT (presumably a requisite for the GRAT due to the retained annuity interest), then sales by the GRAT are reportable by the insider.[96] Sales must be reported on Form 4 by the end of the second business day following the date of the execution of the transaction.[97]

b. Grantor is not trustee or family member does not have pecuniary interest. If the insider is not the trustee, or if the insider is the trustee but neither he nor a family member has a pecuniary interest in the GRAT (unlikely, but perhaps possible following the expiration of the annuity period), then

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[95] SEC Rule 16a-3.

[96] *Id*.

[97] *Id*.

the insider has no reporting obligation. If the GRAT itself is an insider by virtue of 10% ownership, it would report sales in the same manner as any other insider, as described above.

4. End of annuity term. The termination of the annuity period and distribution of any stock to the remainder beneficiaries is reportable as a gift on Form 5 within 45 days after the end of the company's fiscal year.[98] Thereafter, the shares may continue to be reportable as beneficially owned by the grantor/insider, depending upon the identity of the remainder beneficiaries and the relationship to the grantor/insider (such as minor children sharing the grantor's household) because they may be deemed to be beneficially owned by the insider under other applicable SEC rules.[99]

D. Trading restrictions. Insiders are subject to trading restrictions imposed by law, such as insider trading prohibitions and the requirements of SEC Rule 144, as well as restrictions imposed by the company under insider trading policies. Advisors should be careful to make sure that funding the GRAT does not run afoul of these restrictions, and that annuity payments are also excepted.

1. *Query* what would happen if a GRAT were funded solely with company stock and the grantor was not able to either sell the stock (for example, due to securities law restrictions) or distribute the stock to herself (for example, due to company-imposed transfer restrictions) for the period starting on the annuity payment due date and extending past the expiration of the grace period?

2. SEC Rule 144, among other things, restricts sales of stock for the account of insiders. Because the insider generally retains beneficial ownership of the shares in a GRAT, Rule 144 will likely be deemed to apply to transactions by the GRAT (and in any event will apply if the holdings in the GRAT are sufficient to make the GRAT itself an insider). Accordingly, such restrictions might hinder a trustee's ability to make cash distributions with the proceeds of GRAT sales of company stock.

3. Advisors should strongly consider drafting GRATs to expressly permit the trustee to enter into a Rule 10b5-1 plan and/or blind trust, and to delegate and restrict information as necessary to make those arrangements work. More importantly, grantors/insiders

[98] SEC Rule 16b-3; Romeo & Dye, *supra* note 86, at 312.

[99] *See, e.g.*, Rule 16a-1(a)(2)(ii)(A).

should strongly consider having the GRATs actually enter into Rule 10b5-1 plans or similar arrangements so that the above hypothetical does not become reality.

E. Stock options. Insiders who own stock options must deal with the same securities issues with respect to the options as they do with the underlying stock in addition to transfer restrictions set forth in the option plan. Planning for options with GRATs raises other issues.

1. Patent on idea. First, there is some question as to whether anyone has the right to advise a client on funding a GRAT with stock options, at least without paying a fee to Wealth Transfer Group, LLC, which owns a patent (6,567,790) for "Establishing and Managing Grantor Retained Annuity Trusts Funded by Nonqualified Stock Options."[100]

2. How to exercise? Assuming that one gets past the issue of the patent, there is still the issue of how the options are exercised by the GRAT trustee. If the options do not permit cashless exercise, then the GRAT trustee may have a problem, as the grantor cannot contribute additional assets to the GRAT for the GRAT trustee to use as the option exercise price. Perhaps the grantor could loan the necessary amounts to the GRAT? Note also that when options are contributed to a GRAT, the Black-Scholes value is a combination of intrinsic value (the difference between the exercise and trading price) and option/time value. If the options are exercised in the GRAT, the intrinsic value will be realized, but the option/time value will be eliminated.

XIII. Locking in gains, and cutting losses

A. General. Many practitioners have pondered how they may take advantage of and "lock-in" appreciation in a GRAT, or alternatively, how they can terminate an underperforming GRAT in order to "start over."[101] Some have suggested that payments may be made before the anniversary date or end of the calendar year, but there are likely better methods.

B. Acceleration of payments. Making a payment before the due date can allow the grantor to effectively lock in appreciation, as the GRAT is able to satisfy the annuity payment obligation with appreciated assets. If the GRAT instead retained those assets until the due date, the trustee might be forced to satisfy the same obligation with depreciated assets. There are several issues raised by making payments prior to the due date.

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[100] *See Wealth Transfer Group, LLC v. Rowe*, 2006 WL 434187 (D. Conn., 2006).

[101] Akers, *2004 RPPT Symposium*, *supra* note 1, at 26-27.

1. Authority. There is not much authority on when annuity payments must be made.

   a. Annual payments. Payments must be made at least annually.[102]

   b. Fraction or percentages – periodic. If the GRAT uses a fixed fraction or percentage (as is most often the case), payments must not only be paid at least annually, but also "periodically".[103]

   c. Based on anniversary or calendar year. The annuity amount may be payable based on either the anniversary date of the creation of the trust or the taxable year of the trust.[104] The payments can be deferred, up to 105 days (for an anniversary date) or until the trustee is (or would be) required to file the trust income tax return (without extensions).[105]

   d. No commutation. The governing instrument must prohibit commutation (prepayment) of the annuity interest.[106]

   e. Right of withdrawal. A qualified annuity interest cannot be a right of withdrawal.[107]

2. How people accelerate. Some practitioners are probably designing GRATs to be simple GRATs, based upon the anniversary or calendar year, but the trustees are choosing to prepay the annuity payments before the (annual, semiannual, etc.) due dates. This was apparently done to some extent in the *Walton* case.[108] The author is aware of at least one highly respected practitioner who structures GRATs so that the percentage of the annuity is calculated based upon the payment of the annuity at the *beginning* of the term, and the trustee then pays the annuity payment at any time after the beginning of the term, but just not later than the maximum grace period.

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[102] Code § 2702(b)(1), Treas. Reg. § 25.2702-3(b)(1)(i) and (ii)(B).

[103] Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

[104] Treas. Reg. § 25.2702-3(b)(3).

[105] Treas. Reg. § 25.2702-3(b)(4).

[106] Treas. Reg. § 25.2702-3(d)(5).

[107] Treas. Reg. § 25.2702-3(b)(1)(i).

[108] *Walton v. Commissioner*, 115 T.C. 589, 591 (2000).

3. Analysis.

a. Commutation? If the payments are made early, is there a violation of the restriction on commutations?

(1) There is an argument that prepaying annuity payments is not the same as a commutation of the holder's *interest*.[109]

(2) *Query* whether there is more of a risk of commutation where the final payment is prepaid, as the prepayment arguably then terminates the grantor's interest in the GRAT.

(3) The practitioner who designs GRATs based on paying annuity payments at the beginning of the term has a good argument that payments after the commencement of the term are not prepayments, but are merely late payments, which are expressly authorized by the regulations.[110]

b. Right of withdrawal? The few who have commented about accelerated payments have focused upon whether the early payments could be an impermissible commutation. Could accelerated payments be an impermissible right of withdrawal? The author is not aware of any analysis on this issue in the context of accelerated GRAT payments.

c. Not periodic? It has been said that "not less frequently than annually" means just that – the annuity must be paid at least once a year, but can be paid at any time during the year (plus the grace period), and in multiple installments.

(1) However, GRATs which use a fraction or percentage to calculate the annuity payments may be required to

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[109] *See* Treas. Reg. § 25.2702-3(d)(5). *See also* Janes – *Part 1*, *supra* note 56, at 17. ("The conventional view of the term [commutation] is that a commutation implies the termination of a party's interest in a GRAT prior to its stated termination"). Note, however, the Treasury has indicated that commutation was prohibited because it would have shifted "the risk of a decline in interest rates from the remainder beneficiaries to the term holder." T.D. 8395, 1992-1 C.B. 316, 319. Does the prepayment of a single annuity payment shift some rate risk to the remainder beneficiaries?

[110] The author is not familiar with the exact terms of these GRAT trust instruments, including whether the GRATs are based upon the calendar year or the anniversary date of the GRAT. If based upon the latter, is it possible that the first payment must be made not later than 105 days after the creation of the GRAT, rather than by 105 days after the first anniversary?

make the payments on a "periodic" basis – not at any time selected by the grantor.[111]

(2) Does this mean that annual payment GRATs must be paid once per year, and only once per year, on the due date (or within the grace period)?

(3) This view of "periodic" seems consistent with how the remainder is calculated for actuarial purposes. One might argue that there is no policy reason for the IRS to contest early payments, as they actuarially should reduce the value of the remainder. However, the IRS does not necessarily consider policy and results.[112]

4. Suggestion. Advisors should consider carefully whether prepayment is worth the possible risks of an argument that the annuity has been commuted, is a right of withdrawal, or worse, that not paying periodically or pursuant to the terms of the instrument is an improper administration of the GRAT. To date, the author has shied away from prepayments.

C. Other methods. There are other options to "lock-in" appreciation in GRATs before the annuity due date.

1. Sell assets. The trustee of the GRAT can sell the appreciated assets to the market or third parties, but doing so may result in a taxable gain to the grantor. (The grantor may also have a timing issue between the due date of the taxes and the receipt of the annuity from the GRAT.)

2. Grantor buys assets. The grantor could also purchase the assets from the GRAT.

a. This transaction should not be a taxable event for income tax purposes, but the terms must be arm's length to avoid an argument that the grantor has made an improper addition to the GRAT.[113]

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[111] Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

[112] *Compare Estate of Atkinson v. Commissioner*, 115 T.C. 26, 32 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002). In that case, it was alleged that the trustee did not make the annuity payments to the grantor. Even though not making the annuity payments would increase the amount passing to charity, the IRS successfully asserted such failure was one of several reasons for disqualification of the GRAT.

[113] *See* Treas. Reg. § 25.2702-3(b)(5).

b. This method can also be advantageous if the assets have declined in value. In that case, the grantor can purchase the depreciated assets from the GRAT for a promissory note, then contribute the purchased assets to a new GRAT. By the end of the GRAT term for the old GRAT, the grantor's note for the depreciated value of the old GRAT's assets at the time of the purchase, plus interest, would simply be returned to the grantor in satisfaction of the annuity payments from the old GRAT to which the grantor is entitled.[114]

3. Hedging. The grantor may also take steps to lock in a gain via a hedging mechanisms.[115]

XIV. Grantor trust status

A. Grantor trust after annuity period. Grantor trust status for the GRAT in its entirety, at least during the GRAT term, is important in a number of respects, including the following:

1. A contribution to the GRAT in exchange for the annuity payments will not be a taxable event.[116]

2. The GRAT's in kind distribution to the grantor of appreciated property in satisfaction of its obligation to make an annuity payment will not be a taxable event.[117]

3. If permitted by the governing instrument, assets in the GRAT could be swapped tax-free by the GRAT for assets owned by the grantor with an equal value.[118]

4. A trust which, for federal income tax purposes, is treated as a grantor trust in its entirety is a permissible S corporation shareholder.[119]

5. Payment by the grantor of federal income taxes attributable to the GRAT's income will have the added estate planning advantage of

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[114] *See* McCaffrey, *2005 Miami Institute*, *supra* note 1, at ¶ 705.2.

[115] *Question and Answer Session, in* 37TH ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING, at ¶ 1007.3 (Portuondo ed., 2003).

[116] *See* Rev. Rul. 85-13, 1985-1 C.B. 184; PLRs 9239015, 9345035, 9351005, 9352007, 9352017, 9441031, 9444033, 9449012, 9449013, 9451056, 9504021, and 9519029.

[117] *See* Rev. Rul. 85-13, *supra* note 116.

[118] *See* Code § 675(4)(C); Rev. Rul. 85-13, *supra* note 116.

[119] Code § 1361(c)(2)(A)(i).

further depleting the grantor's personal assets without being treated as an additional transfer for transfer tax purposes.[120] In turn, the GRAT will not be burdened by any federal income tax liability, thus potentially leaving more assets for the remainder beneficiaries.

B. Why is a GRAT a grantor trust? Some commentators state that a GRAT is a grantor trust by reason of Code § 673(a), concluding that the value of the grantor's retained interest exceeds five percent of the initial value of the trust's assets.[121] Others cite Code § 677,[122] some emphasizing that the grantor will be treated as owner of the entire GRAT if each annual annuity payment is a larger percentage of the initial GRAT corpus than the Code § 7520 rate in effect at the time of the GRAT's creation, which again will generally be the case.[123]

C. What if the remainder is not held as a grantor trust? Assume that a client chooses not to provide for a continuing trust for the remainder, or chooses to have a continuing, but non-grantor trust for the remainder. When does the grantor trust status end – on the anniversary or calendar year due date, or upon the final annuity payment within the grace period? Is the payment of the annuity amount following the due date (but within the grace period) a taxable event? Are gains realized after the due date taxable to the trust?

1. During the annuity period, a GRAT should be a grantor trust under Code § 677(a)(1), Code § 677(a)(2), or both.[124] If the GRAT trustee following the expiration of the annuity period is not an adverse

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[120] *See* Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

[121] *See* McCaffrey, *2005 Miami Institute*, *supra* note 1, at ¶ 702.2A. *But see* PLR 9152034 (Sept. 30, 1991).

[122] Under Code §§ 677(a)(1) and (2), the grantor will be treated as the owner of any portion of a trust whose income, (1) in the discretion of the grantor, a nonadverse party, or both, may be distributed to, or held or accumulated for future distribution to, the grantor or his or her spouse or (2) without the approval or consent of an adverse party, is so distributed, or is so held or accumulated for future distribution, or is so held or accumulated for future distribution, to the grantor or his or her spouse. *See* Price, *Estate Planning with GRATs and Near GRATs -- Opportunities, Pitfalls, and a Promising Alternative*, 37TH ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING, at ¶ 1107.4 (Portuondo ed., 2003).

[123] *See* Blattmachr & Slade, 836 T.M., *Partial Interests -- GRATs, GRUTs, QPRTs (Section 2702)* (citing Code § 677(a)).

[124] Notwithstanding some disagreement by the IRS, this treatment should apply to the entire trust. *See also* PLR 9501004 (Sept. 29, 1994), in which the taxpayer's contribution of an option to a charitable remainder trust caused the trust to be disqualified as a charitable remainder trust. The Service ruled that the trust would be a grantor trust after the disqualifying contribution, citing Code § 677(a) and Rev. Rul. 85-13, 1985-1 C.B. 184, and ruled that the grantor was deemed to own *the entire* trust. "Because the income allocable to ordinary income or corpus of the Trust may be distributed to Taxpayer in order to make the required distribution of 9-percent of the net fair market value of the assets each year, the Taxpayer will be treated as the owner of the entire Trust pursuant to section 677 of the Code."

party, then the same authority should support continuing grantor trust status until the final annuity payment.

2. If instead the trustee is a child who is also a remainder beneficiary, it would seem that Code §§ 677(a)(1) and 677(a)(2) might not apply, and that reliance upon Code § 673(a) would be required (at least in absence of another grantor trust provision).

D. Reimbursement of taxes. Practitioners should be careful before drafting a GRAT which includes a provision permitting reimbursement to the grantor for her income tax liability. Rev. Rul. 2004-64, 2004-27 I.R.B. 7 may at first blush appear to be solely pro-taxpayer, but it is not.

1. Rev. Rul. 2004-64 holds that the grantor's payment of the income tax liability owed by reason of inclusion of the GRAT's items of income in the grantor's personal income tax return does not constitute a gift by the grantor, so it should also not be a proscribed additional contribution to the GRAT.

2. Rev. Rul. 2004-64 also seems to sanction inclusion of *discretionary*, as opposed to mandatory, income tax reimbursement provisions in grantor trusts, including GRATs. There are several very important caveats, however.

   a. First, the example provided in the ruling states that the trustee is a person not related or subordinate to the grantor within the meaning of Code § 672(c).

   b. Second, the ruling states a discretionary repayment provision, combined with other facts, *may* cause inclusion of the grantor trust assets in the grantor's estate. One cited example of such a bad fact would be if, under applicable state law, the grantor trust's assets would be subject to the claims of the grantor's creditors. Many state self-settled trust statutes may at least raise a question as to whether a GRAT's assets will be exposed to the claims of the grantor's creditors.

   c. Also, one or more actual reimbursements, the grantor's power to remove the trustee and name the grantor as trustee, or the designation of the grantor as a trustee or co-trustee of a GRAT including *discretionary* reimbursement provisions, may be deemed to be a retained Code § 2036(a) enjoyment or right exacerbating the estate tax issues posed by a GRAT.

3. As a result of such potential hazards, an income tax reimbursement provision should be included only after a very careful analysis of the

risks in the particular case and consideration of possible alternatives which may be less risky.

4. Practitioners should consider the use of a "waterfall" provision (*see* X.B., above) in lieu of a tax reimbursement clause.

5. The author does not use a tax reimbursement clause. Even if the GRAT is created in a jurisdiction with a self-settled/domestic asset protection trust statute that purports to prevent creditor access, there are continuing arguments about whether such US statutes are enforceable.[125] Although many disagree on whether domestic asset protection trusts work, who wants to have that argument with the IRS?

XV. Gift tax reporting.

A. <u>You should report GRATs</u>. The author is aware that some practitioners do not report zeroed-out GRATs on gift tax returns. The author prefers to have at least some minimal taxable gift which is then reported on a Form 709.

B. <u>GRATs are future interests</u>. Most practitioners are probably aware that any taxable gift resulting from a GRAT is a future interest and therefore not protected by the Code § 2503(b) annual exclusion. Even though the resulting taxable gift might not create a tax liability (because of the use of the grantor's lifetime gift tax exclusion), a gift tax return must still be filed.[126]

C. <u>Adequate disclosure – not applicable</u>. Many practitioners are familiar with the steps required to make sure that a taxable gift is adequately disclosed on a Form 709 in order to commence the running of the statute of limitations. The requirements are found at Treas. Reg. § 301.6501(c)-1(f). However, the adequate disclosure rules do not apply to GRATs. Instead, GRATs must be "adequately shown" on a Form 709 under the rules found at Treas. Reg. § 301.6501(c)-1(e).[127]

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[125] *See* Lockwood, *U.S. Domestic Trusts as Asset Protection Planning Tools: An Oxymoron*, *in* ASSET PROTECTION STRATEGIES – PLANNING WITH DOMESTIC AND OFFSHORE ENTITIES, 15 (Bove, ed. 2002).

[126] Code § 6019(a). *See also*, Akers, *2004 RPPT Symposium*, supra note 1, at 29. Failure to file a return can result in additions to tax by reason of Code § 6651(a). If the grantor does not owe any taxes, such as because of the lifetime gift tax exclusion, some may assume there is no downside to not filing. However, not filing means the statute of limitations does not start to run under Code § 6501(a). Also, a willful failure to file could be a crime. Code § 7203.

[127] *See also*, Chief Counsel Advice, ILM 200221010 (Feb. 12, 2002). ("In this regard, Treas. Reg. § 301.6501(c)-1(e) sets detailed guidelines for a transfer of property subject to the special valuation rules of section 2701 or section 2701 [sic], while Treas. Reg. § 301.6501(c)-1(f) sets detailed guidelines for gifts made after December 31, 1996 not adequately disclosed on a return filed after December 3, 1999.")

1. The differences between the two standards are not evident on the Form 709. While the requirements in Treas. Reg. § 301.6501(c)-1(e) and (f) overlap, they are not identical, thereby posing traps for the unwary.

   a. Treas. Reg. § 301.6501(c)-1(f)(2)(ii) requires the disclosure of the identity of the transferor and each transferee. Treas. Reg. § 301.6501(c)-1(e)(2)(ii), however, also requires the identity of all other "persons" (apparently not just individuals) "participating in the transactions," and all other "parties" related to the transferor holding an equity interest in any entity "involved in" the transaction.

   b. Treas. Reg. § 301.6501(c)-1(f)(2)(iii) requires, in the case of a transfer in trust, the trust's taxpayer identification number and either a copy of the trust agreement or a description of its terms. This requirement is also set forth in the adequate disclosure portion of the instructions to Form 709. Treas. Reg. § 301.6501(c)-1(e), however, contains no similar requirement for transfers in trust, even though a GRAT is the most likely transfer in trust to be subject to said section of the regulations. A taxpayer referring to Treas. Reg. § 301.6501(c)-1(e) for details (rather than to the specifics in the adequate disclosure portion of the Form 709 Instructions) may therefore not provide a copy or description of the GRAT instrument, even though the trust agreement is arguably more important than any other valuation information in determining the amount of any gift.

   c. Treas. Reg. § 301.6501(c)-1(f)(2)(iv) requires valuation information which is more extensive than what is required by Treas. Reg. § 301.6501(c)-1(e)(2)(iii), but the former requirement can be satisfied by the attachment of an appraisal that meets the requirements of Treas. Reg. § 301.6501(c)- 1(f)(3). There is no similar provision in Treas. Reg. § 301.6501(c)-1(e) for the attachment of an appraisal. Although attaching an appraisal should satisfy the requirement of Treas. Reg. § 301.6501(c)-1(e)(2)(iii), an appraisal might not include the "financial and other data used in determining value," at least for the suggested 5 year period. Although these provisions are somewhat different, at least the adequate disclosure portion of the Instructions to Form 709 does not create further confusion here. Rather, the instructions refer the taxpayer to "1(e)" and "1(f)" of Treas. Reg. § 301.6501 for details as to the information required.

d. Treas. Reg. § 301.6501(c)-1(f)(2)(v) requires a "statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer . . . ." There is no similar requirement under Treas. Reg. § 301.650(c)-1(e).

2. The author has reason to believe that some practitioners have taken the position that the assets used to fund a GRAT need not be valued or disclosed on Form 709, because only the remainder interest in the GRAT is being valued, not the assets within the GRAT itself. The regulations are clear on this point, but it is prudent to include valuation information for such underlying assets.

3. *See* Exhibit I for a form that one may wish to use when disclosing GRATs on Forms 709.

XVI. Miscellaneous

A. Trustee. The practitioner should carefully consider the identity of the trustee of the GRAT.

1. Code § 2036(b). If the GRAT is funded with stock in a "controlled corporation," either the grantor should not serve at all, or perhaps with a "special trustee" who has the sole power to vote the stock in the controlled corporation.

2. Continuing trust. If the GRAT continues in further trust after the annuity term, the advisor will need to carefully consider whether the grantor should serve as trustee.[128]

B. Problems in the boilerplate provisions? Practitioners should carefully consider whether any of the administrative and other "boilerplate" provisions might cause the annuity interest to fail to be a qualified annuity interest.

1. Spendthrift clause. To be safe, it might be best to have spendthrift provisions apply only after the expiration of the annuity term, and following the payment of the last annuity payment. The enforcement of a spendthrift clause to protect the annuitant might

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[128] For an excellent article on the limitations of the grantor's serving as trustee, *see* Akers, *Selection of Trustees: A Detailed Review of Gift, Estate and Income Tax Effects and Non-Effects*, 38th ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING, ch. 3 (Portuondo ed., 2004).

violate the requirement that annuity payments be made at least annually.[129]

2. Additions. Some trusts contain provisions outlining how additional property may be contributed. A GRAT should obviously contain the requisite bar against additional contributions,[130] at least during the annuity period (and any grace period), but the practitioner should also take care to ensure that the boilerplate provisions are not inconsistent.

3. Facility of payment provision. Payments to a custodian or guardian may not violate the GRAT annuity requirements (as the regulations speak in terms of payments made "to (or for the benefit of)" the annuitant.[131] Practitioners should still carefully review facility of payment provisions, especially for provisions allowing mandatory distributions to be held in further trust.

4. S Corp clause. Some trusts contain broad provisions allowing a trustee to amend the dispositive terms of a trust in order to permit qualification as a QSST[132] or ESBT.[133] Ideally these provisions should not be operative during the annuity period (and any grace period).

C. Administration expenses. Practitioners should be careful when a fiduciary will be paid fees, and should consider how to handle the payment of other administration expenses properly charged to the GRAT. If the GRAT itself does not have sufficient cash, the trustee may have to borrow cash to pay these expenses in order to avoid a possible deemed impermissible additional contribution by the grantor (such as if GRAT expenses are paid by the grantor). In the author's opinion, the grantor should be able to loan these funds to the GRAT, as long as the funds are not used to make the annuity payments.[134]

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[129] Code § 2702(b)(1) and Treas. Reg. § 26.2702-3(b)(1)(i). It has also been suggested that a spendthrift clause may permit the IRS to allege that the annuity interest should not be valued using normal actuarial methods, based upon two lottery cases in which annuities received in lotteries were held not to be valued under normal methods because the annuities could not be assigned. *See Gribauskus v. Commissioner*, 342 F.3d 85 (2d Cir. 2003) and *Shackleford v. United States*, 262 F.3d 1028 (9th Cir. 2001). *See also*, McCaffrey, *2005 Miami Institute, supra* note 1, at ¶ 703.7.

[130] Treas. Reg. § 25.2702-3(b)(5).

[131] Treas. Reg. § 25.2702-3(b)(1)(i).

[132] Code § 1361(d).

[133] Code § 1361(e).

[134] Treas. Reg. § 25.2702-3(d)(6). It would be safest, however, to provide sufficient cash funding to satisfy these administration expenses.

D. Apportionment of taxes. It is of course possible that the grantor will die during the annuity period, with the result that some or all[135] of the GRAT assets will be includible in the grantor's gross estate. Practitioners should carefully consider how taxes attributable to the GRAT would be paid – taking into consideration the grantor's testamentary tax apportionment provisions, state law tax appointment statute and Code § 2207(B).[136]

[135] There has been some disagreement as to whether inclusion should be under Code § 2036 or 2039, and some commentators have pointed out that it might be possible that less than the entire GRAT would be includible if the inclusion results from Code § 2036, rather than Code § 2039 (as is the opinion of the IRS). *See* Daniels & Delgass, *Design GRATs to Reap Court-Approved Extra Tax Savings*, PRACTICAL TAX STRATEGIES 324, 325 (Dec. 2003).

[136] For an excellent discussion of this issue, *see* Janes – *Part 1*, *supra* note 56, at 14-15.

EXHIBIT A

GRAT CHECKLIST

A "qualified interest" includes "any interest which consists of the right to receive fixed amounts payable not less frequently than annually. . . ." Code § 2702(b)(1). A qualified interest is further defined as "a qualified annuity interest, a qualified unitrust interest, or a qualified remainder interest." Treas. Reg. § 25.2702-2(a)(5). A "qualified annuity interest" is defined as "an interest that meets all the requirements of [Treas. Reg.] § 25.2702-3(b) and (d)." Treas. Reg. § 25.2702-2(a)(6).

Treas. Reg. § 25.2702-3(b) and (d) set forth 13 requirements for a qualified annuity interest, each of which is discussed below.

☐ 1. The right to a qualified annuity interest must be irrevocable. Treas. Reg. § 25.2702-3(b)(1)(i).

☐ 2. A qualified annuity interest must be a right to receive a "fixed amount." Treas. Reg. § 25.2702-3(b)(1)(i). A "fixed amount" can be either a stated dollar amount or a fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, in either case payable periodically but not less frequently than annually. Treas. Reg. § 25.2702-3(b)(1)(ii). The annuity amount can increase, as long as the dollar amount, fraction or percentage does not exceed 120% of the dollar amount, fraction or percentage in the preceding year. *Id.*

☐ 3. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually. Code § 2702(b)(1) and Treas. Reg. § 25.2702-3(b)(1)(i).

☐ 4. A qualified annuity interest cannot be a right of withdrawal. Treas. Reg. § 25.2702-3(b)(1)(i).

☐ 5. The payment of the annuity amount of a qualified annuity interest may not be satisfied by the issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly. Treas. Reg. § 25.2702-3(b)(1)(i), and for GRATs created after September 20, 1999, the trust instrument must prohibit the trustee from issuing a note, other debt instrument, option, or similar financial arrangement in satisfaction of the annuity payment obligation. Treas. Reg. § 25.2702-3(d)(5).

☐ 6. If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the trust instrument must contain provisions meeting the requirements of the regulations under Code § 664 relating to adjustments for any incorrect determination of fair market value of property in the trust. Treas. Reg. § 25.2702-3(b)(2).

☐ 7. The payments of the annuity must be made at certain times. The annuity amount may be payable based on either the anniversary date of the creation of the trust or the taxable year of the trust. Treas. Reg. § 25.2702-3(b)(3). The payment of an annuity amount based on the anniversary date of the creation of a trust must be paid on the anniversary date, or after the anniversary date, but no later than 105 days after the anniversary date. Treas. Reg. § 25.2702-3(b)(4). If the payments are made based on the anniversary date, proration of the annuity amount is only required if the last period during which the annuity is paid is less than 12 months.

☐ 8. The governing instrument must prohibit additional contributions to the trust. Treas. Reg. § 25.2702-3(b)(5).

☐ 9. A qualified annuity interest must be a qualified annuity interest in every respect. Treas. Reg. § 25.2702-3(d)(1). For example, the interest cannot be a combination of an annuity interest and a unitrust interest. *Id.*

☐ 10. The governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity interest during the term of the qualified interest. Treas. Reg. § 25.2702-3(d)(2).

☐ 11. The governing instrument must fix the term of the annuity interest and the term must be for the life of the term holder, for a specified term of years, or for the shorter thereof. Treas. Reg. § 25.2702-3(d)(3).

☐ 12. The governing instrument must prohibit commutation (prepayment) of the interest of the term holder. Treas. Reg. § 25.2702-3(d)(5).

☐ 13. The interest must meet the definition of and function exclusively as a qualified interest from the creation of the trust. Treas. Reg. § 25.2702-3(d)(1).

EXHIBIT B

SOLVING FOR ZEROED OUT GRAT ANNUITY - 2 YEAR REGULAR GRAT

If the assets inside a Regular GRAT (payments at the end) appreciate at a rate equal to the Code § 7520 rate (R), then at a certain annuity payment amount (P), the remainder (future value) will equal zero. The formula for determining the annuity payment for a 2 year Regular GRAT is **$P = (1+R)^2 / (2+R)$**.

$[(\$1 + R) - P] \times (1 + R) - P = 0$	Initial formula representing performance of zeroed-out GRAT
$[C-P] \times C - P = 0$	To simplify the equation, substitute C for ($1 + R)
$C^2 – PC – P = 0$	Multiply
$C^2 - P(C+1) = 0$	Associate
$-P(C+1) = -C^2$	Subtract C^2 from both sides
$P(C+1) = C^2$	Change signs of both sides
$P = C^2 / (C+1)$	Divide both sides by (C + 1) to solve for P
$P = (1+R)^2 / (1+R+1)$	Substitute (1+R) for C
$P = (1+R)^2 / (2+R)$	Add to get final formula
$P = (1+.06)^2 / (2+.06)$, or $P = (1.06)^2 / (2.06)$, or P = 54.543689%	Solve for P using September Code § 7520 rate of 6%
First year: $100,000,000, plus 6% growth ($6,000,000), less first payment of $54,543,689.32, leaves $51,456,310.68 at the end of the first year. Second year: $51,456,310.68, plus 6% growth ($3,087,378.64), less second payment of $54,543,689.32, leaves $0 at the end of the second year.	Check remainder value for $100,000,000

EXHIBIT C

SOLVING FOR ZEROED OUT GRAT ANNUITY - 2 YEAR GRAD (20%) GRAT

If the assets inside a graduated (20%) GRAT (payments at the end) appreciate at a rate equal to the Code § 7520 rate (R), then at a certain first year annuity payment amount (P), the remainder will equal zero. The formula for determining the 20% graduated annuity payment for a 2 year GRAT is **$P = (1+R)^2 / (2.2+R)$**.

[($1 + R) - P] x (1 + R) - 1.2P = 0	Initial formula representing performance of zeroed-out GRAT
[C-P] x C - 1.2P = 0	To simplify the equation, substitute C for ($1 + R)
$C^2 – PC – 1.2P = 0$	Multiply
$C^2 - P(C+1.2) = 0$	Associate
$-P(C+1.2) = -C^2$	Subtract C^2 from both sides
$P(C+1.2) = C^2$	Change signs of both sides
$P = C^2 / (C+1.2)$	Divide both sides by (C + 1.2) to solve for P
$P = (1+R)^2 / (1+R+1.2)$	Substitute (1+R) for C
$P = (1+R)^2 / (2.2+R)$	Add to get final formula
$P = (1+.06)^2 / (2.2+.06)$, or $P = (1.06)^2 / (2.26)$, or P = 49.7168142% (for first year)	Solve for P using September Code § 7520 rate of 6%
First year: $100,000,000, plus 6% growth ($6,000,000), less first payment of $49,716,814.16, leaves $56,283,185.84 at the end of the first year. Second year: $56,283,185.84, plus 6% growth ($3,376,991.15), less second payment of $59,660,176.99, leaves $0 at the end of the second year.	Check remainder value for $100,000,000

EXHIBIT D

CALCULATING THE REMAINDER FOR A 2 YEAR REGULAR GRAT

The formula to represent the performance of a 2 year GRAT is:

$$\{[(1+i) - P_1] \times (1+i_2)\} - P_2 = Q$$

- i = growth as of the end of first year
- i_2 = growth as of the end of second year
- P_1 = first year annuity payment
- P_2 = second year annuity payment
- Q = remainder value

The equation can be further simplified for a Regular GRAT:

$\{[(1+i) - P_1] \times (1+i_2)\} - P_1 = Q$	Replace P_2 with P_1 (since Regular GRAT)
$[(Y - P_1) \times (1+i_2)] - P_1 = Q$	Temporarily substitute Y for $(1+i)$
$[Y - P_1 + Yi_2 - P_1 i_2] - P_1 = Q$	Multiply within brackets
$Y - 2P_1 + Yi_2 - P_1 i_2 = Q$	Add
$Y + Yi_2 - P_1 i_2 - 2P_1 = Q$	Rearrange
$Y(1 + i_2) - P_1(2 + i_2) = Q$	Associate
$(1+i)(1 + i_2) - P_1(2 + i_2) = Q$	Replace Y with $(1+i)$
$(1+i)(1 + i_2) - \{[(1+R)^2 / (2+R)] \times (2 + i_2)\} = Q$	Replace P_1 with $(1+R)^2 / (2+R)$ (where R equals the Code § 7520 rate)
$(1 + i)(1 + i_2) - \left[\frac{(1 + R)^2 \times (2 + i_2)}{(2 + R)}\right]$	This is the formula for Q, the remainder in a 2 year Regular GRAT

EXHIBIT E

CALCULATING THE REMAINDER FOR A 2 YEAR GRAD GRAT

The formula to represent the performance of a 2 year GRAT is:

$$\{[(1+i) - P_1] \times (1+i_2)\} - P_2 = Q$$

- i = growth as of the end of first year
- i_2 = growth as of the end of second year
- P_1 = first year annuity payment
- P_2 = second year annuity payment
- Q = remainder value

The equation can be further simplified for a Grad GRAT:

$\{[(1+i) - P_1] \times (1+i_2)\} - 1.2P_1 = Q$	Replace P_1 with $1.2P_1$ (since 20% Grad GRAT)
$[(Y - P_1) \times (1+i_2)] - 1.2P_1 = Q$	Temporarily substitute Y for $(1+i)$
$[Y – P_1 + Yi_2 - P_1i_2] - 1.2P_1 = Q$	Multiply within brackets
$Y - 2.2P_1 + Yi_2 - P_1i_2 = Q$	Add
$Y + Yi_2 - P_1i_2 - 2.2P_1 = Q$	Rearrange
$Y(1 + i_2) - P_1(2.2 + i_2) = Q$	Associate
$(1+i)(1 + i_2) - P_1(2.2 + i_2) = Q$	Replace Y with $(1+i)$
$(1+i)(1 + i_2) - \{[(1+R)^2 / (2.2+R)] \times (2 + i_2)\} = Q$	Replace P_1 with $(1+R)^2 / (2.2+R)$ (where R equals the Code § 7520 rate)
$(1 + i)(1 + i_2) - \left[\frac{(1 + R)^2 \times (2.2 + i_2)}{(2.2 + R)}\right]$	This is the formula for Q, the remainder in a 2 year Grad GRAT. (Multiply this result by the amount contributed to get the value of the remainder.)

EXHIBIT F

CONSTANT RATES OF GROWTH - 2 YEAR GRAD GRAT ALWAYS BETTER IF GROWTH EXCEEDS CODE § 7520 RATE

Factor for 2-year Regular GRAT (note that since i_2 equals i, i_2 is replaced with i in the formula on Exhibit D):

$$(1 + i)^2 - \left[\frac{(1 + R)^2 \times (2 + i)}{(2 + R)}\right]$$

Factor for 2-year Graduated GRAT (note that since i_2 equals i, i_2 is replaced with i in the formula on Exhibit E):

$$(1 + i)^2 - \left[\frac{(1 + R)^2 \times (2.2 + i)}{(2.2 + R)}\right]$$

Theorem: Grad GRAT > Regular GRAT when $i > R$:

Grad GRAT		**Regular GRAT**
$(1 + i)^2 - \left[\frac{(1 + R)^2 \times (2.2 + i)}{(2.2 + R)}\right]$	>	$(1 + i)^2 - \left[\frac{(1 + R)^2 \times (2 + i)}{(2 + R)}\right]$
	Subtract $(1 + i)^2$ from each side	
$- \left[\frac{(1 + R)^2 \times (2.2 + i)}{(2.2 + R)}\right]$	>	$- \left[\frac{(1 + R)^2 \times (2 + i)}{(2 + R)}\right]$
	Change to positive (and switch > sign)	
$\left[\frac{(1 + R)^2 \times (2.2 + i)}{(2.2 + R)}\right]$	<	$\left[\frac{(1 + R)^2 \times (2 + i)}{(2 + R)}\right]$
	Divide by $(1 + R)^2$	
$\frac{(2.2 + i)}{(2.2 + R)}$	<	$\frac{(2 + i)}{(2 + R)}$
	Cross-multiply	
$(2.2 + i) \times (2 + R)$	<	$(2 + i) \times (2.2 + R)$
	Multiply	
$4.4 + 2i + 2.2R + iR$		$4.4 + 2.2i + 2R + iR$
	Subtract 4.4 and iR	
$2i + 2.2R$	<	$2.2i + 2R$
	Subtract $2i$ and $2R$	
$.2R$	<	$.2i$
	Divide by .2	
R	<	i

EXHIBIT G

DIFFERENT RATES OF GROWTH - GRAD GRAT ALWAYS BETTER IF SECOND YEAR GROWTH EXCEEDS CODE § 7520 RATE

Factor for 2-year Regular GRAT:

$$(1 + i)(1+i_2) - \left[\frac{(1 + R)^2 \times (2 + i_2)}{(2 + R)}\right]$$

Factor for 2-year Graduated GRAT:

$$(1 + i)(1+i_2) - \left[\frac{(1 + R)^2 \times (2.2 + i_2)}{(2.2 + R)}\right]$$

Theorem - Grad GRAT > Regular GRAT when $i_2 > R$:

<table>
<tr><th><u>Grad GRAT</u></th><th></th><th><u>Regular GRAT</u></th></tr>
<tr><td>$(1 + i)(1+i_2) - \left[\frac{(1 + R)^2 \times (2.2 + i_2)}{(2.2 + R)}\right]$</td><td>$>$</td><td>$(1 + i)(1+i_2) - \left[\frac{(1 + R)^2 \times (2 + i_2)}{(2 + R)}\right]$</td></tr>
<tr><td colspan="3">Subtract $(1 + i)(1+i_2)$ from each side</td></tr>
<tr><td>$- \left[\frac{(1 + R)^2 \times (2.2 + i_2)}{(2.2 + R)}\right]$</td><td>$>$</td><td>$- \left[\frac{(1 + R)^2 \times (2 + i_2)}{(2 + R)}\right]$</td></tr>
<tr><td colspan="3">Change to positive (and switch > sign)</td></tr>
<tr><td>$\left[\frac{(1 + R)^2 \times (2.2 + i_2)}{(2.2 + R)}\right]$</td><td>$<$</td><td>$\left[\frac{(1 + R)^2 \times (2 + i_2)}{(2 + R)}\right]$</td></tr>
<tr><td colspan="3">Divide by $(1 + R)^2$</td></tr>
<tr><td>$\frac{(2.2 + i_2)}{(2.2 + R)}$</td><td>$<$</td><td>$\frac{(2 + i_2)}{(2 + R)}$</td></tr>
<tr><td colspan="3">Cross-multiply</td></tr>
<tr><td>$(2.2 + i_2) \times (2 + R)$</td><td>$<$</td><td>$(2 + i_2) \times (2.2 + R)$</td></tr>
<tr><td colspan="3">Multiply</td></tr>
<tr><td>$4.4 + 2i_2 + 2.2R + iR$</td><td></td><td>$4.4 + 2.2i_2 + 2R + iR$</td></tr>
<tr><td colspan="3">Subtract 4.4 and iR</td></tr>
<tr><td>$2i_2 + 2.2R$</td><td>$<$</td><td>$2.2i_2 + 2R$</td></tr>
<tr><td colspan="3">Subtract $2i_2$ and $2R$</td></tr>
<tr><td>$.2R$</td><td>$<$</td><td>$.2i_2$</td></tr>
<tr><td colspan="3">Divide by .2</td></tr>
<tr><td>R</td><td>$<$</td><td>i_2</td></tr>
</table>

Regular GRAT beats Grad GRAT when $i_2 < R$ by an amount equal to (Z x contribution).

$Z = (1+R)^2 * [0.2y/(2+R)(2.2+R)]$, where y= the difference between R and i_2.

EXHIBIT H

ACTUAL "HURDLE RATES" FOR 2 YEAR GRATS – ASSUMING 105 DAYS OF DEFERRAL

	Hurdle Rates	
Code § 7520 rate	**Regular GRAT**	**Grad GRAT**
3.0%	2.509375%	2.517998%
4.0%	3.342380%	3.352391%
4.2%	3.508775%	3.518976%
4.4%	3.675104%	3.685463%
4.6%	3.841364%	3.851853%
4.8%	4.007557%	4.018146%
5.0%	4.173682%	4.184341%
5.2%	4.339740%	4.3504340%
5.4%	4.505730%	4.516441%
5.6%	4.671653%	4.682346%
5.8%	4.837509%	4.848154%
6.0%	5.003298%	5.013866%
6.2%	5.169021%	5.179481%
6.4%	5.334676%	5.345000%
6.6%	5.500265%	5.510423%
6.8%	5.665787%	5.675749%
7.0%	5.831244%	5.840980%
8.0%	6.657531%	6.665701%
9.0%	7.482177%	7.488043%

Example – no deferral. A 2 year Regular GRAT without deferral with an assumed rate of return equal to the Code § 7520 rate (assume June 2006 rate of 6%) should have a remainder of $0.00. $1,000,000 would grow to $1,060,000 by year 1, less the first year annuity payment of $545,436.89, leaving $514,563.11. During the second year, this amount should grow to $545,436.90, and after the second equal annuity payment, result in $0.01 left at the end of the 2 year term.

Example – 105 day deferral. A 2 year Regular GRAT created in June 2006 with a full 105 day deferral and an assumed rate of return equal to 5.003298% should have a remainder of $0.00. $1,000,000 would grow to $1,050,032.98 by year 1. Following 105 days of deferral,[137] the value in the GRAT should be $1,064,884.28. After payment of the first year annuity of $545,436.89, $519,447.39 should remain. During the following second year (again, with 105 days deferral), this amount should grow to $545,436.89, and after the second equal annuity payment, would result in $0.00 left at the end of the 2 year term.

[137] $1,000,000 x $(1+5.003298\%)^{(1+105/365)}$

EXHIBIT I

FORM FOR DISCLOSING GRAT ON FORM 709

JOHN DOE
SSN: 123-45-6789
2006 Form 709
Supporting Calculation of the
Transferred and Retained Interests

Taxpayer provides the following information as required by Treas. Reg. § 301.6501(c)-1(e)(2).

Donee: The John Doe 2006 GRAT created under trust agreement dated September 14, 2006 (the "GRAT"), with John Doe (the "Taxpayer") as both grantor and Trustee. A copy of the GRAT trust agreement is attached to this Form 709.

Gift: The remainder interest in the GRAT following payments to the Taxpayer in annual installments over a two year term. The property transferred to the GRAT on September 14, 2005 consisted of a 10% Class B membership interest in Doe Investments LLC, a Nevada limited liability company. An appraisal of the contributed assets is attached.

The total fair market value of the assets contributed to the GRAT was $1,000,000. The value of the gift of the remainder interest has been determined as follows:

Value of property transferred to GRAT	$	1,000,000.00
Less: Present Worth of Annuity (see Attached Statement)[138]		999,900.00
Taxable Gift	$	100.00

Pursuant to Treas. Reg. § 301.6501(c)-1(e)(2)(ii), the following is a list of all parties related to the Taxpayer holding an equity interest in Doe Investments LLC as of September 14, 2006, immediately following the Taxpayer's transfers to the GRAT:

John Doe 123-45-6789 Taxpayer 123 Main Street USA Owner of 1% Class A interest	The John Doe 2006 GRAT 123-45-6789 Donee 123 Main Street USA Owner of 10% Class B interest Copy of trust attached
Jane Doe 213-45-6789 Taxpayer's spouse 123 Main Street USA Owner of 89% Class B interest	

[138] This refers to the actual calculation, such as produced by commercial software.