Document ID#: 547200610037

AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

2006 Joint Fall CLE Meeting

TITLE: GRAT Planning - The Basics

AUTHOR: Hundley, Laura

PANEL: Grantor Retained Annuity Trusts - The Basics

DATE: 10/20/06

COMMITTEE: Estate and Gift Taxes

GRAT PLANNING – THE BASICS

Laura S. Hundley
Holland & Hart LLP
Boulder, CO

ABA 2006 Joint Fall CLE Meeting
Section of Taxation & Section of Real Property, Probate and Trust Law
Estate and Gift Tax Committee Program
October 20, 2006

I. INTRODUCTION

The grantor retained annuity trust (GRAT) is a highly effective way to transfer wealth at little to no gift tax cost. Tax efficiency, simplicity and flexibility are some of the hallmarks of the GRAT technique. For the donor who wants to shift future asset appreciation at no gift tax cost, the GRAT is a uniquely powerful planning solution.

This outline gives a brief overview of the basics of GRAT planning. It sets forth general background on the technique, typical features of a "classic GRAT," and aspects of the technique that commonly appeal to donors. It is intended to give a "running headstart" to those planners who are relatively new to GRATs and a brief refresher on certain key planning issues for more seasoned GRAT planners.

II. GENERAL BACKGROUND

A. <u>Description</u>

1. The GRAT is a "freeze" technique that allows a donor to shift future asset appreciation to beneficiaries at nominal to no gift tax cost, while retaining most or all of the income from the asset for a period of years.

2. It is a creature of the Internal Revenue Code and Treasury Regulations, resulting from the Chapter 14 special valuation rules enacted in 1990.

3. It is an irrevocable trust that makes a series of annuity payments to the grantor for a set term. At the end of the term, the remaining trust principal passes to the remainder beneficiaries free of gift or estate tax (assuming the grantor survives the term).

4. A GRAT allows a grantor to:

   a. Minimize or eliminate gift taxes on the transfer of property;

   b. Transfer asset appreciation at minimal to no transfer tax cost; and

   c. Retain some degree of control over the property.

B. <u>Goals</u>

1. Outlive the term

The grantor must survive the term of the GRAT, otherwise some or all of the value of the trust property at the grantor's date of death will be included in her taxable estate.

2. Outperform the section 7520 rate

a. The grantor's retained interest and the remainder interest are valued according to the section 7520 rate.

b. The 7520 rate "assumes" a certain level of appreciation. If the assets grow at a rate higher than the assumed level, the additional appreciation passes gift and estate tax free to the remainder beneficiaries.

C. <u>Valuation</u>

1. The GRAT technique results from the special valuation rules of Chapter 14. Sections 2701- 2704. Section 2702 establishes rules for valuing gifts in trust to family members that are subject to retained interests.

a. Section 2702 imposes a "subtraction rule" to value gifts. As long as the grantor's retained interest is a "qualified interest" under section 2702, the value of the gift equals the fair market value of the property less the value of the grantor's retained interest. Section 2702(b).

b. If the grantor's retained interest is not a "qualified interest," it is valued at zero, and the gift equals the entire fair market value of the property.

2. The gift occurs upon the initial transfer to the trust.

3. Key factors affecting the value of the GRAT remainder interest:

a. Length of the term;

b. Amount of the retained annuity percentage; and

c. Section 7520 rate when the trust is funded.

D. <u>Selected Governing Instrument Requirements</u>

Section 2702 and the regulations contains various requirements to constitute a "qualified annuity interest." Section 2702(b) and Reg. § 25.2702-3. Some of these requirements include:

1. <u>Annual payments</u>

Payments must be made to the annuitant no less frequently than annually. Section 2702(b)(1).

2. Annuity must be fixed amount or a fraction of initial value, and may increase by no more than 20% annually

The annuity amount may either be a stated dollar amount or a fixed fractional percentage of the initial fair market value. Reg. § 25. 2702-3(b)(1)(ii). The stated amount may increase or decrease in any year, but any increase is limited to a 20% increase over the amount in the prior year. Reg. § 25.2702-3(e) Ex. 2.

3. No additional contributions

The governing instrument must prohibit additional contributions to the trust. Reg. § 25.2702 – 3(b)(5).

4. No amounts payable to other persons

During the annuity term, the governing instrument must prohibit distributions from the trust to or for the benefit of anyone other than the annuitant. Reg. § 25.2702-3(d)(3).

5. No commutation

The governing instrument must prohibit commutation of the annuity interest. Reg. § 25.2702-3(d)(5). Thus, the trustee cannot prepay the grantor's annuity interest (and terminate the trust early) in the form of a present value lump sum.

6. No use of notes to fund annuity payments

The final regulations require that the governing instrument "must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity." Reg. § 25.2702-3(d)(6).

E. Tax Consequences

1. Gift tax

a. If the terms of the trust satisfy the applicable requirements under section 2702, the value of the gift is the present value of the remainder interest passing to the remainder beneficiaries.

b. The gift tax annual exclusion is not available for a GRAT gift, since the remainder beneficiaries do not receive a present interest in the trust property. Reg. § 25.2503-3(a)

2. Income tax

a. A GRAT is typically a grantor trust as to both income and principal. Grantor trust status can result under various grantor trust rules, including:

(1) The grantor is treated as the owner of the income portion of the trust if the retained interest exceeds 5% of the value of the trust. Section 673.

(2) When the grantor retains certain powers over the trust principal, typically a non-fiduciary power to reacquire trust principal by substituting other property of an equivalent value, grantor trust status can apply. Section 675(4)(c).

(3) During the annuity term, a requirement that the GRAT must pay the grantor the trust income and, to the extent that income is not sufficient, trust principal, to satisfy the annuity payments creates grantor trust status. Section 671.

b. As a result of the grantor trust status, the grantor is treated as the owner of the GRAT property for income tax purposes during the annuity term and must report on her personal income tax return all income, deductions and credits attributable to the trust property.

c. Many practitioners recommend that the remainder interest pass to a separate grantor trust at the end of the GRAT term, in order to maintain the flexibility and general benefits of grantor trust status.

d. Benefits of grantor trust status:

(1) The grantor must pay income tax on all trust income including capital gains, thus allowing the grantor to make gift tax free gifts to the remainder beneficiaries.

(2) There is no taxable gain when the GRAT distributes appreciated property in satisfaction of the annuity payment. Rev. Rul. 85-13,1985-1 C.B. 184.

(3) There is no taxable gain if the grantor purchases the GRAT property during the annuity term. Rev. Rul. 85-13, *supra*.

(4) The trust may be an S corporation shareholder. Section 1361(c)(2)(A)(i).

(5) Under certain circumstances, the trust does not need to obtain a taxpayer identification number or file income tax returns. Reg. § 1.671-4.

3. <u>Estate tax</u>

a. A key drawback of the GRAT is the inclusion of the trust property in the grantor's gross estate if she dies during the GRAT term.

(1) If the grantor dies during the term, all or part of the value of the GRAT property at that time is included in the grantor's gross estate under section 2036 or section 2039.

(2) In the case of a "zeroed-out GRAT" (discussed below), the trust will continue after the grantor's death for the balance of the term, and the trust assets will not be available for the payment of the grantor's estate taxes. As a result, the grantor must make other arrangements to pay the estate tax attributable to the GRAT.

(3) Some practitioners advise covering the estate tax exposure through the purchase of term life insurance (via an irrevocable life insurance trust).

(4) Short term GRATs can also be used to reduce the risk of mortality.

b. If the grantor survives to the end of the trust term, the remaining trust assets pass to the designated beneficiary, and none of the trust assets will be included in the grantor's estate for estate tax purposes at her subsequent death.

4. <u>GST tax</u>

a. A GRAT is not an effective generation-skipping planning technique. Under the "ETIP rules," no GST exemption can be allocated to the GRAT property until the grantor's retained term ends (*i.e.*, when the "estate tax inclusion period" (ETIP) is over).

b. Under section 2642(f), a grantor cannot allocate GST exemption to transferred property during that period in which the property would be includible in the grantor's estate (other than by reason of the application of the transfer within three years of death rule under section 2035) if she were to die.

c. At the end of the annuity term, the grantor can only protect the trust property from GST tax by allocating her GST exemption to the full value of the trust property at that time (at its presumably appreciated value). As a result, there is no opportunity for leveraged use of the exemption. If the grantor dies during the term, the retained interest could be a direct skip or could result in a later taxable termination and/or distribution. Section 2612(c)(2).

d. The GRAT, therefore, is not a useful method for transferring wealth to grandchildren or more remote descendants (unless the parents are deceased when the GRAT is created).

III. TYPICAL FEATURES OF A "CLASSIC GRAT"

A. <u>Structure</u>

1. <u>Funding asset</u>

a. GRATs typically are funded with assets that have the potential for significant appreciation over the section 7520 rate in the short term.

b. Such appreciation can occur through asset value growth and/or discounts on the value of the funding asset (*e.g.*, due to lack of marketability and/or minority interest characteristics).

2. <u>Zeroed-out funding</u>

a. The "zeroed-out" concept

(1) A GRAT may be structured so that there is no gift tax on funding the trust. This is done by setting the present value of the grantor's annuity payments at an amount equal to the value of the property transferred to the GRAT. In that event, the remainder interest has no value (it has been "zeroed out"), and no gift tax is payable. This result stems from the section 2702 "subtraction method" for valuing the grantor's gift to the remainder beneficiaries.

(2) Because no gift tax is payable, there is no "tax downside" to implementing the GRAT – either in the case of the GRAT assets underperforming the section 7520 rate or the grantor dying during the annuity term. In either case, because no gift tax is payable, the grantor is no worse off than if the GRAT had never been established.

b. The "Notorious Example 5"

(1) Until recently, zeroing-out was not an option. Example 5 of Reg. § 25.2702-3(e) took the position that a GRAT could never be zeroed out completely. It provided that the value of the grantor's retained annuity interest must always be discounted for the fact that she may die during the term.

(a) The value of the retained interest was not the actuarial value of the right to receive an annuity for a full term; rather, it was the value of the right to receive the annuity for a term or until the earlier death of the grantor.

(b) Since there is always the chance that the grantor could die during term, this rule would always discount the value of the grantor's retained interest. Reg. § 25.2702-3(e).

(2) Example 5 provided that this "mortality discount" applied even if the annuity was, under the governing instrument, payable to the grantor's estate for the remainder of the term if the grantor died during the term.

c. The *Walton* case

(1) Fortunately, the Tax Court invalidated Example 5 in *Walton v. Commissioner*, 115 T.C. 589 (2000), in a unanimous, reviewed opinion. The case directly addressed whether Example 5 is correct. The Tax Court rejected Example 5 and held that it is an invalid interpretation of section 2702.

(2) The IRS did not appeal *Walton* and, three years later, acquiesced in the result. Notice 2003-72, 2003-2 CB 964. The IRS then removed Example 5 from the regulations. Reg. 25.2702-3(d)(4) & (e), Example 5 (amended February 15, 2005).

(3) The key consequence of *Walton* is that GRATs can now be truly "zeroed-out" (*i.e.*, with no taxable gift on funding). Grantors can now create GRATs with an annuity value equal to the entire value of the property transferred to the trust. In the fact situation presented in Example 5, the IRS will now treat a retained annuity payable to the grantor or the grantor's estate for a set term as a qualified interest for the full term (*i.e.*, not as a qualified interest payable for a term or until the grantor's earlier death).

d. General practices on zeroing-out

(1) Although *Walton* (and the IRS's subsequent removal of Example 5) establishes that a GRAT can be zeroed-out, practitioners differ on whether it is advisable to fully zero-out a GRAT.

(2) Some practitioners prefer to have at least a nominal gift and to disclose the GRAT gift on a gift tax return, in order to start the three-year gift tax statute of

limitations. Others opt to fully zero out the GRAT gift and believe filing no gift tax return is the advisable approach.

3. Single asset (and single asset class) GRATs

a. Funding a GRAT with a single asset (or asset class) is one technique for reducing the risk of poor investment performance during the annuity term.

b. By using a single asset GRAT, the potential underperformance of one asset/asset class will not "drag down" the superior performance of other assets.

4. Short-term

a. Two-years is the minimum term used by most practitioners.

(1) The statute and regulations do not, however, impose any clear restriction on the minimum term. Section 2702(b)(1) refers to "fixed amounts payable not less frequently than annually." Reg. § 25.2702-3(b)(1)(ii) refers to amounts "payable periodically, but not less frequently than annually."

(2) Rulings and case law, however, have caused the two-year minimum to become a general rule of practice. See Letter Ruling 9239015 (IRS ruled that a GRAT annuity interest was a qualified interest with a term of two years); and *Walton v. Commissioner*, 115 T.C. 589 (2000), in which the Tax Court upheld GRATs with a two-year term (the case actually ruled on other aspects of the GRATs, specifically the valuation of the remainder following a fixed term of years).

b. Benefits of short-term GRATs

(1) A series of short-term GRATs can help reduce the risk of negative investment performance. With several short-term GRATs, poor investment performance in one GRAT will not dilute the success of another GRAT that outperforms the section 7520 rate.

(2) A short-term GRAT reduces the estate tax risk of the grantor dying during the term.

(3) A shorter term for the GRAT may also give the grantor a greater sense of financial security. If the grantor's circumstances (or those of the remainder beneficiaries) change during the GRAT term, the grantor knows that she will recover a sizable portion (or all) of the transferred asset within a short time.

c. Drawbacks of short-term GRATs

(1) A short-term GRAT runs the risk that the section 7520 rate increases during the term.

(2) There is a risk that Congress will eliminate or tighten the rules that govern GRAT planning during the annuity term. A short-term GRAT would provide a more limited period of any potential "grandfathering" protection.

(3) A short-term GRAT, while a good "hedge" against negative investment performance, may not be as effective as a long-term GRAT in capturing steady positive returns. This result is especially likely if the grantor waits until the end of the prior GRAT to create a new GRAT (rather than fund staggered GRATs, where a new GRAT is created at the end of each year with that year's annuity). For a helpful discussion of this issue, see Katzenstein, *Running the Numbers: An Economic Analysis of GRATs and QPRTs*, Paper presented at ALI-ABA Course of Study "Planning Techniques for Large Estates," April 2006.

5. <u>Liquidity to fund annuity payments</u>

a. Generally, the best method for making the annuity payments is to use cash (rather than in-kind distributions). By using cash, the presumably appreciating assets can stay in trust for a longer period (and out of the grantor's estate).

b. Cash may be available if the gifted assets are sold prior to the annuity payment being due or if the GRAT is funded with high income producing assets.

c. If the asset does not produce sufficient cash flow to pay the annuity amount, fractional interests in the asset or specific assets could be used to satisfy the annuity payments. This is generally not the preferred approach, however, given that the GRAT is intended to retain appreciating assets. If the annuity payments are made with in-kind distributions, the grantor could fund new GRATs with the distributed assets.

B. <u>Drafting</u>

1. <u>Formula provision to define the annuity amount</u>

a. The regulations define a "qualified annuity interest" as an "irrevocable right to receive a fixed amount." The "fixed amount" can be either:

(1) a stated dollar amount or

(2) a "[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." Reg. § 25.2702-3(b)(1)(ii)(B).

b. A formula annuity is generally agreed to be the superior approach (particularly in the case of a GRAT funded with closely-held business interests or other hard-to-value assets).

c. If the formula annuity is used, and the gift tax value of the transferred property is increased on audit, the formula acts as a savings clause:

(1) Any increase in the value of the transferred property is largely "absorbed" in the form of an increase in the annuity amount paid to the grantor; and

(2) The taxable gift remains the predetermined fraction of the total value of the transferred property.

(3) The grantor is, therefore, protected from any substantial gift tax.

d. Many practitioners believe this savings clause feature is an important advantage of using GRATs over other techniques, in which the use of valuation adjustment clauses has been scrutinized by the IRS.

2. Increasing payments ("backloading")

a. The regulations allow the annuity amount to be increased by up to 20% each year (whether the annuity is expressed as a dollar amount or a fraction of the initial fair market value of the trust property). Reg. § 25.2702-3(b)(1)(ii).

b. By using escalating payments, the GRAT keeps appreciating assets in the trust, and out of the grantor's estate, as long as possible.

c. A GRAT with a 20% increase in the annuity payment each year will generally outperform any other GRAT (particularly in the case of a GRAT with steadily appreciating assets).

3. Substitution power

a. Many practitioners include in the GRAT trust document the power in the grantor to reacquire trust property by substituting other property of equivalent value. Section 675(4)(C).

b. The substitution power is useful both in supporting grantor trust status and in providing flexibility to reconfigure the GRAT assets, as needed.

C. Performance Management

1. Monitoring

a. To improve the success of the GRAT, the trustee and grantor should closely monitor the performance of the GRAT assets during the term.

b. With a poorly performing GRAT, the grantor and trustee should take affirmative steps to manage the assets. The trustee should consider selling the poorly performing asset (and reinvesting the cash proceeds in a more promising asset), and/or the grantor could exercise the power to substitute assets of equivalent value.

c. In general, large losses early in the GRAT term result in a "failed GRAT." This stems from the same principles that govern investment portfolio performance. Large early losses necessitate substantial later gains in order to "get back to even."

2. Substitution of other assets

a. If the GRAT underperforms the section 7520 rate early in the annuity term, the grantor can exercise the substitution power to "swap out" the poorly performing asset in exchange for cash or a promissory note and "start again."

b. The grantor would contribute the purchased property (now at a depressesed valuation) to a new GRAT, and the underperforming GRAT would pay out its remaining assets (cash or promissory note) to the grantor over the balance of the term.

c. Such a sale to the grantor (or the grantor's spouse) has no income tax consequences if the GRAT is a wholly-owned grantor trust. Rev. Rul. 85-13, 1985-1 C.B. 184.

d. If the substitution power is used, it is critical to ensure the substituted assets are of exactly equal value, as the regulations prohibit additional gifts to the GRAT. Reg. § 25.2702-3(b)(5).

e. Before exercising the substitution power to "swap out" publicly traded stock, care must be taken to comply with any securities law restrictions (in case the power is considered an option or exercise of the power is treated as an insider trade).

IV. ASPECTS OF GRAT PLANNING THAT COMMONLY APPEAL TO DONORS

A. <u>Financial security</u>

1. Retained income stream

2. Current asset value returned to donor

B. <u>Control</u>

1. Grantor can be trustee

2. Ability to substitute assets (to replace poorly performing assets and/or to shift low basis trust assets back to the grantor to position for a basis step-up at death)

C. <u>Risk management</u>

1. Grantor (not beneficiaries) bears downside investment risk

If the trust property decreases in value (or does not appreciate at a rate greater than the 7520 rate), the entire trust property is paid back to the grantor in annuity payments, and nothing passes to the remainder beneficiaries.

2. Upside can be capped

a. If the grantor is concerned about "too much" trust property passing to the remainder beneficiaries, the governing instrument could "cap" the value of the remainder interest, with the excess paid back to the grantor. The cap could be a mandatory ceiling or it could be a pro rata sharing in the upside above a certain threshold.

b. In the case of a zeroed-out GRAT, there is no gift tax "cost" to the capping approach.

c. The cap has no effect on the gift tax value of the remainder interest (*i.e.*, it does not reduce the value of the gift).

D. Flexibility

1. Power to substitute assets.

2. Ability to couple with other techniques (such as intra-family loans, *i.e.*, the remainder interest could be used as a debt repayment fund for loans made by the grantor to her children).

3. Ability to exit the transaction within a short period, in the case of a short-term GRAT, if circumstances change for the grantor and/or beneficiaries.

E. Clarity

1. Statutory technique

For many grantors, the GRAT is uniquely appealing as a gifting technique because it is expressly authorized by the Internal Revenue Code. In addition, the regulations set forth detailed guidance on how to structure the trust and draft the governing instrument in compliance with the statutory requirements.

2. Specific "hurdle rate" to beat

Grantors often find comfort in having a specific "hurdle rate" against which to benchmark their gifting success. A specific return target provides a clear performance goal.

3. Focuses on first generation only

Many grantors (particularly younger grantors) find it appealing that the GRAT is a technique to shift wealth to their children and not to more remote generations. Especially for grantors with young children and no grandchildren, the GRAT can feel like a more appropriate strategy for their current circumstances.

F. Tax efficiency

1. The grantor can choose the level of taxable gift – including a zeroed-out gift requiring no use of gift tax exemption.

2. The formula approach for the annuity amount operates as a savings provision in the event of a gift tax audit (avoiding significant gift tax liability or exemption usage).

3. The grantor trust status provides further wealth transfer "leverage," with any income tax liability paid by the grantor creating a gift tax free wealth transfer to the remainder beneficiaries.