Document ID#: 547200610051

AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

2006 Joint Fall CLE Meeting

TITLE: Basic GRAT Funding and Administration Issues

AUTHOR: Kronenberg, James

PANEL: Grantor Retained Annuity Trusts - The Basics

DATE: 10/20/06

COMMITTEE: Estate and Gift Taxes

BASIC GRAT FUNDING AND ADMINISTRATION ISSUES

James Kronenberg
Principal/Associate Fiduciary Counsel
Bessemer Trust
New York, NY [1]

Prepared for the ABA Fall 2006 Meeting of the Section of Taxation
Estate and Gift Tax Committee
Denver, CO, October 19-21, 2006

I. Funding Issues

A. When is the GRAT Created? The Treasury Regulations require that the annuity payment date be tied to either (i) the taxable year of the trust or (ii) the date of the creation of the trust. Treas. Reg. §25.2702-3(b)(3). Most GRATs use the latter formulation because tying the payment date to the taxable year means that a prorated payment of the annuity will have to be made at the end of the calendar year, which hurts the growth prospects of the GRAT assets and creates more administrative burden.

What is the "creation date"? A basic tenet of trust law is that a trust does not exist unless property has been transferred to the trustee. Therefore, many GRATs are created by transferring a nominal amount of cash to the trust and listing the other property to be transferred on an attached schedule to the trust agreement. Query: are subsequent transfers to the GRAT prohibited "additional contributions" within the meaning of Treas. Reg. §25.2702-3(b)(5)? Probably not if the assets are listed on the schedule of assets to be transferred. However, care should be taken to actually transfer all of the assets before the end of the month in which the GRAT was created. The regulations under §7520 provide that the rate to be used in calculating the value of the annuity and remainder interests is the rate for the month which includes the "valuation date," defined as the date "on which the gift is complete." Treas. Reg. §25.7520-1(b)(1)(ii). This will avoid any possible argument that the applicable §7520 rate is one other than the one for the month of the creation of the trust.

Because some assets, like interests in family partnerships or closely held businesses, may be difficult to transfer (that is, they may require additional consents or paperwork), care should also be taken to complete all of the appropriate paperwork for execution immediately after the signing of the GRAT. Some planners have suggested transferring hard-to-value assets

[1] The many outlines, musings and other written materials of Steve Akers of Bessemer Trust in Dallas, TX were of great value in the preparation of this outline.

into an LLC prior to establishing a GRAT and subsequently transferring the interests in the LLC by simple assignment when the GRAT is created.

There may be securities law disclosure issues on the transfer of publicly-traded stock held by insiders.

B. Watching the §7520 rate. After the decision to establish the GRAT is made, there is an opportunity to wait until the following month to see if the applicable §7520 rate goes down. The applicable federal rates, including the §7520 rate, are published by the IRS on or about the 20th of each month. This gives planners approximately 10 days to determine if the GRAT should be created and funded in the current month (because the rate is going up) or in the next month (because either the rates are going down or because the rates are staying the same and there are other reasons to delay the creation of the GRAT).

II. Administration Issues

A. How to Make Annuity Payments.

1. Cash. Using cash is the easiest and best way to make each annuity payment. Cash would be available if (i) the GRAT is funded with cash, (ii) the asset is income producing, is sold or redeemed or (iii) the trustee borrows funds from a third party.

2. In-Kind Distributions. Fractional interests in the GRAT assets can also be used to pay the annuity amount.

If the payment of the annuity is not made on the exact date prescribed in the trust instrument (see the below discussion on the 105-day grace period), the values of securities or property used should be as of the date of distribution. If the assets are not publicly traded, they will likely require appraisals to determine their value (again, as of the date the payment is actually made). If using a recent appraisal of a hard to value asset, it is a good idea to get an update letter from the appraiser stating that the value has not changed between the date of the appraisal and the date of distribution.

Any appraisal should include appropriate valuation discounts, which can be problematic if the discounts are higher than discounts that may have been taken on the same asset when contributed to the GRAT. For example, if a majority interest in an FLP was contributed to a GRAT, so that little or no discounts are appropriate, a distribution of a smaller, minority interest in the FLP in satisfaction of the annuity payment will result in a larger discount on the annuity payment. This works against the purposes of the GRAT because a larger percentage of the FLP is distributed back to the grantor.

The in-kind distribution will not result in taxable income to the trust or the beneficiary because the GRAT is a grantor trust (see below).

3. Loan from Grantor. Regulations issued in 2000 prohibit the grantor from making loans to the GRAT to satisfy the annuity obligation. Specifically, the regulation provides that the issuance of notes, other debt instruments, options or similar financial arrangements, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount. Treas. Reg. §25.2702-3(b)(1)(i). The preamble to the final regulations says that the annuity payment must be made either with "cash or other assets held by the trust." T.D. 8899, 2002-2 C.B. 288

The preamble makes clear that the GRAT trustees may borrow funds from an unrelated party to make the annuity payment. However, because indirect loans from the grantor are also prohibited, the IRS will apply the step-transaction doctrine where a series of transactions result in an indirect loan from the grantor. For example, the IRS will characterize the following as an indirect loan from the grantor: the GRAT trustee borrows from a bank to make the required annuity payment and then borrows cash from the grantor to repay the bank. *Id.*

4. Loan from Third Party. As mentioned above, the preamble to the final regulations prohibiting loans from the grantor to make the annuity payment expressly allow loans from third parties to make the payment, subject to the step-transaction prohibition.

B. When the Annuity Payment Must Be Made.

1. General Rule. §2702 requires that annuity payments must be made at least annually, but the regulations make clear that the trust does not have to be based on the trust's taxable year. The annuity payment can be made annually based on the anniversary of the trust's creation. Treas. Reg. §25.2702-3(b)(3).

2. 105-Day Grace Period. The regulations under §2702 allow the annuity payment to be made within 105 days of the anniversary of the creation of the GRAT. If the annuity payment date is tied to the end of the trust's taxable year, the payment must be made no later than the date the trust's income tax return is due (or if the trust does not file an income tax return because it is a grantor trust, no later than the date the return would have been due had the trust been required to file a return). Treas. Reg. §25.2702-3(b)(4). The regulations are silent with respect to whether

interest needs to be paid on any late annuity payment that is made within the allowed grace period and, therefore, interest is not typically paid. One of the benefits of the grace period, and presumably one of the purposes for including it in the regulations, is the ability of the trustees' to obtain an appraisal if they are planning to distribute a non-publicly traded asset in satisfaction of the annuity payment.

C. Expenses of the GRAT

1. Ordinary Expenses. Because additional contributions to the GRAT are prohibited, the GRAT trustee should pay all expenses related to the trust out of trust assets.

2. Capital Calls. If the GRAT assets consist of interests in private equity funds or other private investment funds that require periodic contributions of capital, an issue arises as to how such payment can be made, given that additional contributions to the trust are prohibited. Two options are (i) funding the GRAT with cash sufficient to cover all future capital calls and (ii) loans from the grantor or third party. If the loan proceeds are restricted for the purpose of making the capital calls and not annuity payments, which is prohibited, there will be a stronger argument that there is no step-transaction (see the discussion above on Loans from the Grantor). However, a loan from a third-party would be safer.

D. Income Tax Issues.

1. Grantor Trust Status. GRATs will almost always be treated as grantor trusts with respect to both income and corpus. This allows transactions between the grantor and the trust, including in-kind distributions in satisfaction of the annuity payment, to be ignored for income-tax purposes. There are a number of different Code sections that could pull a GRAT into grantor trust status (this list is not exhaustive):

a. §673(a): The trust will be a grantor trust if the grantor retains a reversion of the trust corpus in the grantor's estate in the event the grantor dies before the expiration of the GRAT term if the reversion is worth more than 5% of the value of the property.

b. §677(a): The trust will be treated as a grantor trust to the extent that the trust income may be distributed to the grantor without the consent of an adverse party or in the discretion of the grantor or non-adverse party. This makes is clear the trust would be a grantor trust as to income. The IRS has also ruled privately that a GRAT would be considered a grantor trust as to corpus where the trust instrument required that the annuity payments be paid from income, and to the extent income is insufficient, from principal. See, e.g., PLR 9449012, 9449013.

c. §674(a): The trust will be treated as a grantor trust to the extent the beneficial enjoyment of income or principal is subject to a power of disposition, by the grantor or non-adverse party, without the consent of an adverse party. If the grantor retains a power of appointment over principal (to which income may be added), §674(a) should trigger grantor trust status.

d. §675(4): The trust will be treated as a grantor trust if the trust instrument gives the grantor a non-fiduciary power to reacquire trust assets by substituting assets of equal value. (However, the IRS will not issue a ruling as to whether this power will result in grantor trust treatment because it argues that it is a factual issue as to whether the power is held in a non-fiduciary capacity.)

2. Returns and Taxpayer ID Numbers. A GRAT, as a grantor trust, either must file a Form 1041, or follow the alternate reporting procedures described in Treas. Reg. §1.671-4(b)(2). If the trust files a 1041, the form is left blank and a statement is attached indicating the tax items sent to the grantor for inclusion on the grantor's Form 1040. The grantor trust box on the Form 1041 should be checked.

In some circumstances, no Form 1041 need be filed and the trustee of the GRAT does not need to obtain a tax ID number. Under Treas. Reg. §1.671-4(b), if (1) the trust is a grantor trust, all of which is treated as owned by the grantor, (2) the grantor provides to the trustee a complete Form W-9, and (3) the trustee gives the grantor's name and taxpayer ID number to all payors to the trust during the taxable year, the trust need not file a Form 1041, and the items of income will be reported directly to the grantor. If the above conditions are satisfied, the grantor does not need to obtain a taxpayer identification number until either the first taxable year of the trust in which all of the trust is no longer owned by the grantor (or another person), or until the first taxable year of the trust for which the trustee no longer reports pursuant to Treas. Reg. §1.671-4(b)(2)(i)(A). Treas. Reg. §301.6109-1(a)(2)(i).

2. Who Pays the Income Tax? Because the GRAT is a grantor trust, the grantor is responsible for any income tax attributable to the GRAT. This is a desirable result from a transfer tax point-of-view because the GRAT assets can grow tax-free, giving them a better chance of out-performing the §7520 rate. In Rev. Rul. 2004-64, the IRS has given assurance that this payment of income tax will not be considered a taxable gift.

Upon the grantor's request, can the GRAT reimburse the grantor for the income tax paid? Yes provided the trust agreement allows it. However, if the trust agreement or state law requires that the grantor be reimbursed for the trust's taxes, the entire GRAT will be included in the grantor's gross estate for estate-tax purposes under §2036.